



Competition Bureau  
Canada

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Canada

**CANADIAN RADIO-TELEVISION  
AND TELECOMMUNICATIONS COMMISSION**

**TELECOM PUBLIC NOTICE CRTC 2005-2**

**FORBEARANCE FROM REGULATION OF LOCAL EXCHANGE SERVICES**

**ORAL PRESENTATION**

**OF**

**THE COMMISSIONER OF COMPETITION**

**September 27, 2005**

**CHECK AGAINST DELIVERY**

## Introduction

1. I would like to begin by thanking the Commission for this opportunity to share the Competition Bureau's views about the important issue of local forbearance. I am accompanied today by Richard Taylor, Deputy Commissioner of Competition, Civil Matters Branch, and Patrick Hughes, Senior Economist, Economic Policy and Enforcement.
2. At the outset, I would like to clarify that I will only be speaking to issues involving the general framework in this proceeding. I would note that we are nearing two years since I have been in my current position as Commissioner of Competition. However, out of abundance of caution, and in consultation with the Office of the Ethics Commissioner, I have recused myself from any participation in the specific Aliant application because of my former involvement with BCE Inc. and Aliant. Mr. Taylor, in his capacity as Deputy Commissioner, has had direct oversight of the specific application. I would therefore appreciate it if you would hold any questions regarding the Aliant-Eastlink situation to the end, permitting me to excuse myself and allowing my colleagues to assist the panel.
3. I am very pleased to have the opportunity to address the Commission today on the issues raised in Telecom Public Notice CRTC 2005-2, *Forbearance from Regulation of Local Exchange Services*.
4. The issues raised in this proceeding, namely a framework for forbearance from regulation of local telephone service, are critical to the development of competitive local phone services in Canada. Greater reliance on market forces and competition in place of regulation offers significant benefits to Canadians in terms of competitive prices, greater choice, innovative services, as well as enhanced service quality.

5. The statutory framework governing forbearance is clear. Subsection 34(2) of the *Telecommunications Act* requires the Commission to forbear from regulating a service “[w]here the Commission finds **as a question of fact** that a telecommunications service or class of service is or **will be** subject to **sufficient** competition to protect the interests of users.”
6. The ability of market forces to substitute for regulation turns on the ability of the regulated firm to exercise market power absent regulation. As the Commission is aware, the term “market power” refers to the ability of a firm to profitably cause one or more facets of competition, such as price, output, quality, variety, service, advertising or innovation to significantly deviate from competitive levels for a non-transitory period of time.
7. The Bureau’s approach to the assessment of market power is set out in the 2004 Merger Enforcement Guidelines, or MEGs. In merger analysis, the Bureau considers whether the merged entity will be able to sustain higher prices than would exist in the absence of the merger. In forbearance analysis, the Commission must consider whether forbearance will permit the regulated company to sustain higher prices than would exist if regulation remains. As the goals of merger and forbearance analysis are very similar, the MEGs provide a robust economic framework for the analysis of forbearance.
8. The MEGs approach to the assessment of market power has been widely endorsed. The framework has been accepted by the Competition Tribunal and the Canadian courts. It is also consistent with the framework that has been adopted in the U.S. and the EC to assess the ability of a firm to exercise market power. In the EC, this analysis is also employed to determine the requirement for *ex ante* regulation of telecommunications services. The Commission has also adopted the MEGs framework for the purposes of forbearance analysis. In Telecom Decision CRTC 94-19, the

CRTC adopted the concept of market power as the standard by which to determine whether or not a market is, or is likely to become, competitive. The Commission also recognized that defining the relevant product and geographic market is a prerequisite to assessing whether market power exists. Significantly, in Decision 94-19, the Commission also rejected an approach that concentrates solely on market share, noting that the MEGs require assessment of a number of other factors. In particular, the Commission recognized the importance of evidence of rivalrous behaviour as well as the pace of innovation and technical change in the relevant market.

