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-- Session IV: Competition Issues in Telecommunications --

Contribution from Mexico

9-10 September 2009, Santiago, Chile

*The attached document from Mexico is circulated to the Latin American Competition Forum FOR DISCUSSION under session IV of its forthcoming meeting to be held in Chile on 9-10 September 2009.*

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**LATIN AMERICAN COMPETITION FORUM  
- 9-10 September 2009, Santiago, Chile -**

**Session IV: Competition Issues in Telecommunications**

**Mexican Telecommunications Interconnection Regime: Executive summary<sup>1</sup>**

*Submitted by the Mexico's Federal Competition Commission to the Latin American Competition Forum on September, 10 2009.*

1. This note analyses the Mexican telecommunication interconnection regime. It identifies that this regime limits competition between operators; increases final prices; and restricts growth in the sector. The note proposes public policy actions to resolve this situation.

**I. Competition and growth in retail telecom services<sup>2</sup>**

Market performance

2. Mobile and broadband services have exhibited strong penetration growth, as well as price reductions over time. However, compared to other OECD countries, Mexico shows slower growth and higher prices.

3. In 2008, the penetration rates (subscriber per 100 inhabitants) for fixed telephony, mobile telephony and broadband services were 19, 73 and 7, respectively. Meanwhile, the corresponding average penetration rates in other OECD countries were 36, 114, and 25. Moreover, Mexico has the second lowest investment per access line among OECD countries, which further deteriorates its competitive position.

4. Between 2006-2008 prices of mobile and broadband services decreased by 10.3% and 32.2% annually, respectively. Meanwhile, prices for fixed telephony increased by 5% annually. These price

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<sup>1</sup> This is a summary of a paper being prepared by the Federal Competition Commission and a group of experts from the OECD Competition Division, which includes a detailed description of the calculations and information sources used here.

<sup>2</sup> Price comparisons are based in purchasing power parity (PPP) and OECD averages data exclude prices in Mexico

reductions generated consumer benefits estimated to be in the order of 4.8 billion USD per year, equal to 11.4% of current expenditures in these services.

5. Nevertheless, compared to other OECD countries telecom services are expensive in Mexico. Specifically, the prices of fixed, mobile and broadband services were 39%, 26% and 31%, respectively, higher than the average OECD price. Consumer benefits would have been even greater if prices in Mexico were similar to average OECD prices. The additional potential benefits are estimated to be in the order of 14.9 billion USD annually, equal to 34.6% of current expenditures in these services.

### Market Structure

6. Telecom markets are highly concentrated but show a downward tendency. Telmex-Telcel group has a 85.6% share of fixed line services, 71.8% of mobile services and 68.6% of broadband services. In cable television Grupo Televisa and Megacable have 45.7% and 21.2%, respectively. These market shares are high by international standards.

7. Cable firms' participation in telephony services is low at only 1.9% of total subscribers and cable services offered by telephone companies are also low. Competition in broadband services is greater, with 31.4% and 68.6% provided by cable and telephony companies, respectively.

8. There are important entry barriers such as: investment required to deploy networks, absence of local loop unbundling, interconnection requirements, brand promotion and advertising expenses, interconnection tariffs that exceed costs, network effects that favor large networks and access to spectrum.

### Profit Margins

9. Profit margins in Mexico are high compared to other countries. In 2008, Telcel, the major mobile operator in Mexico, reached an EBITDA<sup>3</sup> margin of 64%, while the average margin for mobile operators in other OECD countries was 37.6%. In the same year, Telmex, the major fixed operator in Mexico, registered an EBITDA margin of 47%, while the average margin for the 9 of the major operators in Spain, Canada, Sweden, United Kingdom, France and the US was 28%.

## **II. The role of regulation and interconnection**

10. Every network requires interconnection with other networks but every network controls access to its customers and that access can be used, under certain conditions, in an anticompetitive manner. Regulation of interconnection can guard against this possibility and ensure an optimal use of network to obtain the positive network effects that characterize telecommunications services.

11. Interconnection issues can be categorized into one-way and two-way interconnection. An example of one way interconnection is a long distance carrier that requires access to the local network, while an example of two-way interconnection is two mobile operators that need to interconnect with each other.

12. Vertically-integrated operators that compete with non-vertically integrated suppliers in the downstream market may have an incentive to set interconnection tariffs in an anticompetitive manner. This risk is reduced if tariffs are set at Long Run Incremental Costs, but Cost Models should utilize

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<sup>3</sup> Earnings Before Interest, Taxes, Depreciation and Amortization

forward-looking methodology using either top-down or bottom up approach. Most common models are TSLRIC<sup>4</sup> and TELRIC<sup>5</sup>.

13. There are three risks associated with two-way interconnection. The first is the double marginalization problem while the second is that the interconnection price can be used for purposes of collusion. The third potential problem is that large networks can harm smaller networks by setting high interconnection prices and discriminate in favor of on-net calls.

