Comments by the Portuguese Competition Authority on the Revision of the Guidelines on public funding to broadband networks

The Portuguese Competition Authority (PCA) welcomes this initiative of revising the Guidelines on public funding to broadband networks, and the public consultation as part of the process. The PCA would like to present a contribution regarding Question 8.1:

Several Member States requested vertical separation on the subsidized networks (the wholesale operator of the network shall not engage in retail service provision) to avoid risk of discrimination, support competition and push take-up rates as a result of public intervention. In your view, what would be the costs and the benefits of requesting this condition? In what circumstances would you consider vertical separation to be an effective remedy?

The monopolist owner of a bottleneck input, which is also present in the retail market, may have the incentive and the ability to discriminate against retail entrants, to limit competition in the retail market. According to the European Commission\(^1\), vertical separation could eliminate the vertically integrated incumbent's incentives to discriminate or deny access in favor of its own retail subsidiary, and thereby foster service-based competition. The benefits of vertical separation, eliminating discrimination, must be weighed against its drawbacks, namely, its implementation costs; the need for regulatory oversight of the monopolist infrastructure provider to control the tendency for excessive pricing; and the loss of economies of vertical integration, or coordination, and economies of scope.

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The Portuguese Competition Authority conducted a study, Brito et al (2011)², to investigate if vertical separation reduces discrimination and increases welfare. More specifically, the study compared the incentives of a monopolist wholesaler to discriminate against retailers under vertical integration with one of the retailers and under vertical separation. In addition, the study compared the welfare level under the two scenarios.

Under vertical integration, Brito et al. (2010) show that, if the access price is low, or, if the access price takes intermediate values and the quality of the services of the entrant relative to those of the incumbent's retailer is low, the incumbent's wholesaler discriminates against the entrant by lowering the quality of the input supplied. When the access price is high the incumbent does not discriminate against the entrant. Under vertical separation, Brito et al. (2010) show that, if the access price and the relative quality of the entrant are both low, the wholesaler discriminates against the entrant; if the access price is low and the relative quality of the entrant is high, the wholesaler discriminates against the incumbent's retailer. When the access price is sufficiently high, or there is a low asymmetry between retailers, the wholesaler does not discriminate against either of them.

Any eventual benefits that vertical separation may have in terms of reducing non-price discrimination must be measured against the double marginalization effect it creates. By separating the wholesale and retail activities of the incumbent, one is in fact increasing the marginal costs of the retailer. Under integration, the access price was simultaneously a cost for the retailer that cancelled with the corresponding benefit for the wholesaler, that is, it was an internal transfer. After separation, this increase in the retailer's marginal cost leads to a higher retail price per unit and hence to lower consumption. This negative effect of separation is less significant when the access price is low. However, it is precisely when the access price is low that the vertically separated wholesaler has incentives to maintain discriminatory practices.

Furthermore, Brito et al. (2010) show that discrimination is not always socially undesirable. For sufficiently high quality differences between retailers, it is welfare increasing to degrade the quality of the retailer that has the lowest relative quality. Under these circumstances, quality degradation against the lower quality retailer induces consumers to switch to the

higher quality retailer, where they buy a higher number of units. Hence, even when vertical separation does eliminate discrimination, it is not guaranteed to increase welfare. These results were derived assuming that there are no vertical integration economies and ignoring the costs of the separation process. Either of these two factors only makes vertical separation less socially desirable.

The effect of vertical separation on investment is also unclear. On the one hand, vertical separation would give greater legal certainty to both the incumbent and new market entrants, which could encourage investment in the market. It would reduce the incentive for incumbents to delay investments in access upgrades for fear of making their own current retail services obsolete. And by fostering service-based competition it would also allow entrants to climb the ladder of investment. On the other hand, since entrants may prefer paying for access rather than building up infrastructures of their own, there may be a decrease in the investment incentives for retail entrants. Moreover, the incumbent’s incentives to invest are generally smaller under vertical separation than under vertical integration, because an independent upstream monopolist ignores the positive effect of its investment on downstream profits. Vertical separation might also reduce investment due to higher uncertainty about final demand and poor coordination between infrastructure and service development.

Concluding, there are no grounds to take for granted that vertical separation will eliminate non-price discrimination. Even if it did, it is unclear that it would be socially beneficial. Taking into account all the disadvantages related with this instrument, especially the ones related with its impact on investment, vertical separation must be applied with extreme care.