9. Proper application of this framework requires a highly fact-specific, forward-looking, assessment of detailed evidence on substitutability of services, costs, both sunk and incremental, capacity and sales of existing and potential suppliers of the relevant products in each relevant geographic market, barriers to entry, and change and innovation.
10. For the reasons expressed in the MEGs and endorsed by the Commission in Decision 94-19, a “bright-line” forbearance test, based on ILEC market share loss, is not appropriate. Market share loss, in and of itself, is not sufficient to establish either that the ILEC has market power, or that the ILEC no longer has market power. There is, quite simply, no one-to-one relationship between market share loss and market power.
11. However, the Bureau acknowledges that a full-blown market power assessment is complex, time-consuming and costly. For this reason, the Bureau has tried to identify a stream-lined approach - something between a full-blown market power assessment and a bright line market share test - that could serve as the basis for stream-lined analysis of ILEC requests for local service forbearance, once the relevant product market has been identified. To this end, the Bureau has identified a set of conditions that, if

satisfied, should be sufficient to conclude that an ILEC does not possess market power in the provision of local exchange services. Specifically, the Bureau has proposed that once the relevant product markets for ILEC local exchange services have been identified, the CRTC could stream-line its forbearance analysis by focusing on the following six conditions:

- (1) There exist at least two independent facilities-based service providers – the ILEC and a facilities-based entrant – capable of offering local service that has been determined to fall within the relevant product market for ILEC local service;
- (2) The entrant is able to obtain and retain a local customer base;
- (3) The entrant's variable costs of providing local service are similar to or lower than the ILEC's variable costs of providing local service;
- (4) Neither the ILEC nor the entrant is capacity constrained;
- (5) There is evidence of vigorous rivalry between the ILEC and the entrant in the provision of local service; and
- (6) Industry characteristics are such that the ILECs are unlikely to engage in anti-competitive behaviour.

12. The relationship between these conditions and the full-blown MEGs analysis will be fleshed out as I step through the application of the MEGs framework to the evidence in this proceeding. I would first like to note that Appendix 1 contains a checklist of key questions the Bureau would typically ask as part of this approach and identifies interrogatory responses on the public record that will assist in coming to a conclusion.

Our final argument also contains a list of confidential or unanswered interrogatories that can be helpful.

### **Market definition**

13. Proper definition of the relevant product and geographic markets for ILEC local exchange services is critical to forbearance assessment, regardless of whether a full-fledged market power analysis, a bright-lines test or the stream-lined approach proposed by the Bureau is applied.

#### ***Product Market***

14. The Bureau uses a step-by-step approach to defining relevant product markets. The analysis begins with each ILEC local service, and the market is progressively expanded to include other local services that are determined to be **close** substitutes for the ILEC local exchange service. The Bureau considers a number of factors that provide indirect evidence of substitutability. The views, strategies and behaviour of buyers often provide a reliable indication of whether buyers are likely to switch to another product in response to a significant price increase. The views of industry participants are also considered. Various functional indicators, such as end use, physical and technical characteristics, price relationships and relative price levels, as well as switching costs, also help to determine whether products should be considered to be close substitutes.
15. The Bureau posed interrogatories to interested parties in this proceeding, seeking information on customer switching, customer take-up and churn rates, and marketing and pricing strategies, in order to obtain the information necessary to assess substitutability of cable telephony, VoIP and wireless services for ILEC local exchange services. Some responses

to these questions were filed in confidence and some questions were not answered.

16. There is insufficient information on the public record for the Bureau to make a determination of the relevant product market in this proceeding. The Bureau has sought to assist the CRTC in its analysis by identifying three pivotal factual issues that will need to be addressed to define relevant product markets for ILEC local exchange services.
17. First, are consumers willing and able to substitute other technological forms of access for ILEC circuit-switched local exchange services? Specifically, in determining the extent to which cable telephone, VoIP and wireless services are considered or are likely to be considered by consumers to be close substitutes for ILEC local exchange services within one to two years, the Bureau encourages the CRTC to assess the evidence of customers in this proceeding .
18. Second, do ILEC local services have attributes that competitor local services cannot match? This requires a detailed assessment of customer perception of the quality of access and features associated with the different services.
19. Third, are competitors successful in retaining local service customers and, if so, what mechanisms do they use to reduce customer churn? Actual switching by customers indicates that customers are willing to try the competing local service; customer retention by an entrant suggests that customers consider its service to be an effective substitute for ILEC local exchange service.