14. Similar to the solution for one-way interconnection, setting interconnection tariffs at Long Run Incremental Costs helps minimize these potential anticompetitive acts. There are other cost standards identified in the economic literature that can be used for interconnection under certain conditions that can also result in efficiency. Efficient Component Prices sets tariffs at incremental cost plus opportunity cost of the vertically-integrated operator. However, it is not commonly used to set interconnection prices in practice. Ramsey Prices sets prices at incremental cost plus recovery of common costs in proportion to the elasticity of demand but is also unusual in practice. Some countries have added a markup on mobile interconnection charges to account for network externalities. Finally, call externalities can be taken into account when setting prices as well, usually resulting in a termination price below cost.

15. Discriminating between *on-net* and *off-net* calls may or may not be anticompetitive depending on market conditions. It may be efficient as it helps internalize call externalities and minimizes incentives for using termination as an instrument of collusion. But it can also be used anticompetitively against smaller networks. This latter risk is minimized if termination rates are set at Long Run Incremental Costs.

16. A *bill and keep* regime also reduces anticompetitive incentives but it could create inefficiencies if the call benefits are different from the benefits the called party receives.

### III. Regulatory Framework for Interconnection

#### International Experience

17. Although there are differences between countries regarding interconnection regimes, there are also several common elements. The following are the major points that can be derived from an analysis of the international experience.

- Most countries require local loop unbundling, Mexico being the only OECD country that does not have it in place;
- Under two-way interconnection, tariffs may be set via bilateral negotiation with the regulator acting as an arbiter or through ex-ante regulation;
- There is an emerging trend for regulating mobile interconnection tariffs;
- Interconnection tariffs are generally set using Long Run Incremental Costs and usually have a mark-up above incremental cost to allow for the recovery of fixed and common costs;
- Also important is the existence of independent regulators and an efficient legal system and institutions.

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<sup>4</sup> Total Service Long Run Incremental Cost

<sup>5</sup> Total Element Long Run Incremental Cost

## Regulatory Framework in Mexico

18. The Mexican Federal Telecommunications Law establishes obligation of interconnection in a non-discriminatory and reciprocal manner. Interconnection is left to negotiation between networks with intervention by the Federal Telecommunication Commission (Cofetel for its initials in Spanish) if the parties cannot reach an agreement. The current fixed interconnection rate of 0.8 US cents per minute applies for local traffic whenever unbalanced traffic exceeds 15%, otherwise a bill and keep regime applies. The mobile interconnection rate was set among the operators at 1.21 peso per minute. In 2008, the Ministry of Communications (SCT for its initials in Spanish) established a price of 0.54 pesos based upon a cost model but that rate has not been applied due to judicial proceedings.

19. Cofetel and SCT can regulate interconnection when a firm is declared a dominant provider. The regulated rates should cover long run incremental cost. Currently there is no standing dominant operator determination as the issue has been litigated since 1997.

20. Telmex's concession contract requires it to meet certain coverage obligations and regulates its local telephony prices; all other prices are not regulated. This operator has not been required to offer local loop unbundling and is the only broadband telephony provider. Although in 2009 Cofetel established regulations for Telmex to offer local loop unbundling, the issue is under judicial review.

## **IV. Interconnection Conditions**

### Tariffs

21. In Mexico, fixed interconnection rates are not considered a competition problem. Bill and keep applies unless unbalanced traffic exceeds 15%, and the rates have been regulated by Cofetel based upon a Long Run Incremental Cost Model. Thus, this section deals primarily with the mobile interconnection rate.

22. The existing calling party pays regime in Mexico provides incentives for mobile operators to set high interconnection charges. Mobile interconnection rates have decreased since 2004 but they are still high compared to other calling party pays countries. In 2008, Mexico registered the fourth highest rate among 22 OECD countries with a calling party pays regime. The rate in Mexico was of 15.5 US cents per minute (cpm) while the average in these countries was of 10.5 cpm. An additional problem arises in Mexico because the charge is rounded to the next minute while in most other countries it is charged by the second.

23. The mobile termination rate in Mexico is higher than cost estimates from Long Run Incremental Cost Studies based upon results from the SCT model and other models. Thus, the current rate is about 3 times greater than the costs.

24. The above evidence suggests that the lack of regulation in Mexico has resulted in mobile termination rates that are above costs. Regulators in other countries facing similar results have increased regulation of the mobile termination rate. The European Commission has recommended regulating mobile termination based on Long Run Incremental Costs; they estimate this methodology would reduce rates by about 70%.

### Discrimination in favor of on-net traffic

25. Mobile operators provide prepaid and postpaid services: 92% use prepaid in Mexico. However, postpaid users are more intensive users of mobile services, and account for a higher share of. Discrimination in favor of on-net calls is a common practice among all mobile carriers in Mexico.

