

private sector

Interconnection Disputes

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*This is the second of three
Notes evaluating how best
to balance antitrust and
sector-specific approaches
in regulating
telecommunications.
The first assesses which
deals more quickly and
effectively with key
regulatory issues. The
third discusses how the
balance between the two
affects competition.*



Antitrust or Sector Regulation and the Case of New Zealand

Full liberalization of telecommunications markets provides scope for relying largely on general antitrust rules and institutions for economic regulation. But at least for a time after liberalization, sector-specific rules and institutions are likely to be needed in some areas, including interconnection. This Note draws lessons from the experience of New Zealand. After fully liberalizing its telecommunications market in the late 1980s, the country relied primarily on antitrust instruments to regulate interconnection until 2001, when it introduced a new regime putting heavier emphasis on sector-specific regulation.

In telecommunications, interconnection agreements allow one operator to use the networks of other operators, including their physical infrastructure and software systems. Thanks to these interconnection agreements, each operator can give users of its own network access to the users or services of other networks. One of the key regulatory objectives in telecommunications is to ensure that operators conclude such agreements under equitable conditions. When disputes about the conditions of interconnection arise, are antitrust or sector-specific rules and institutions a better choice for resolving those disputes fairly?

In New Zealand the regulatory model for telecommunications adopted at the end of the 1980s made limited use of sector-specific instru-

ments. Primary responsibility for a range of technical issues—including interconnection—lay with the operators themselves. Any interconnection disputes that might arise were to be resolved through antitrust rules applied by antitrust authorities.

A first case, between Telecom (the incumbent) and Clear (a competitor), involved the long distance market. Clear needed interconnection to the local loop, monopolized at the time by Telecom, so that it could compete in the national and international long distance market. Clear's negotiating position was somewhat strengthened by the government's unwillingness to approve Telecom's privatization until an interconnection agreement had been reached. From Clear's point of view, the final agreement,

concluded in March 1991, was an improvement over the standard interconnection terms previously offered by Telecom.¹ Telecom's standard offer stated that its competitors would be charged an interconnection price equivalent to the price paid by Telecom's business users and the customers of the new operators would have to dial a three- or four-digit access code. By contrast, in the 1991 agreement interconnection charges were 6 percent lower than standard business rates, and Telecom agreed to eliminate the access code once Clear's share of the long distance market exceeded 9 percent.

In 1993, however, Clear argued that Telecom had been late in providing noncode access after the 9 percent threshold had been reached and that Telecom had charged an unreasonable price for granting that access. The dispute was resolved through arbitration. Clear obtained satisfaction on both counts, but only after a protracted hearing that lasted 13 weeks and involved many expert witnesses.

A second case related to the mobile market. BellSouth started negotiations on GSM interconnection with Telecom in February 1992 and reached an agreement with Telecom by mid-1993. The agreement proved less advantageous than the one Clear had secured earlier. For example, BellSouth had to pay slightly more than the standard charge for business users. Other provisions of the agreement were later dropped because they were obviously anticompetitive.

A third case, which proved extremely controversial, related to local loop interconnection and kept Clear and Telecom at loggerheads from 1991 to 1995. Clear, already operating in the long distance market, also wanted to provide local telephone services in competition with Telecom. The two companies failed to reach an agreement on the conditions of Clear's access to Telecom's local network, and Clear brought an action against Telecom before the High Court.

Some issues were easily resolved. The judges unanimously pronounced that Telecom's attempts to impose an access code on Clear's customers and to force Clear to pay the same interconnection price as Telecom's large end users with their own switches were anticompetitive.

Other issues proved much more difficult to resolve. Telecom argued that the efficient com-

ponent pricing rule (ECPR) should be used to determine the interconnection price, while Clear countered that the ECPR was contrary to antitrust law (box 1). The High Court recognized that the ECPR would enable Telecom to recover its monopoly profits as well as its economic costs. It indicated, however, that the rule would compensate Telecom for having to meet universal service objectives while still enabling Clear to enter the market if it were more efficient than Telecom. The court concluded that application of the rule would not reveal an anticompetitive purpose and would therefore not violate antitrust law. The court did not impose any specific interconnection price on the parties, however, urging them instead to resume negotiations and resolve their differences within the framework it provided.

Clear appealed the decision. The Court of Appeal overturned the High Court's ruling, concluding that use of the ECPR would amount to obligating a new entrant to indemnify the monopolist for any loss of profits. This, it judged, would put the new entrant at a competitive disadvantage, and in those conditions an anticompetitive purpose could be assumed. The court ruled that the interconnection price should be based on the incremental costs involved in providing interconnection services plus a reasonable return on capital. It refused to set a specific interconnection price, however, arguing that it was not a price fixing authority.

Telecom then contested the judgment of the Court of Appeal before the Privy Council in Britain, the highest court in New Zealand's judicial system. The Privy Council rejected the decision of the Court of Appeal and ruled, as the High Court had, that use of the ECPR would not violate antitrust law. The Privy Council judged that, in applying the ECPR, Telecom would not be using its dominant position, since it would be acting just as firms in competitive markets do in seeking to recover the opportunity costs of providing services to competitors. The Privy Council left the parties with the task of trying once again to agree on a specific price that would conform to its judgment.

After arduous negotiations and government pressure, Telecom and Clear finally reached an agreement in March 1996 with interconnection prices below ECPR levels.

