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A GUIDELINE FOR CONDUCTING MARKET REVIEWS

The Authority issues this document to provide clarity to stakeholders and licensees as to how market reviews are to be conducted, including the public consultation process, the relevant powers of information-gathering and the types of information which may be requested.

This document is intended to be used as a guide and may be updated from time to time.

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Contents

List of Figures

List of Tables

1. Introduction

The preamble to the Electronic Communications Act, no. 36 of 2005 (the "ECA") states that the ECA aims:

> *"To promote convergence in the broadcasting, broadcasting signal distribution and telecommunications sectors and to provide the legal framework for convergence of these sectors; to make new provision for the regulation of electronic communications services, electronic communications network services and broadcasting services; to provide for the granting of new licences and new social obligations; to provide for the control of the radio frequency spectrum; to provide for the continued existence of the Universal Service Agency and the Universal Service Fund; and to provide for matters incidental thereto."*

The ECA introduces two key factors into governance of the provision of electronic communications services:

- A technology-neutral regulatory regime
- Explicit intention to facilitate greater competition in the ICT sector

The legislative mandate to evaluate and address market failures where they occur stems from the South African government's policy of enhancing competition both within the electronic communications sector (via the ECA) as well as the broader economy (via the Competition Act, no 89 of 1998).

The motive behind enhancing competition is to stimulate both allocative and dynamic efficiency up and down as well as across value chains in the supply of goods and services to the South African consumer. The objective is to ensure that the supply of goods and services to the South African consumer is achieved at a fair quality as well as a fair price. Achieving this objective requires a balance to be made between returns on investment in the production and supply of goods and services to the South African consumer and the price (including quality and consumer protection measures) ultimately paid by the South African consumer for such goods and services.

The ECA explicitly acknowledges the importance of this trade-off by including, in the objects of the Act:

2(d) encourage investment, including strategic infrastructure investment, and innovation in the communications sector;

2(f) promote competition within the ICT sector;

2(z) promote stability in the ICT sector

1.1. Purpose

The purpose of this document is to provide stakeholders with an outline as to how the Authority intends to implement the provisions encompassed in the ECA aimed at enhancing competition.

The document is structured as follows:

- Section 2: The public consultation process
- Section 3: The process for identifying the need for regulation
- Section 3: Information requirements

2. The public consultation process

Given the importance of forward-looking regulation as well as regulatory certainty the following process will be followed to ensure regulatory transparency.

Step 1: Priority Markets

The Authority will identify priority markets based on observable trends in the South African electronic communications sector, the need to regulate at the source of the potential problem as well as consideration of government policy objectives.

Step 2: A Market Review

A market review consists of a specific focus on one of the identified priority markets

