



Technical Report

Technical Assistance to the National Telecommunications Commission May 2005-April 2006

by Atty. Jose Gerardo A. Alampay

Prepared for

**Commissioner Ronald O. Solis
National Telecommunications Commission
Republic of the Philippines**

Submitted for review to

USAID/Philippines OEDG

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Preface

This report is the result of technical assistance provided by the Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE) Activity, under contract with the CARANA Corporation, Nathan Associates Inc. and The Peoples Group (TRG) to the United States Agency for International Development, Manila, Philippines (USAID/Philippines) (Contract No. AFP-I-00-03-00020-00, Delivery Order 800). The EMERGE Activity is intended to contribute towards the Government of the Republic of the Philippines (GRP) Medium Term Philippine Development Plan (MTPDP) and USAID/Philippines' Strategic Objective 2, "Investment Climate Less Constrained by Corruption and Poor Governance." The purpose of the activity is to provide technical assistance to support economic policy reforms that will cause sustainable economic growth and enhance the competitiveness of the Philippine economy by augmenting the efforts of Philippine pro-reform partners and stakeholders.

This report was written by Atty. Jose Gerardo A. Alampay to summarize technical assistance provided to the Philippine National Telecommunications Commission (NTC) at the request of its Commissioner, Ronald Olivar Solis, between May 2005 and April 2006 to help it formulate a competition policy/framework for the telecommunications sector. This framework will provide guidelines to implement the provisions of the Public Telecommunications Policy Act that call for a competitive telecommunications market. In providing this assistance Atty. Alampay was ably assisted by Dr. Ma. Joy Abrenica, Economic Policy Accounting Expert, and Jhiedon Florentino, Research Associate, plus two expat advisors, Steve Magiera and Larry Darby from Nathan Associates Inc.

The views expressed and opinions contained in this publication are those of the author and are not necessarily those of USAID, the GRP, EMERGE or the latter's parent organizations.

Technical Assistance to the National Telecommunications Commission May 2005-April 2006

The National Telecommunications Commission (NTC), through then Commissioner Ronaldo Solis, requested EMERGE to provide the NTC with technical assistance to help it formulate a competition policy/framework for the telecommunications sector.

The NTC wanted to articulate how, as a regulator, it can apply competition policy and principles to promote healthy competition in the Philippine ICT market. Related to this, the NTC also sought a review of existing laws because emerging technologies and applications (such as VOIP and convergence of technologies), made possible by the rapid developments in the telecommunications sector, have made certain provisions of that law obsolete and/or increasingly dated.

The following is a summary of activities undertaken, and accomplishments delivered in connection with EMERGE technical assistance to the NTC, as indicated in the Terms of Reference dated May 2005.

Reports/Deliverables Due	Results
<p>Research Memorandum and Analysis on the NTC Memorandum Circular on Service Performance Standards for the Cellular Mobile Telephone Service, in the broader context of competition policy.</p>	<p><i>Success Milestone</i></p> <p>The National Telecommunications Commission (NTC) encouraged more competition and innovation in wireless services through a much anticipated decision that allowed Sun Cellular, the mobile phone brand of Digital Mobile Philippines Inc., to continue with its promotional pricing for subscribers within its network.</p> <p>The regulator rejected petitions of Pilipino Telephone Corp. (Piltel) and Innove Communications Inc., units of bigger players Smart Communications Inc. and Globe Telecom Inc., to halt the practice of offering unlimited calls and text or SMS messages for a fixed sum.</p> <p>Telecommunications firms are now permitted to set their own standards for different pricing plans, as long as subscribers are told what these standards entail. At the same time, the NTC told the companies to improve their standards.</p> <p>EMERGE provided research and technical assistance to the NTC on this issue, as part of the proposed activity for the development of a comprehensive competition policy framework for the ICT sector. The decision is noteworthy to the extent that it (a) recognizes the role of consumers in driving TelCo behavior and incentives; and (b) allows them to continue having “options that enable them to shop for and choose the price-quality package that best suits their needs.” (May 2005)</p>

<p>Assistance in the organization and documentation of consultations, roundtable discussions, workshops and/or conferences with ICT sector stakeholders to solicit inputs and comments on the competition policy framework, and to build broad-based support and appreciation for the same.</p>	<ul style="list-style-type: none"> • Together with Gigo Alampay as team leader, two telecoms policy experts (Larry Darby, Steve Mageira) from abroad and a local telecom/regulatory expert (Joy Abrenica), EMERGE embarked on a series of interviews with industry and government stakeholders to identify key issues and concerns that ought to be addressed by such a framework. The experts also conducted a 3-hour briefing on competition policy concepts and practices for the NTC, and submitted a briefing paper on competition policy, at the latter's specific request. (June 28, 2005, see Attachments 1 and 2) • EMERGE consultants conducted a workshop on rate setting for the National Telecommunications Commission, at the request of the Commissioners. The workshop focused on the various regulation models pertaining to the setting of prices or rates for telecommunications services. (December 2005) • Expat consultant Steve Mageira submitted a paper on competition and international best practices in connection with universal service (August 5, 2005, see Attachment 3), as well as provided inputs on issues for consideration by the Commission for its then planned consultative document on competition policy (August 11, 2005, see Attachment 4). • To further support the NTC, EMERGE prepared, at the Commission's request, a presentation highlighting the key competition policy issues being considered for the consultative document, both for use as an internal reference by the Commission and for its own presentations to industry stakeholders as it moves to defend and solicit stakeholder support for the competition policy initiative. (September 21, 2005, see Attachment 5). • A roundtable discussion on the issue of Significant Market Power (SMP) obligations was held at the UP School of Economics. Co-sponsored by UPSE and the National Telecommunications Commission (NTC), the event is part of NTC efforts in encouraging public and stakeholder debate and discussion on the broader topic of competition policy for the telecommunications sector. The roundtable discussion was very well attended, with participants from all major telecommunications carriers, PAPTELCO, value-added service providers and civil society well represented. (March 2006)
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	<ul style="list-style-type: none"> • The NTC conducted the Seminar on the Imposition of Significant Market Power Obligations and Asymmetric Regulation at the Asian Institute of Management. The forum was attended by the major stakeholders of the industry and was moderated by NTC Deputy Commissioner Sarmiento. Tony Shaw, an Australian-based telecoms regulation expert, presented various issues related to Imposition of SMP Obligations. (April 2006) • The NTC, with EMERGE assistance, formed and met several times with a Technical Working Group (TWG), composed of NTC officials and private sector representatives to study, and draft recommended rules for Reference Interconnection Offers, later renamed as Reference Access Offers (RAO).
<p>Assistance to the NTC in the identification of specific data/information that should be required for purposes of setting fair and competitive interconnection rates between and among incumbents and competitors; and draft update for the NTC Annual Report Guidelines for public telecommunications entities to ensure that such details and information are captured through the said Guidelines</p>	<p><i>Extension of Technical Assistance</i></p> <p>As of July 2006, this particular activity/deliverable was still ongoing. The release of the consultative document on Competition Policy identified the imposition of significant market power (SMP) obligations on dominant carriers as one of four steps that the NTC should consider. And in this respect, the identification of data and information that is needed for purposes of setting fair rates was determined to be a key component of the Competition Policy initiative, and particularly the proposed imposition of (SMP) obligations.</p> <p>This activity was therefore carried on as part of the extension of the TA to the NTC through June 2007.</p>
<p>Draft Consultative Document on Competition Policy for the ICT Sector, based on research on best practices and past experience, and on inputs from stakeholder discussions, workshops and conferences; identifying and defining practices that constitute anti-competitive behavior; and providing possible options for competition policy guidelines; including options</p>	<p><i>Success Milestone</i></p> <p>The NTC released its consultative document on a comprehensive competition policy framework for the ICT sector for public comment and forcefully signaled its serious resolve to promote competition in the sector.</p> <p>The competition policy framework was seen as necessary to correct the flaws in the regulatory environment that restrain competition and prevent the efficient functioning of the market. It was an important step that will guide future initiatives and decisions of both the Commission and the private sector as they contemplate competition-related issues.</p>

<p>for the setting a fair basis for interconnection rates between and among incumbents and competitors.</p>	<p>In the main, the consultative document recommended and sought public comment on a set of policies (i.e., imposing significant market power obligations, mandating unbundling of network elements, allowing for resale of services and enforcing after-the-fact regulation of prices) that can come in the form of memorandum circulars to be issued and subjected to separate public hearings by the Commission. (December 12, 2005, see Attachment 6)</p>
<p>Assistance in the organization of an NTC-sponsored “Conference the Future of Competition in the Information and Communications Technology Sector</p>	<ul style="list-style-type: none"> • In light of comments received on the consultative document on competition policy, the NTC reconsidered and determined that a broad general conference might be premature and that it make more sense to narrow the focus on the first of the four key recommendations: SMP Obligations. <p>Thus, the NTC conducted the Seminar on the Imposition of Significant Market Power Obligations and Asymmetric Regulation at the Asian Institute of Management, which was attended by the major stakeholders of the industry and was moderated by NTC Deputy Commissioner Sarmiento. Tony Shaw, an Australian-based telecoms regulation expert, presented various issues related to Imposition of SMP Obligations. (April 2006)</p>
<p>Research Memoranda, Drafts and/or Briefs to support NTC efforts to formulate interconnection pricing guidelines, and to articulate how the NTC, as a regulator, may apply competition policy principles and tools to the continuously evolving information and communications technology sector.</p>	<ul style="list-style-type: none"> • At the request of the NTC, EMERGE submitted a policy paper by expat consultant Larry Darby which discussed the economic and policy options that the NTC could consider as it moves to finalize its resolution of the issues raised on service standards and predatory pricing in the Philippine telecommunications market. (June 2005, see Attachment 7) <p><i>Success Milestone</i></p> <p>The NTC issued Memorandum Order 3-11-2005 or its Guidelines for the Registration of VoIP Providers and Resellers. This paved the way for the full implementation of their earlier Memorandum Circular 05-08-2005 declaring VoIP as a Value Added Service and opening it up for entry even by non-telcos. (November 2005)</p>

	<p><i>Extension of Technical Assistance</i></p> <ul style="list-style-type: none"> • As a result of feedback received from the Consultative Document for Competition Policy, as well as the two consultative forums (UP Roundtable Discussion, and AIM Video Conference), the NTC requested for additional technical assistance in coming out also with rules mandating Reference Interconnection Offers (RIO). RIOs are basically default interconnection agreements that small players can accept, without having to go through a lengthy negotiation process with big players. This will not only make things faster and more efficient, it will also lessen the regulatory burden on NTC, which presently uses more than 10% of its time ascertaining data and information relating to interconnection negotiations. <p>This activity was therefore carried on as part of the extension of the TA to the NTC through June 2007.</p>
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Attachments

- 1) Presentation: “Competition Policy: Principles, Practices and Challenges for the NTC, Perspectives and Practices from other Countries,” June 28, 2005
- 2) “Philippines Competition Policy Overview,” by Steve Magiera, June 29, 2005
- 3) “Universal Service—Competition and International Best Practices: Implications for the Philippines,” by Steve Magiera, August 5, 2005
- 4) “Issues for the Consultative Document on Competition,” by Steve Magiera, August 11, 2005
- 5) Presentation: “Developing Competition Policy Framework for ICT, NTC Consultative Document,” September 21, 2005
- 6) Draft NTC Consultative Document on the Development of a Competitive Policy Framework for the Information and Communications Technology Sector,” released by the NTC for comment on December 12, 2005
- 7) “Predatory Firm Behavior in Philippines Telecommunications Markets,” by Larry Darby, July 28, 2005

Competition Policy: Principles, Practices and Challenges for the NTC

Perspectives and Practices
from
Other Countries

Presentation to
National Telecommunications
Commission
by
EMERGE-USAID
June 28, 2005

Overview of Presentation

- Want to be demand responsive;
engage in discussion
- Presentation road map
 - Competition policy overview
 - Review of competition policy issues
 - Focus on interconnection
 - Conclude with dispute resolution issues

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June 28, 2005

Competition Policy: Overview

- What is "competition"?
- Rationale for telecom competition
 - Monopoly not "natural", but government created and protected
- Competition policy goals; not an end to itself, but a means to improved economic performance
- Telecom competition will lead to:
 - *Better ICT sector performance*: More investment, more consumer choice, greater efficiency in the use of scarce resources, supplier adaptation, technological dynamism, responsiveness to users, and others
 - *Better macroeconomic performance*: Jobs, productivity, economic growth, price stability and improved trade

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June 28, 2005

How Does It Work?

- Competition refocuses management attention to:
 - User needs
 - Rivals' rate/service offerings
- Competition creates
 - new incentive structures; forces innovative conduct; vests control in users
- The "Invisible Hand" of the Market

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Some Competition Policy Roles for Government

- Different models for definition, implementation and enforcement
 - General Competition Policy Authority
 - Antitrust agency; broad sectoral authority; highly selective enforcement; emphasis on precedential cases; focus on competition.
 - Broad Sectoral Authority
 - Regulatory agency; limited jurisdiction; day-to-day engagement; numerous dockets; complaint oriented; focus on broad “public interest” including competition
 - The Public Utility Model – Specific sector, like telecom
 - Combinations of these

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Role of Government and Role of Markets in Competition Policy

- Market failure v. government failure
 - Government “managed” competition (No!)
 - Government “enabled” competition (Yes!)
- Government can improve performance by
 - Enabling competitive market structures
 - Through licensing, spectrum allocation
 - Requiring competitive conduct
 - Prosecuting anticompetitive conduct
- The critical role of “incentive” structures
 - Who wins (loses) the regulatory “game”?

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Elements of Competition Policy Programs

- Goal is improved market performance
- Means include
 - Changing market structure
 - Entry policies
 - M and A policies
 - Changing corporate structure
 - Divestment, separate subs or accounting
 - Changing firm behavior in the marketplace

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Changing Incumbent and Entrant Conduct by Regulation

- First, understand management and shareholder incentives
 - To grow; To earn; To avoid risk
- Second, understand distribution of power
 - Market power, economic power, political power, legal power, staying power, power over perceptions
- Third, review all regulations in the context of these incentive and power relationships

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Some Illustrations

- Ambiguous v. clear statutory language
- Burdens of proof
- Default settings
- Who wins in the case of a tie?
- Rate of return v. price cap regulation
- "Gaming" regulatory processes

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Barriers to Competition in Philippines Telecoms (I)

- Barriers to entry
 - Statutory barriers
 - Regulatory barriers
 - Spectrum access, Licensing, regulatory build out requirements, lack of enforcement, assorted restrictions
 - Techno-economic barriers
 - Capital intensity, economies of scale/scope

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Barriers to Competition in Philippines Telecoms (II)

- Incumbent conduct
 - Price Discrimination
 - Vis-à-vis different user classes
 - The cross-subsidy problem
 - Vis-à-vis different retail entities
 - Its own retail operations vs. that of competitors
 - Service Discrimination
 - Nonprice dimensions
 - Delays, refusals, blockages, uncertainties
 - Raising rivals' costs

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Inputs to Competition Policy Analysis

- Definition of purpose
 - Structural analysis—mergers; divestiture
 - Analysis of market conduct
 - Analysis of firm structure
- Recognition of objectives
- Market definition
 - Product/Service scope
 - Geographic scope
- Market share; market power; market dominance

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Tests for Market Power/Dominance

- Market share thresholds
- Barriers to entry
 - Potential entry
 - Contestability
- Access to indispensable inputs
 - Capital, technology, intellectual property
 - Control of “essential facilities” – two tests
 - Are they required for competitive success?
 - Can they “practically” or “feasibly” be replicated
- Critical role of context and judgment
 - Dominance
 - Abuse of dominance

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Remedies

- Competition policy remedies
 - Diagnose then prescribe
 - Source of problem
 - Market structure; corporate structure; market behavior
 - Remedies
 - Revise laws, implement new rules
 - Injunctions, fines, disenfranchisement, divestiture, reorganization
 - Ordering affirmative actions; new accounting schemes, new pricing standards, new interconnection practices

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Will "Duopoly" Market Structure Lead to Effective Competition?

- Maybe, maybe not!
- Numerous models of duopoly
 - Most suggest some form of recognition of "mutual interests"
 - "Intense" long run rivalry improbable
- Relative "power" of duopolists key
 - Dominant firm and smaller rival may lead to a variety of outcomes

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Monopoly Incentives and Regulatory Powers

- Firms consider costs and benefits
- Power to remedy abuse
 - Enforceable orders?
 - Credible threats and commitments
 - License revocation (deny service to public?)
 - Payment of damages or compensation
- Regulators should compare expected cost of sanctions to benefits of "abuse"

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Perspectives on “Predatory” Pricing or Cross Subsidy

- Frequent charge of “predatory” rates
- From competitor point of view
 - All price competition is predatory
- From regulator point of view
 - Must compare prices/rates to cost
 - What cost standard?
 - By whose accounting?

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Cost-based Ratemaking

- Countless notions of costs and cost standards
- The cost allocation problem; who should pay what costs?
 - Direct v. indirect costs
 - Fixed v. variable costs
 - Common v. usage sensitive
 - Most network costs are common to different uses; users; and services
- The 64 Million Peso Question: “How to separate and allocate common costs to different rate elements?”
- Cost causation solves only part of the problem

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Rate-based Cost making

- No absolute cost standard; experts disagree
- Searching for costs
 - Very expensive
 - Arbitrary
 - Inconclusive
- Cost accounting solutions imperfect
 - Arbitrary allocations
 - Time and resource intensive
- Rates are regulated by cost impressions, regulatory goals and expert judgment
- What is cost of capital? What is LRIC; TELRIC?

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Requirements for "Good" Competition Policy

- Clear goals
- Awareness of "tradeoffs" among goals
- Transparent processes
- Information access; disclosure
 - Timely and accurate
- Regulators must have good information
 - Users needs and wants – structure of demand
 - Technological opportunities
 - Costs
 - Risks
 - Trends in demand, costs and technologies

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“Bad” Competition Policy: Signs of failure

- Bias among contestants (regulatory capture)
 - Regulatory uncertainty
 - Ambiguity, inconsistency lack of understanding of process and rules
 - Regulatory delay
 - Time is money!
 - Opportunities delayed are opportunities lost
 - Cartel management
 - Efforts to “manage” market evolution and shares
 - Indecisiveness, lack of enforcement
- All of these influence capital markets, investment, new service innovation, consumer choice***

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Core Competition Policy Issues

- Mergers, acquisitions, vertical relationships
- Ratemaking principles, standards, applications
- Spectrum assignment and allocations
- Licensing – terms, conditions, enforcement
- Universal service obligations
- Service quality standards
- Regulatory treatment of new services
- Interconnection

***All are important;
some are critical!***

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Why Focus in Interconnection?

- In transition from monopoly to competition, interconnection is most important dispute
 - Competing commercial interests involved
 - Competition depends on interconnection policy success
 - Interconnection involves carrier cost sharing AND division of revenues
 - Points of interconnection influence quality of services

*A Thought Experiment:
Suppose the networks making up the
Internet were "disconnected"!!*

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Interconnection Issues Are Extensive and Complex

- Technical issues
 - Standards, compatibility issues, signal quality, network architecture and provisioning,
- Competitive issues
 - Points of interconnection, quality of service, timeliness, sharing responsibility for shared resources, co-location; degree of unbundling
- Service issues
 - Services to be provided by incumbent; operational support services; quality; cost
- Regulatory issues
 - Meaning of equal access, assessment of interconnection costs and charges; treatment of USO obligations; determination of ongoing dispute resolution mechanisms.

