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ROUNDTABLE ON BRINGING COMPETITION INTO REGULATED SECTORS

Contribution by Mrs. Andrea Butelmann (TDLC, Chile)

-- Session I --

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LETTING THE MONOPOLY COMPETE: THE CASE OF CHILEAN FIXED LINE TELECOMMUNICATION

Contribution by Mrs. Andrea Butelmann
Ministro
Tribunal de Defensa de Libre Competencia (TDLC, Chile)

1. Chilean "efficient firm model" is a scheme, with similarities to the benchmark model. The regulator has to "design" the most efficient company to serve the demand for a period of 5 years. Price structure is set in order to make present value of this hypothetical project equal to cero. The hypothetical firm becomes the benchmark for the real firm. Only the dominant firm in the market has faced regulation for consumer prices, while smaller firms have only their access charges set by the authority.

2. Even though in the telecommunication industry we observe a dynamic technological development that is bringing an important degree of competition, traditional fixed line technology is still the cheapest alternative and has enough sunk costs to preempt entry if allowed to.

3. During the last few years the mobile network has increased its market penetration more than fixed line telecommunication did in the last 30 years. Cable TV has developed technologies to serve voice communication on its network, and WLL technology (wireless last mile) has become a serious threat for traditional fixed line systems for some segment of customers.

4. In this presentation we discuss the implications of incipient competition on the incumbent competitive position, the alternative solutions, and their strengths and weaknesses.

1 Theory and history of the telecom economy

1.1 Network economy and crossed subsidies

5. Telecommunication is a network based industry. The decreasing average costs are mainly explained by this feature. The higher the density of customers and/or intensity of use, the lower the cost of service.

6. The regulator set prices for telephone services for each "cost areas" (CA). An CA is a group of geographic areas with the same price structure will prevail. The bigger the CA the more likely is to impose cross-subsidies within it.

7. Moreover, in most countries there is mandatory universal access, which forces the telecommunication firms to serve all the demand in their areas of service, even if new clients generate losses to the company. In absence of competition universal access obligation does not impose financial stress to the incumbent, high costs of new low demand clients are distributed proportionately among all the consumers. Generally, this obligation binds only the incumbent, who covers all areas of service; newcomers are able to target only the area of service of their interest.

8. Going back to the pure monopoly case, the problem with cross subsidies is that they distort the consumption decisions. High demand consumers face a marginal price above the marginal cost they impose to the firm and low demand consumers face a marginal price below the marginal cost they impose to the firm.

9. Cross subsidies inefficiencies are usually ignored by governments while distribution implication are overvalued because of political reasons.

10. On the other hand, when the incumbent faces some competition, large CAs and universal access obligation impose financial stress for the incumbent.

1.2 Situation in Chile

11. Chile was divided in 5 CA's during the 1999-2004 tariff period. For the 2004-2009 periods the number of CA's increased to 9. Authority has decided as well that each city should be assigned only one CA. This decision poses a difficult situation for the incumbent since most cities have heterogeneous consumer densities.

12. The most relevant case is Santiago with over six million inhabitants. In Santiago coexists high populated areas, low populated areas, high demand consumers and low demand consumers.

13. For the 1999-2004 periods Telefónica CTC Chile, was to charge one price scheme to every consumer in Santiago, dealing with a high level of cross subsidies.

1.3 Alternative technologies and the end of the hegemony

14. The market share of fixed line monopolies is decreasing, the reasons are mainly technological. The optimal scale of some elements of traditional technology has been reduced. At the same time, competitive technology, namely "broad band" has allowed the transmission of TV, Internet and voice by the cable TV network at a competitive price. A duplication of fixed line networks is becoming common in populated areas.

15. Competition of fixed lines first arises in high density areas, but cable TV allows competition to expand to not as dense residential areas as well.

16. In the voice communication industry the market share reduction is even sharper. The wireless technology has become a widely used technology, increasing more than 3 times its market share in the last 5 years.

1.4 Situation in Chile

17. TV cable companies had become a serious threat for the incumbent. The main cable company, VTR is offering phone service by its broad band. Since VTR may choose where to offer phone service, choosing only densely populated areas, plus a low marginal cost of offering broad band for consumers already connected to the TV cable net has resulted in an important client loss from CTC to VTR in residential areas.

18. A second threat is net duplicators. It is important to note that in general net duplicators would face higher costs than the incumbent, but the later has to price all the consumers the same price while the former may discriminate among clients. The most relevant net duplicators in Chile are: Entel, Manquehue, Cmet, GTD in business areas.

1.5 Cross subsidies and non discrimination rule: a sweet for new entrants

19. A relevant question is if competition in the fixed line sector is socially efficient. We will leave this question to the reader and will answer a simpler question: Can a newcomer, with higher cost than the incumbent, make profits under the CAs regulatory scheme? The answer is yes.

20. As CAs become smaller the tariff scheme becomes more complex, this imposes a limit in the CAs size. No matter how small CAs are constructed, there will be enough heterogeneity so to find consumers, lets call them “good consumers” for whom the price of the incumbent is higher than the marginal cost they impose to the firm.

