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COMPETITION COMMITTEE****Barriers to Exit – Note by Mexico**

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More documents related to this discussion can be found at
<http://www.oecd.org/daf/competition/barriers-to-exit.htm>

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1. Introduction

1. This document provides an overview of the IFT's practice on the assessment of barriers to exit in both competition and sectorial law enforcement. It describes a special procedure included in the 2014 Federal Law of Economic Competition (LFCE, by its acronym in Spanish) that has the purpose to identify barriers to competition that could lessen the process of competition and, in that case, propose remedies. It refers to some provisions of the 2014 Telecommunications and Broadcasting Federal Law (LFTR, by its acronym in Spanish) that aim to remove barriers to exit identified in the telecommunications and broadcasting sectors. Finally, it presents a summary of some relevant cases where the IFT has analysed barriers to exit.

2. Legal framework

2. The assessment of barriers to exit, expansion and entry is at the core of the competition analysis of mergers, the existence of market power (or competition conditions), and anticompetitive practices.

3. The LFCE establishes that competition analysis shall consider barriers to entry, and the elements that may foreseeably alter such barriers (e.g. the supply of other competitors)¹:

4. *"In order to establish whether a single or a number of Economic Agents have substantial power in the relevant market, or else, to resolve on competition conditions, effective competition, existence of substantial power in the relevant market or other matters related to the competition process or free market access referred to in this Law or any other Laws, rules or administrative provisions."*

5. According to the Regulatory Provisions of LFCE for telecommunications and broadcasting sectors (Regulatory Provisions), the following elements could be considered as barriers to entry:

1. Financial costs, the costs of developing alternative channels and limited access to financing, technology or efficient distribution channels;
2. The amount, indivisibility and recovery period of the required investment, as well as the absence or low viability of alternative uses of infrastructure and equipment;
3. The obligation of having concessions, licenses, permits or any kind of authorization issued by the Public Authority, as well as rights of use or exploitation protected by the legislation on intellectual and industrial property;
4. The investment in advertising required for a brand or commercial name to acquire a market presence that allows it to compete with established brands or names;
5. Limitations to competition in international markets;

¹ Article 59 of the Federal Economic Competition Law. Available at: http://www.ift.org.mx/sites/default/files/traducccion_lfce-2.pdf

6. The restrictions constituted by practices carried out by the Economic Agents established in the relevant market, and
 7. The acts of any Public Authority or legal provisions that discriminate in the granting of incentives, subsidies, access or support to certain producers, marketers, distributors or service providers.
6. The LFCE does not make a direct mention of barriers to exit. However, in practice the IFT takes into account barriers to exit and considers them as barriers to entry, because when potential entrants evaluate the possibility to enter into a market, they take into account the investment required, including those that constitute sunk costs (e.g. specialized machinery, deployment of networks and others). Therefore, the existence of barriers to exit can dissuade the entrance to a market.
7. Therefore, for the IFT, the analysis of barriers to entry shall include those elements that could limit market contestability, like barriers to exit. Commonly, barriers to exit are associated with:
- The existence of sunk costs, which arise from investments that once committed are not recovered due to their specialization and lack of alternative uses.²
 - The restrictions or the imposition of requirements, established in the legislation and regulatory framework that increases the cost to exit from a market.
 - Long run contracts or the establishment of clauses that could potentially delay the ability of exiting a market or the reallocation of assets in the short run.
8. Markets in the telecommunications and broadcasting sectors exhibit barriers to exit, mainly in the form of sunk costs related to significant specialized investment on infrastructure and spectrum. The first one is an *endogenous* sunk cost, and the second one is *exogenous*.
9. Competition policy has played a relevant role advocating for reducing such exit barriers. On one hand, the Sectoral law (LFTR) allows sharing active and passive infrastructure.³ On the other, it promotes the use of secondary markets⁴ to allow cessions, leases and swaps.

3. Spectrum payments as barriers to exit

10. Broadly speaking, in Mexico spectrum pricing has two components on the primary markets (auctions). The first one corresponds to the amount bided in the auction (approximately 10% of the total cost), and the second one are the annual fees (approximately the remaining 90% of the total cost). This pricing structure has effects on allocative efficiency and the sunk costs of the spectrum and aftermarkets' outcomes.
11. In designing *spectrum* auctions, the IFT as competition authority and sectoral regulator has a dual task. Firstly, it has to establish proper reserve prices to enhance entry

² OCDE; "Glossary of industrial organization economics and competition law". Available at: <http://www.oecd.org/regreform/sectors/2376087.pdf>.