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Competition Policy and Dispute Resolution

- Implementation is difficult and controversial
- Key to effective competition policy is effective dispute resolution
 - Articulate policy goals
 - Establish standards and rules
 - Monitor compliance
 - Investigate complaints
 - Enforce the rules
 - Resolve disputes
- Simple in principle, but vexing in practice

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Effective Dispute Resolution is Critical

- Unresolved disputes
 - Undermine development of new policies, firms and services
 - Lead to uncertainty and delay;
 - Dampens investment incentives/opportunities
 - Reduces consumer choice
 - Basically retard and sacrifice the benefits of competition policy noted above

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All Regulatory Goals Depend on Effective Dispute Resolution!

- Competition
- Investment (risk and uncertainty)
- Consumer choice
- Introduction of new services
- Innovation
- Level playing fields
- Fairness; Transparency

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Unequal Power: The Core Dispute Resolution Problem

- In the transition to competitive markets, firms have unequal power
 - Market/economic power
 - Political power
 - Power from command over resources – litigation skills, expertise, experience
- Uncertain legal framework magnifies power inequalities
- Regulatory intervention required in the presence substantial power asymmetries

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Alternative Dispute Resolution (ADR) Mechanisms

- Private negotiations
 - Unmediated
 - Mediated by
 - Private party
 - Government representative(s)
- Arbitration
 - Compulsory v. voluntary
 - Baseball arbitration
- Regulatory adjudication resolving differences
 - Ex Ante
 - Ex Post
- Court adjudication
- Legislative Action

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Power Structure of Negotiations

- Role of incumbent
- Role of entrant
- Role of users
- Role of regulator
- Role of courts

Incumbents hold the cards!

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Incentives to Agree!?

- What is the default setting?
- What prevails if negotiations fail?
- What are penalties/rewards for failure to agree?
 - Who pays? How? How much?
- Winning by failing?
- Negotiations viewed as negative sum game for incumbents; positive sum game for entrants

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Critical Interconnection Question Faced by All Regulators

How does government compel, induce or otherwise persuade firms with commercial, technological, legal and political power to change market behavior in ways their principals consider to be against their commercial interests?

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Conclusion

- Our plan for the next few months
 - Review status quo, trends and outlook
 - Review 7925
 - Identify interconnection barriers
 - Select “resolution options” from OCs
 - Weigh options in the context of Philippine markets and institutions
 - Leave the decisions to you!

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June 28, 2005

June 29, 2005

Philippines Competition Policy Overview (Interview Notes Organized by Issue)

“A healthy and competitive environment shall be fostered, one in which tele-communications carriers are free to make business decisions and to interact with one another in providing telecommunications service, with the end view of encouraging their financial viability while maintaining affordable rates.” [Article II. Sec 4f, RA 7925]

I. Dominant Carriers Executive order 109 and subsequently RA 7925 demonopolizes the industry so that there are now at least two operators allowed to compete in all geographic areas in the Philippines. Even so, many areas of the country are dominated by a single carrier. Thirty-seven of the 85 provinces in the Philippines are dominated by companies with market shares exceeding 75% of the fixed line market.

The interconnection clause of the reference paper annexed to the Basic Agreement on Telecommunications refers to “dominant” carriers. The Philippines dropped this clause in its own reference paper since its legislation refers to all carriers.

II. Interconnection

Interconnection among big carriers seems no longer to be a problem. In 2000, Govt threatened to require the carriers to interconnect at a single location (all an exchange located on Wilshire Blvd in US). So PLDT and Globe decided to interconnect on their own terms. Same for Globe and Smart when SMART switched from AMPS to GSM in 1999. The Team believes the following to be the main interconnections issues that need to be addressed in the Consultative Document:

1. Wireline to wireline (also in rural areas. Example is two telephones right next to each other but from different carriers. Calls between the phones are long distance call.)
2. Wireline to ISP (Many ISPs are operated by big telcos).
3. Large wireless to small wireless (e.g. is Sun being blocked by the Globe and Smart, or is the Sun pricing scheme causing too much congestion?)
4. Dominant carriers determine POI
5. Newcomers (see example of Sun above).
6. Enforcement (does the NTC have adequate resources to enforce interconnection rules, especially for newcomers?)

We received contradictory information on interconnection arrangements, and need to confirm that we have the interconnection directive of 2002? Does the directive contain language on nondiscrimination, uniform access, uniform rates? According to one interviewee, the original draft on interconnection contained language on sanctions and penalties, but this was watered down in final version. As a result, NTC lacks enforcement powers.

At one time, most types of interconnection were apparently handled by revenue sharing. Since higher prices lead to higher revenues, there was little pressure to bring down retail rates. Now,

we have been informed that there are fixed charges for access. The charge for terminating an international call is US12 cents per minute. List other access charges.....

RA79 contains language on cross subsidies for universal service. These cross subsidies are to be used to compensate carriers for SAS and other build-out requirements. However, they have been eroded by reduced international settlement rates and competition in the long distance market. Consequently, carriers argue that the Govt cannot impose cost-based rates.

III. VOIP

Only licensed carriers can provide VOIP. New rules would classify VOIP as a value added service. This would permit ISPs to provide VOIP, provided that they can interconnect, etc.

Main competition issues are:

1. VOIP will further erode cross subsidies for local network.
2. Unfair competition from ISPs owned by carriers. {There are claims that carriers cross-subsidize their ISP subsidiaries. Accounting separation is required by.
3. National internet exchanges are not all interconnected.
4. Unbundling of local loop is not mandated, so ISPs and other potential operators are unable to offer DSL.
5. Uplink (seems to be no problem since there are several options)
6. Foreign investment share (40% but 0 if we are talking of cable since cable classified as broadcasting).
7. Leased Lines (carriers control price of leased lines, we need more info on this market.)

IV. Retail Pricing

At one times, prices were regulated in such a way as to cross-subsidize local exchange service through higher prices for long distance and international services. International prices have been driven down as a result of international pressures (FCC) to lower accounting rates. Ratio of incoming international to outgoing is 10 to 1. Revenues from incoming are \$15 billion. Outgoing cellular calls and fixed line calling card calls to US have flat rate of US 40 cents per minute.

There was confusions about the current situation with price regulations. One interviewee said that prices were deregulated. Another said that there is a ceiling on prices for all types of services provided on fixed line (unclear about mobile). Another said that prices are regulated in rural areas but not in metropolitan areas such as Manila. We need a list of all price circulars issued by the NTC. Main competition issues are:

1. What prices to regulate; metered vs. flat rates
2. QOS and pricing (e.g. Sun cellular)
3. Allow carrier selection for long distance. How about indirect access for international?
4. Allow resale by VAS (we did not discuss this; we need input from NTC).
5. Predatory Pricing

V. Universal Service

Under SAS, carriers were permitted to build 10 times as many lines in urban areas as in underserved/unserved areas. Carriers focused on urban areas first and failed to meet rural

targets. The result was an oversupply of fixed lines in urban areas. Some feel that the problem with SAS was that it was not technology neutral since it required roll out using fixed line technology.

DOTC is not clear on next steps after SAS and govt wants a model to replace SAS. In future (e.g. as part of 3G licenses), companies may be allowed to replace fixed lines with community telephone centers.

Output-based subsidy schemes have been considered, but carriers will refuse to contribute to a new universal fund. They argue that they are already being taxed by the rollouts required under SAS. Since cross subsidies are also being eroded, they should not be required to pay a new tax.

Carriers requesting demand compensation from previous roll outs under SAS. Is there an NTC (AGILE) study on SAS?

Cellular coverage is now substantial. Depending on whom you talk to, 75% to 90% of population has access to a cellular signal. On the other hand, there are quotes that 35000 of 42000 Philippine barangays have no telephone service. (We must resolve this). It appears that the Philippines has an affordability problem, not an access problem?

Main competition issues are:

1. Interrelationship between access deficit charges, competition in retail markets and price rebalancing, and universal service obligations.
2. New types of universal services programs (e.g. output based subsidies)

VI. Licensing

Licensing in the regulated parts of the industry requires a congressional franchise to operate a telecommunications service and a Certificate of Public Convenience and Necessity or a Provisional Authority (PA). In order to obtain a PA, carriers must demonstrate that they are technically and financially capable to carry out the service and that sufficient demand exists. The PA contains a description of the service, the rates that may be charged, and the regulations under which the service can be provided. The private sector complains that one of the biggest barriers to investment is the length of time required to obtain a license. This is in part due to the fact that decisions on licenses can be appealed as abuse of discretion.

Main Competition Issues:

1. Timing and Procedures for obtaining licenses
2. Competitive Safeguards (some aspects of competitive safeguards are already required, but we are unsure whether these requirements are strictly enforced. An example is accounting separation for an ISP owned by a carrier).
3. Eliminate congressional franchise requirement (is this possible since this appears to be a requirement for many business licenses?).
4. Open up nation wide licenses for fixed lines to all carriers?
5. Licensing for convergence. { We understand that there are new licensing regulations being developed that will reflect trends in other ASEAN countries towards licensing

systems under convergence. We need to get the draft regulations. See also DOTC CD of 2000 on market structure.)

VII. Numbering

We understand that there is no constraint on numbering. The Philippines currently uses 7-digits, and could move to eight digits if needed. The cost of a sim card (including activation) is extraordinarily low at only 150 pesos.

Competition Issues:

1. Number portability ????

VIII. Frequency Management

Private sector suggests that poor frequency management is another factor hampering investment. Licensing process is slow and there appears to be a lot of allocated frequency that is not be used. In part, this is due to the warehousing of frequency (e.g. UHF). In part, it is due to technological change that allows more users in a given bandwidth (FM radio for example). We are not sure whether there are other allocation problems as well (e.g. quality of the government's frequency management database, enforcement operations). JIKA may have done a study on this. Private sector suggests increasing user fees which are paid every September as one way to release warehoused frequency.

Note: in other countries, improved frequency management practices have led to substantial increases in govt revenues from frequency fees.

Five (or is it 2?) new licenses for 3G will be issued. Govt may require new players to roll out network; but unlike SAS, can put up call centers rather than wireline. Some companies would also like new frequency assignments as pay back for SAS buildout.

1. Frequency Allocation
2. Frequency Fees
3. Frequency Licensing

IX. Mergers

Provide a framework that guides regulators on dealing with potential mergers and acquisitions. Should the powers rest with a separate competition authority or with the sector regulator?

X. Legislation

Apparently, new legislation is being developed to replace or amend RA7925.

1. Fiscal autonomy (Funding for NTC is through general budget. Frequency fees are returned to the Treasury and are not available to NTC. Private sector would probably support greater fiscal autonomy by returning funds to NTC in order to improve regulatory process.
2. Political independence (Terms of commissioners are coterminous with the term of the government. Some argue that the politization of the Commission is an important deterrent to investment. Length of licensing process was another.)
3. Enforcement powers



**Universal Service -- Competition and International Best Practices
Implications for the Philippines**

**SUBMITTED TO:
EMERGE Project**

**SUBMITTED BY:
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**DATE:
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Universal Service -- Competition and International Best Practices Implications for the Philippines

Historically, universal service programs were often based on the assumption that regulated monopolies made excess profits and that those profits should be used to expand the network into unserved areas.¹ Competition was not an issue since there was no competition. Now, however, rapid technological change has changed the economics of telephone networks, and universal service and competition are closely intertwined. This is especially the case for the mandatory service obligations that were used by the Philippines under the Service Area Scheme (SAS).

- 1) One goal of SAS was to provide at least one competitor for the incumbent telecommunications provider in all regions of the Philippines.
- 2) SAS relied on revenues from one part of the network to subsidize the expansion into less profitable areas. Competition has eroded those subsidies and undermined the effectiveness of the program.
- 3) The private sector views their decision to invest under SAS as a contract with the Government. As a result, companies have resisted policy reforms that would bring greater competition to the market.

This report reviews the impact of the SAS program, draws implications from similar programs elsewhere in the world, and lays out suggestions for the future based on international best practices.

Overview of the Philippines SAS Program²

The legal foundations for SAS are the anti-monopoly provisions of the 1987 Constitution and Executive Order (EO) 109 of 1993. The regulatory environment that subsequently developed reflects the view that deregulation and competition are the best ways to develop the Philippines telecommunications sector. Under E.O. 109, nine new companies were granted licenses to operate International Gateway Facilities (IGF) and Cellular Mobile Telephone Systems (CMTS).³ In return, the companies were obligated to provide local exchange service in designated unserved and underserved areas. The goals of SAS were to speed the rollout of the fix-line network into unserved and underserved areas and to introduce competition into areas formerly monopolized by the Philippine Long Distance Telephone Company (PLDT). Government targets were a telephone density of 10 lines per 100 people by year 2000, and 100% coverage for all municipalities by 2001.

¹ In this report, we use the words “universal service” and “universal access” interchangeably. In the Philippines, it appears that most programs aim at universal access, which refers to a situation in which every person has reasonable access to the public telephone network.

² The discussion that follows is based on [NTCA, 2002], [Aldaba, 2002] and [Seráfica 2000].

³ In 1999, two other companies joined the program in order to provide service to areas still unserved by existing companies.

In more detail, SAS required:

- 1) A minimum roll-out of 300,000 local exchange lines for IGF operators and an additional 300 lines for each additional international switch termination in excess of 1000 terminations.
- 2) A minimum rollout of 400,000 local exchange lines for CMTS operators, and an additional 4 lines for each additional CMTS line in excess of 100,000 subscribed lines.
- 3) Priority for unserved and underserved areas with an urban to rural deployment ratio of ten to one.
- 4) Public Calling Offices (PCOs) in barangays could be credited against local exchange lines when such lines were not viable.
- 5) An implementation period of five years that was later moved forward to three years under the Public Telecommunications Act of 1995 (RA 7925).

The SAS divided the Philippines into eleven service areas that consisted of both urban and less profitable rural markets. Initially, as many as two SAS companies were licensed to compete with PLDT and with the local provincial operator in each service area. The Government also limited the number of carriers allowed to serve each area in order to prevent markets from being overly fragmented. Profits from CMTS, IGF, and other profitable parts of the network were to be used to subsidize service in the less profitable areas.

The Aftermath of SAS

The SAS program period corresponded with years of very strong growth in telecommunications infrastructure. Between 1990 and 1997, foreign direct investment in telecommunications rose dramatically from US\$0.89 million to US\$292.3 million annually and led to a fourfold increase in the number of fixed lines between 1995 and 2000 (Table 1). Over these years, teledensity in the Philippines rose from 2.0 to 9.1, and almost reached the Government's target.

Table 1: Infrastructure for Telecommunications Services in the Philippines (1990-2004)

Year	1990	1995	2000	2004
No. of Fixed Lines (million)	0.61	1.41	6.91	6.47
Annual Growth		18.2%	37.4%	-0.5%
No. of Subscribed Lines (million)	N.A.	N.A.	3.06	3.44
Percent Subscribed	N.A.	N.A.	44.3%	53.2%
Teledensity (based on total fixed lines)	Approx 1.0	2.0	9.1	7.8
Cellular (million subscribers)		0.49	6.5	32.9

N.A. = Not Available

Source: NTC.

While there was a significant increase in the total number of lines, the SAS program has been faulted for not meeting its other targets. Six SAS operators built the required number of total lines, but failed to meet rollout requirements in all of their assigned areas. All other companies failed to meet their rollout requirements and two did not even start. In the end, there was a huge bias in the location of lines towards metro Manila, which accounts for 47% of all fixed lines, and urban areas more generally, which account for 72%. At the same time, some 50% of Philippine towns remain unserved by fixed lines.

Even more serious a problem is the fact is that there is now an enormous amount of unused capacity in fixed lines. By 2000, less than half the total lines available were subscribed, and even this underestimates the problem for companies participating in SAS. The figures in Table 1 include PLDT. In the 1990s, PLDT embarked on a major expansion program (Zero Backlog Program) in response to heavy criticism about its exceedingly long customer wait lists and perhaps because of pending competition from new SAS carriers. Of the 2.6 million lines built by PLDT between 1995 and 2000, 1.7 million were subscribed. If these lines are excluded from the totals in Table 1, the percentage of subscribed lines for SAS providers falls to only 29%. For some companies, the subscription rate is far worse.⁴

The problems with SAS have been attributed to numerous factors. Most are due to unanticipated changes in the market; a few are related to program design and policy failures. Some would argue that a failure to take into account unanticipated market changes is itself a policy failure.

Market factors contributing to the high levels of excess capacity include:

- The 1997 Asian economic crisis which led to a slowdown in the demand for telephone service and aggravated the over-supply situation in SAS service areas. The crisis may have also made it more difficult to obtain finance for the final completion of the rollout program in less profitable rural areas.
- Excess capacity due to the lag of one-to-two years between rollout and the development of market demand.⁵
- The booming market for cellular which may have contributed to lower demand for fixed lines. In the early years of SAS, cellular was still expensive. Now, prepaid sim cards, text messaging and other new technologies have made cellular more affordable and a substitute for fixed lines.⁶ The subscriber base for cellular has grown by 60% per annum since 1995 and is now far above that for fixed lines.
- Lack of affordability in rural areas. According to one estimate, people in remote areas could not afford to subscribe to fixed line phones even if the price were one-fifth that charged by private carriers.
- Rapidly declining profit margins for international calls, which were one source of cross-subsidy for build-out in less profitable areas. In part, declining profit margins was due to lower international accounting rates and the availability, even if illegal, of cheaper options such as callback, international resale and VOIP.⁷ In part, SAS may have contained elements of its own demise since it increased the number of IGF operators and thereby led to greater competition for international service.⁸

⁴ On positive side, some believe that the unused switching capacity in urban areas can be extended to outlying towns and municipalities at reasonable cost using new technologies.

⁵ Since the percentage of subscribed lines still stood at only 55% several years after the completion of SAS in 2004, this explanation for SAS failures seems no longer relevant.

⁶ Almost the entire subscriber base (97%) for one cellular company consists of prepaid. Text messaging, which is priced at 1 peso per message, also competes with cellular voice, priced at 8 pesos per minute, and fixed-line voice, priced at 4 pesos per three minutes.

⁷ The accounting rate with the United States fell from \$1.20 in 1995 to \$.16 cents in 2002. International calls are now priced at a flat rate of \$.40 cent per minute for any destination.

⁸ Although there are now eleven IGF operators, only BellTel and PLDT have nation-wide IGF licenses.

- Stagnating revenues for domestic long distance because of declining rates and the shift to cellular.⁹

Design and policy failures that may have contributed to problems with SAS include:

- An implementation period that was too short for proper planning;
- Lack of technological neutrality because of the emphasis on fixed lines;
- Lack of rebalancing for local tariffs. Telecommunications carriers petitioned for rate rebalancing and metering as one way to increase revenues and reduce the number of unsubscribed telephone lines. Although the Government agreed to allow metering of local calls, public protests forced the NTC to alter the plan and only allow it as an option for consumers.¹⁰
- Restricted geographical coverage for designated rollout in SAS areas, which ignored economies of scale and which may have made it difficult for small carriers to compete with PLDT. PLDT has a national franchise to operate all over the country and continues to dominate the market.

The Policy Legacy of SAS

Evaluations of SAS are mixed. On the one hand, the SAS program is credited with the steep rise in the teledensity of the Philippines. On the other, SAS left companies weighed down by huge levels of unused capacity and by heavy debt. Even the growth that is usually attributed to SAS may have been due to deregulation and the opening of the market to new companies, most of which are joint ventures with foreign companies.

