

CPRC Discussion Paper Series

Competition Policy Research Center Fair Trade Commission of Japan

Competition and Regulatory Issues in Network Industries: Case Study Lessons for Japanese Telecoms and Postal Sectors

Shanker A. Singham

Chairman,
International Roundtable for Trade & Competition Policy, Inc.

CPDP-20-E March 2006

**This paper reflects the discussions in the CPRC Informal
Workshop on April the 11th , October the 4th in 2005 and
February the 13th in 2006.**

1-1-1, Kasumigaseki, Chiyoda-ku, TOKYO 100-8987 JAPAN

Phone:+81-3-3581-1848 Fax:+81-3-3581-1945

URL:www.jftc.go.jp/cprc.html

E-mail:cprcsec@jftc.go.jp

Abstract

Postal privatization in Japan offers great opportunities to deliver consumer benefits and innovation to Japanese citizens. Whether those benefits will be delivered or not will depend on how pro-competitive the regulatory structure will be that underpins the privatization process. The Competition Agency, JFTC, plays a crucial role in advocating pro-competitive reforms in this area. Many of these pro-competitive reforms have also been delivered in the telecoms sector, and it is thus important to study this sector for useful lessons which can be applied in the postal context.

The paper reviews the prospects for pro-competitive postal privatization, and applies the latest learning on the mechanics of privatization. The paper also notes that postal privatization does not take place in a vacuum, and sits within the overall context of a changed global communications economy. The cost reductions brought about by the printing press amounted to a fraction of the cost reductions brought about by the microprocessor (a factor of 1,000 to 10 million). This means that the current revolution is every bit as powerful as the renaissance and industrial revolution before it. Indeed Professor Lawrence Summers, the president of the Harvard University, noted that we were in the third major revolution of the last thousand years, at the Davos World Economic Forum event in 2006.

The paper examines the interface between regulatory systems in the telecoms and postal sectors, and competition issues. In particular the paper focuses on the upcoming postal privatization and how the Japanese ministries involved can ensure that the privatization benefits consumers and leads to consumer welfare gains in the economic sense. In the context of both telecoms and postal, three areas that predominate are:

- (i) Reserved Sector. How big should the reserved sector be? What impact does the size of the reserved sector have on competition in the unreserved areas?
- (ii) Cross-Subsidization. The paper considers whether cross-subsidization is always harmful, or whether a more consumer welfare standard needs to be adopted. If so, how is the issue affected by legacy government ownership and legacy privileges.

The paper evaluates and makes recommendations regarding upcoming postal privatization.

TABLE OF CONTENTS

1.	INTRODUCTION TO PRO-COMPETITIVE REGULATION GENERALLY	1
2.	TRANSITION FROM REGULATION TO COMPETITION	1
3.	NEW COMMUNICATIONS ECONOMY	4
4.	THE APPLICATION OF PUBLIC GOODS THEORY TO THE POSTAL SECTOR	5
5.	POTENTIAL BARRIERS TO EFFECTIVE COMPETITION	7
	a. State Aids and Regulated Industries	7
	i. State Aids and EU Law	8
	ii. US State Action Exemption	11
	b. Cross-Subsidization	15
6.	ADVOCACY ROLE OF THE COMPETITION AGENCY	16
7.	DEALING WITH LEGISLATORS	18
8.	GLOBAL COMPETITION ADVOCACY	19
9.	TELECOMMUNICATIONS	20
	a. Teléfonos de Mexico	20
	b. Other Telecom Issues	22
	i. Structural Separation	22
	ii. Accounting Separation	23
10.	POSTAL REGULATION	23
	a. Arguments in Favor of Postal Privatization	24
	b. Costs in Private Firms	25
	c. Reserved Sector Analysis	25
	d. Universal Service Issues in Postal	26
11.	ENSURING PRIVATIZATION LEADS TO COMPETITION	28
12.	POTENTIAL ISSUES IN JAPANESE POSTAL PRIVATIZATION	29
	a. Evaluation of JPCo's Cost Base	29
	b. Auctioning off Reserved Sector?	34
	c. Interconnection and Access Pricing	36
	d. Impact of Work Sharing	38
13.	FURTHER COST CONSIDERATIONS: HOW TO AVOID THE CROSS-SUBSIDIZATION PROBLEM	39
	a. Below-Cost Pricing	39
	b. Market Power and Recouping Costs	41
14.	PREVENTION IS BETTER THAN CURE	42
15.	CONCLUSION	43