20. Again, appendix one sets out questions that relate to these factual issues and identifies relevant interrogatory responses that are on the public record.

### ***Geographic Market***

21. With respect to the relevant geographic market for local exchange services, each location appears on its face to be a separate relevant geographic market. A customer will not purchase the service from another location if price is increased. For the purposes of assessing market power, however, the Bureau believes that the geographic market can be defined in terms of locations that have the same supply options. In other words, the geographic market is defined by the overlapping footprint of the ILEC's network and one or more independent networks that are capable of offering local service that has been determined to fall within the same relevant product market as ILEC local exchange service.
22. Parties have filed, in confidence with the Commission in this proceeding, network coverage maps.
23. If there is overlapping network coverage in a very large portion of an exchange, the exchange may be an appropriate relevant geographic market for forbearance purposes. Complete, or 100% coverage, may not be essential. If the Commission is concerned about the potential for the ILEC to increase prices for service to the limited number of locations that are served by ILEC facilities only, the Commission could consider retaining a simple price ceiling to protect these customers from price increases, much as it did in the case of DDD.
24. As an additional safeguard, entrants may be able to supplement holes in their networks by leasing facilities from ILECs. This may have the

additional benefit of permitting the Commission to collect data on a more uniform basis using the local exchange. Appendix 2 contains an illustration of how this concept might work in a traditional ILEC territory.

## **Assessing constraints on the exercise of market power**

### ***Market Structure***

25. The Bureau typically begins its assessment of competitive constraints on the exercise of market power by examining market shares and market concentration levels. Subject to the first two conditions set out in paragraph 11, the mere existence of a competitor that can take ILEC customers rapidly without incurring significant costs, is likely to impose competitive discipline on the ILEC regardless of the revenue or customer shares of the competitor. In these circumstances, the capacity to effectively serve locations is a more appropriate measure of market share for the purposes of market power assessment, than revenue.
26. Market shares are only an indicator of potential market power if they are calculated using a proper definition of the relevant product and geographic markets and data for all existing and uncommitted entrants. An uncommitted entrant is a service provider that would not have to expend significant funds in order to enter the market. Capacity market shares, properly calculated, capture uncommitted entrants.
27. It is possible that other potential entrants - and by that I mean suppliers that are not currently in the market and are not uncommitted entrants - discipline market power. However, because there appear to be significant sunk costs and time lags associated with the construction of new network facilities, other potential facilities-based entrants are unlikely to provide an effective constraint on market power of the ILECs.

28. For these reasons, the stream-lined approach to forbearance analysis proposed by the Bureau focuses on existing and uncommitted entrants. This is captured by condition 1, in paragraph 11, which requires that customers have access to at least two independent facilities-based service providers – one the ILEC and another a new entrant – capable of offering local services that have been determined to fall within the same relevant product market as ILEC local service. Condition 1 also tracks the relevant geographic market for forbearance – i.e., locations where the ILEC and new entrant networks overlap.

29. Condition 2 of the stream-lined framework proposed by the Bureau for assessing local forbearance serves as a check on the correctness of the product market definition. The condition requires the CRTC to consider whether the new entrant is able to obtain and retain a local customer base.

### ***Rivalry***

30. As a general rule, the mere existence of a single entrant is not sufficient to discipline market power of an incumbent. However, competition between two independent facilities-based service providers is likely to be effective when most of the costs of providing service are fixed and sunk. If this is correct, then even a duopoly market structure could provide effective competition. An assessment of rivalry will confirm whether or not this is the case.

31. The Bureau has proposed three conditions in its stream-lined approach to forbearance that address the extent of rivalry in the relevant markets. Two of these conditions – the absence of capacity constraints and lower entrant variable costs – are necessary conditions for effective competitive

- rivalry between the ILEC and the entrant. The final “rivalry” condition requires the Commission to assess evidence of actual and vigorous rivalry.
32. The Bureau encourages the Commission to examine capacity and cost information, to determine whether the necessary conditions for rivalry appear to be met, as well as evidence of actual rivalry – illustrated, for example, by pricing and marketing strategies - and evidence of customer perceptions of entrant advantages, such as bundling, to determine whether rivalry between the ILEC and a new entrant is, or is likely to be, vigorous.
33. Again a set of questions and interrogatory responses are set out in Appendix 1.