Perhaps more importantly, the SAS program resulted in a market structure and policy regime that are being taken into consideration when evaluating new policies. In some cases, the introduction of new policies is being stymied by these considerations, thus causing uncertainty about the direction of future market reforms. A few examples are:

- 1) The Government is considering requiring build-out requirements as a condition for new 3G spectrum allocations. However, the NTC has not yet penalized SAS operators who failed to meet their rollout obligations. Doing so would further exacerbate the problems of these companies and/or lead to additional excess capacity.
- 2) In the years following the Telecommunications Act of 1995, interconnection fees were determined from revenue sharing arrangements negotiated by the carriers. In 2002?, however, the NTC issued new orders that would move the country towards cost-based pricing for interconnection. Cost-based pricing would further erode the ability of carriers to

⁹ While companies may have suffered from declining long distance rates, companies also benefited from lower interconnection fees. Formerly, the fee for interconnecting to the PLDT backbone was 70% of every peso in revenue from a long distance call. The fee has declined to 40% for calls interconnecting on the National Digital Transmission Network, an alternative backbone built by PLDT's competitors.

¹⁰ It is also unclear whether raising Government ceilings on local rates would have benefited companies much. The Telecommunications Act of 1995 allows the NTC to exempt a service from rate regulation if there is sufficient competition. As a result, the NTC has removed most services from rate regulation, except local exchange and mobile services. These are subject to rate ceilings, which are now being made superfluous by price competition.

cross-subsidize. Consequently, the NTC and carriers have still not agreed on a transition to cost-base pricing.¹¹

- 3) The need to continue cross-subsidies under SAS prevents further policy reforms in international service. The Government prohibits private leased lines, international resale, call back, and has been reluctant to classify VOIP as a value-added service that can be offered by ISPs and other non-franchised service providers.
- 4) Rather than full competition, SAS resulted in a “series of regional duopolies,” each with its own domestic and international carriers. Consequently, consumers have little say about their choice of carriers [World Bank]. Even so, there appears to be little interest in opening up the market further to new players because of the financial problems of SAS carriers and because of the politics of obtaining a Congressional Franchise,

Mandatory Build-out Requirements – An Evaluation

The Service Area Scheme is an example of the mandatory build-out programs that have become quite common in many developing countries for promoting universal service. The build-out requirements are imposed as a condition of license and usually rely on revenues from international, long distance, and other profitable parts of the network to cross subsidize unprofitable parts of the network.

As is the case with the Philippines, competition, new technologies, and international accounting rate reform have gradually eroded these subsidies in most countries. The programs appear inherently unsustainable since carriers target those profitable segments of the market that are to provide subsidies, while ignoring or delaying build-out in those segments that are to receive subsidies. Competition in and of itself reduces the subsidies available from profitable segments of the market. Even in countries that have maintained high prices for international and long distance services, build-out programs are being called into question. Some such countries continue to have the lowest teledensities in the world [Infodev].

Build-out requirements have other problems and inefficiencies as well. In effect, build-out requirements are taxes on operators.

- 1) In using build-out requirements to achieve universal service, the Government is in effect taxing one part of the telecommunications network to provide investment and operating funds for another. It is unlikely that the network can generate enough tax revenues from within itself to overcome the Philippines’ low penetration rate for fixed lines.
- 2) The taxes inherent in build-out requirements lack transparency. At one extreme, the entire cost of the build-out, including most operating costs, might need to be cross-subsidized by other profitable parts of the network. This might be the case in build-out areas with marginal lands and with low population density. At the other extreme, the build-out might be so profitable that it will occur anyway without a subsidy. Since the tax incidence of the build-

¹¹ During the years before 2000, there were many complaints about interconnection with PLDT. These complaints involved the technical aspects of interconnection and revenue sharing arrangements that favored PLDT. Interconnection may have contributed to the problems of new SAS carriers. [See “Report on Interconnection.”]

out depends on so many different factors, it is extremely difficult to estimate the “implied” tax and to ensure that it is levied equally on all operators.

- 3) The taxing mechanism is itself inefficient when compared to more targeted programs. Poor workers without phones are forced to pay higher long distance rates in order to subsidize higher income consumers with phones. For subsidized parts of the network, all users benefit from the subsidy even if they can afford to pay the full economic cost.

In conclusion, mandatory build-out requirements suffer from a number of weaknesses that make them inefficient and probably unsustainable in the long run. Consequently, these types of programs are being phased out in most countries, and are being replaced by more efficient targeting mechanisms to promote universal service.¹²

Next Steps – Competition Policy and a Universal Fund for Universal Service

Experience from a large number of countries indicates that the introduction of market reforms focusing on competition can significantly increase the supply of telecommunications services [Infodev]. The Philippines appears to have seen some of these benefits already. Waitlists and service quality of PLDT have improved significantly; the foundations for the future growth are in place with a large number of carriers in the market; international and long distance rates have declined and there are competitive pressures on some local rates; and a vibrant market for wireless appears to be developing.¹³ The next step in this process is for the Government to remove any regulatory uncertainty and to move forward with a clearly laid out competition policy for the telecommunications sector. [See forthcoming Consultative Document on Competition Policy.]

Competition is consistent with development of the entire network and will lead to more affordable prices for consumers, but will not overcome the affordability problems that limit rollout of the network into remote areas. This appears to be the case in the Philippines where there has already been significant roll-out, but the subscriber base for fixed lines is only 50%. Even more striking is the proportion of the population that can receive a cellular signal. According to some estimates, this proportion is 70% or more. The real constraint in the Philippines appears to be affordability, not lack of supply.

In order to address affordability problems in a manner consistent with competition, a growing number of countries are supplementing competition policies with specially funded programs that

¹² Even if build-out requirements are eliminated, incumbent SAS operators may argue that they are still losing money because of past universal service obligations. During the transition to cost-based interconnection, some countries impose access deficit charges (ADCs) on top of interconnection fees in order to compensate carriers that provide universal service at below cost. ADCs are difficult to estimate, lead to excessive costs for competitors, and suffer from the same problems as less direct methods of cross-subsidizing universal service obligations. If access deficit charges are imposed, they should be clearly distinct from interconnection charges and should be temporary (i.e. phased down over a fixed timeframe).

¹³ We have heard of complaints by foreign investors that the cost of telephone service in the Philippines is among the highest in the Asian region. It would be useful to verify whether this is indeed the case. If incorrect, the situation should be clarified with investors. If correct, more analysis is needed on why and whether high prices are due to a failure of policy.

target subsidies at universal service objectives in uneconomic areas (Table 2). These programs rely on incentives, not obligations, to provide universal service and are market-oriented. Such programs were originally established in Peru and Chile during the 1990s, and are now becoming more widespread as accepted best practices internationally [See Intelcon Research, 2004]. They are now known as universal service funds (USF).

Table 2: Universal Service Funds Throughout the World

Country	Funding Source	Fund Disbursement
Argentina	1% of operator gross revenues	Government
Brazil	1% of operator gross revenues from telecom services	N. A.
Chile	Government budget	Competitive bidding
Columbia	5% of national and long distance revenues plus funds from license fees	Competitive bidding
Dom. Rep.	2% of operator levies	N.A.
Ghana	1% of fixed operators net revenue	N.A.
Guatemala	Spectrum Auctions	N.A.
India	5% of all operator revenues	N.A.
Malaysia	6% of weighted revenue from certain services of fixed and mobile network operators.	Initially, only Telkom Malaysia had access to funds. Now competitive bidding.
Mexico	Details not yet available.	
Nepal	2% levy on revenues of incumbent, ISPs, and mobile operators	Competitive bidding
Peru	1% of all operators' and CATVs' gross revenues	Competitive bidding
Philippines	Details not yet available	
South Africa	0.17% of all operators' revenues	Telecenters and areas of greatest need.
Uganda	1% levy on operators, postal service, couriers, ISPs, etc.	Competitive bidding

N.A. = Not Available. Source: [Intelcon, 2004]

Universal service funds collect revenues from various sources and provide subsidies that are targeted at high cost areas and/or low-income consumers. The most efficient funds provide relatively small subsidies as incentives to private telecommunication operators, who provide the service. Good examples are the funds of Chile and Peru.

The Universal Access Programs of Chile and Peru

In the 1990s, both Chile and Peru established universal funds that were used to provide subsidies targeted at universal access in rural areas. Chile's target was 6 thousand unserved localities between 1995 and 1999. The program was financed from the national government budget and reflected the view that universal access is a social policy that is the responsibility of the government, not telecommunication operators and subscribers. Peru's target was 4.5 thousand localities between 1998 and 2004. Financing was from a 1% levy on the gross revenues of the telecommunications sector. Both programs used auctions to determine who obtained the subsidies. This resulted in subsidies that were generally 50% or less of those thought necessary to provide universal service. After meeting their program targets, both countries widened their programs to include telecenters with internet access [Infodev].

Funding sources for universal service programs include the government budget, levies on the revenues of telecommunications service operators, licensing concessions and spectrum

allocations, and fees on subscribers. First best policy is to fund universal service out of general tax revenues (e.g. Chile). This reflects the fact that most programs have a social objective to bring telecommunications services to the poorest segments of the population and should be part of the government's social policy, rather than an obligation of telecommunication carriers. In addition, it was noted earlier that taxing telecommunications to build-out telecommunications may not have much impact on access. There is not enough money in the sector.

If funding must come from within telecommunications, it is better to maintain technological and service neutrality by taxing the general revenues of the sector. Taxes on specific types of services or parts of the network lead to by-pass and to other inefficiencies similar to those with build-out requirements.

Universal service fund programs usually target access to basic voice telephone, with some enhancements such as emergency calling and directory assistance. The programs are technologically neutral and able to incorporate some of the numerous possibilities now evident with mobile public phones. Enhanced services are encouraged and should be automatically licensed, but usually are not part the programs during their initial phases. Later, some programs have been expanded to include telecenters with a wider range of services.

Although many countries are enamored with the idea of developing telecenters with Internet capability as part of their universal service programs, this could add considerably to the cost of the program. According to Intelcon, "most Internet public access models promoted by the ITU and by international donors have to date only had a short run pilot experience, but it is enough to provide the general conclusion that they are largely unsustainable in the long run." Infocon then goes on to suggest that countries focus initially on Internet Points of Presence in main rural population centers [Intelcon, 2005]. As in the case of basic telephone service, countries also need to ensure that competition policies affecting the Internet are in place to ensure low cost access. In the Philippines, competition issues include local loop unbundling and the provision of ADSL by ISPs, cross subsidies for internet services by franchised telecommunication operators, discriminatory access, and the interconnection of ISPs.

The most efficient universal fund programs rely on the private sector for major decisions regarding technology, and use a bidding process to ensure the most efficient use of public resources. Winning projects are those requiring the smallest subsidy from the fund. Alternatively, programs can be designed to award projects to those bidding the maximum universal service coverage for a given subsidy.¹⁴ In either case, the auction process leverages the maximum amount of private sector funding possible since only the uneconomic portion of the services needs to be subsidized. The private sector finances the rest. In Chile and Peru, the ratio of private sector investment to subsidy was six to one. Many projects required no subsidy at all since bidders apparently took into account additional benefits from network build-out.

Subsidies can be reduced further by encouraging simultaneous bidding on more than one project. By allowing applicants to bid on different combinations of the same projects at different subsidy

¹⁴ This is the "dual" of minimizing the subsidy and under most conditions, the two methods should lead to identical results. Of the two methods, awarding projects by maximum universal service coverage should be easier to administer.

amounts, the fund can capture the scale economies inherent in allowing operators to treat multiple projects as a single overall project.

Conclusions

The Philippines telecommunications sector received a big boost under the Service Area Scheme when the market was opened up to new players. Waitlists and the service quality of PLDT improved significantly; the foundations for the future growth were put in place with the licensing of new carriers; there are competitive pressures on international, long distance, and some local rates; and a vibrant market for wireless appears to be developing. Nevertheless, SAS left a legacy of underutilized capacity and fragmented markets served by regional duopolies. This has made it difficult to move forward with additional reforms.

The next step is for the Government to lay the regulatory foundations for a competitive market in telecommunications. While the Philippines may have already experienced the initial surge in growth that results from opening markets, much else needs to be done to ensure that markets are competitive. The benefits from competition are perhaps most seen in the case of cellular where a range of new applications has developed. These applications (e.g. text messaging as a substitute for email) make communications affordable in rural areas at much lower levels of income. Together with new business models for delivering services, they have increased the revenue potential from service in rural area considerably.

Competition will not overcome all of the affordability problems that limit rollout of the network into remote areas. For this, international best practice is to supplement competition policy with specially funded programs that target subsidies at universal service objectives in uneconomic areas (Appendix A). The best of these programs treat universal service as a social policy to be financed from general government revenues and use an auction process to leverage additional private sector finance. The Alternative Communications Program (ACP) proposed in the DOTC Consultative Paper of 2000 appears generally consistent with such programs. A review of the ACP in 2002 reached the following conclusion.

Universal Service Fund

Setting up a specialized fund to make available cash subsidies to catalyze additional private investment, especially in least profitable locales, would be the single most important step towards achieving the DOTC's service objectives in rural areas [Wellenius, 2002].

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Appendix A: Implementation Procedures for Targeted Subsidies from a Universal Fund

Below are some of the broad steps that need to be taken in order to introduce targeted subsidies from a universal fund.

1. Determine an Administrator for the Fund. In some countries, the Fund is administrated by a special autonomous board (e.g. Special Board for Universal Access or SBUA).
2. Establish a mechanism for financing the system (e.g. general government revenues, telecommunications revenues net of interconnection fees, spectrum fees, etc.)
3. Define the types of projects (e.g. a pay phone in an unserved village) that will qualify for universal service funding and performance criteria for the service.
4. Determine whether universal service operators will be allowed to provide local switching and compete with the existing local loop, if any.
5. Lay out licensing, interconnection, and other requirements of universal service operators:
 - Establish an interconnection regime for universal service operators terminating calls on the PSTN, and vice versa.
 - Specify the regulated price for services under the program. Universal service operators are contracted to provide service at that price for xx (e.g. 10) years.
 - There are no restrictions on technology.
 - Any required spectrum is provided free with the license.
 - All universal service licenses are nonexclusive and are valid for yy (e.g. 30) years.
 - No other carriers will receive subsidies to compete with universal service provider for the period of the latter's license.
 - Universal service operators are automatically licensed to provide enhanced telecommunications services at unregulated prices.
6. Request universal service proposals from local and regional governments, neighborhood associations, NGOs, private institutions, telephone operators, and the general public, etc.
7. Group proposals into projects for universal service funding. Projects should be grouped into fairly large areas so as to permit economies of scale and lower subsidies.
8. Determine the maximum subsidy that can be granted for each project.
9. Auction the universal service projects. The winning projects are those that bid the lowest subsidy. This subsidy could include the discounted present value of the future operating subsidies needed to keep the project viable for zz (e.g.10) years.¹⁵
10. Provide a one-time subsidy payment to the winning bidder after the project is built.
11. The SBUA monitors all projects for compliance with bid documents and service requirements.
12. The SBUA is itself subject to independent audits on the management of universal service funds.

Source: Adopted from [Magiera and Taschdijian, 2003].

¹⁵ In the United States, operational subsidies are provided on an annual basis. In the above program, the subsidy is paid only once, but can include the discounted present value of the bidder's estimate of future operational subsidies. One result is that the data requirements and administration costs for managing the USO fund should be much lower than in the U.S.

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August 11, 2005

Issues for the Consultative Document on Competition

Regional Price Comparisons.

I think it important to have some idea about how Philippine prices for local, long distance, international and internet use compare with those elsewhere in the world. If they are low, it is important to advertise this to potential investors. If they are high, it is important to know why and whether this is a policy failure. You might try comparing Philippines with a few select countries in the region such as Malaysia, Indonesia, Thailand, and Singapore. {Be careful in using the ITU as a source since price plans differ considerably across countries and the ITU may not take these differences into account. For example, the cost of 3 minute call may seem same between two countries, but the timing increment for charging can vary considerably. In Indonesia, its every 6 seconds.}

SAS Build-Out.

There appears to be a lot of overhang from the SAS program. Carriers use their SAS obligations as an excuse for refusing policy reforms. What are the commitments made by the Government to SAS carriers? What are the legal obligations of the Government towards SAS carriers? Are there other ways to compensate carriers? Note that SAS occurred during the heyday of telecom investment in the 1990s. Lots of companies took a beating on those investments. Companies in Asia with unhedged US\$ debt were particularly hard hit by the Asian financial crisis. For all I know, companies in the Philippines may have been the lucky ones????

Should the Government penalize SAS providers that have not met their rollout out requirements, or drop the requirement? In order to be fair to old SAS providers, should new franchises also be required to build out? In my opinion, it is best to clean the slate. Abolish all old requirements and do not impose new ones. If ADCs are being used to compensate carriers for necessary reforms, they should be distinct from interconnection charges, based on costs(?), and have a clear phase-out period.

Universal Service Funds. The DOTC has developed a program for a universal service fund which appears generally to conform to best practices internationally. If this is the case, the Consultative Document should support the DOTC and point out that DOTC programs are consistent with the Consultative Document's proposed policies on competition. Also, consider whether it is possible to transfer the financing for certain SAS obligations from the companies to the universal service fund. {Companies do not want to pay a tax for the universal service fund because of their SAS obligations. International best practice is that the universal service should be funded from general revenues.}

Local Market Competition.

Develop a competition map for Philippines. Is it true that that the market has a lot of players, but competition is limited since the market is divided into a series of regional duopolies? {37 of the 85 provinces are dominated by companies with market shares exceeding 75% of the fixed-line market.} How do major urban markets compare with rural markets? Is the market in metro Manila competitive? How do you define dominant carriers? How much substitution is there between cellular and fixed-line service? Is cellular placing downward pressure on prices for fixed-line service? Should the NTC license new entrants into local markets?

Retail Price Regulation. Which services/markets should be regulated by the NTC. Can one justify asymmetric price (and interconnection regulation) between urban and rural markets?

Long Distance and International Competition. What are the remaining competition issues in the long distance and international markets? Are consumers free to choose their long distance carrier? Why not provide nation-wide IGF licenses to all companies currently holding regional IGF licenses? Indirect access for international?

Competition and the Internet. How can the NTC improve the function of internet markets? Competition issues include local loop unbundling, cost of leased lines and the provision of DSL by ISPs, cross subsidies for internet service by franchised telecommunication operators even though this is forbidden, and interconnection of ISPs.

Competitive Safeguards. Review regulations on competitive safeguards. For example, is accounting separation required for existing carriers? If so, is it being enforced?


Licensing. Other countries in the Asian region have adopted new licensing systems based on convergence; so there are a number of models out there. What are the major issues that need to be addressed in the PI (e.g. cable is currently considered broadcasting and is therefore subject to 100% domestic ownership). Would it be difficult to transition from the current system to a convergence-type system?

Interconnection.

Philippines is now interconnected in the sense that all carriers can interconnect, but PLDT still dictates POI. Also, heard about difficulties facing new carriers entering market (e.g. Sun).

Companies claim that unbundling and LRIC are unfair because of SAS. During interviews, we obtained incomplete information on the transition from revenue sharing to fixed fees for access and interconnection. The Consultative Document should review this transition and document any problems. How were the fees determined? Does the Philippines have a WTO obligation to adopt cost-oriented rates and is it meeting that obligation?


Frequency Management. Lots of complaints about warehousing of frequency. Need to conduct a review of the frequency management system (broadcasting). Is the system computerized? How good are the data? What is the relationship between licensing, spectrum use requirements, and payment of spectrum fees? This probably needs to be a separate project.