1. Introduction to Pro-Competitive Regulation Generally

The purpose of this paper is to examine the role of pro-competitive sectoral regulation, its impact on consumer welfare optimization, and the competitiveness of a national economy. We will review in particular the telecoms and postal sectors, the latter in light of postal sector reform in Japan. We focus case studies on the telecom and postal sectors because these sectors are very important as the communications infrastructure for the modern day business world. Lowering the costs and rendering these structures more efficient will lead to cost savings for business which will be consequently better able to compete on the global stage. Thus we can see that ensuring pro-competitive regulation delivers consumer-welfare-enhancing benefits has a direct impact on the competitiveness of the Japanese economy. There are also similarities between these two sectors from which general principles can be learned.

Sector regulation presents specific issues for competition policy. The roles of antitrust and sector regulation for regulated industries are complementary but at times in tension. One is forward looking and prophylactic in nature. That is, sector regulation seeks to identify a problem before it happens and creates an administrative process to proscribe behavior *ex-ante*. Competition policy/antitrust looks to regulate industries *ex post* and reacts to marketplace conditions.

In regulated industries, a number of sectors have transitioned or are transitioning from traditional regulation to competition. It is during this transition period in which we should be particularly concerned because market power in the transition might forestall true competition beyond the transition phase. Many sectors undergoing this type of transition have a strong legacy of state interventionism in the economy, including state ownership of regulated industries. Some of these industries have been fully or partially privatized while others remain under state ownership. In a number of countries the privatizations have not been accompanied by market liberalization that would ensure that incumbents could not engage in anti-competitive practices. In markets that continue to have state owned enterprises (SOEs), entrants are faced with a situation where a government serves as both regulator and market participant. In countries with fairly new competition and sector agencies, there is particular concern that a lack of strength in the competition regulator will lead to industry capture. Competition agencies, particularly those in the transitioning economies, must focus on preventing anti-competitive behavior in this area. By competition, we mean a normative framework based on economic efficiency and consumer welfare. An act that reduces consumer welfare or economic efficiency is anti-competitive.

2. Transition from Regulation to Competition

The pitfalls of monopoly are well known, and consist of higher prices and lower production. However, where there are significant economies of scale, a situation might exist where high levels of market power may be necessary to deliver consumer welfare benefits. These situations historically have been referred to as "natural monopolies." In "natural monopolies," competition would require the installation of redundant systems. To prevent this inefficiency, governments sometimes provide for legislated monopolies in areas where natural monopolies occur, such as network industries like postal, telecom or electricity. In other instances, the government creates a monopoly in such areas by its own accord because of political ideologies such as nationalization or import substitution. However, this creates a host of problems that do not occur with private monopolies. In both cases, competition agencies play a role in ensuring (i) pro-competitive regulation and (ii) that welfare

benefits are maximized (avoiding both cannibalistic competition on the one hand and welfare diminishing monopolization on the other).

Over the past decade, many governments have recognized the benefits of competition and chosen to privatize several state monopolies. During this privatization process, the enforcement of competition law becomes all the more crucial. This is because privatization in itself is not a guarantee of increased competition and the accompanying benefits. If a state monopoly is privatized without the removal of the public sector restraints (such as anti-competitive legislation) that protect its monopoly power, then it will come as no surprise that the result of the privatization will be a private monopoly. When the aim of reform is to increase competition, public sector restraints leading to private monopoly will result in the failure of those aims. Regarding postal, the decision to privatize the postal service is a very positive step. Unlocking the force and benefits of competition will lead to major opportunities for Japanese consumers and businesses alike. The postal and related delivery services are the communications infrastructure of the modern business world. If these are efficient and low cost, business costs will decrease and lead to more competitive businesses. However, the precise manner in which the privatization will roll out will determine whether the benefits of competition will be successfully unlocked.