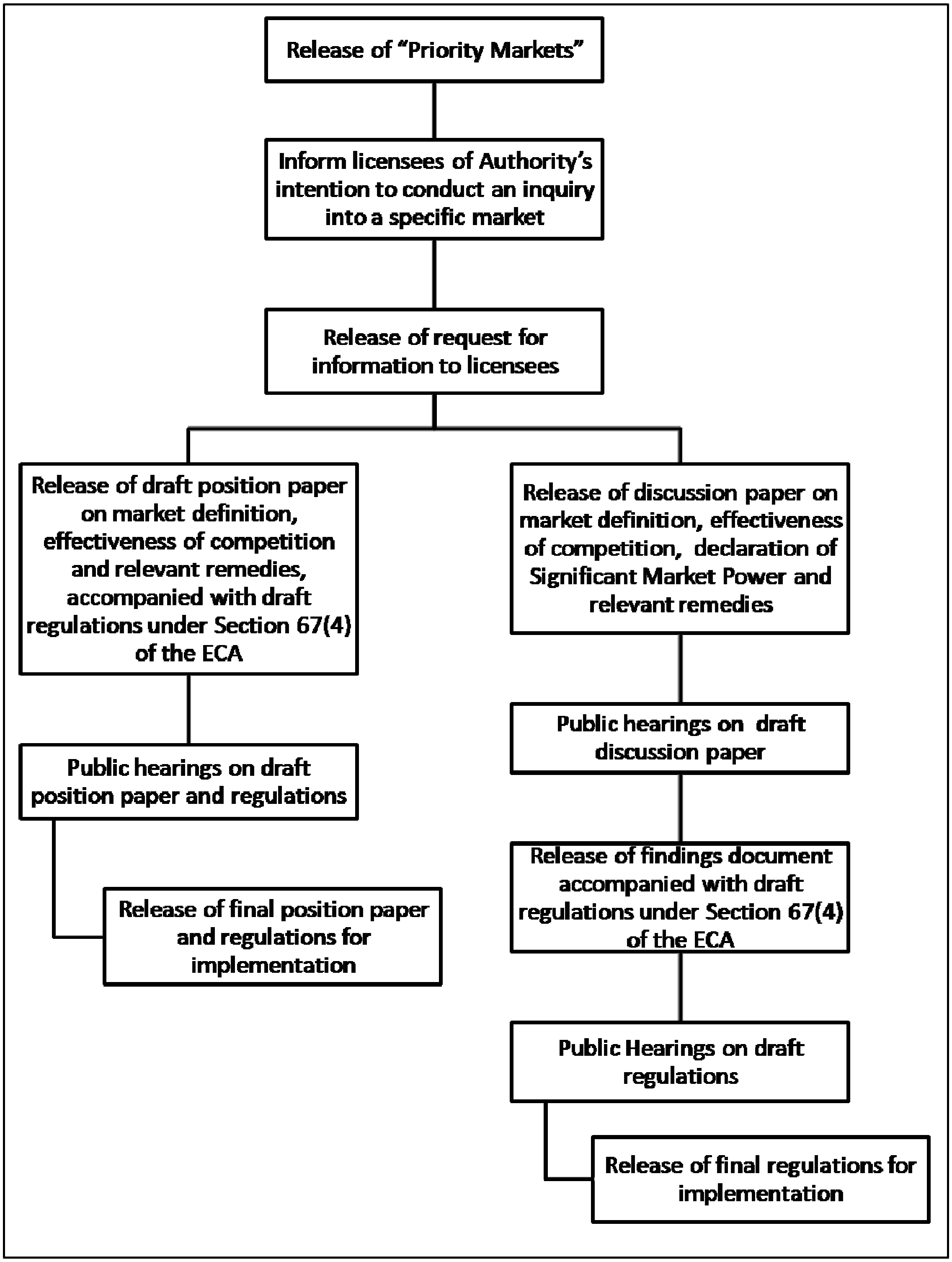
A complete Market Review consists of the following phases:

1. Conducting exploratory investigations into a specific market
    a. Such work will include both the definition of a market as well as the evaluation of the effectiveness of competition within the defined market
    b. The identification of licensees deemed to hold significant market power, if necessary
    c. The identification of pro-competitive remedies, if necessary
2. The development and finalisation of regulations on the outcome of exploratory investigations, if necessary

The Authority will communicate to licensees the provisional timeframes and specific processes within a market review at the time of commencement of a market review.

Depending on the complexity of a market review, the Authority may choose one of two consultation processes to conclude a market review, as outlined in Figure 1 below:

Figure 1: Public Consultation processes



This process indicates that the development of regulations under Section 67(4) takes place **on the outcome of Phase 1 of a market review**.

3. The process for identifying the need for pro-competitive regulation in the South African ICT sector

This section discusses the:

- Legislative requirements to be met when considering defining and evaluating the effectiveness of competition within a market
- Factors to be considered in defining a market
- Methodologies to be used in evaluating the effectiveness of competition
- Regulatory measures applicable to enhance competition

3.1. Legislative requirements

Section 67(4) of the ECA provides the Authority with the legislative powers to address market failure, where it exists. Economic analysis combined with competition law principles has refined the process of identifying and addressing market failures into three distinct steps:

- Defining the market in question
- Evaluating the effectiveness of competition within the defined market
- Concluding whether any particular player has significant market power in the market and if so, is this power detrimental to social welfare, i.e. do monopoly rents exist.

The actions envisaged in the ECA include the Authority conducting sufficient research in Phase 1 of a market review to:

- Determine the boundaries of a specific market (i.e. market definition)
- Evaluate the effectiveness of competition within a specific market

The outcome of such research will lead to a determination as to whether any specific licensee(s) hold significant market power under the provisions of Section 67 and promulgated in terms of regulations under Section 67(4).

Regulations emanating from a market review will therefore include:

- A definition of the relevant market or market segment
- The methodology used to determine the effectiveness of competition
- The identification of those licensees deemed to have significant market power
- The pro-competitive measures applicable to those licensees to promote competition
- The schedule for review and the provision for the monitoring of anti-competitive behaviour

3.2. Factors to be considered when defining a market

Defining a market is an exercise in establishing the boundary within which the provision of particular products or services may be grouped.