**DEVELOPING COMPETITION POLICY
FRAMEWORK FOR ICT**

NTC Consultative Document

21 September 2005

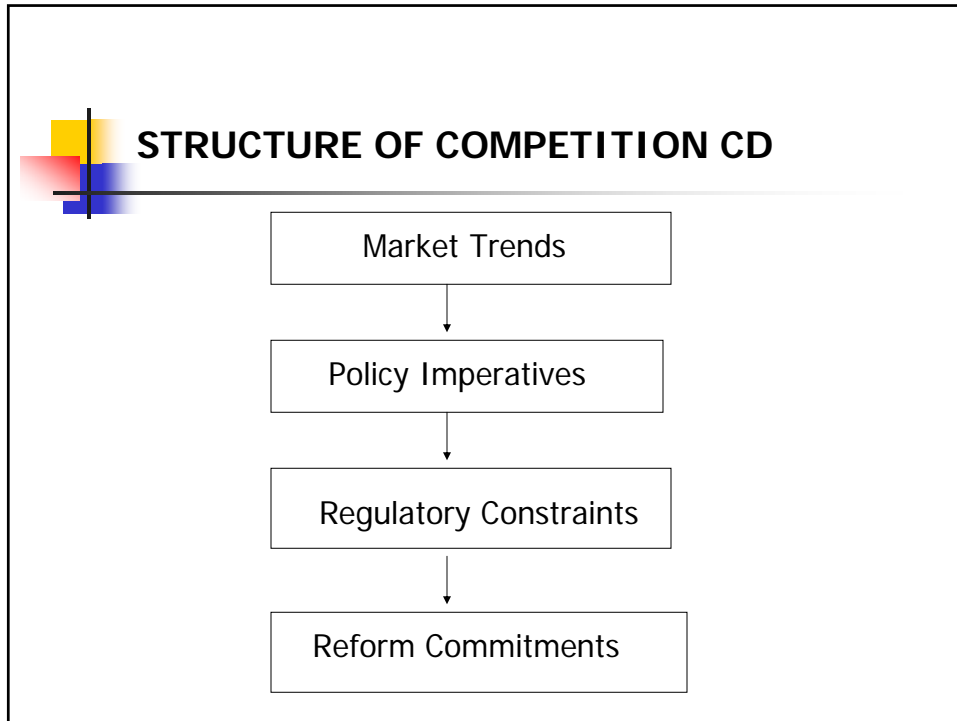


MOTIVATIONS FOR COMPETITION CD

- NTC's recognition that competition issues exist and must be responded to

- Signaling instrument of paradigm shift in regulation
 - technical & econ. regulation → competition regulation
 - prospective → retrospective
 - mediation → pro-active regulation

- Win broad-based support for reform initiatives
 - eliminate notions of regulatory capture
 - build confidence on NTC as governance institution




MARKET TRENDS

- **Key message:** Market competition is ineffective and unsustainable.
- **EFFECTIVE COMPETITION**
 - actual and/or potential competitors restrains incumbents' market behavior
 - absence of players with significant market power
 - 'market power' = 'market influence' = 'dominant position'
 - ability to profitably raise prices above competitive level for non-transitory period



MARKET TRENDS

- SUSTAINABLE COMPETITION
 - Long-run financial viability of competitors
 - Impact of deregulation on market competition
- Goal is to address current competition issues to establish **effective and sustainable competition.**



MARKET TRENDS

Trend 1: Increasing market concentration and deteriorating financial condition of non-dominant providers.

- 2-firm concentration ratio: 1999 vs. 2004
 - LEC: 70% → 75%
 - CMTS: 85% → 96%
- “bottom-line” in 2004:
 - largest two carriers: P 39.2 B NET INCOME
 - Next largest two carriers: P 2.3 B NET LOSS



MARKET TRENDS

Trend 2: IGF and IXC markets foreclosed to competition

- High access charges imposed by incumbent carriers squeeze margins of entrants
- IGF and IXC operators limited by size of subscribers' base
- Principles of "symmetry" and "nondiscrimination" abused to maintain high access charges



MARKET TRENDS

Trend 3: Cross-subsidization of services from mobile to fixed market to restrict competition in the latter

- Shift in preference from fixed to mobile phone services undermined the wired business
- SAS sanctions cross-subsidy but for universal service
- Predatory pricing benefits consumers but only in the short-run.



MARKET TRENDS

Trend 4: Large carriers engage in vertical price squeeze to restrict competition in internet services.


- Precipitated by growth in data and internet services (26%) compared to flat growth in wireline business (1.3%)
- Exit of small ISPs induced by:
 - a) High wholesale price of access input (E1/R2 lines)
 - b) Limited access to local loop (bitstream access only)
- Imputing “reasonableness” of wholesale price constrained by lack of information on carriers’ costs



POLICY IMPERATIVES

Objectives:


- a) Curb existing abuses of market power
- b) Level the playing field
- c) Improve transparency in regulation



POLICY IMPERATIVES


Policy 1: Imposition of Significant Market Power (SMP) Obligations

- Object is a licensee in a “dominant” position to act without significant competitive restraint from its competitors and customers
- SMP *per se* is not being penalized, rather it is the **abuse of market power**
- Regulation is imposed in advance, instead of *ex post* abuse of market power, because the impact may be uncertain and/or irreversible.



POLICY IMPERATIVES


- Two key issues:
 - a) Determination of dominance or SMP
 - b) Specification of obligations on dominant licensees
- Market share is often used as criteria, but other variables such as power to make pricing and other decisions, entry barriers, etc. also inform the determination.
- Common SMP obligations:
 - a) Obligation to align prices with costs
 - b) Separate accounting
 - c) Publication of RIO



POLICY IMPERATIVES


Policy 2: Mandate network unbundling

- Objectives:
 - a) Reducing entry barriers
 - b) Avoid unnecessary duplication of investments
 - c) Encourage deployment of new services
- But may weaken entrant's incentive to invest in own facilities → Facility-based competition
- Unbundling policy may be "transitional" and "selective."



POLICY IMPERATIVES


- Issues:
 - a) What network elements to unbundle
 - b) Depth of access to local loop (full, line-sharing, bitstreaming, subloop)
 - c) Co-location arrangements
 - d) Pricing



POLICY IMPERATIVES

Policy 3: Allow for resale of services


- Mandate carriers to offer services at wholesale or discounted rates so they could be resold
- Expected benefits:
 - a) Downward pressure on prices
 - b) Stimulate demand for existing networks
 - c) Encourage innovation; improve service quality
 - d) Facilitate entry of new service providers



POLICY IMPERATIVES

- Issues:
 - a) Whom to mandate resale → Dominant licensees
 - b) How to avoid disincentive to invest in own infrastructure


Retail price > resale price > termination/origination charge to service providers > interconnection price to infrastructure operators



POLICY IMPERATIVES


Policy 4: Streamline pricing regulation:
(i) *ex post* regulation if non-dominant licensee
(ii) *ex ante* and *ex post* regulation if dominant licensee

- Rationale:
 - a) Current practice is almost tantamount to no pricing regulation
 - b) Proportionality principle: policy measures should be “proportionate” to objectives
 - to curb abuse of market power



POLICY IMPERATIVES


- Issues:
 - a) What competition test to apply
 - which conduct to consider having the “purpose or effect of preventing or substantially restricting competition”
 - b) Burden and standard of proof
 - OFTA: civil standard of proof → Balance of probabilities



REGULATORY CONSTRAINTS

Handicap 1: Lack of resources to govern effectively

- Funding issue → Manpower and equipment constraints
- Win industry support to enable NTC to:
 - Collect past due SRF
 - Raise SRF
 - Lobby for retention of collection with DBM



REGULATORY CONSTRAINTS

Handicap 2: Past regulatory lapses and policy flaws eroded confidence on NTC

- Admission of past lapses allows NTC to:
 - a) Remove credibility burden on new policies
 - b) Strictly enforce existing regulations
 - c) Win support of non-dominant licensees



REGULATORY CONSTRAINTS

Handicap 3: Absence of competition law and limits to constitutional and statutory powers of NTC


- Absence of explicit mandate for competition regulation
- Patent anti-competitive practices are left unregulated
- Quasi-judicial authority appears weak



REGULATORY CONSTRAINTS

Handicap 4: Lack of information on regulatees

- Information asymmetry between regulator and regulatee
- Partly a result of non-exercise of regulatory power to enforce submission of required reports
- Need for systematic information system
- Need for capacity to analyze information and act accordingly



REFORM COMMITMENTS

Task 1: Take pro-active stance on competition issues

- Options for competition regulation:
 - a) General competition body
 - b) Sector-specific regulation
 - c) Industry self-regulation → Industry forums + industry code
- Only (b) is feasible at this stage
- Basis: RA 7925 – NTC as “principal administrator”; mandated to “take necessary measures ... to foster “healthy competitive environment”



REFORM COMMITMENTS

Task 2: Enforce strict compliance to reporting requirements on regulatees

- Stipulate and enforce administrative sanctions for non-compliance

Task 3: Restore regulatees’ confidence on the Commission

- Exercise statutory and administrative powers
- Set time limits in resolving cases
- Improve transparency in regulation



REFORM COMMITMENTS

Task 4: Work for NTC reform bill

- Must win industry support for such bill

NTC Consultative Document
On the Development of a Competition Policy Framework
For the Information and Communications Technology Sector

I. Introduction

The Philippine telecommunications industry marks its first decade of market reform this year. It was March 1995 when the Philippine Congress passed Republic Act (R.A.) 7925, otherwise known as the Public Telecommunications Policy Act of the Philippines which paved the way for opening the telecommunications market to competition. Then and now, R.A. 7925 is considered a landmark law that transformed a vital and strategic industry, and inspired similar reforms in other sectors, notably banking, shipping, downstream oil and power. And, despite limitations that have become apparent only years subsequent to its passage, R.A. 7925 is still credited for breaking away from the growth-stifling tradition of monopoly, public sector provisioning, and heavy-handed regulation.

It is also instructive to be reminded at the onset that when the Philippines launched its reform of the telecommunications sector, there were few experiences to draw from. The Philippines was among the first 11 countries to have permitted competition in fixed line network, and among the first 14 countries to have de-monopolized the international telephone service. Moreover, except for Chile and the Philippines, the league of early reformers was composed of developed economies. In other words, the Philippines had to break new ground in designing a reform framework appropriate to the condition and needs of a developing country.

The achievements of the past ten years following the passage of R.A. 7925 are undeniable. Access to telecommunication services has grown many folds than initially anticipated. Investments in the sector defied the sluggish growth in the rest of the economy, and indeed, continue to drive the prospects for future economic growth.

Yet, it is equally clear from the massive underutilized infrastructure and the debt burden amassed by Philippine carriers that entry and competition could have been managed more effectively.

For one, the reform blueprint attempted to push universal service by practically leaving the market to its own devices, challenging the conventional view that such could be more viably achieved through public investments or regulator-directed private investments. The result was a concentration of access to telecommunication services in urban and relatively higher income areas which highlighted the inherent contradiction and tension between promoting competition on the one hand, and relying on cross-subsidization of services to finance universal access, on the other.

Moreover, a key issue faced by policymakers when they break up a monopoly is determining the optimal number of new players that would be allowed to challenge the

incumbent. Too many entrants could lead to ruinous competition and socially wasteful duplication of investments. In this instance, while such risk is not lost to policymakers, the reform blueprint nonetheless accommodated the entry of nine new carriers, a number that some consider too many given the size of the market. Today, there is widespread apprehension on the effectiveness and sustainability of what appears to be competition among a relatively large number of service providers in the market.

Finally, it must be pointed out that beyond the spheres of law and policy, technological developments that were not anticipated at the time R.A. 7925 was passed, continue to move forward at a rapid and dizzying pace. Emerging technologies and applications made possible by the rapid developments in the telecommunications sector (such as VOIP, wireless technologies and other opportunities opened by convergence) increasingly handicap the NTC as it struggles to provide appropriate responses to the needs of the sector and demand of the public for competitively priced and wider array of goods and services.

The Commission therefore views the development of such a competition policy framework as timely and as an affirmative duty mandated by law. Such a framework is necessary to correct the flaws in the regulatory environment that restrain competition and prevent the efficient functioning of the market. It is an important step that will guide future initiatives and decisions of both the Commission and the private sector as they contemplate competition-related issues.

A Competition Policy Framework for the sector is perhaps long overdue given that the Commission has long defined its vision “as a proactive regulatory agency” committed to promoting “a globally competitive, universally accessible and affordable information infrastructure and services.” Indeed, a competitive market is acknowledged the most efficient mechanism for developing a modern, ubiquitous and affordable information infrastructure, but past regulatory regimes were not prepared to assume this strategic role.

The Commission envisions that the framework development will proceed in three phases:

- ?? **Phase One** identifies and validates the imperatives for a competition policy framework and the fundamental changes in regulation that the Commission ought to pursue.
- ?? **Phase Two** examines in detail key competition issues bearing on the sector, including, in particular, pricing, interconnection and spectrum management.
- ?? **Phase Three** consolidates the outcomes of the consultations in the preceding phases into a coherent and comprehensive policy framework.

It must be emphasized that the Commission will involve and actively encourage the full participation of all stakeholders, particularly from the private sector and civil society, in all phases of this very critical initiative.

It is in the spirit of transparency and openness, therefore, that The National Telecommunications Commission (hereafter Commission) now invites public comment on this **Consultative Document on the Development of a Competition Policy Framework for the Philippine ICT Sector**, as the first step towards the development of the policy framework for competition in the information and communications technology sector. In the main, it covers:

- ?? A review of **four market trends** deemed to impinge on current and future state of competition in the sector;
- ?? An exploration of **four major policies** that may change the balance of market power, hence the nature and degree of competition;
- ?? An assessment of the quality of current regulation, identifying **four major handicaps** of the Commission; and
- ?? A discussion of **four urgent tasks** for the Commission to effectively govern a dynamic and complex industry.

Comments from industry stakeholders and other interested parties in relation to any and all issues raised in this Request should be sent (in both hard copy and electronic formats) on or before January 31, 2006 to:

**Office of the Commissioner
National Telecommunications Commission
BIR Road, East Triangle, Diliman, Quezon City**

All Comments will be made publicly available at the NTC and shall be posted on the NTC website (www.ntc.gov.ph).

II. Four Apparent Trends Defining the State of Market Competition

For purposes of assessing the state of competition, the Commission simplified its definition of the telecommunications market as being comprised of three submarkets: fixed line, mobile, and internet and data services.

The goal of the Commission is to ensure that competition in all three submarkets is **effective** and **sustainable**.

Competition is deemed effective when existing and/or potential service providers have the capacity to prevent an incumbent provider from using its market power to keep prices above underlying costs over a considerably long period. Thus, the effectiveness of competition is unrelated to the actual number of service providers in the market, for a market with a single service provider could be just as competitive as one with several providers. **What is important is that the threat of actual or potential competition is sufficient to discipline the behavior of the incumbent.** This therefore requires competitors to hold reasonably strong market position such that the incumbent cannot ignore the impact of their possible response to any anti-competitive conduct on its part.

A sustainably competitive market, on the other hand, may be viewed at two levels. One is the capacity of existing providers to remain viable in the long run and hence to pose continuous market challenge to the incumbent. It requires competitors to hold reasonably secure market positions that can likely endure competitive challenges from the incumbent. At another level, sustainability pertains to the ability of market forces to maintain a competitive environment even after regulation has been removed. That is, competition is truly sustainable if it persists even under a deregulated environment.

Question 1: Do you agree that the effectiveness and sustainability of market competition should be the overarching goal of the Commission? Is there other higher goal that should guide the Commission's undertaking?

At least four apparent trends suggest to the Commission that competition in all three markets is neither effective nor sustainable.

Trend 1: Several licensees have emerged dominant and financially viable in the submarkets, while the market shares of the other licensees have been reduced to almost insignificant levels. These other licensees are thus unable to pose effective competition against the dominant providers.

The Commission records show that since market liberalization, the number of service providers in most market segments is either increasing or relatively stable. As of the end of 2004, there were 73 local exchange carriers (LECs), 14 inter-exchange carriers (IXCs),

11 international gateway facility (IGF) operators, 5 cellular mobile telephone service (CMTS) providers, and 329 value-added service (VAS) providers, of which 43 are internet service providers (ISPs). In 1999, the numbers were not too different except for VAS: 76 LECs, 12 IXC, 11 IGF operators, 5 CMTS providers, and 106 VAS providers, of which 31 are ISPs.

A mere headcount of service providers, however, misrepresents the true state of competition in the ICT market. While the Philippines has one of the highest number of service providers per capita, only a handful of these licensees are effectively competing in the market.

An analysis of the available data¹ reveals that the LEC and CMTS markets have become more concentrated despite the growth in market demand. In the fixed line market, the two largest carriers account for about three quarters of the market, leaving only a quarter of the market to 71 other carriers. In the CMTS, the two largest service providers control 96% of the market. In both markets, the market shares of competitors are too small to pose any significant threat on dominant providers.

¹ Two alternative measures of competition reveal in Table 1 that the LEC and CMTS markets have become more concentrated despite the growth in market demand. The Herfindahl-Hirschman Index (HHI)¹ in the former increased from about 3,900 in 1999 to more than 4,200 in 2004, while in the latter, from about 4,000 to 4,900 during the same period. This index takes account of the relative size and distribution of firms. A score close to 0 implies intense competition among a relatively large number of firms, each having small and almost equal proportion of the market, while the maximum score of 10,000 corresponds to a monopoly. In the U.S., a market with HHI less than 1,000 is considered not concentrated; between 1,000 and 1,800, moderately concentrated; and more than 1,800, concentrated.

A simpler measure of concentration that however ignores the distribution of firms is an *n*-firm concentration ratio, which represents the sum of market shares of *n* largest firms. In the fixed line market, the two largest carriers account for about three quarters of the market, leaving only a quarter of the market to 71 other carriers. In the CMTS, the two largest service providers control 96% of the market.

Table 1. Measures of Market Competition in Fixed lines, Mobile and Internet Services

	1999	2004
Fixed lines service		
Number of operators	76	73
Subscribers base	2,892,435	3,437,491
Herfindahl-Hirschman Index	3,931	4,240
2-firm Concentration ratio	70.12	74.62
Cellular mobile telephone service		
Number of operators	5	4*
Subscribers base	2,849,880	32,935,875
Herfindahl-Hirschman Index	4,093	4,858
2-firm Concentration ratio	84.65	96.31
Internet services		
Number of operators	31	43
Subscribers base	350,000	1,200,000

*SMART and PILTEL are considered to belong to one group, *i.e.*, PLDT group.

In the internet service market, the absence of data on subscription base of service providers precludes a similar analysis of concentration. The Commission however is of the impression that the previously regarded competitive market, dominated by a teeming number of relatively small service providers, has also become concentrated and dominated by subsidiaries of large carriers. The Commission further is of the opinion that a few independent service providers remain viable but their market positions are threatened by their dependence on access to the infrastructure owned by the carriers.

But it is not only the competitors' weak command of the market that is a cause of concern. Equally disconcerting is the fact that most of the non-dominant service providers are in precarious financial condition. An indication of this can be gleaned from the comparative five-year financial performance of the largest two and next two largest carriers (by size of asset) in Table 2. Excerpted from the financial statements of carriers are the earnings before income tax and depreciation and amortization (EBITDA), net income and gross revenues. Revenues that would allow a carrier to cover the operating expenses and 15% of the cost of investment in information infrastructure are calculated and compared against actual revenues. The figures clearly show that while the largest two carriers are able to recoup at least 15% of their costs of investment in most years, the next two largest carriers are weighed down by perennial losses in their operations.

Financial data for the other carriers are scarce but one could reasonably expect the smaller carriers to be in no better shape than their counterparts with larger revenue base.