³ Article 139 of LFTR.

⁴ The IFT assess the potential anticompetitive effects derived from the transaction. The analysis run by the authority is similar to a merger analysis.

and reduce barriers; and secondly, it has to encourage the most efficient use of spectrum and preserve the capacity to invest in infrastructure.

12. To prevent incentives to hoard or speculate on spectrum pricing, the LFTR establishes that a licensee cannot cede a spectrum license before a three-year period from its granting. This example illustrates that a regulatory measure must be assessed carefully. This provision could be partially seen as a barrier to exit in the aftermarket, when it is justified to enhance efficient use of the spectrum.

13. The most efficient way to assign spectrum is by allowing the market to set the price. This is the fundamental purpose of auctions. Therefore, *spectrum* pricing shall be mainly determined in the auction, while the annual fees should be set at reasonable levels with a view to recover the regulator's spectrum management costs, but not as a fiscal income. Otherwise, spectrum pricing and structure could discourage participation and worst case scenario leave vital in-demand spectrum unsold, or at best, artificially increase the final price paid which risks reduced network investment and higher consumer prices (or lower quality and coverage) (GSMA, September 2017). In this regard, the IFT published a study on the "*Cost of Radio electric Spectrum in Mexico*" and issued a recommendation to the Mexican tax authority.⁵ These efforts aim to reduce barriers, including sunk costs, to create conditions and to facilitate high capital investments required to deploy next generation networks capable to support continued innovation in digital applications and services (Bauer, February 2008).

4. Procedure to declare the existence of "barriers to competition"

14. The LFCE establishes a *special* procedure to identify essential facilities and barriers to competition.⁶ Barriers to competition include the analysis of barriers to entry and exit to a relevant market.

15. This procedure initiates *ex officio* or by the request of the Federal Executive Branch directly or through the Ministry of Economy. It starts when there are elements that indicate an absence of effective competition conditions in a market, and the existence of competition barriers to free market access or essential facilities that may generate anticompetitive effects. To this date, the IFT has initiated two investigations relying on article 94 of the competition law.⁷

16. Following file integration, the Board shall render a pertinent resolution, which may include:

⁵ The Ministry of Treasury and Public Credit (Secretaría de Hacienda y Crédito Público), within the process to draft the 2020 annual fees for spectrum, included in the Federal Duties Law (Ley Federal de Derechos).

⁶ Article 94 of LFCE.

⁷ On February 1, 2018, the Investigative Authority of the IFT published, on the Federal Daily Gazette, two abstracts about two investigations initiated to determine the possible existence of barriers to competition and free competition that may generate anticompetitive effects in the market of fixed telecommunications services, one in the State of Mexico and the other in the State of Guanajuato. Abstracts are available in Spanish at: http://www.dof.gob.mx/nota_detalle.php?codigo=5513219&fecha=14/02/2018 and http://www.dof.gob.mx/nota_detalle.php?codigo=5513220&fecha=14/02/2018.

1. Recommendations to Public Authorities. The IFT shall notify to competent authorities about the existence of legal provisions unduly preventing or distorting free market access and competition in the market. Those authorities, in turn, shall proceed as applicable within their jurisdiction and in accordance with procedures foreseen under current laws. The IFT's resolutions shall be published.
 2. An order to the pertinent Economic Agent to eliminate a barrier unduly affecting free market access and competition process;
 3. Determination as to the existence of essential facilities and guidelines to regulate, as the case may be, forms of access, prices or rates, technical conditions and quality, as well as the application schedule, or
 4. Divestiture of assets, rights, equity interests or shares of the Economic Agent involved, in the extent required to eliminate anticompetitive effects, shall apply any time different corrective measures prove insufficient to solve the identified competition issue.
17. This powerful tool allows competition authorities in México to assess regulations and draft regulations imposed by other authorities in order to advocate for the removal of barriers to entry, expansion, mobility and exit. The use of this tool shall fall in line with the distribution of powers granted by the Constitution to other authorities among the different levels of government (e.g. federal, state or municipal).
18. It is important to highlight that in all cases, the IFT has to verify that the proposed recommendations will generate efficiency gains in the markets. The burden of proof befalls either on the regulators or the economic agents involved. The considered gains in efficiency are those that result from innovation in the production, distribution, and marketing of goods and services.