A “market” is the interplay between consumer demand for and the supply of a specific product or service, including geographic availability. The exercise of defining a market involves identifying a particular product or service supplied by one or more suppliers and evaluating whether the same or similar consumer-desired outcome may be achieved through the consumption of other products/services, if available. This exercise implies that the original hypothesis is that the desired consumer outcome may only be achieved from the consumption of a particular product or service. If it may be shown that the same/similar desired outcome may be achieved through the consumption of additional products/services, then the definition of the market has to be expanded to include these additional products/services. The Authority may use the Hypothetical Monopolist Test, including the Small (but) Significant Non-transitory Increase in Price (SSNIP) test, as well as other alternatives, including the examination of ‘practical indicia’, during the process of defining a market.

In defining a market, the Authority must consider both barriers to entry (which may restrict the number of products/services on offer) as well as the dynamic characteristics of the market in question. These are expanded upon below:

- *Barriers to entry*:
  - Structural: examples of structural barriers to entry are:
    - **large sunk costs of network construction**, which increase barriers to entry and exit and give significant competitive advantages to 'first movers'
    - **significant economies of scale, scope and density**, which put newer 'smaller' entrants at a competitive disadvantage to the larger incumbent(s) or first-movers who have a lower per-unit cost base. The presence of very high fixed costs can result in one firm having control over core facilities critical in the provision of access (sometimes referred to as a bottleneck or essential facility)[1];
    - **demand-side network effects** that reflect the desire by customers to be able to communicate to and receive communication from anyone (i.e. the value of any-to-any connectivity).

[1] This aspect also falls under consideration in the evaluation of the effectiveness of competition as per Section 67(6)(b)(ii)

        - **Vertical integration.**[2] Many electronic communications markets have at least one vertically integrated operator (often one being a former statutory monopolist). Such a licensee's downstream subsidiaries may compete with other licensees but typically has control over an essential input in the upstream market. Problems can emerge when a vertically integrated operator uses its market power in the upstream market to provide an unfair competitive advantage to its downstream subsidiary.
    - Legal: the Authority deems legal barriers to entry to be those barriers in place other than any potential barriers in place in terms of the ECA or ICASA Act. This includes any primary legislation as well as other legislative requirements, such as municipal by-laws.
    - Regulatory: The Authority deems regulatory barriers to be those barriers to entry in place in terms of the ECA or the ICASA Act.
- *Dynamic character and functioning of the market*: issues to be considered when defining the market include:
    - Demand-side substitution: demand-side substitution occurs when consumers choose to switch products based on the products' characteristics, price and/or intended use. The extent to which consumers are able to choose different products/services to achieve the same end outcome determines the scale and scope of the market to be determined. In effect, the greater ease the consumer faces in switching from the use of one existing product to another in order to provide the same/similar service, the less the potential for a licensee to have control over the price charged to or the quality received by the consumer. The objective of evaluating demand-side substitution is to establish whether the consumer has choice of the use of different products to achieve the same desired outcome. If a choice of product exists, under demand-side analysis the scope of the market will have to be expanded.
        - Challenges regarding demand-side substitutability:
            - Demand-side substitutability may, conceptually, always be possible. The important feature is the extent to which the existence of demand-side substitutability may constrain the market power of a licensee. If a consumer may change products easily to achieve the same desired outcome, then the supplying firm/s has an incentive to keep the price of a product low, i.e. to prevent consumer switching and the ensuing loss of licensee-specific

[2] This is a key aspect for declaring a licensee to have significant market power as per Section 67(5) of the Act.

revenue. However, consumer switching may be constrained for a number of reasons[3].

- Product bundling. Bundling of different services within one offering to the consumer may mean that the overall market consists of market segments within which the market power of licensees is to be evaluated
- A case-by-case analysis is therefore warranted in determining the impact of demand-side substitutability on the definition of a market.

- Supply-side substitution: supply-side substitution occurs when a change in the market (e.g. an increase in the sales price of a product) leads to an increase in the number of licensees who provide the same product to the consumer. An increase in the supply of products provided by *different licensees* in the market aiming to satisfy the same outcome, as per demand-side substitution, reduces the market power of supplying firms. The objective of evaluating supply-side substitution is to establish whether a change in the price of a product would entice a greater number of suppliers to enter the market in question, thereby enhancing consumer choice and reducing the market power of a firm
  - Challenges regarding supply-side substitution:
    - For supply-side substitution to impact on the market, such substitution has to be both comparable to the existing product as well as available within a limited period of time. Supply-side substitutability is therefore only an important element where its impact is equivalent to that of demand-side substitution.
    - Timeframe: aspects such as investment costs and the actual time it takes to enter and provide services affect the impact of supply-side substitution on the market power of a licensee.
    - A case-by-case analysis is therefore warranted to establish whether supply-side substitution is timely, likely and sufficient to have an impact on the definition of a market.