A significant problem with respect to SOEs in particular is that they are not profit-maximizing entities. The guarantee of an SOE's monopoly power and its regulation by a governmental agency changes its behavior from economic to political – it must influence and manipulate the regulatory agency for its own gain. In addition to attempts to increase costs or hide profits in cost to allow it to earn excessive profits, the monopolist may also try to curry favor with influential figures. This can take the form of creating pricing schemes to appeal to political allies or paying its employees inflated salaries to mobilize a constituency base highly interested in influencing the regulatory agency.¹ The power of the regulatory agency over their functions leaves the monopoly with little if any incentive to respond to actual consumer demands or market conditions.²

Since the purpose of SOEs is not necessarily to earn profits, they are instead interested in driving out competitors. As such, SOEs have an incentive to undercut their private rivals:

Government firms use the benefits of monopolized business sectors, along with many other advantages of government ownership, to price competitive activities below cost. Antitrust authorities call this 'predatory pricing' when done by private firms but ignore the behavior of government firms. The effect, however, is the same: competing private companies don't enter or are driven from the market.³

Private firms cannot sustain predatory pricing as easily because shareholders are likely to punish firms that price below marginal cost in order to drive out competitors. A government market participant, however, can sustain predatory pricing precisely for the reason that market forces will not act to end such practices. In addition, the non-profit maximizing firm may not try to recoup the lost profit of a predatory pricing scheme (a key element of the US predatory pricing test). This is

¹ Richard A. Posner, *The Effects of Deregulation on Competition: The Experience of the United States*, 23 *Fordham Int'l L.J.* 7 (2000).

² David E.M. Sappington and J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 *Antitrust L.J.* 479(2003).

³ Rick Geddes, *Government Enterprises: The Forgotten Antitrust Concern*, available at http://www-hoover.stanford.edu/pubaffairs/we/current/geddes_0600.html.

why governments tend to be, at best, revenue maximizers, whereas the private firms tend to be (or should be) profit maximizers.

In the transition from SOEs to private ownership, public sector restraints must also be proscribed as part of competition policy in regulated industries. Public sector restraints cover the behavior of government-owned companies, and the impact of regulatory policies and laws that distort competitive markets, such as state aids. As Tim Muris, the former Chairman of the US Federal Trade Commission (“FTC”) argues:

Attempting to protect competition by focusing solely on private restraints is like trying to stop the flow of water at a fork in a stream by blocking only one of the channels. Unless you block both channels, you are not likely to even slow, much less stop, the flow...The same is true of antitrust enforcement. If you create a system in which private price fixing results in a jail sentence, but accomplishing the same objective through government regulation is always legal, you have not completely addressed the competitive problem.⁴

Thus, effective regulated industry oversight requires the elimination of public sector restraints.⁵

Public sector restraints are addressed in the competition laws of most countries. The only major developed market where there is a specific competition exception to state action is the US market. In large part, this is due to the particular history of the United States, where there was much less of a history of state intervention in the economy than one finds in other countries. Under US law, the state action exemption has its juridical basis in the *Parker v. Brown* decision. In *Parker*, the Supreme Court rejected the contention that the California raisin proration program violated the Sherman Act.⁶ The Court found that the prorate program was not created to operate by force of individual agreement or combination, but rather by the legislative command of the state and did “not intend to operate without that command.”⁷ Therefore, the Court found that the law did not violate the Sherman Act because the Sherman Act was not created to limit the ability of state officials or legislatures to regulate commerce. The Court buttressed this holding in the sovereignty accorded to state legislatures under the Constitution, which could only be limited by Congress. The Court did, however, place a limitation on the exemption by stating that it did not grant immunity to people or corporations who violated the Sherman Act under the guise of a state grant of authority.⁸

In order to qualify for immunity under the *Parker* standard, “the challenged restraint must be clearly articulated and affirmatively expressed as state policy,” and “the policy must be actively

⁴ Timothy J. Muris, State Intervention/State Action – A U.S. Perspective, Fordham Annual Conference on International Antitrust Law & Policy, New York, NY Oct. 24, 2003.