21. Suppose a firm A with the same cost structure than the incumbent. This firm can serve the “good consumers” at their marginal cost plus an “extra normal rent”, equal to the difference between the marginal cost of good consumers and the average cost charged by the incumbent. Remember that the marginal cost of good consumers is lower than the average cost charged by the incumbent. Now suppose a firm B, with the same cost structure of the incumbent plus an extra cost ε. If ε is small enough, this firm can serve the good consumers at a price equal to its cost plus an extra normal rent, ε lower that extra-normal rents of firm A.

22. The incumbent could respond to a follower by lowering the tariff of the good consumers, but the non discrimination rule forces it to offer the lower tariff also to bad consumers in that CA.

2. Possible solutions

23. In Chile, the telecommunication law admits that competition will ultimately prevail in telecom market. For that reason it does not impose price regulation automatically but designates the antimonopoly authority to judge if price regulation is needed given the degree of competition observed in the market. The law simply says that if there is not enough competition, prices should be set by the regulatory authority, otherwise prices will be set by market forces. This binary solution, fixing prices or letting the market work, does not guide the transition from a regulated absolute monopoly to a real free market and that is the reason why the process for finding a solution was so lengthy.

2.1 Free pricing and regulated alternative

24. If followers’ survival is based on cross subsidies, under free pricing competition will disappear. If followers disappear the incumbent faces no more competition, forcing the government to resume regulation. In that case there are two inefficient alternatives:

- Regulation with inefficient competition.
- Free market and monopoly prices.

25. It is possible to improve the social surplus combining the two alternatives. Allowing the incumbent to charge free prices and forcing it to maintain a regulated tariff for consumers who prefer it, prevents inefficient competition and danger of monopoly pricing.

2.2 Situation in Chile

26. It is not easy to determine whether followers in Chile survive due to competitive price structures or by taking advantage of implicit crossed subsidies in the tariff structure of the incumbent. Probably both situations coexist.

27. In the most populated areas net duplication should be efficient if the incumbent network is overused, that’s the case of Entel’s offer of comunication downtown; i.e.; the business area. High demand residential consumers should be a fine business to TV cable network with or without cross subsidies.

28. The inefficiencies are most likely to be present in middle demand and/or middle density areas, where there is not enough traffic to justify two networks and where marginal users of phone by TV cable network impose a high cost.

2.3 Predation risk

29. In the last chapter we argued that if the followers have a competitive structure free pricing is the social optimum. But if the incumbent uses predatory practices the last condition does not hold.

30. The predatory practice risk increases if the incumbent has the possibility to reduce the prices only to consumers that are willing to move to the competition. It also increases if the price reduction can be given for a short period of time to make competition leave the market.

31. If the regulator can restrict the use of selective price reductions and short term price reductions, it would be too costly for the incumbent to perform predatory practices.

3. Statistics in Chile

32. In Chile, there are 9 fixed line companies with 3,5 million lines; i.e., a penetration of 20% approximately. The market share of the incumbent (CTC) is close to 90% and in great extensions of the territory is the only service provider. On average, the incumbent is followed by 3 small providers taking a share between 1% a 10 % in each CA. Nevertheless, the degree of competition within the CA is concentrated in smaller areas where the challengers have captured, in some cases, a quarter of the demand.

33. On the mobile phone market, there are 4 firms with a total 6 million clients. Being a more expensive technology, average traffic for mobile phone client is only 70 minutes a month compared to 600 minutes for a fixed line subscriber. Thus, total traffic through fixed lines is five times that of the mobile network.

34. Then market power of the incumbent has been seriously challenged by other fixed line companies for heavy users and by mobile network in the case of low traffic consumers.

4. Solution adopted in Chile

35. In 2003, price *flexibility* for CTC was decreed in Chile. The authority asked the Antitrust Commission in several occasions to allow CTC to offer alternative plans that would adjust to different consumer’s needs. The authority should continue setting prices in each CA and the incumbent has to offer the plan with the regulated tariff to all consumers in the CA. Consent was granted after three years of analysis and discussions.

36. The decree considers two classes of consumers: that which traffic does not exceed 15,000 (lowered to 1200 in 2004) minutes a month and bigger consumers. For the small consumer category, each alternative plan should be available for every consumer in the CA. Furthermore, the plans should comply with the following requirements:

- each plan must be available to be contracted for at least one year;
- contracts are indefinite in time;
- there is no permanence requirement for consumers, who may unilaterally change to any plan being offered;

- plans may be designed by the incumbent and need no previous approval, but they should be reported to the authority and be widely published both in written media and the company's website.

37. For the larger consumer segment, the incumbent is free to negotiate with the consumer a plan, without the obligation to extend, or inform, the offer to every consumer in the CA.

38. Conclusion: Ways should be found to move from a regulated market to a competitive market, when technological progress allows competition. These solutions should prevent the incumbent from re-monopolizing the market through predation; otherwise, the pendulum will keep moving from regulation to deregulation and back.