[3] For example, long-term “lock-in” contracts or the lack of availability of an alternative supplier even though contracts are short-term.

3.3. The methodology used to evaluate the effectiveness of competition

Effective competition is a state of being within a particular market where, at a point in time, no one (or group thereof) licensee has significant market power.

Effective competition exists when:

- consumers have sufficient choice regarding who provides the services they seek, at reasonable prices
- sellers have access to buyers without justified restrictions imposed by external parties, including competitors and legislation
- The price charged for a product or service is a result of the interplay between consumers and licensees, i.e. no one firm has price-setting power
- Any variation in price in products or services is a result of differences in the cost of provision or characteristics inherent to the product, such as quality

Where any one, or a combination, of the above is not met, a licensee may have significant market power.

Section 67(6)(b) outlines the factors to be considered when evaluating the effectiveness of competition in a market. The guiding principle behind any evaluation is that the focus is forward-looking, i.e. the market may be deemed ineffectively competitive only if a licensee (or group) is deemed to have significant market power over a period of time into the future. The Authority will determine the time period to be considered on a case-by-case basis.

3.3.1. Factors to be considered when evaluating effectiveness of competition

A number of factors are required to be considered when coming to a determination on the effectiveness of competition. A brief discussion of some of these factors is provided below:

- *Assessment of relative market shares*: Market shares provide an indication of the extent of market power a licensee may have in a particular market. Market shares may be calculated by value or by volume depending on the product or service in question. Although a high market share does not necessarily indicate whether a licensee enjoys significant market power, competition law in South Africa defines a firm as being dominant according to the below scales:
    - it has at least 45% of that market;
    - it has at least 35%, but less than 45%, of that market, unless it can show that it does not have market power; or
    - it has less than 35% of that market, but has market power.

- *Actual and potential existence of competitors*: a forward-looking assessment of the effectiveness of competition within a market is required to take into account existing as well as potential competitors and the impact of an increasing number of players providing services in the same market on whether it is possible for a licensee to have significant market power. In terms of actual and potential existence of competitors, the assessment will take due regard of all possible barriers to entry as well as the likelihood that entry will have an impact on the market powers of existing licensees. To this extent, new entrants to a market represent a form of supply-side substitution.
- *The level, trends in concentration and history of collusion in the market*: Concentration ratios indicate the degree to which specific firms within a market may have significant market power. The most common measurement is the Hirschmann-Herfindahl Index (HHI). This method calculates the sum of the squares of actual competitors' market shares. The summation represents a concentration level for the relevant market. Although the HHI index is commonly used, other methods may be applied from time to time. The history of collusion will be assessed by evaluating price movements of products offered by competitors as well as making reference to any complaints lodged with and initiated by the Competition Commission of South Africa[4].
- *The overall size of each of the market participants*: the overall size of each market participant will determine the extent to which each participant is able to exercise market power. An example of this issue is where a firm has extensive economies of scope and scale.
- *Control of essential facilities*: Certain facilities required to facilitate the development of interoperable and interconnected networks require substantial investment to the extent that only a small number of licensees may be able to accomplish such investment. Whilst such investment is crucial in achieving Object 2b & c of the ECA, it may be possible for the investing firm to foreclose firms from entering any market reliant on the existence of a specific facility. A forward-looking assessment of a market will therefore consider the value or importance of specific facilities in the provision of an end-user service and the extent to which ownership of such a facility impacts on the market power of a particular licensee.
- *Technological advantages or superiority*: Licensee-specific technological advantage, or superiority, is often a case of increasing dynamic efficiency within a licensee, thereby enhancing the end-user experience. Technological advantages may even "exist" as a result of one licensee using more efficient business processes (ordering systems, consumer support etc.). However, it is also possible for a licensee to leverage a specific technological advantage to enter into adjacent markets. Examples of such behaviour include bundling or tying practices as well as linked sales. Such practices may be deemed as harmful to competition. Given that new technologies can be adopted by all

[4] www.compcom.co.za

market participants over time, concerns regarding the effectiveness of competition can only be related to those factors that are to impact on the level of competition during the defined period of forward-looking assessment, i.e. three years.