Interconnection as an anticompetitive instrument

26. The smaller fixed operators (Axtel, Avantel and Alestra) have complained about the mobile interconnection rates being excessive and anticompetitive. They state that on-net tariffs that are below the mobile interconnection rate is proof that the rate is anticompetitive and provides a subsidy. This issue becomes more important because of the entry of new cable TV operators.

27. In addition, Telefonica Moviles has filed a complaint before the Competition Commission charging Telcel with discriminatory treatment of on-net vs. off-net. They argue that on-net prices that are below the mobile interconnection rate harm Telefonica. It seems that Telefonica is seeking to solve this issue by having Telcel raise its on-net prices, not by having Telcel reduce its mobile interconnection rate.

28. A regulation that eliminates the discriminatory treatment between on-net and off-net by requiring the incumbent firm to raise on-net prices and not to alter the mobile interconnection rate would be the worst possible solution. This would be like using regulation to implement a collusive agreement among the mobile operators.

29. In Mexico, the interconnection regulatory framework has faced many implementation problems, including the following:

- Agreements are not public thus there can be discriminatory arrangements that prevent efficient interconnection and favor certain networks;
- Interconnection is offered at points that are not technically efficient;
- Ineffective implementation of dominance proceedings because of long judicial delay;
- Imposition by Telmex of inadequate interconnection terms to other operators;
- Lack of enforcement of sanctions for interconnection violations;
- The existence of overlapping regulatory regime by Cofetel and the SCT; and
- Cofetel's inability to resolve interconnection disputes within the 60 day time frame.

**V. Effects of high interconnection rates on final customers**

30. The Mexican telecom markets exhibits inefficiencies in terms of prices and penetration of services and the lack of competition is a central reason. With respect to one-way interconnection, high prices for dedicated leased lines is a major problem. This situation can be improved with the incorporation of the CFE's network to supply these services. Regarding two-way access, an excessive mobile termination rate is a major problem, thus resulting in higher off-net prices. The economic literature predicts this situation, especially in calling party pays countries. High mobile market concentration implies that given high mobile termination rates, users pay higher prices.

31. This inference is strengthened by the evidence of high prices and high profit margins in the mobile sector. The impact on prices of a high mobile interconnection rate can be significant. For example, using an OECD basket of telecom services, between 22% and 26% of the calls of mobile users are to mobile customers of other networks and between 19% and 31% of calls from fixed-line callers are to mobile customers. A correlation analysis among OECD countries indicates that a reduction of 1% in the

mobile interconnection rate results in a 0.69% and 0.26% reduction in average final price of mobile and fixed services, respectively.

32. Setting the mobile interconnection rate in Mexico (15.5 US cents per minute) at the average OECD rate in calling party pays countries (10.5 US cents per minute) would entail a 32.3% reduction. This would reduce mobile and fixed-line prices by 22.4% and 8.5%, respectively. The resulting consumer savings are estimated to represent 25.6% and 8.5% of mobile and fixed-line expenditures, respectively.

33. This situation results in subsidies from fixed-line networks to mobile networks and so deteriorates the competitiveness of the former which is further affected by the entry of cable TV operators into the fixed market. These subsidies can be used as a mechanism of regulatory arbitrage between Telmex and Telcel, given that they are in the same economic group. An increase in the mobile termination rate increases fixed-line prices (who call mobile customers) without violating the price cap regime for local services under which Telmex operates because the additional revenue is transferred to mobile operators (mostly Telcel). This argument is reinforced because local services tend to have low price elasticity of demand which means that Telmex subscribers don't reduce demand proportionately.

34. Likewise, discrimination in favor of on-net calls cannot be considered anticompetitive, *per se*, but a mobile termination rate above costs helps facilitate that discrimination as an instrument to raise rivals' costs. This is especially troubling given the unique opportunity for new entry with the new spectrum assignments upcoming. If interconnection conditions are not competitive, it is unlikely that new suppliers will be successful even if the assignment process is procompetitive.

32. A policy of reducing mobile termination rates to competitive levels would reduce retail mobile prices and increase penetration for mobile and fixed line services. In the short run off-net prices would decrease. In the medium and long terms it would eliminate competitive restrictions between networks and would promote lower prices and an efficient expansion of supply.

33. Finally, it is necessary to strengthen conditions of interconnection with established networks (fixed and mobile) in terms of opportunity and technical efficiency. Equally, it is necessary to strengthen the regulatory framework to guarantee that operators do not delay interconnection and use it as an instrument to raise rivals' costs.

## **VI. Recommendations**

34. Competitiveness of Mexican telecommunications can be improved through policies that improve the efficiency of interconnection services. The following actions would help achieve this goal: i) Strengthen Cofetel's independence, and its sanction and enforcement capacities; ii) Provide Cofetel with explicit powers to declare bottlenecks and essential facilities and to set access conditions to these facilities; iii) Establish in the law that interconnection tariffs and tariffs associated with unbundled network access are regulated based upon long run incremental costs.