Main approaches to interconnection pricing

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- **Historical cost-based pricing:** Includes costs that are specifically attributable to the provision of interconnection services plus a share of the common costs (generally evaluated through historical accounting).
- **Long-run incremental cost (LRIC) pricing:** Includes the incremental costs incurred in the long run that result from the provision of interconnection and that would be incurred by an incumbent using the most efficient current technology to provide the interconnection.
- **Efficient component pricing rule (ECPR):** Includes the actual costs of providing interconnection plus the opportunity cost of (or profit forgone in) providing interconnection.
- **Peering arrangements (or bill and keep):** Implies that parties provide each other with free access to their networks. The formula may closely reflect costs when traffic flows from one operator's network to that of the other are roughly in balance.

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interconnection prices on long distance or mobile competitors so as to gain a competitive advantage over them. It also was the case when the incumbent faced competition in the local market from operators that appeared too weak to respond to unfavorable interconnection conditions by competing vigorously for market share.²

So, for example, when government pressure subsided in the long distance interconnection case, Telecom—which held a monopolistic position in the local market and competed with Clear in the long distance market—reneged on its agreement with Clear. Clear finally obtained satisfaction, but only after difficult arbitration. In a similar situation in the mobile market Telecom used its dominant position to force BellSouth to accept unfavorable interconnection conditions. The local loop interconnection case provides yet another example. Clear's ability to compete for market share in local services was apparently insufficient to persuade Telecom to offer an acceptable interconnection price.

This last case also revealed the inability of judges, operating under an antitrust regime, to determine what constituted an equitable interconnection price. The three courts that examined the case disagreed with one another and ultimately failed to impose a specific price on the parties. In addition, their reasoning appeared to be flawed in some instances. For example, the Privy Council's conclusion that, in applying the ECPR, Telecom would not be using its dominant position—because it would be acting just like firms do in competitive markets—ignores the fact that Telecom had much greater opportunity costs and a much greater ability to force its rivals to cover those costs than firms operating in competitive markets.

In 2000 a ministerial inquiry concluded that the policy of relying heavily on general competition law had fallen short of expectations and pointed to a number of changes needed, particularly relating to interconnection. A law adopted in 2001 to introduce these changes required that interconnection prices be based in most cases on the long-run incremental cost (LRIC) of providing interconnection. It also established a specialized telecommunications unit, headed by a newly appointed telecommunications commissioner, within the antitrust authority.

Some lessons of experience

Antitrust regulation appears well suited to addressing some clearly anticompetitive interconnection issues. It worked well in the local interconnection case, for example, where the outcome prevented Telecom from imposing an access code on Clear's customers and forcing Clear to pay the same interconnection price as Telecom's large end users.

Antitrust regulation has also been adequate in some cases where the government put pressure on operators to reach an agreement. Clear was able to extract a relatively favorable interconnection agreement from Telecom in 1991, enabling competition in the long distance market, thanks in part to the government's refusal to approve Telecom's privatization until agreement was reached.

Antitrust regulation has tended to work poorly, however, when specific interconnection conditions had to be imposed, in the absence of government pressure, on operators that lacked incentives to agree. This was the case when the incumbent held a monopolistic position in the local market and could use it to impose high

Broadly speaking, these reforms yielded the desired results. After having fought so bitterly in the first half of the 1990s to impose the ECPR on Clear, Telecom accepted the terms of a peering arrangement that give Clear free access to its local network in exchange for free access to Clear's own local network as long as certain conditions are met (such as roughly balanced traffic flows between the two networks).

The way forward

New Zealand undoubtedly benefited from adopting sector-specific rules and establishing specialized regulatory capacity to tackle difficult interconnection pricing issues. But sector-specific instruments may not be needed forever. Mobile phone service is progressively substituting for fixed service; cable television networks are delivering telephone service and broadband Internet; WiMax and other emerging wireless technologies are being commercially tested as a means to deliver a mix of voice, data, and video products; and power lines are being tested as a way to provide broadband access. As local operators grow in number, the incumbent will find it more and more difficult to impose high interconnection prices on competitors in the long distance and mobile markets, since these competitors will be able to choose to negotiate interconnection with other local operators. And as new local operators gain strength, they will be able to compete more fiercely for market share with the incumbent, reducing its incentive to try to impose high prices for local network interconnection.

Today, with local incumbents tending to remain dominant in the local market, sector-specific tools are likely to continue to be needed to set interconnection prices in most cases. But there are signs that the situation is starting to change. As noted, Telecom recently concluded a peering arrangement with Clear, one of its main competitors in the local market; it also concluded a similar agreement with another competitor, TelstraSaturn. These agreements differ from the LRIC methodology, which regulatory authorities now have to apply when parties are unable to come to an agreement. So it appears that the existence of the fallback LRIC regime was less instrumental in persuading

Telecom to conclude peering arrangements with Clear and TelstraSaturn than the fact that Telecom now faces strong competitors in the local market and thus has incentives to offer them favorable interconnection terms.

As enough experience is gained in setting interconnection prices under a sector-specific regime, an antitrust-based system may become increasingly appropriate for resolving such pricing issues. With interconnection agreements in place, antitrust authorities would have benchmarks, or precedents, to set interconnection prices themselves. And once antitrust authorities are seen as credible and predictable regulators, operators are more likely to reach agreements on their own.

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