- *The degree of countervailing bargaining power*: the existence of customers with a strong negotiating position may reduce the market power of a licensee. When purchasers of a service are large and powerful, they can effectively halt an attempt by a licensee to increase prices. There are many factors to be considered in evaluating the degree of countervailing bargaining power, including:
    - The proportion of a licensee's total product purchased by a specific customer
    - The portion of the costs for a service in relation to total customer expenditure
    - Price and quality sensitivity
    - The availability of sufficient information for customers to make informed decisions as well as face insignificant switching costs.
- *Easy or privileged access to capital markets and financial resources*: Infrastructure construction requires substantial up-front capital costs which may only be recouped over the medium to long term. It is likely that only a small number of licensees will be able to access the requisite resources to fund such endeavours. As such, access to capital markets and financial resources is naturally constrained by the costs of infrastructure construction. Concern as to whether a market may be ineffectively competitive courtesy of access to capital markets is therefore constrained to evaluating whether all licensees participating in that market have equal potential access to capital and financial resources.
- *Dynamic characteristics of the market*: high levels of growth, innovation and product/service differentiation cumulatively indicate a market that is dynamically competitive as different licensees enter/exit offering different services at different prices within the same market. A market that exhibits little or no change in the type of services available, limited growth and the lack of consumers being able to purchase differentiated components of a service (i.e. bundling or product tying is prevalent) may serve as indications that competition is ineffective.
- *Economies of scale and scope*: economies of scale and scope arise when increasing production causes average costs to fall and where average costs for one product are lower as a result of it being produced jointly with another product by the same firm respectively. Both economies of scale and scope may arise naturally out of technological or product innovation and therefore not pose any concern regarding the effectiveness of competition within a market. However, substantial economies of scale and scope may act as a barrier to entry to specific markets and therefore increase the market power of a particular licensee. Economies of scale and scope are a concern when the

minimum efficient scale of entry is large when compared to the total market as well as there being substantial losses if exit were to be considered.

- *The nature and extent of vertical integration*: Vertical integration exists where one licensee providing products/services in one market is also present in a market at a higher or lower level of the value chain. Vertical integration, as for access to capital markets and economies of scale and scope, may represent the most efficient outcome for the provision of services. However, vertical integration may also promote dominance by restricting market entry where a licensee has control of upstream and/or downstream markets and the potential to lever market power, thereby hampering the development of competition
- *Ease of entry into the market*: the threat of new entry into a defined market may pose as sufficient constraint on the market power of an existing licensee. However, such market entry represents a form of supply-side substitution. Excluding legal and regulatory barriers (assessed when defining a market), the potential for independent market entry is constrained by the costs of such entry. Barriers to independent market entry may exist as a result of substantial sunk costs, existing market participants having exclusive purchasing agreements with key input suppliers or whether the level of technological innovation may impact on potential market entry. Ease of entry to a market must be timely, likely and sufficient in order to increase the level of competition in a market.

3.4. A discussion on possible pro-competitive terms and conditions

A range of possible pro-competitive terms and conditions exist. The imposition of such obligations is intended to correct the specific identified market failure. Therefore not all possible pro-competitive conditions will be applied if a market review reveals a lack of effective competition.

The ECA lists a number of possible pro-competitive conditions, outlined in Section 67(7).

3.4.1. Transparency, non-discrimination and accounting separation

A transparency obligation may be imposed on a licensee deemed to have significant market power. A transparency obligation does not necessarily have any impact on the conduct of a licensee in a market but it assists in identifying conduct which will reduce the effectiveness of competition as well as ensure that parties wishing to purchase services from the deemed licensee are sufficiently informed of its internal practices.

A transparency obligation therefore represents an effort to enhance countervailing bargaining power within a market. However, increased publicly available information on its own may not have any impact on the structure of the market. Therefore the principle of non-discrimination is often included in a transparency obligation.

One objective of a non-discrimination obligation is to ensure that a licensee that self-supplies specific inputs to its own operations does so at fair and reasonable prices. In other words, if a licensee self-supplies an input at a different price to the price of the same input as sold to competitors, such a differential must be justified.

An obligation for functional accounting separation and the submission of regulated financial records (or RFR) to the Authority aims to further ensure that internal transfer pricing between business units is transparent, with the objective of ensuring that cross-subsidization does not occur. The requirement for the submission of such information may also form part of a price control remedy. The format and accounting methodology is to be stipulated by the Authority.