5. Sectoral law's elements that impact on barriers to exit

19. As referred above, in the telecommunications sector it is common to observe barriers to exit, especially in the form of sunk costs. The LFTR recognizes it and establishes some procedures aiming to foster certain practices that could result in diminishing sunk costs, subject to a competition assessment. In this regard, the LFTR mandates the IFT to promote:
1. Passive and active infrastructure sharing.⁸ The IFT shall verify the conditions of the sharing agreements at any time, to assess their impact on effective competition in the sector concerned and may establish measures to offer access to sharing to any concessionaire under non-discriminatory conditions, as well as those required to prevent or remedy adverse effects on competition.
 2. Secondary spectrum markets. The IFT shall promote them, observing the principles of promoting competition, removing barriers to entry of new competitors, and efficient use of the spectrum. In a secondary market, economic agents can acquire or lease rights to use spectrum.

⁸ Article 139 of LFTR.

6. Assessment in merger cases

20. In several cases, the IFT has identified the need for spectrum licenses and their (sunk) costs as sources of barriers to exit, which are assessed as barriers to entry.⁹ Those cases include acquisitions of GSF Telecom and Nextel México by AT&T;¹⁰ the transfer of a license to provide commercial radio services in the city of Tuxtla Gutiérrez, Chiapas;¹¹ and TVI's acquisition by Grupo Televisa (GTV).¹²

21. Additionally, it has identified as a barrier to entry/exit in these sectors the highly specialized infrastructure and equipment needed to provide telecommunications and broadcasting services, limiting its use only to the provision of those services. The profitability of the infrastructure and equipment used to provide these services would be absent or insufficient if used in alternative processes, as stated in the assessment of the acquisitions of GSF Telecom and Nextel México by AT&T.

22. The IFT has analyzed endogenous sunk costs, especially those associated with advertising and Research & Development (R&D). In the AT&T-Time Warner merger¹³ and in the Disney-Fox merger¹⁴, the IFT identified as a barrier to entry/exit the investment in advertising related to the creation and recognition of the brand. Moreover, another important sunk cost analyzed in these mergers was the rights of transmission of relevant sports events.

23. Additionally, in the Disney-Fox merger, the IFT analyzed the investment on R&D related to the audience analysis as a sunk cost. The programmers, thanks to years of experience and investment, have gotten to know audiences' preferences.

⁹ As an example, in the last spectrum auction for mobile telecommunication services conducted by the IFT, one winner had to pay approximately 70 million dollars for 80 MHz in the country. This amount does not include the payment that the operator has to cover regarding usage rights.

¹⁰ Resolution issued by the IFT on the acquisitions of GSF Telecom and Nextel México by AT&T: Available in Spanish at: http://apps.ift.org.mx/publicdata/VP2_P_IFT_EXT_290415_86.pdf, and http://apps.ift.org.mx/publicdata/VP2_P_IFT_EXT_181214_282.pdf.

¹¹ Available in Spanish at: http://apps.ift.org.mx/publicdata/versionpublicapift18031590_1.pdf

¹² The IFT found several risks of coordinated effects arising from the ownership of shares and rights by a person belonging to Grupo Multimedios in CVQ, a subsidiary of GTV. The risks were identified in the provision of broadcast television service. One of the elements that the IFT considered to determine the existence of potential risk of coordination was the assessment of barriers to entry. According to the economic competition theory, if a market, among other elements, has high entry barriers, a reduced number of competitors and high market concentration, the risk of market coordination is higher. In this case, the IFT determined that the need for spectrum to provide broadcasting television service was a barrier to entry due to the cost of the spectrum and its scarcity. The merger was approved subject to structural conditions aimed at avoiding potential harmful effects in this market. Available in Spanish at: http://apps.ift.org.mx/publicdata/Version Publica P_IFT_EXT_190216_7.pdf.

¹³ Available in Spanish at: http://apps.ift.org.mx/publicdata/VP_P_IFT_150817_487.pdf

¹⁴ Available in Spanish at: <http://apps.ift.org.mx/publicdata/verpubpift110319122canx.pdf>

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