***Potential for anti-competitive behaviour***

34. The final condition in the stream-lined approach to forbearance requires that industry characteristics be such that the ILEC is unlikely to engage in anti-competitive behaviour.
35. There are two types of anti-competitive conduct that must be considered – anti-competitive (or in the Bureau’s terminology, predatory) pricing and raising rivals’ costs.
36. The requirement of at least two independent facilities-based service providers constrains the ability of the ILEC to raise rivals’ costs. In the event that the facilities-based entrant requires few services from the ILEC to provide competitive local service, there is little if any scope for the ILEC to raise wholesale price in order to engage in price squeezing.

37. The Bureau is also of the view that the presence of at least one other independent facilities-based service provider will likely significantly limit the incentive or ability of an ILEC to engage in an effective predatory pricing strategy. There are a number of reasons why it may be rather difficult for an ILEC to force an independent facilities-based competitor to exit the market.
38. First, predation may initially require an ILEC to sacrifice substantial profit. If the capital costs of facilities-based entry are primarily sunk and fixed costs, and thus incremental costs are relatively low, it will take a dramatic price reduction by the incumbent to induce exit. Economic theory predicts that the entrant will only exit if rates fall below its incremental costs.
39. Second, even if a particular rival is driven from the market, any sunk investments would not be lost to the market. Thus, even after the ILEC makes this initial profit sacrifice, new rivals may enter using the same assets and facilities left behind by the first service provider. It would likely be difficult for an ILEC to justify its costly price reductions to its shareholders and financial markets when the prospect of re-entry by new competitors would continue to limit the ILEC's market power even after the initial rival is driven from the market.
40. Third, when assessing the likelihood of predation by an ILEC, it is important to bear in mind that the Commission has already addressed many of the cross-subsidy concerns in the past by replacing earnings regulation with price regulation. The price cap regime will remain in place in non-forborne markets, thus limiting the scope for ILECs to recoup the costs of dramatic price reductions in forborne markets by raising prices in non-forborne markets.

41. In the end, even though it is unlikely, predatory pricing can never be ruled out entirely in this or any other market. As a transitional measure, it may be appropriate to maintain a temporary price ceiling in forborne markets. Such a ceiling would further limit the scope for ILECs to recoup foregone profits. Although highly improbable, an ILEC may be able to drive out a particular rival from the market and deny future new entrants from acquiring the assets and facilities. Even under this scenario, it would be very difficult for the ILEC to justify costly price reductions if it remains subject to a price ceiling for a period of time.

### **Other Issues**

42. The Bureau considers that the concepts of “just and reasonable rates” and “no unjust discrimination” continue to be relevant and appropriate in regulated telecom markets. However, where forbearance is warranted, the Commission ought to forbear fully with respect to section 27 of the *Telecommunications Act*. This is the case since it is not clear how competition sufficient to protect the interests of users with respect to rates under subsection 27(1) would be insufficient to protect users’ interests with respect to subsection 27(2). Indeed, once regulated companies are no longer found to have market power, competition should determine prices, and reliance on the general provisions of the *Competition Act*, rather than sector-specific regulation under the *Telecom Act*, would be more appropriate to deal with allegations of anti-competitive conduct. Where the Commission deems it necessary to retain jurisdiction under subsection 27(2), for example to deal with network interconnection and access issues, it should do so expressly and make clear that it does not intend to apply such powers to regulate retail rates.

43. Public Notice 2005-2 has raised a number of other issues relating to local service forbearance. The Bureau has set out its position on these issues in its argument. We would be pleased to respond to any questions that the Commission has with respect to the Bureau's position on any of the issues raised in this proceeding.

44. Finally, since I will not be addressing the Aliant application, I would again refer the panel to the Bureau's final argument in this area which was prepared under Mr. Taylor's direction.