3.4.2. Price controls

Price controls, be they in a wholesale or retail market, may be necessary where ineffective competition is found. The form of regulatory action would be determined on a case-by-case basis, including the relevant costing methodology to be applied. Price controls may take the form of a minimum price to be charged, a maximum or a combination of the two. Inherent in costing of the provision of a service, any price control intervention will have to consider the impact of product bundling, predatory pricing and any other behaviour which may harm competition.

3.4.3. Controls on the type of services to be provided

In certain cases, a licensee with significant market power may be the only licensee with the ability to ensure certain social objectives are achieved. This may mean that the Authority may impose the requirement to provide particular services, or conversely, to limit the provision of specific services. Examples may include an obligation to broadcast certain content or to provide access points in under-serviced areas.

3.4.4. Other remedies.

The Authority may impose any other pro-competitive terms and conditions designed to address any identified market failure. This could include the requirement for functional separation.

4. Information requirements to complete market reviews

The sharing of information between the Authority and licensees is of key importance. The Authority may require firm-specific information in order to ensure that an evidence-based decision is made. Secondly, it is also crucial that the Authority share the outcomes of its work with stakeholders to ensure that all evidence and views have been considered when decisions have been made.

Tables 1 and 2 contain a non-exhaustive list of the types of information the Authority may seek when defining a market and evaluating the effectiveness of competition

In addition, benchmarking data, evidence of prior anti-competitive behaviour and any other additional information may be used to support the Authority's decision-making process.

Table 1: Possible data requirement for defining the market

Factors to be considered	Criteria	Type of information
Non-transitory barriers to entry		
	Structural	• Network infrastructure • Fixed investment trends • Level of self-provisioning
	Legal	• Qualitative review of legislation that may hamper market entry
	Regulatory	• Qualitative review of existing regulatory body that may hamper the development of competition
Dynamic character and functioning of the market		
	Substitutability	• Product/service characteristics per type of customer, e.g. residential versus non-residential • Churn rates • Switching costs • Price transparency on the supply and demand side • Prices and volumes (for bundled and unbundled products)

Table 2: Possible data requirements to evaluate the effectiveness of competition

Factors to be considered	Type of information
Assessment of market shares, the level and trends in concentration, overall size of market participants, economies of scale and scope	• Turnover/revenue • Volume of traffic per service • Number of end-users • Number of “transactions” (e.g. calls, dial-up or connection sessions etc) • Network capacity utilisation • Bundling of services (including sales volumes and utilisation)
Control of essential facilities, nature and extent of vertical integration and technical superiority	• Network infrastructure • Investment and operational expenditure • Control and ownership of infrastructure • Relationship between companies • Qualitative information regarding product/service characteristics
Actual and potential existence of competitors	• Number and dates of new market entry and exit
Degree of countervailing bargaining power and dynamic characteristics of the market	• Specific customer (or category) share of total turnover • Price trends and consumer switching data • Price transparency of available products • Rate of product differentiation/ new product introduction
Easy or privileged access to capital markets/resources and the ease of entry into the market	• Qualitative information • Trends in market shares • Market growth

4.1. Powers of the Authority to request information

The Authority may base its decisions on publicly available information, information obtained through specific requests to licensees or a combination of the two. It is in the interest of all parties to co-operate with the Authority in order to ensure that sound regulatory decisions are made.

The Authority has the legislative powers to require licensees to submit information on request, as outlined in Section 4(3)(g) of the ICASA Act of 2000, which states that the Authority:

> *“may, by notice in writing, direct the holder of a licence in terms of the underlying statutes to produce or furnish to the Authority, at a time and place specified in the notice, any documents and information specified in such notice and relating to any matter in respect of which a duty or obligation is imposed on such licensee by this Act or the underlying statutes”*

4.2. Timeframes and Collection methods of information

The accuracy of defining and analysing markets depends to a large degree on the timely provision of market information as well as the accuracy and reliability of the information provided.

The Authority will from time to time release questionnaires in order to make up-to-date evidence-based decisions. Licensees are typically required to provide such information within 30 business days of the request for information.

4.3. Information meetings with Licensees

The Authority is committed to ensuring a co-operative and continuous dialogue with licensees' appointed contact persons regarding the collection of market information.

Such a dialogue will initially be by letter, with further meetings and fora on a licensee and stakeholder basis arranged where deemed necessary.