Table 2. Financial Performance of Major Carriers
(billion pesos)

	2000	2001	2002	2003	2004
Largest two carriers					
EBITDA	21.8	34.6	46.8	58.1	77.3
Net income	1.2	7.0	9.9	21.5	39.2
Actual gross revenue	80.7	115.9	126.0	147.2	181.9
Required gross revenue to recover 15% cost of money	93.0	112.3	110.2	118.7	148.5
Difference between actual and required gross revenues	-12.3	3.7	15.8	28.5	33.4
Next two largest carriers					
EBITDA	2.6	1.6	0.8	-4.2	
Net income	-3.2	-5.4	-5.6	-9.0	
Actual gross revenue	10.5	11.6	10.5	10.3	
Required gross revenue to recover 15% cost of money	15.1	15.9	15.8	17.7	
Difference between actual and required gross revenues	-4.6	-4.3	-5.4	-7.4	

Question 2: Do you support the assessment that the balance of market power in the industry is highly skewed? To what extent are the current financial difficulties of most carriers (except for a few large ones) affecting the state of market competition and future development of the industry?

Trend 2: The precarious financial condition of non-dominant licensees is less a consequence of the smallness of their subscribers' base than a product of unregulated price squeezing behavior of the dominant licensees.

A price squeeze occurs when a major vertically integrated supplier sells inputs to its downstream competitors at a price so high, relative to its own retail price, that they cannot be expected to compete profitably in the same retail market. It can occur when operators with market power control certain activities that are key inputs for competitors in downstream markets and where those same key inputs are used by such operators or their affiliates to compete in the same downstream market.

In the telecommunications market, for example, a dominant firm can deliberately effect a price squeeze on a smaller competitor under a setup where the price of an intermediate good (e.g. the access charge) is negotiated. The determination of access charge, in this example, creates a competitive risk especially to potential entrants if the incumbent raises access price and lowers the final product price (which its competitors must match if they are to compete), thereby putting a price squeeze on new entrants.

In the context of the Service Area Scheme (SAS), the issue of price squeezing is particularly relevant. Since the onset of competition in the Philippine telecommunications sector, non-dominant licensees have been remonstrating that unless the Commission acts upon the access charge imposed by the incumbent, the cross-subsidy business model of the SAS would not be tenable.

Note that the viability of segmenting the market and imposing service obligations on carriers under SAS was premised on the feasibility of using domestic and international toll revenues to subsidize fixed line services. And indeed, SAS was viable at the start of the local exchange rollout in 1996, when the accounting rate was as high as \$1.20 and the incumbent's (PLDT) access charge was \$0.35, thereby providing carriers with a margin of \$0.25 per minute of international call to finance the rollout.

In subsequent years, however, the accounting rate declined with the advent of new technologies that made it easier to bypass the system. New carriers would have been able to adjust to the collapse of the accounting rate system were it not for the fact that the incumbent kept its access charges high. Specifically, the accounting rate has fallen faster than the incumbent's access charge, thereby squeezing the margins of the IGF operators.

The same trend was apparent in the IXC market where bypass technologies and mobile services are exerting downward pressure on national long distance rates. The unregulated access charge of the dominant licensee in the face of declining international and long distance rates deprived the smaller carriers of resources for roll-out and for posing effective competition against the incumbent.

In addition, the Commission's mandate on all carriers to provide indirect access to each other's network has also been rendered ineffective because the high access charge precludes one carrier from viably carrying another carrier's traffic.

In 2002, when the incumbent raised and pegged the access charges to US\$0.12 for fixed line and US\$0.16 for mobile services, it became doubly difficult for smaller IGF operators to remain viable amidst the continuous downward pressure on settlement rates. Consequently, one's IGF operation could only be as large as one's subscribers' base. This goes as well for the IXC business. Given the high concentration in fixed line and CMTS markets, competition in the international and domestic toll business is now limited to the few carriers with significantly numerous subscribers.

Question 3: Do you agree that unchecked vertical price squeezing behavior by dominant licensees has been mainly responsible for the financial woes of smaller carriers? How are smaller carriers coping with price squeeze? What market opportunities are still open smaller carriers if the price squeeze continues?

Trend 3: Horizontally integrated licensees are engaged in cross-subsidization to stem the churn out from fixed to mobile services, to the detriment of non-integrated licensees.

Fixed line service providers that are not licensed to provide mobile services are increasingly disadvantaged by their competitors with mobile service licenses. In recent months, the Commission has received numerous complaints of predatory pricing against certain carriers whom are perceived to be using revenues from their mobile services to support their market strategies in the fixed line market. At the heart of this issue is that the shift in consumer preference from fixed to mobile phone services which, by itself, has rendered it difficult to sustain the financial viability of wired services.

Yet the shift in preference was largely unanticipated at the time SAS was designed. Neither was it envisioned that the mobile service market would have evolved to become less competitive than the fixed line market.² Thus, while the SAS sanctions cross-subsidy of fixed services using revenues from mobile services, it was envisaged under a different market environment. To use revenues from one service market subject to less intense competition to cross-subsidize one's conduct in another service market subject to more intense competition does not constitute *per se* anti-competitive conduct. But, if a carrier

² The reverse is true in most economies, *i.e.*, fixed line market is less competitive than mobile service market as the entry barrier in the former is higher.

holds substantial power in one market and takes advantage of such power by cross-subsidizing its service offerings to hinder or substantially reduce competition in another market, then its conduct must be construed as improper.

Cross-subsidization inevitably puts downward pressure on prices of the subsidized market, thereby benefiting consumers. The benefits however may only be temporary if the long-term impact on competitors is to weaken them to such extent that they are unable to pose effective and sustainable competition, or worse, to induce their eventual exit in the market. Moreover, the resultant fierce price competition may not only prevent competitors from acquiring new customers. It may also curtail their infrastructure investments. If the latter happens, then the unfettered cross-subsidization of services could frustrate not only market competition, but also universal service.

Question 4: How accurate is the above description of cross-subsidization of services by integrated licensees? What indicators may be used to detect cross-subsidization? How can non-integrated licensees overcome their market disadvantage if vertically integrated licensees are permitted to continue cross-subsidizing their services?

Trend 4: Large carriers appear to be leveraging their control of the last mile into the unregulated value-added service market.

In recent years, the growing demand for internet and data services has enticed major carriers to engage in value-added services, particularly internet services. As shown in Table 3, the share of data services in the revenues of large carriers is still modest. But as the growth of wireline revenues tapers, while that of data services surge, large carriers can be expected to become more aggressive in their VAS undertakings.

Table 3. Revenues of Four Largest Carriers

	2000	2001	2002	2003	2004	Average annual growth %
<i>(Billion pesos)</i>						
Wireline	56.8	59.2	57.6	58.5	61.0	1.3
Wireless	31.6	55.6	75.2	110.6	130.3	42.3
Data* and internet	3.0	2.8	3.7	5.3	6.8	26.0
Total	91.4	117.7	136.5	174.4	198.2	21.5
<i>Share (%)</i>						
Wireline	62.2	50.3	42.2	33.6	30.8	
Wireless	34.6	47.3	55.1	63.4	65.8	
Data* and internet	3.2	2.4	2.7	3.1	3.4	

*Over wireline only.

In the past, the Commission has not been keen on monitoring the impact of large carriers' presence in the VAS market, not the least because this market has always been regarded competitive because of low entry barriers. However, the growing concentration of the VAS market, coupled with the increasing dominance of carrier-affiliated service providers that could be inferred from the exodus of small ISPs, has become a matter of interest for the Commission.

The concern of the Commission is whether the large carriers are using their control of the local loop to inhibit independent service providers from competing. It has been alleged that the wholesale price of access input (E1/R2 lines) that the incumbent carrier charges to independent ISPs bars the latter from competing effectively. This is because the margin between the retail price for VAS charged by the incumbent's affiliate and the incumbent's wholesale price for access input is too narrow to allow independent ISPs to remain viable (in other words, effecting a price squeeze as discussed previously).

Ascertaining the validity of the allegation requires the Commission to determine the reasonable costs of transforming the access input into retail service. In an ideal scenario, such costs combined with the wholesale price of access input should not exceed the retail price of the carrier's affiliate. Otherwise, the carrier can be deemed to have overpriced the access input and/or underprice its retail service, with the intent of hindering or reducing competition.³

Unfortunately, the Commission cannot make such an imputation without information on the "reasonable" costs of providing VAS, *i.e.*, the cost of a service provider that is "equally efficient" as the carrier's affiliate. Neither has the Commission enforced strict accounting separation on vertically integrated carriers so they may be required to supply information that would reveal if the affiliate would have covered its production costs if it had to buy access from its parent.

Whether due to the Commission's failure to respond to said charge against large carriers or a natural outcome of market competition (less efficient providers bowing out of the race), the fact is that only about 5 independent ISPs are believed to have the capacity to compete against carrier-based ISPs.

Question 5: Is there support for the view that large carriers have used their control of the last mile to favor their affiliates at the expense of independent ISPs? What evidence may be offered to boost this claim? What regulatory intervention is required to enable independent ISPs compete against carrier-affiliated ISPs?

³ This is the imputation test used by the Australian Competition and Consumer Commission (ACCC) to detect vertical price squeeze.

III. Four Major Policies to Level the Playing Field

The apparent trends discussed in the preceding section point to the core of market competition problem in the industry – the hitherto unchecked behavior by some dominant carriers of leveraging the power that they hold in one market into another. This has resulted in various forms of abuses of market positions and unfair practices such as cross-subsidization, predatory pricing, and vertical price squeeze, among others. The lack of effective competition in one market has spilled over into another, thereby transforming markets such as VAS that used to be fertile ground for competition by small- and medium-sized service providers into a concentrated, carrier-dominated market.

Thus, all three submarkets in the industry can now be considered dominated by a few vertically and horizontally integrated service providers.

To address the current imbalance of market power, the Commission is contemplating the implementation of four major policies that have been used with success in other regulatory regimes to facilitate and promote effective and sustainable competition in the information and communications technology sector. Specifically, these policies constitute what the Commission is presently inclined to believe are necessary and deliberate steps to promote competition where it is currently ineffective or unsustainable, and to introduce competitive safeguards to protect non-dominant providers against the unreasonable exercise of market power by dominant providers.

Policy 1: Impose Significant Market Power (SMP) obligations

In other jurisdictions, the current Philippine situation as characterized by the trends discussed above would have clearly called for imposition of heavier regulatory obligation on service providers who occupy dominant positions, compared to those imposed on non-dominant providers.

The rationale for unequal treatment of dominant and non-dominant licensees is well accepted in many regulatory regimes. Singapore, Malaysia, Hong Kong, and EU are few examples of regimes that recognize the need for different regulatory treatment of dominant licensees to balance the distribution of market power, and thus make competition more effective and sustainable. It is considered judicious of regulator to distinguish between licensees whose conduct are not constrained adequately by competitive market forces (dominant service providers) and those that are subject to competitive market forces (non-dominant service providers). The former is made to comply with more stringent regulatory requirements, while the latter operate under minimum regulatory rules, but are nonetheless subject to ex post enforcement of competition rules.

Where competition has been rendered ineffective by the dominance of some licensees, regulators of Hong Kong, UK, Singapore and Malaysia, to name a few, consider it

expedient to impose obligations on dominant licensees to provide competitive safeguards for non-dominant licensees.

In adopting this policy, two issues emerge:

- (a) the determination of dominance or significant market power (SMP), and
- (b) the specification of obligations on dominant licensees.

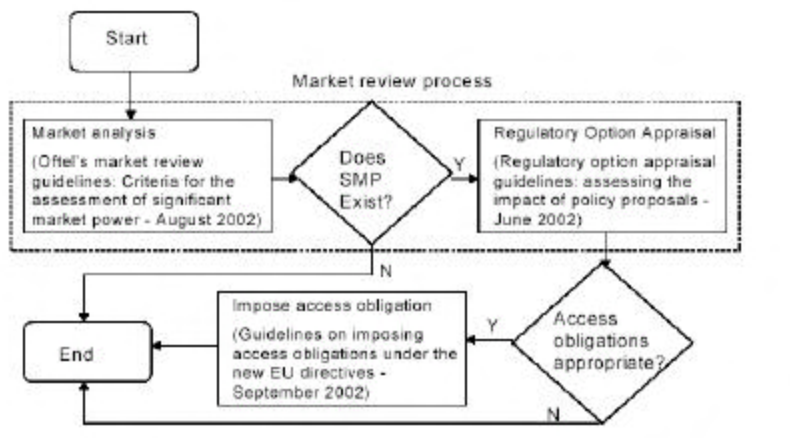
Determining Significant Market Power

There is broad agreement on the principles that can be applied to determine dominance or SMP (even though the actual implementation may vary in different regulatory regimes). Dominance is regarded as a position of economic strength that allows its holder to make market decisions appreciably independent of considerations for competitors and consumers. Simply put, a dominant licensee is not subject to competitive market forces.

To determine if a licensee stands impervious to market forces requires an incisive assessment of the market, taking account of both actual and potential competition. A host of criteria is therefore used to determine dominance, among them: market share, control of bottleneck infrastructure (that which is not easily duplicated but required for delivery of various services), technological superiority, consumer power, economies of scale and scope, and vertical integration.

Of these, market share is widely considered as the most transparent indicator of SMP. In the European Union, for example, a market share of 40% gives rise to a presumption, but not conclusion, of SMP. If such share is however declining or fluctuating over time, it is taken as indication of lack of SMP. On the other hand, a market share of less than 25% is deemed insufficient for a licensee to behave as if it were unaffected by market forces.⁴

⁴ The graph below shows the relevance of determining SMP in terms of imposing access obligations under the new European Union directives.



A licensee's dominance is evaluated in reference to a specific product or service market, thus the definition of a market is also relevant. Defining a relevant market requires technical consideration of demand and supply conditions. However, in cases where a licensee is able to leverage the power it holds in one market into another (horizontal or vertical) market, then its dominant position is deemed to apply on both. That this is the case in the Philippines, as elaborated in the preceding section, tends to simplify the task of defining the scope of market dominance.

Specifying SMP Obligations

Perhaps a more contentious issue is specifying the obligations of dominant licensees. In Singapore, these obligations are stipulated in the Telecommunication Act. Among the "duties" ascribed to dominant licensees, in addition to those applicable to other licensees, are:⁵

- ~~///~~ Duty to provide service at just and reasonable prices, terms and conditions
- ~~///~~ Duty to provide service on a non-discriminatory basis
- ~~///~~ Duty to provide unbundled telecommunication services
- ~~///~~ Duty to provide service on reasonable request
- ~~///~~ Duty to allow resale of end user telecommunication services
- ~~///~~ Duty to allow sales agency to resell end user telecommunication services
- ~~///~~ Duty to file tariffs with the regulator and to obtain approval prior to offering or modifying the terms of its offerings of certain services, among them end-user, resale and wholesale
- ~~///~~ Duty to publish tariffs
- ~~///~~ Duty to provide service consistent with effective tariffs
- ~~///~~ Duty to develop a Reference Interconnection Offer (RIO)
- ~~///~~ Duty to publish all interconnection agreements⁶

The additional burdens imposed on dominant licensees are designed not only to provide competitive safeguards to non-dominant licensees, but also to facilitate the entry of new service providers, specifically by allowing resale of services. Moreover, while the competition law implicitly requires all licensees (dominant and non-dominant) to offer services at "just and reasonable prices, terms and conditions", mandating this principle explicitly on dominant licensees recognizes the market leadership that the latter assumes. Note that non-dominant competitors are cannot set prices, terms and conditions that are less attractive than those offered by dominant licensees. Compelling dominant licensees to make such a service offering is tantamount to requiring the whole industry to follow the same.

⁵ Sections 4 and 6 of the Telecommunication Act (Chapter 323): Code of Practice for Competition in the Provision of Telecommunication Services 2005.

⁶ At the request of either of the licensees, the IDA may withhold publication of any portion of an interconnection agreement "if IDA determines that it contains proprietary or commercially sensitive information" (Section 6.5 of Telecommunication Act, emphasis mine).

Perhaps the most significant obligation imposed on the dominant licensee by the Singaporean regulator (Info-communications Development Authority, IDA) is the development of RIO, the terms of which it has to approve. Non-dominant licensees have the option of obtaining interconnection-related and mandated wholesale services from the dominant licensee by accepting the RIO, or by negotiating an individualized interconnection agreement.

As a default mechanism, therefore, the RIO is a means of ensuring that the dominant licensee provides interconnection on non-discriminatory terms to its competitors. Since the terms of the RIO have to pass regulatory scrutiny, unfair terms and conditions of interconnection are avoided, thereby affording protection to non-dominant licensees who are often at the short end of the bargaining for interconnection.⁷ Moreover, the availability of RIO cuts short the often long, tedious and costly interconnection negotiations.

Finally, obligating dominant licensees to publish access prices and interconnection agreements, combined with the regulator's exercise of its powers to approve prices of end-user, resale and wholesale services, will prevent the kind of anti-competitive behavior that large carriers are accused of.

Question 6: Do you agree that additional regulatory burdens should be placed on dominant licensees in order to ensure effective and sustainable competition in the ICT market? What criteria may be used to determine dominance? How should markets be defined for purposes of determining dominance? What obligations should be imposed on dominant licensees to be able to effectively counter-balance their market power? Do you think the idea of a Reference Interconnection Offer would be useful and relevant in the Philippine context?

⁷ A standard RIO could contain the following:

- /// Description of the services and facilities to be provided, including their technical characteristics;
- /// Location of the points of interconnection and access and of other associated facilities;
- /// Technical standards for access and interconnection;
- /// Conditions for access to supplementary and advanced services (including support systems, information systems or databases for pre-ordering, provisioning, ordering, maintenance, and repair requests and billing);
- /// Ordering and provisioning procedures;
- /// Changes, terms of payment, and billing procedures;
- /// Traffic management;
- /// Maintenance and quality of interconnection and access services;
- /// Measures to ensure compliance with requirement of network integrity;
- /// Intellectual Property Rights (IPR);
- /// Dispute resolution procedure between parties before requesting national regulatory authority intervention;
- /// Duration and renegotiation of agreements;
- /// Rules for allocation between operators where supply is limited;
- /// Standard terms and conditions of supply.

Policy 2: Mandate unbundling of network elements

The Commission has considered mandating the unbundling of network elements since early 2000, as a policy tool for promoting competition. The issue of opening access to carriers' networks is even more relevant now, in light of the Commission's recent regulatory pronouncements regarding Voice over Internet Protocol (VoIP) which would allow VAS providers to offer VoIP. Without an unbundling mandate that would open access by VAS providers to carrier networks, there is a risk that the VoIP rules will only be rendered inutile.

In simplest terms, unbundling refers to the provision of network elements on a stand-alone basis. The owner (access provider) may offer its network "bundled" on a "take-it-or-leave-it" basis; or "unbundled," thereby allowing a service provider (access seeker) to choose only the specific network elements that it requires.

Network elements that could be unbundled include access lines (local loops and related functions), local switching functions, tandem switching function, inter-exchange transmission, access to signaling links and signal transfer points, access to call-related databases, central office codes, subscriber listings, operator services, directory assistance functions and operations support systems (OSS) functions. The most important of these elements is the local loop or so-called "last mile."

It should be noted that unbundling is among the regulatory principles enunciated in the WTO Reference Paper that suggests an incumbent should be made to provide interconnection to competitors on a sufficiently unbundled basis so the latter would avoid charges for components that they do not require for delivering their services.⁸

An unbundling policy is viewed pro-competitive because it would lower technical and economic barriers to entry by allowing a new operator to obtain some components of its network from the incumbent, while building the other components. It likewise promotes efficiency by avoiding the unnecessary duplication of investments. Deployment of new services is also encouraged since service providers can combine new technologies (*e.g.* ADSL and IP data/voice switches) with components of existing networks (*e.g.*, access lines).