⁵ See Shanker A. Singham, *Is it Time for an International Agreement on Uncompetitive Public Sector Practices?*, 27 Brook. J. Int'l L. 35 (2001).

⁶ *Parker v. Brown*, 317 U.S. 341 (1943). Under the proration program, the California Agricultural Committee sets production limits in order to maintain the price of raisins. See *id.* at 347.

⁷ *Id.*

⁸ See *id.* See also *Rice v. Norman Williams Co.*, 102 U.S. 654, 662 (1882) (holding that upholding the validity of a state statute does not insulate a firm's invocation of the statute from scrutiny under the Sherman Act).

supervised.”⁹ In *California Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, the Court struck down a California statute because, although the price fixing restraint was clearly expressed as state policy, the state neither set the prices nor regulated the reasonableness of the price schedules. Had California’s program completely controlled the distribution of liquor within the state, that comprehensive regulation would have been exempt from the Sherman Act under the state-action doctrine.¹⁰ Thus, state legislation that appears inconsistent with federal antitrust law can survive preemption if it qualifies under the state action exemption doctrine.

It is interesting to note a change in direction of US policy in the area of competition exemptions and the state action exemption in particular. As early as 1978, Robert Bork saw an enormous proliferation of regulatory and licensing authorities in the US and he argued that this would damage the US economy if allowed unchecked, thus recognizing the importance of competition advocacy in the regulatory process in the US.¹¹ The FTC’s recent State Action Task Force has had successes in identifying this problem.¹² It noted that states should be prevented from acting opportunistically towards one another, and that this was an important part of the federal process. One of the recommendations of this task force was to introduce the explicit definition of a market participant (for whom there would not be a state-action exemption).

The current transitions from regulation to competition come at an interesting time in communications history in terms of technological innovation and its influence on the comparative process.

3. New Communications Economy

In the 21st century, the way information is delivered to consumers is undergoing a rapid and total change. People are organizing themselves around information and content, and less on materials and delivery. In this age, downward pressure on delivery costs brought about by the costless delivery of information over the internet and e-mail is almost total. This has caused a shift to the actual content – a complete reversal from the McLuhanesque “medium is the message”. It is hard to explain the full impact of the information revolution. Suffice it to say that cost reductions brought about by the printing press were of the order of 1,000. Cost reductions brought about as a result of the invention of the microprocessor are of the order of 10 million. The printing press led to the industrial revolution as the microprocessor has led to the information revolution, but the impact of the microprocessor will be far greater. In a speech in Davos (2006) to the World Economic Forum, Professor Larry Summers noted that we were currently living through the third revolution of the last thousand years (the renaissance and the industrial revolution being the first two).

In many ways, there is a new communications economy which applies to the way that all manner of products are transported across borders. In this new communications economy, the activities of a telecommunications provider, carrying information across the e-mail, or a mail carrier

⁹ *City of Lafayette v. La. Power & Light Co.*, 435 U.S. 389, 410 (1978). See also *Cal. Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980) (“*Midcal*”).

¹⁰ See *Midcal*, 445 U.S. at 106.

¹¹ Robert H. Bork, *The Antitrust Paradox: a Policy at War with Itself* (1978).

¹² See Federal Trade Commission, Report of the State Action Task Force: Recommendations to Clarify and Reaffirm the Original Purposes of the State Action Doctrine To Help Ensure That Robust Competition Continues to Protect Consumers (September 2003).

carrying the same information in documentary form, or an express delivery provider carrying the same document can be weighed. Since these different platforms in some senses compete against each other, it is important that nothing is done that damages one or the other in the government's regulatory supervision of the sector. In order to ensure the most efficient and effective delivery channel, it is important that the channels are allowed to compete against each other. Economists have described the theory that underpins such competition as the theory of "monopolistic competition." Under this theory, individual monopolies can compete better against each other and promote overall consumer welfare in an economic sense.