However, compelling the incumbent to unbundle could dampen the incentive of new operators to invest in their own facilities. It is argued that the limited or non-availability of unbundled loops will compel entrants to invest in alternative network like fixed wireless or mobile. Moreover, if unbundled elements are priced below costs, it may also weaken the incumbent's incentive to enhance its own facilities. Thus, while an unbundling policy may promote competition for delivery of services in existing network

⁸ The Philippines is among the 69 countries that have adopted the Reference Paper, although the Philippine Congress has yet to ratify the Fourth Protocol.

(service-based competition), it may however inhibit facility-based competition, which could stifle the development of the industry in the long-run.⁹

The tension between lowering entry barriers on the one hand, and undercutting incentives for infrastructure investment, on the other, has divided regulators on the virtue of mandating unbundling. In the OECD, for example, only 23 of its 30 member economies have introduced local loop unbundling (LLU).¹⁰

In practice, several versions of unbundling policy exist. Some countries, for example, mandate “transitional unbundling,” *i.e.*, only for a limited period to “jumpstart” competition. In others, “selective unbundling” is implemented, *i.e.*, unbundling access to some network components but not all. Experiences of developed countries in unbundling now suggest that while unbundling policy is sound, it should be limited to essential (bottleneck) facilities so as not to distort incentive to invest in infrastructure.¹¹

Local Loop Unbundling (LLU)

Local loop is an example of an essential facility. Where the incumbent remains dominant in the local loop, an unbundling policy is considered imperative in introducing effective competition. That is the case in Singapore where the incumbent Singtel still controls nearly 100% of fixed lines even after the market has been fully opened to entry.

The Singapore regulator requires Singtel to offer unbundled network elements (UNE) and unbundled network services (UNS) as part of its dominant licensee’s obligation. Four network elements have been identified for mandatory offering: (i) local loops, including feeder, distribution, distribution point and inside wiring; (ii) sub-loops and associated distribution points; (iii) line sharing or loop spectrum which allows an interconnecting operator to deploy DSL services over Singtel’s network; and (iv) distribution frame access to allow interconnecting operator to cross-connect the loop to its equipment. However, only two services have been stipulated for UNS, namely, provision of access to emergency services call centers, and the addition of local telephone location data to the emergency services database.

In Korea, LLU policy is credited not only with promoting competition in the local access market, but also for accelerating the roll out of broadband services, including internet, e-commerce, video and other data services. Indeed, competitive provisioning of broadband services is feasible only with open access to the local loop.

⁹ As a policy goal, facility-based competition is considered superior to service-based competition since the former is believed to create more demand, stimulate more innovation and maximize efficiency compared than the latter.

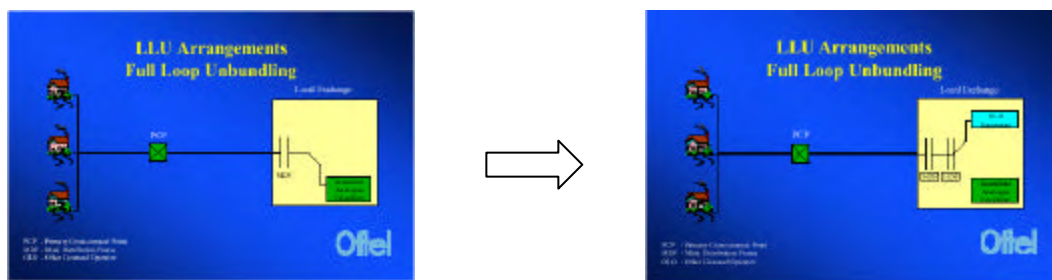
¹⁰ As of end of April 2002 (Malaysian Communications and Multimedia Commission, 2003).

¹¹ The rationale for this suggestion is the following: not only is it uneconomical for every service provider to duplicate such type of facility or infrastructure (because of strong scale economies), but the owner of an essential facility has also the opportunity to monopolize complementary or downstream segments. The unbundling policy is designed to counter-balance the power of the essential facility owner.

Local loop can be unbundled in several ways depending on the depth of access that the network owner is willing or mandated to provide. Four broad types of LLU are described as follows:

✍ Full unbundling gives the interconnecting party full access and control over the local loop, *i.e.*, access to copper bcal loops terminating at the local switch and sub-loops terminating at the remote concentrator or equivalent facility. In this form of unbundling, the link between the main distribution frame and the local switching equipment on the access provider’s premises is re-routed and connected to the interconnecting operator’s switch.

WE CAN PLACE GRAPHS LIKE THESE BELOW TO ILLUSTRATE THE LOCAL LOOP UNBUNDLING

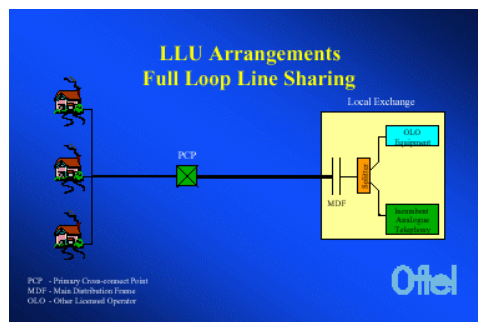


Before Full-Unbundling

After Full-Unbundling

Local Loop Unbundling Factsheet, OFTEL

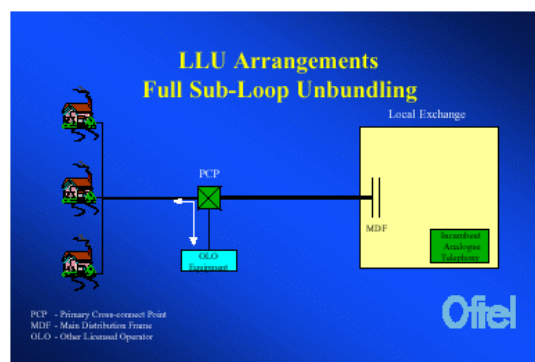
✍ Line sharing involves the shared use of the copper loop. This form opens the access only to the high-frequency spectrum of the local loop. Nonetheless, it permits competitive provision of Digital Subscriber Loop (DSL) systems and services. The access provider and interconnecting operator can provide services over the same loop. For example, a customer can retain the former as its telephone service provider and at the same time, select the latter to provide high-speed internet service over the same loop.



✍ Bitstreaming limits the access to high-speed bit stream. The network owner would have to install a high-speed access link to the customers’ premises and

make it available to the other operators to enable them to provide high-speed services. Technically, bitstream access can be provided to any transmission system since it only requires reservation of a specified bandwidth instead of dedicated use of a physical loop. Thus, this form of unbundling does not require the access provider to provide physical access to its loop and therefore it is able to retain control over its network.

Access to sub loop provides the interconnecting party access to the network in between the main distribution frame and the customer premises equipment. This type of access is required for very high bandwidth services that can only be transmitted in short distance on the copper cable. Because the technical issues for establishing sub loop access are too complex to regulate, only a few regulators (such as the EU) have implemented this type of unbundling.



The effectiveness of local loop unbundling in promoting competition depends largely on the manner of its implementation. The regulator may require full unbundling, or it may simply mandate loop access without specifying the type of access arrangement. If unspecified, a network owner will likely limit the access to high-speed bit stream, as what local carriers are offering VAS providers.

The Commission notes, however, that even with bitstreaming type of unbundling, a network owner could delay the installation of high-speed access link until it is able to provide high-speed access services. Independent ISPs have complained to the Commission in the past about the delays by one carrier in installing high-speed access link, purportedly to give time to its ISP subsidiary to establish its base in the market. Whether this is true or not, the Commission is inclined to believe that a policy that does not specify the form of local loop unbundling required on incumbent would have limited value.¹²

¹² In Malaysia, the absence of a clear-cut mandate on the incumbent Telekom Malaysia to unbundle its local lines allows its subsidiary, TMNet, to control 70 percent of the internet service market.

Apart from specifying the network elements to be unbundled, a policy on mandatory unbundling has to contend with two other issues: collocation arrangements and pricing of unbundled network elements and collocation space. These issues are not covered in this Consultation Document. The Commission intends to flesh out their details in a separate document on interconnection as part of the second phase of this initiative, sometime in the first quarter of 2006.

Question 7: Will a policy of mandatory network unbundling improve the balance of market power in interconnection negotiations? Which network elements should be unbundled? What type of local loop unbundling should be mandated? How can the regulator enforce network unbundling effectively?

Policy 3: Allow for resale of services

The opportunity to resell services that would have been otherwise offered by carriers arises when the latter are required to offer them at wholesale or discounted rates to competitors who can then sell them to their own customers. Clearly, such opportunity will arise only if the regulator requires carriers to make their services available for resale.

The market benefits of allowing resale has been demonstrated in a number of other countries, including the United States. For one, it facilitates entry of new service providers that may initially lack the capital to build their own networks. Resale allows them to engage in arbitrage, *i.e.*, purchasing a large volume of minutes or calls at a quantity discount and reselling them to small customers at prices lower than the retail prices offered by established carriers. Alternatively, resellers may obtain some services from established carriers and combine them with their own. Ultimately, the result is a downward pressure would be exerted on market prices, while consumers are feted to a wider array of service offerings.

Resale has also been found to spur the usage of existing networks. This is a consequence of demand created by new service providers who would have to be innovative in bundling services in order to attract customers. Thus, given the huge excess capacity on their networks, non-dominant carriers that are finding it difficult to expand their subscribers' base could find in resale an opportunity to recoup sunk investments incurred in their network roll-out.

Question 8: Will creating an opportunity for resale make the markets more competitive? Should the obligation to create an opportunity for resale be applied only to dominant licensees? What market benefits can be expected to accrue to non-dominant licensees if they allow for resale of their services? How much margin between the wholesale and retail prices of services is necessary for resale to be viable?

Policy 4: Enforce *ex post* regulation of prices

The Commission is also considering the streamlining of its current pricing regulatory framework by limiting *ex ante* regulation to dominant licensees and subjecting all others to *ex post* regulation. *Ex ante* regulation refers to the current policy of requiring licensees to seek regulator’s approval before launching any tariff, discount or similar price promotion. In contrast, *ex post* regulation refers to the determination of whether a tariff or other pricing strategy constitutes anti-competitive conduct and therefore must be sanctioned, only after such tariff or strategy has been adopted.

Under such a pricing regulatory framework, only dominant licensees would be required to seek *prior* approval from the regulator for any discount or price promotion; other licensees engaging in similar price adjustment would only have to provide the Commission with advance notification.

The above notwithstanding, the Commission may initiate an enforcement action against any licensee, either on its own motion or at the request of a private party, if it finds reason to suspect that the price conduct of the licensee has an adverse impact on competition. In such a case, the Commission will notify the licensee and conduct an investigation. If the licensee continues with its conduct, then it must then bear the risk of penalties that would be imposed should the investigation validate the initial findings of the Commission.

This shift in pricing paradigm is consistent with the proportionality principle, articulated by the European Commission and adhered to in advanced regulatory regimes. This principle calls for policy measures that are “proportionate” to the objectives. Applied to pricing regulation, if the intent is primarily to curb abuse of market power, then accordingly, the regulation should focus on the licensee who has capacity to commit the abuse.

Moreover, *ex ante* regulation should only be imposed on a licensee whose actions are not restrained by competitive forces and where *ex post* remedies are not sufficient to reverse the impact of the conduct on market competition. In the case of a non-dominant licensee, although its conduct may have the effect of inhibiting or restricting competition, the fact that it is non-dominant suggests that it has neither the market scale nor deep pockets to affect market competition to a degree that cannot be corrected or reversed by the retrospective application of regulation. Proportionality also implies that *ex ante* pricing regulation may be completely withdrawn if a given market is deemed sufficiently competitive.

In applying competition principles in pricing regulation, two issues have to be addressed by the Commission:

- (a) the appropriate competition test to apply, and
- (b) the standard of proof question.

On the former, the inquiry is what conduct may be considered to have the “purpose or effect of preventing or substantially restricting competition,” and therefore should trigger regulatory action.¹³ Some types of conduct, such as price fixing, fall ostensibly under such a classification, but others are less easy to discern.

The other issue deals with question of standard of proof. In Hong Kong, the Office of Telecommunications Authority (OFTA) has adopted the civil standard of proof, *i.e.*, the regulator decides on the “balance of probabilities.” Having decided that given the available evidence, the conduct of the licensee is more likely than not to constitute anti-competitive behavior, the action against the licensee is initiated. If the licensee could offer evidence to the contrary, the regulator will consider the claim and verify it to the extent possible. The regulator is however not required to offer a counter-proof to the claim if it decides to reject it.

Question 9: Is the paradigm shift in pricing regulation as described above tenable in the Philippine context? Which services should still be subject to *ex ante* price regulation? How can *ex post* price regulation be effectively enforced? Is a standard of proof similar to that applied in Hong Kong appropriate in the Philippine setting? Are there any other standards that might better apply?

¹³ This phrase is commonly used by different jurisdictions in defining anti-competitive practice, see for example, Section 7K of the Telecommunications Ordinance of Hong Kong.

IV. Four Regulatory Handicaps of the Commission

The difficulty of the Commission to offer immediate and effective response to developments that are ostensibly threatening competition, such as those noted section I, can be traced to a number of handicaps. At least four of these constraints stand out, namely: resources, legacy of past lapses, regulatory powers and information.

In discussing these issues, it is not the intent of the Commission to absolve itself from its past remissions or present responsibilities. Rather, it is to put in perspective a plan of action (outlined in the next section) to address them.

Handicap 1: The Commission lacks resources to govern effectively and achieve its mandated goals.

Regulatory oversight over the telecommunications industry requires possession of considerable number of professional staff, modern equipment, fairly adequate information database and political independence – all of which the Commission lacks or has insufficient and inadequate numbers. The Commission needs greater technical expertise to manage spectrum efficiently, to monitor the service quality being provided by licensees, to enforce technical standards, and to discern when any diminution in competition is in fact a consequence of improper conduct by any licensee.

It may be argued that budget limitation is inherent of government institutions in a developing country. But elsewhere, regulatory agencies have managed to resolve the funding problem (as well as the associated issue of political independence) by resorting to a variety of funding mechanisms, *e.g.*, licenses, spectrum fees, regulatory taxes, and fees for allocating numbering resources.

The Commission however is constrained to a single source of funding, *i.e.*, government appropriation. None of the supervision and license fees that it collects is retained in the agency. And while the Commission's collection of fees has increased 12-fold over the decade since 1992, its budget has only doubled in the same period. Given that the complexity of regulatory issues grows proportionately with the size of the industry, the growing disparity between the demands on the Commission and its capacity to respond can no longer be ignored.

Handicap 2: Past regulatory lapses and policy flaws are undermining the credibility and effectiveness of the Commission as regulator.

In the past, the Commission has taken a mediatory stance on most issues brought to its attention. Some stakeholders have viewed such response as inadequate from a regulator whom they expect to check against abuses of market power. The Commission's forbearance on infractions of some licensees has also worked against its credibility as regulator. For example, when the Service Area Scheme (SAS) participants defaulted in

their obligations, the Commission had the recourse of revoking their provisional authority to operate, but it did not. It does not help that some of the policies that the Commission is made to enforce are problematic, such as the SAS.

The legacy of these lapses in regulation is the erosion of confidence in the Commission's capacity to resolve disputes and correct market failures. The Commission recognizes that a number of stakeholders may become reluctant (if they are not already so) to bring matters to the Commission if they cannot expect to obtain just relief. This state of affairs has permitted patent exercises of market power to remain unsanctioned, distorted market incentives and encouraged collusion.

Handicap 3: Limits to the constitutional and statutory powers of the Commission exist and are significant.

Three pieces of legal and regulatory issuances rightly deemed competition as the most efficient mechanism for providing incentives for firms to expand their networks, introduce new technologies and services, and embark on new business ventures, to benefit both their own as well as the consuming public's interests:

- ?? Executive Order 59, issued in 1993, which mandated the compulsory interconnection of authorized public telecommunications carriers in order to create a universally accessible and fully integrated nationwide telecommunications network;
- ?? Executive Order 109, issued a few months after the implementation of Executive Order 59, which required all cellular mobile telecommunications services (CMTS) operators to install at least 400,000 telephone lines within three years, and international gateway facility (IGF) operators to put up 300,000 lines within five years; and
- ?? The Public Telecommunications Policy Act of the Philippines (RA 7925) which complemented Executive Orders 59 and 109, and laid down the foundation for the administration, conduct, and direction of the telecommunications industry.

At the heart of these issuances, and the resultant and undeniable success, was a conscious policy choice to promote competition, institutionalized through RA 7925 which provided that:

A healthy competitive environment shall be fostered, one in which telecommunications carriers are free to make business decisions and to interact with one another in providing telecommunications services, with the end in view of encouraging their financial viability while maintaining affordable rates. (RA 7925, Art. II, sec. 4(f)).

Ironically, the very same legal instruments, including the Constitution, which provided the critical spark to the liberalization and fostering of competition in the Philippine

telecommunications market now appear to limit, if not hamper the continued development of, and increased competition in the ICT sector. The commercialization of new technologies, particularly those built around data and internet protocol technologies, are delayed if not actually proscribed, by unclear or technology-specific rules, often frustrating government's desires to further promote competition.

The Constitution

In the context of competition policy, there are two points worthy of note in the Constitution.

First, the Constitution explicitly deals with and espouses competition in its provision on monopolies and combinations in restraint of trade under Section 19 of Article XII (National Economy and Patrimony) which states that

(t)he State shall regulate or prohibit monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed.

Similarly, Art 16 (General Provisions) Section 11 provides that

Congress shall regulate or prohibit monopolies in commercial mass media when the public interest so requires. No combinations in restraint of trade or unfair competition therein shall be allowed.

The Constitution, in other words, does not prohibit monopolies per se, but rather specifies a public interest test for regulating monopolies. Moreover, the Constitution makes a specific declaration that unfair competition shall not be allowed, presumably by firms with monopoly or market power.

The second point that should be noted, and which was likely unforeseen by the crafters of the Constitution as regards its now evident impact on competition in the ICT sector, relates to the Constitutional provisions on the ownership of public utilities and mass media.

Article 12, sec. 11 of the Constitution provides that

No franchise, certificate, or any other form of authorization for the operation of a public utility shall be granted except to citizens of the Philippines or to corporations or associations organized under the laws of the Philippines at least sixty per centum (60%) of whose capital is owned by such citizens...

x x x

The participation of foreign investors in the governing body of any public utility enterprise shall be limited to their proportionate share in its capital, and all the executive and managing officers of such corporation or association must be citizens of the Philippines.

On the other hand, Art. XVI, sec. 11 provides that

The ownership and management of mass media shall be limited to citizens of the Philippines, or to corporations, cooperatives or associations, wholly-owned and managed by such citizens.

These provisions reflect the traditional legal provisions that regulate different ICT-related industries (i.e., telecommunications, cable, broadcast, value-added service, mass media companies, and arguably even power) separately and differently.

Technology, however, has not been limited by such artificial separations, and has now blurred the differences between those industries. It is now technically, if not legally, possible for players from these various industries to compete among and between each other. Telecommunications companies could, for example, provide mass media services and content, just as cable companies can now easily provide internet-related services, including voice over IP telephony.

These possibilities bring with them new challenges to the Commission; and the ownership limitations prescribed by the Constitution effectively limit, or at least cloud the business and investment possibilities that are now possible in this era of convergence. Suffice it to say, for now, that while there is a consensus between government and market players that full-blown competition between ICT players is, in principle, a desirable outcome, competition in the Philippines must flower – for better or worse – under such limitations as effectively mandated by the Constitution and related laws that reflect similar constraints.

Statutory Overview of Competition-Related Statutes and the ICT Sector

The principal statute governing the regulation of telecommunications providers, RA 7925, contains several pertinent declarations related to the interplay between market conduct of regulated firms, national policy and optimal regulations.

Article II, Section 4 paragraph (f) of RA 7925 declares as a matter of national policy that competition shall be fostered and in such a way as allow carriers to make economic decisions that will assure both their financial viability and rates that are affordable to end users. Thus, it states that:

...a healthy competitive environment shall be fostered, one in which telecommunications carriers are free to make business decisions and to interact with one another in providing telecommunications services, with

the end in view of encouraging their financial viability while maintaining affordable rates...

R.A. 7925 also mandated the privatization of government-owned and operated telecommunications facilities, while deregulating rate and tariff fixing, and removing the 12 percent cap on rate of return.

Value-added services (VAS)¹⁴ providers are not regulated and needs only to register with the Commission, provided that they do not set up their own networks and rely solely on the transmission, switching and local facilities of enfranchised telephone companies.

In terms of determining end-user prices, traditionally, the industry adhered to a return on rate base (RORB) regulation, which set the maximum allowable return of 12% based on the net book value of property, plant and equipment plus working capital covering two months average operating expenses. RA 7925 eliminated the 12% ceiling but provided no basis for the determination of "fair and reasonable" rates. The industry has been pushing for rate rebalancing and metering. In the absence of a set of principles and concrete guidelines for rate setting, the resolution of these issues remains contentious.

By far, the most critical competition issue that has emerged from the liberalization of telecommunications is interconnection, which is required to enable subscribers of different carriers to communicate with one another or enjoy the services of other carriers.

Interconnection issues can also be expected to arise once VoIP is deregulated and VAS providers start offering the same to the public for compensation.

RA 7925 and its Implementing Rules and Regulations provide some guidelines but these have proven to be inadequate in resolving interconnection issues. The price of interconnection, which can take the form of an access charge or a share of the revenues, is not regulated. Instead, the determination of interconnection and access tariffs are left to negotiations between concerned parties. Being bilateral in nature, settlement of the terms of interconnection is determined by the relative bargaining strengths of the carriers. Access payments usually make up a significant portion of the operating costs of a new entrant (e.g., 30-40%) while it is a source of revenues for incumbents particularly in the beginning when the direction of calls is from subscribers of the new carriers to the subscribers of incumbents.

Congressional intent in leaving negotiations to the parties was probably driven in large part by its recognition of the Commission's above stated difficulty in attracting and keeping qualified personnel with varied managerial, financial, and technical expertise due to low civil service compensation. The lack of clear policy on access charges and

¹⁴ These refer to enhanced services beyond those ordinarily provided for by local exchange operators, inter-exchange operators, and overseas carriers, including internet services.

interconnection, nonetheless, can unfairly expose new entrants to strategic behavior (e.g. price squeezing) by incumbents.

For its part, the NTC now confronts the increasingly urgent need to formulate a framework that will guide it in resolving these issues and responding to the inevitable new ones that will arise in the future. Regulatory clarity – to the extent that it is possible – coupled with honest empowerment and capacity building that will allow the NTC to freely and effectively promote and/or manage competition in the sector is a prerequisite to the full growth and development of the ICT sector in the Philippines.

Handicap 4: The Commission lacks pertinent information on the operations of the regulatees.

All regulators contend with the fact that they have to depend mostly on information supplied to them by parties whom they regulate. Information asymmetry between a regulator and regulatee, *i.e.*, the former knowing less than the latter, is universal that not even progressive regulators have found ways to overcome.

The Commission however faces a severe information constraint in part due to its own neglect or failure to adequately exercise its regulatory powers to consistently and universally compel licensees to comply with reportorial obligations. Consequently, it does not have a database nor a system of information gathering that would allow it to more thoroughly analyze trends and make informed market intervention when necessary.

Question 10: Are there other constraints or handicaps that limit the ability of the Commission to regulate effectively? How can the Commission overcome these constraints?
--

V. Four Urgent Tasks of the Commission

Faced with the foregoing constraints, the Commission realizes the need for internal reforms to effectively implement the major competition policies outlined in Section II and to strengthen its institutional capacity to govern. Thus, simultaneous with the Commission's efforts to set the above stated policies in place, it also intends to begin undertaking the following measures:

Task 1: Assume a proactive regulatory stance on competition-related issues.

The Commission, in the exercise of its regulatory functions, must often balance, and sometimes even choose between, various public goals, including:

- ?? Achieving universal service by making affordable ICT services available to all citizens;
- ?? Ensuring that consumers have access to modern products and services that are of high quality, and corollarily are protected from fly-by-night providers; and
- ?? Elimination of the ability of any firm to exercise undue market power;

In the past, the Commission has largely exercised forbearance on issues of competition, choosing to leave the settlement of issues to the parties, where possible, and being involved only when called upon to do so by formal petition or complaint by any party.

In the context of the discussions above, and consistent with its statutory mandate as the "principal administrator" of R.A. 7925 and as such "to take the necessary measures to implement the policies and objectives" of the said law, including in particular the fostering of a "healthy competitive environment" and "full universal service," the Commission is now of the mind, and shall henceforth assume a proactive regulatory stance on competition related issues.

The issuance of this consultative document is, therefore, both a sincere effort by the Commission to involve all stakeholders in this ongoing process, and a first clear signal from the Commission of its desire to be more involved and deliberate in its efforts to promote competition in the ICT sector.

Task 2: Enforce strict reporting requirements on regulatees.

Further, the Commission shall more strictly monitor compliance with all required submission of reports and agreements from licensees. The Commission commits to be more diligent in ensuring licensees' compliance to their reportorial obligation, particularly those by dominant licensees. The Commission shall henceforth stipulate and enforce administrative sanctions for non-compliance.

Task 3: Strive to restore regulatees' confidence in the Commission.

The Commission is considering several measures to win back the confidence of stakeholders on the regulatory institution. The first shall be to exercise its statutory and administrative powers (including the imposition of appropriate sanctions and penalties) in order to credibly enforce policies. Another is to set time limits in resolving cases brought to the Commission.

The Commission shall continue to improve transparency of its regulatory conduct by publishing important decisions, regulations, consultations with stakeholders and other pertinent documents on the web. The Commission shall also continue to improve its mechanisms for soliciting and responding to public feedback and complaints.

Task 4: Work with the legislature to introduce changes in the regulatory structure.

In the forthcoming months, the Commission will exert maximum effort for the legislative body to consider its proposed law that aims to strengthen the regulatory capacity of the Commission. The NTC bill has sought, among others, fixed term of office for the Commissioners to shield them from political intervention, financial autonomy, and strengthening of quasi-judicial power. The Commission will also seek means to provide financial incentives to its personnel while improving the quality of its plantilla.

Question 11: Will the four measures enumerated above help the Commission improve its governance? What other measures should the Commission undertake to become more effective as a regulator?

VI. Conclusion

This Consultative Document lays down the major competition issues confronting the Philippine telecommunications industry. It should be clear that the major competition policies as well as the internal reforms that the Commission intends to pursue have a single objective, that is, to ensure that the market forces will eventually be allowed to perform the tasks of disciplining suppliers and delivering maximum benefits to consumers.

In this transition to competition, the Commission believes, and now seeks build broad stakeholder support behind such belief, that it must assume a more prominent and active role in leveling the playing field, and preparing the grounds for future market deregulation.

Below, to repeat, is a summary of the questions for which the Commission seeks input and comments from all ICT sector stakeholders:

1. Do you agree that the effectiveness and sustainability of market competition should be the overarching goal of the Commission? Is there other higher goal that should guide the Commission's undertaking?
2. Do you support the assessment that the balance of market power in the industry is highly skewed? To what extent are the current financial difficulties of most carriers (except for a few large ones) affecting the state of market competition and future development of the industry?
3. Do you agree that unchecked vertical price squeezing behavior by dominant licensees has been mainly responsible for the financial woes of smaller carriers? How are smaller carriers coping with price squeeze? What market opportunities are still open smaller carriers if the price squeeze continues?
4. How accurate is this document's description of cross-subsidization of services by integrated licensees? What indicators may be used to detect cross-subsidization? How can non-integrated licensees overcome their market disadvantage if vertically integrated licensees are permitted to continue cross-subsidizing their services?
5. Is there support for the view that large carriers have used their control of the last mile to favor their affiliates at the expense of independent ISPs? What evidence may be offered to boost this claim? What regulatory intervention is required to enable independent ISPs compete against carrier-affiliated ISPs?
6. Do you agree that additional regulatory burdens should be placed on dominant licensees in order to ensure effective and sustainable competition in the ICT market? What criteria may be used to determine dominance? How should markets be defined for purposes of determining dominance? What obligations

- should be imposed on dominant licensees to be able to effectively counter-balance their market power?
7. Will a policy of mandatory network unbundling improve the balance of market power in interconnection negotiations? Which network elements should be unbundled? What type of local loop unbundling should be mandated? How can the regulator enforce network unbundling effectively?
 8. Will creating an opportunity for resale make the markets more competitive? Should the obligation to create an opportunity for resale be applied only to dominant licensees? What market benefits can be expected to accrue to non-dominant licensees if they allow for resale of their services? How much margin between the wholesale and retail prices of services is necessary for resale to be viable?
 9. Is the paradigm shift in pricing regulation (limiting *ex ante* regulation to dominant licensees and subjecting all others to *ex post* regulation) tenable in the Philippine context? Which services should still be subject to *ex ante* price regulation? How can *ex post* price regulation be effectively enforced? Is a standard of proof similar to that applied in Hong Kong appropriate in the Philippine setting? Are there any other standards that might better apply?
 10. Are there other constraints or handicaps that limit the ability of the Commission to regulate effectively? How can the Commission overcome these constraints?
 11. Will the four measures discussed above (taking a proactive regulatory stance, enforcing strict reporting requirements, restoring confidence in the Commission, and legislative reform) help the Commission improve its governance? What other measures should the Commission undertake to become more effective as a regulator?

Comments on this present initiative to develop a competition policy framework for the ICT sector need not be limited to the topics or questions enumerated above, and all interested parties are invited and encourage to submit any other view or comment they feel is relevant and/or useful to this effort.

In sum, the Commission trusts that this Consultative Document will lead to a common understanding of the state of, and steps necessary to promote competition in the ICT sector; and that it will encourage the participation and support of stakeholders for the Commission's initiative, ultimately resulting in rules, policies and actions that benefit both industry and consumers alike.

December 16, 2005

(Signed)
RONALD OLIVAR SOLIS
Commissioner

(Signed)
JORGE V. SARMIENTO
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POLICY ADVISORY MEMORANDUM

July 28, 2005

FOR: Gigo Alampay

CC: Gilbert Llanto
Joy Abrenica
Steve Magiera

RE: Predatory Firm Behavior in Philippines Telecommunications Markets

This memorandum addresses current standards for defining and identifying predatory market behavior by firms operating in markets for telecommunications network services, equipment or combinations thereof. It responds to questions raised by NTC officials during our recent meeting and focuses in the first instance, as those questions did, on a 1997 Supreme Court ruling (G.R. No. 124360) on related matters (outside the telecom space) in the case of Tatad v. Secretary of the Department of Energy and the Secretary of the Department of Finance.

The memorandum begins with some context including a summary statement of relevant law; sets out applicable economic analyses; then, concludes with implications for regulatory policy and rules respecting selected issues now, or soon to be, faced by the NTC.

BACKGROUND AND CONTEXT

Pricing behavior of rival firms in the Philippine telecoms marketplace is one the most critical elements of competitive processes that in the end are expected to and usually do increase consumer welfare. Pricing is not and cannot be regarded by firms independently of the quality and cost of goods/services they are offering at different price levels. Price relative to cost of production shapes the extent to which firms can earn and be profitable. Price in conjunction with service quality (as perceived by users) drives choice and determines market share, revenue and earnings – each of which is a driver of network investment in future periods. Service quality also helps determine the level of production costs. Thus, the circle – interrelated price, cost and quality – is complete for both suppliers and users.

Users of telecommunications services, like consumers of services more generally, have unlimited wants, limited means for satisfying them and, generally, a variety of alternatives from which to choose as they attempt to get as much “utility”, “wellbeing” or personal “welfare” as possible from their limited means. Thus, users typically compare the services according to what

they get for what they must pay. They identify as best they can the relations of “costs to benefits” of the price/quality “bundles” represented by different products and services available in the market; they compare those across a broad or limited range (depending on the structure of market supply); then, they choose one or another so as to get the highest valued price/quality bundle for their money.

Providers of alternative services or products are therefore rivals or competitors with each other as each of them independently vies to win consumer favor, sell them products/services, win market share and thereby make profits or earn for their respective shareholders.

A particular rival supplier “wins” by offering price quality bundles that are preferred and chosen by end users instead of the offerings of rivals. However, the process of rivals vying for the favor of end users is in the nature of a “zero sum game” for those players, since winning by one firm generally implies losing by another. Winning a customer implies either a lost customer or a lost opportunity to win that customer by another firm. Thus, competitive market conduct (expressed in terms of price and/or quality) designed to win customers that does so successfully has two results; consumers are benefitted, but other firms are harmed. This consumer benefit coupled with competitor harm suggests for some a dilemma and is the source of controversy about predatory pricing or predatory quality variation.

Consumers are typically benefitted by firm behavior, but rivals are harmed. There may however be instances in which consumers may be helped in the short run but harmed in the long run by aggressive market conduct by particular rivals. That would be the case if short term market conduct by a particular rival undermined the basis for long term competition by so harming competitors that market structure changed in ways that shielded and permitted aggressive competitors to raise price or alter quality in ways that harmed consumers.

COMPETITION POLICY AND REGULATORY ISSUES

The foregoing provides context for several issues that may arise for the Philippine public regulator of private market conduct by telecoms carriers within its purview. These include:

- (1) What is “predatory” market conduct?
- (2) How does one identify “predatory” market conduct and differentiate it from “healthy” market competition?
- (3) Under what circumstances, if any, is “predatory” market conduct rational market behavior for competitive firms?
- (4) Can predatory conduct extend to variation in service quality?

There are variations on these, but their consideration as stated will reasonably exhaust the main issues that will be addressed below.

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GOVERNING STATUTES

While the focus of this memorandum is an economic or market analysis of predatory behavior by regulated firms and how best regulatory authorities might apply such analyses, such analyses cannot be usefully undertaken outside the context of the constitutional, legal and regulatory environment within which public policies and regulatory provisions may be applied. In that context several overriding matters of law come into play. First and foremost is the Constitutional provision in Section 19 of Article XII which declares:

“The State shall regulate or prohibit monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed.” (Emphasis added.)

The Constitution specifies a public interest test for regulating monopolies, but more specifically also provides a specific declaration that unfair competition shall not be allowed, presumably by firms with monopoly or market power.

The principal statute governing regulation of telecommunications providers, RA 7925, contains several pertinent declarations related to the interplay between market conduct of regulated firms, national policy and optimal regulations. Thus Article II, Section 4 paragraph (f) of RA 7925 declares as a matter of national policy that competition shall be fostered and in such a way as allow carriers to make economic decisions that will assure both their financial viability and rates that are affordable to end users. To wit:

...a healthy competitive environment shall be fostered, one in which telecommunications carriers are free to make business decisions and to interact with one another in providing telecommunications services, with the end in view of encouraging their financial viability while maintaining affordable rates:... (Emphasis added)

Further to the pricing issue, Article III Section 5 para (a) of the same elaborates the relevance of pricing that generates “sufficient returns” in declaring that the NTC should:

“Adopt an administrative process which would facilitate the entry of qualified service providers and adopt a pricing policy which would generate sufficient returns to encourage them to provide basic telecommunications services in unserved and underserved areas. (Emphasis added)

It is of course both notable and apparent that the statutory standard regarding the intersection between pricing and the standard of “sufficient” returns implies clearly a relationship between rates charged to end users and costs of production to suppliers. Linking returns to pricing implicitly links prices to costs and is key to evaluating the “health” of different pricing and product strategies.

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The same statute elaborates in Article III, Section 5, para (d) by providing that the NTC shall meet the goals of healthy competition, free decisionmaking, financial viability of carriers and affordable rates. Thus, the statute provides that the NTC shall:

“Foster fair and efficient market conduct through, but not limited to, the protection of telecommunications entities from unfair trade practices of other carriers...”

While unfair trade practices are to be prohibited in the course of NTC assurances of fair and efficient market conduct, Article III Section 5 para (e) of RA 7925 expressly directs the NTC to focus on the needs of business and individual users (rather than on the interests of competitive carriers). Specifically, the NTC shall:

“Promote consumers’ welfare by facilitating access to telecommunications services whose infrastructure and network must be geared towards the needs of individual and business users...” (Emphasis added.)

Concern for the quality of competition and carrier market conduct is also reflected in provisions of Article 28 of the New Civil Code which makes any person who shall engage in unfair competition liable for damages. Specifically,

Unfair competition in agricultural, commercial or industrial enterprises or in labor through the use of force, intimidation, deceit, machination or any other unjust, oppressive or highhanded method shall give rise to a right of action by the person who thereby suffers damage. (Emphasis added.)

On the question of quality standards and pricing practices, and germane to questions addressed below, RA 7925, Article VII, Section 20, para (a) declares that users have the right to, among others:

...service which is non-discriminatory, reliable and conforming with minimum standards set by the Commission...

In sum, the Constitution, RA 7925 (the principal statute governing regulation of telecom carriage/service) and the civil code can be reasonably read to make clear that efficient and fair pricing and other aspects of market conduct are the means for achieving the goals of promoting the broad public interest and of improving consumer welfare in particular in the course of regulating telecom carrier market conduct.

An important question is what meaning to assign to words and intent of the provisions.

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A DIGRESSION ON “TATAD”

As noted above, the legal standard for evaluating carrier market conduct is in important part derived from the Philippine Constitution. As I understand it, the principal case – certainly

an important case -- interpreting that clause is FRANCISO S. TATAD, petitioner, vs. THE SECRETARY OF THE DEPARTMENT OF ENERGY AND THE SECRETARY OF THE DEPARTMENT OF FINANCE, respondents. [G.R. No. 127867. November 5, 1997]

The “Tatad” case involved the constitutionality of Republic Act No. 8180 which focused on deregulation of the downstream oil industry and other matters. “Tatad” was not directly concerned with prices in the telecom sector as defined in RA 7925, but “Tatad” was and is nevertheless an important precedent from the Supreme Court, since it addressed specifically certain allegations about predatory market conduct.

For more detailed reference and discussion hereinbelow, I call attention here to key, relevant passages from “Tatad”. The passages cited here are long so as to provide the proper context for the critical language which I have underlined for emphasis.

In “Tatad” the Supreme Court made clear its commitment to competition; expressed concerns about monopoly as a delimitor of competition; and, laid the groundwork for setting policies to promote market competition in the presence of monopoly. Each suggests important precedents for competition policy and regulation in the telecom sector. The Court stated:

...Beyond doubt, the Constitution committed us to the free enterprise system but it is a system impressed with its own distinctness...[O]ur free enterprise system is not based on a market of pure and unadulterated competition... Combinations in restraint of trade and unfair competitions are absolutely proscribed Section 19, Article XII of our Constitution is anti-trust in history and in spirit. It espouses competition. The desirability of competition is the reason for the prohibition against restraint of trade, the reason for the interdiction of unfair competition, and the reason for regulation of unmitigated monopolies. Competition is thus the underlying principle of section 19, Article XII of our Constitution...We subscribe to the observation of Prof. Gellhorn that the objective of anti-trust law is "to assure a competitive economy, based upon the belief that through competition producers will strive to satisfy consumer wants at the lowest price with the sacrifice of the fewest resources..." He adds with appropriateness that there is a reliance upon "the operation of the `market' system (free enterprise) to decide what shall be produced, how resources shall be allocated in the production process, and to whom the various products will be distributed. The market system relies on the consumer to decide what and how much shall be produced, and on

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competition, among producers to determine who will manufacture it."

Again, we underline in scarlet that the fundamental principle espoused by section 19, Article XII of the Constitution is competition for it alone can release the creative forces of the market. But the competition that can unleash these creative forces is competition that is fighting yet is fair. Ideally, this kind of competition requires the presence of not one, not just a few but several players. A market controlled by one player (monopoly) or dominated by a handful of players (oligopoly) is hardly the market where honest-to-goodness competition will prevail. Monopolistic or oligopolistic markets deserve our careful scrutiny and laws which barricade the entry points of new players in the market should be viewed with suspicion..

The Court made very clear, albeit in a different market context, that it subscribes to the language of Professor Hovenkamp who in turn sets forth the foundations for embracing market forces as driven by sovereign consumer choice to determine what is produced, with what methods and by whom. Also quite notable in the current context is the Court's emphasis on minimizing use of scarce resources, for it suggests the Court's affection for low cost production and prices, while the discussion of "competition that is fighting yet fair" focuses on and expresses "suspicion" about monopoly and "laws" (or interpretations thereof) that heighten barriers to entry to new players. Each of these points is directly applicable to contentions raised in the context of telecom services markets.

The Court went on to address the meaning of predatory pricing. Again, it cited with full approval the authority and view of Professor Hovenkamp. The Court emphasized the importance of the rationale for predation, namely to create monopoly power which can be exploited in the future, while, notably, also emphasizing that its concern was with large incumbents, not with the behavior of new entrants. Thus:

...[Professor] Hovenkamp gives the authoritative answer and we quote: "The rationale for predatory pricing is the sustaining of losses today that will give a firm monopoly profits in the future. The monopoly profits will never materialize, however, if the market is flooded with new entrants as soon as the successful predator attempts to raise its price. Predatory pricing will be profitable only if the market contains significant barriers to new entry."

...[There are here]significant barriers which discourage new players to enter the market. Considering these significant barriers established by R.A. No. 8180 and the lack of players with the comparable clout of [large incumbents], the temptation for a dominant player to engage in predatory pricing and succeed is a chilling reality.

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As an important aside here, I hasten to note that the definition of predatory pricing in R.A. No. 8180 was, fortunately, not embraced by the Court. I say fortunately, because it is wrong as a matter of economic principle and as a matter of sensible policy definition and application. Moreover, it is without precedent, so far as I can tell, throughout the world. Specifically, Section 9 of R.A. 8180 states that as a means to “ensure fair competition...” certain kinds of market conduct should be prohibited, including:

...Predatory pricing which means selling or offering to sell any product at a price unreasonably below the industry average cost so as to attract customers to the detriment of competitors...

This standard is wrong, and if adopted would prohibit the very kind of market behavior that any rational or potentially successful competition policy is and should be designed to encourage. Competition works because it gives firms the incentive to become cost efficient and to pass along such efficiencies to customers, without regard to whether it harms their higher cost competitors. In fact causing harm to competitors from prices based on more efficient, lower cost production methods is exactly the kind of market conduct rationale competition policy intends to promote, since that is the mechanism which impels inefficient firms to emulate the performance of their more efficient rivals. Efficiency based price reductions designed to attract market share (and, yes, to harm rivals by reducing their market shares) tend to force all firms to become efficient and to pass along the savings to end users. Any rule, such as the one cited here from R.A. 8180, that would prohibit efficient firms from pricing below the average cost of their less efficient rivals so as to attract customers from their competitors, would harm users and the national economy, while being absolutely inconsistent with sensible economic policy. It is the welfare of users and the economy that provides the benchmark for valuation of market conduct, not the welfare of competitors. Competition hurts competitors and it is supposed to do so.

ECONOMICS OF PREDATORY CONDUCT IN COMPETITIVE MARKETS

Claims of predatory pricing are typically more a conjecture than a theory. If a price reduction hurts a competitor or supplier or another economic entity, it is subject to being branded “predatory”, “destructive”, “cut-throat” or any of a number of other pejorative appellations. As such it is regarded as one of several forms of “exclusionary” behavior focused on rivals rather than consumers or end users. Of course the beneficiaries of such price reductions regard them as signs of healthy competition and consistent with both the theory and practice of workably competitive markets.

The commonly conjectured predation scenario implies or contains most of the elements that follow. First, the predator targets its prey; identifies the prey’s cost of production; cuts price below the prey’s cost; forces the prey to cut price and/or lose market customers or volume, but in either event thereby incurring operating losses; maintains the predatory rate until the prey goes out of business; then raises price to profit maximizing levels, while retaining in its competitive

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arsenal the threat to lower prices again, thereby deterring would be entrants who might be attracted to predator's high profits. The result is dead competitors, throttled competition and monopoly profit in perpetuity. There are variants on this theme, but they contain most of the core elements of destruction (or intimidation) of competitors, then reaping the benefits of that destruction by harming users with higher prices.

Competition is a dynamic process. It is a strategic process involving strategies and counter-strategies, tactics and counter-tactics and moves, counter-moves and counter-counter-moves by firms bent on succeeding by winning customers from – yes imposing penalties on and otherwise harming -- their rivals. Thinking of competition as rivalry among suppliers designed to take and hold customers, to win them away from each other, to undermine and “one-up” rival suppliers through various means renders the notion of “predatory” pricing or “destructive” market behavior a bit strange, since in a sense all competitive behavior is harmful to competitors.

Both economic theory and business practice confirm that large, incumbent providers of branded services or products typically enjoy “first mover” advantages – brand and name recognition; customer loyalty; market experience and knowledge; economies of scale and/or scope; learning (by doing) economies; and others – that cannot easily be offset by new entrants or younger, smaller rivals. In such circumstances, the menu of competitive market practices available to nonincumbents is limited in scope, a fact that may be compensated for by greater intensity in the use of limited means available to them.

The fact of the matter is that relatively young firms and startups in network industries characterized by large capital costs that are effectively sunk and fixed — industries like the wireline or wireless telecommunications business in the Philippines -- must always price below their average costs in order to win market share, grow and achieve scale sufficient for long term survival. Such startups and young firms typically finesse capital costs in the short run by postponing repayment of creditors and/or rewarding shareholders and, instead, using cash from operations to build, expand and grow the business through aggressive, costly market conduct – promotional pricing, promotional service differentiation, costly advertising, product development and the like. (This phenomenon is especially important in matters related to service quality differentials as discussed below.)

Lower prices (even prices below costs) for new firms lead to more volume over which fixed overhead may be spread and therefore to lower unit costs for the next period. For start up firms, market share and rapid growth in market share are keys to competing successfully with entrenched first mover, incumbents.

The necessary conditions for successful predation are straightforward, wellknown and appreciated no doubt by potential practitioners. They include:

- Substantial market power held by the predator;
- A financial “deep pocket” sufficient to “finance” losses from below-cost prices;
- Barriers to profit induced re-entry by the prey or new entry by others; and

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- Downstream monopoly profits sufficient to amortize and earn on earlier losses.

Some have come to think of predatory behavior as “investing in exclusionary practices”, “imposing costs on rivals” or simply in “purchasing market share”. This way of thinking is instructive for it calls immediately to attention the facts that a) such behavior requires firms to undertake the equivalent of making short term cash outlays and b) such outlays, plus a reasonable rate of return, must be eventually recovered by the practicing firm, if they are to make commercial sense. As a matter of sound business judgment it is difficult to show how a small, relatively new firm would find it advisable to attempt to predate a larger, better financed, more mature, better known rival. None of the necessary conditions cited above are present in such a case.

Indeed it is difficult (but not of course impossible) to conceive of real world circumstances that would favor such a market tactic by larger, more nearly dominant carriers or firms. It is notable in this regard that the US Supreme Court in 1993 held that (*Brooke Group v. Brown & Williamson Tobacco*) “true” predatory pricing as defined here was in that case and most likely in general to be an irrational business practice. Accordingly, the US agency with responsibility for enforcing “fair” competition has not successfully prosecuted any company for predatory pricing since that time.

Proponents of the theory that predatory pricing is irrational point to the fact that it must be a larger firm that engages in the practice, in order to be able to withstand the losses longer than its competitors. However, even a larger, more mature firm will lose more money when they drop their prices below cost, because they have a larger market share to begin with. Furthermore, they may not be able to recoup these losses because when they raise their prices to high levels, it provides a strong incentive for another firm to enter or re-enter the market and undercut them.

SEPARATING “PREDATORY” BEHAVIOR FROM HEALTHY COMPETITION

The challenge for policymakers and regulators worldwide in various industries where predation has been alleged is to separate healthy market conduct that serves the purposes of competition from destructive market conduct designed to destroy or weaken competition.

Fair (healthy, normal, good) competition and predatory (exclusionary, cutthroat, destructive) competition both harm rivals. Thus, harm to rivals is an indirect goal of all competitive behavior designed to win favor from users/consumers at the expense of rival suppliers. Indeed the mark of the success of healthy competition is the extent to which the conduct of firms forces other firms to respond as a means of maintaining consumer favor and thereby avoiding harm. The antithesis of competition is cooperation among firms to avoid harming each other.

Fortunately, there is a straightforward, easily administered test that allows differentiating healthy from unhealthy firm conduct. Both unhealthy competitive conduct and healthy competitive conduct harm rivals. Thus, **the impact on rivals is not a good test for harms.** However, good competition creates benefits for consumers at the expense of rivals. Thus, the

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test should be if consumers are likely to gain in the long term. The addition of consideration of “long term” consumer welfare is key, for it would be negative in the case of true predation in which they (consumers) benefit from lower prices in the short term, but are forced to pay higher prices in the longer term when the successful predator, having eliminated rivals, increases prices. The positive, long term consumer welfare test has the advantage of a) focusing on consumers, b) being long term in nature and c) focuses the valuation of any pricing behavior away from the negative impact on rivals and permits it to be differentiated in the first instance from healthy market behavior.

In addition to aggressive pricing, other forms of market behavior regarded by neutral observers as healthy actions as part and parcel of competitive market processes may nonetheless be branded as “predatory”, “destructive” or “cutthroat” by rivals. Aggressive advertising or product promotion; price cutting; heavy expenditures on research and product development; service differentiation and improvement; quality differentiation and pricing are a few examples. We turn now to consideration of concerns and allegations that competing by offering different service quality levels may be “destructive” or “predatory”.

PREDATION, SERVICE DIFFERENTIATION AND QUALITY COMPETITION

Firms can compete in a variety of ways. Price competition is the best known, but equally potent, or certainly not far behind in terms of importance is competition based on varying the attributes of the product or service – quality competition, product or service differentiation, service enhancement, product variation, customization, market segmentation and others combine to suggest the range of competitive activities involving some form of change in the product or alteration of service characteristics as means to capture market share by tailoring output to conform to the particular preferences, tastes or uses of individual or classes of customer.

Product or service differentiation as a method of waging rivalry in the marketplace is absent only in the highly theoretical models economists have devised and call “Perfect Competition” where, by assumption, all products in a market are homogenous. They cannot be differentiated one from the other by ambient quality characteristics. Consumers choose among them only on the basis of price. While such market models are the starting point for economic analysis, most models incorporate the fact that consumers have different preferences for similar services and that suppliers find it profitable to attempt to satisfy those different tastes.

Real world markets are nearly always marked by considerable differentiation, customization or other methods by sellers attempting to satisfy consumer wants and preferences. The usual sequence of business activity would be a) identifying user needs and wants – what they would be willing to pay for, b) estimating the marginal production cost of making those characteristics available, c) actually differentiating the service and making it available and finally d) making users aware of the differentiated product/service and its merits relative similar offerings in the marketplace.

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User preferences are quite varied. Suppliers attempt to identify the differences, how they are valued by users and then they try to fill that need with appropriately configured price/quality bundles. Those facts account for the wide variety of similar, but differentiated products, in the market for, say, cars, appliances, insurance policies, financial services, shoes, cosmetics, financial securities, and, yes, telecommunications services. Markets generally do a pretty good job of matching products and services with the diversity of consumer or user preferences. The key is the size of the market for different variations and the costs of varying the product. Only the very wealthy can direct markets to tailor services to their individual needs.

However, there are circumstances in which markets fail. They may in some circumstances fail to provide the socially “optimal” level of service quality. The sources of such failure are too diverse to address here, but generally they relate to the presence of “externalities” – that is circumstances in which the public costs or benefits of a given economic activity diverge from its private costs or benefits. Thus, for example, markets provide too much “pollution, because the public cost exceeds the private cost; markets provide too little government activities like public safety, education, etc. because the public benefits exceed the private benefits.

In the case of quality of telecom services, government has traditionally intervened because of market failure attributable to monopoly. In short, an unregulated monopolist in pursuit of maximum profits would likely choose to offer lower quality service than is publicly optimal. Monopoly owners of networks have the incentive to discriminate in favor of the own retail services and against wholesale services provided to their rivals. For these and other reasons, government has traditionally intervened to set service standards and require monopolists or firms with substantial market power to meet those standards in at least some of their offerings. If some users prefer lower quality service, so be it. Even a monopolist is generally free to meet that lower benchmark, provided it continues to meet the higher standard for customers who prefer it and for customers who have no alternative to monopoly supply.

As noted above in the context of discussing new entrants need to offset first mover advantages of incumbents (size, access to capital and other critical inputs, experience, brand recognition, consumer, etc.), it is often both necessary from the entrants’ point of view and desirable from a public policy point of view for entrants to pursue very aggressive marketing practices (in both price and product variation senses) as a means of building share, revenue and customer base quickly as means to hedge the very substantial fixed, sunk capital costs associated with telecom infrastructure construction. Unit costs are typically very, very high at low levels of market penetration for such firms. Early and substantial increases in customer bases, volume per user and cash flow are frequently necessary conditions for entrants’ long term survival.

Offering a “degraded” quality of service is very commonly the competitive weapon of choice for an entrant competing with a large, entrenched, wellknown incumbent. There are numerous illustrations from other national telecommunications services and equipment markets in which entrants offer a diminished quality product/service as a means of building share, reducing unit costs, creating free cash flow for further expansion and service improvements and

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generally attempting to overcome incumbent advantages. Markets for computers, computer chips, hard drives, long distance telecom services, programmed entertainment services, computer network services, internet services, wireline voice, wireless telecom services, satellite services and numerous “enhanced” telecom services are just a few instances in which entrants worldwide have offered “less quality” as a means of building critical customer mass sufficient to springboard to incumbent status.

PREDATORY QUALITY DIFFERENTIATION IN PHILIPPINES WIRELESS MARKETS

The offer of reduced quality of service by a recent entrant into Philippine wireless markets has elicited charges of predation by some of its competitors.

Digital Mobile Phils., Inc. (Digitel) recently offered to provide, under its “24/7” Plan, unlimited Sun-to-Sun calls and text for P250 a month or P100 for 10 days. Both rates are well below the going rate offered by incumbents. Experience of users of the service suggests that demand has responded so substantially that customers attempting to use the service are experiencing a call set up success rate below that set out by the NTC in its Memorandum Circular No. 07-06-2002 which establishes service standards for MTS.

Setting aside for present purposes a) empirical questions the actual or true call set-up success rate and b) legal or regulatory questions about the intent, applicability or efficacy of Memorandum Circular No. 07-06-2002 which established minimum standards for a “monopoly” market environment, we will focus here on contentions that the offering is predatory, indicative of “ruinous competition”, involves unfair or unreasonable rates or otherwise is a mark of unhealthy competition that ought to be prevented by the NTC. We make three points.

Point One. The “24/7” plan offered by Digitel does not appear to meet any of the necessary conditions for predatory market behavior. These are:

- Substantial market power held by the the alleged predator;
- A financial “deep pocket” sufficient to finance losses from below-cost prices;
- Barriers to profit induced re-entry by the prey or new entry by others; and
- Downstream monopoly profits sufficient to amortize and earn on earlier losses.

While we have not undertaken an exhaustive, or even thorough, analysis of Digitel’s corporate history, circumstances or prospects, every indication available suggest that the company meets none of these conditions and is thus incapable of predatory behavior designed to destroy rivals.

Point Two. In competitive markets such as the market for wireless services in the Philippines, the opinions of users, as reflected in their choices of carriers and services, should be given substantial weight. As a matter of both economic principle and Philippine law, as reflected in the TATAD opinion, consumers in a competitive market are the ultimate arbiters of

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service quality and other aspects of supplier behavior. As noted above the Court held as much when it declared that: “The market system relies on the consumer to decide what and how much shall be produced, and on competition among producers to determine who will manufacture it.”

As the NTC has pointed out, this is precisely what is happening in the market place. Firms are offering new price/quality options and consumers are selecting those they prefer.¹

Absent showing of specific harm other than loss of share by market rivals, it would not increase consumer welfare – the goal of competition policy and regulation – nor otherwise be in the public interest for the NTC to prevent the offer or forbid the choice of a price/quality service bundle eagerly chosen by consumers.

Point Three. The NTC’s duty to protect consumers by assuring that carrier offerings meet minimal standards is relieved but not eliminated in cases where consumers freely opt for degraded quality when accompanied by lower price. As set forth above, most markets offer a wide array of price quality bundles from which buyers can choose the one which best meets the dual test of their disposable income budgets and their preferences for service quality. In view of consumers’ choices and the popularity of innovative price/quality bundles, the NTC could, consistent with its responsibilities to protect the public interest, forebear from applying quality standards designed for a monopoly carrier in a noncompetitive market environment. It can of course do so without abdicating its overall responsibility for protecting consumers by enforcing quality standards in cases where firms have market power and market forces appear incapable of doing so.

Regulatory forbearance in circumstances where competitive markets adequately serve the public is appropriate and consistent with the principles of fair competition, consumer welfare, reliance on users to drive resource allocation and otherwise serves the broad public interest.

CONCLUSION

Charges of predation are frequently based on short term harm to rivals, which harm is of the kind and extent expected by the operation of healthy markets and constructive competition. The necessary conditions for true predation that eliminates firms or destructive competition that

1 The NTC observed: “While the concerned service performance standards are intended to increase the quality of service offered by CMTS providers, the Commission is aware that consumer desires and needs appear to now be more varied and have expanded beyond basic quality satisfaction. Indeed, the popularity of the new and innovative price plans introduced by the parties themselves reflect the appreciation that consumers have options that enable them to shop for and choose the price-quality package that best suit their needs...[t]he Commission is greatly concerned that an inflexible application of this Circular could result in (a) depriving consumers of wider choice in services; and (b) a failure to encourage the very competitive and innovative offerings that it should increasingly encourage and protect as the sector’s regulator.

destroys markets and market processes are rigorous and not often met. Key is the need to create market power and the ability to recoup short term losses in the long run. Predatory market behavior is, to the extent it is at all feasible, pretty much the exclusive domain of large, incumbent firms with access to significant financial resources and the ability to enforce barriers to entry. Small firms, newly entered and competing with established incumbents are very unlikely to undertake predation, but they will necessarily be very aggressive competitors as means of offsetting first mover advantages of incumbents.

There is no principled basis for regulatory concern about the potential for predatory service quality variation by entrants. Service differentiation is a tried and true market tactic for new entrants attempting to overcome their handicaps and to offset first mover advantages.