In the virtual world, the meaning of geography is changing. People no longer think of themselves as creatures of a particular physical space. They are as likely to have interests in common with, for example, a Yahoo group member in the US or Europe as in their home town of Tokyo. They may not have much in common with their nearest neighbors in the traditional sense of the word. Increasingly, connectivity is between people, and place is less relevant, just as content and not carriage is king. Another thing that has changed is the speed with which global business is now conducted, powered by the internet. The speed of this change is so fast that the communications channels must be fast also.

All of this has important consequences for telecom and postal companies. The speed of the regulatory system is important. For example, in the US, the current regulatory system which applies to USPS is not tenable, where it takes ten months to approve a postal increase. At this important juncture in the evolution of communication technology, the policy implemented by the state has a substantial impact on the degree of competition in the industry, both at the time of deregulation and in the future.

4. The Application of Public Goods Theory to the Postal Sector

The original motivation for a letter mail monopoly was that communications were a vital part of ensuring national identity. The Post satisfied the public goods theory, because consumers that benefited from the service did not deprive others of its benefits or limit supply. Under ordinary public goods theory, there is an incentive for a monopoly to be declared because of the market failure brought about as a result of the fact that we are dealing with public goods. Market failure occurs because the marginal cost curve of these kinds of public goods decreases to zero (instead of being a U-shaped curve as is the case with other goods). This occurs because they generally have very high fixed costs, such as infrastructure and so forth, that means that the average-cost curve declines. This means that as more and more services are provided, costs decline to zero as does price. This prevents the service provider from functioning and hence explains the request for state subvention or in extreme cases, state-mandated monopoly.

However, with the advent of e-mail, the internet, and value-added telecommunications services, the arguments favoring public goods models are less and less persuasive. There is no longer a compelling public interest in ensuring that people have access to postal service because of the many other ways that information is transmitted. Furthermore, even if those arguments held up, there would be no reason not to permit competition, rather competition with regulated rates would be the norm in cases which are supposedly natural monopolies.

Conventional public goods analysis is frequently given as the reason supporting a natural monopoly. In this world, competition is shunned for fear that it will give rise to duplicated

networks and less rather than greater efficiency. In this context, it is important to note that legislated monopolies were created before the development of public goods theories. In other words, much of the economics to justify natural monopoly theory occurred well after the political forces that gave rise to natural monopoly. The reality is that natural monopoly theories never did hold much weight. Viewing the competitive process as a dynamic one, we can see that few industries could say that the free market, applying a natural monopoly would allow consolidation to monopoly without the potential for new entrants or future competition acting as a restraint. Even if there are still adherents to the concept of natural monopoly, the number of industries that do not now have substantial infrastructural bypass capabilities is small and declining. One can look at the impact of wireless technology on the wired market and the arguments for natural monopoly there that were based on the high fixed costs of building the network. In the case of postal, this is even further removed from the realm of natural monopoly because of the ways that competing methods of getting information to people do not rely on or in any sense interconnect with the Post's network.

A major issue is the notion of whether in a dynamic competitive environment, there is such a thing as excessive competition. "Ruinous" or "excessive" competition frequently harms high cost producers and benefits consumers. Consumers are harmed only if the low cost producers are actually producing below cost, and hence setting up the conditions for monopoly later. The whole concept of public goods theory rests on the presumption that in certain cases monopoly is the preferred market condition, because competition would invariably be excessive and lead to duplication. However, there is no reason in a public goods context why free competition as opposed to a legislatively granted monopoly might not lead to a large provider, and there is no inconsistency with normal competitive conditions that this should occur. It certainly does not mean that certain industries are prone to natural monopoly, or that the market fails in certain cases.

In most network industries that had previously been thought to be natural monopolies, such as the electric utilities industry, competition has been an important element in keeping downward pressure on price.

While the notion of natural monopoly in general has broken down, postal services are the least likely entities to qualify for such treatment even if the notion were accepted. In electricity, telecom or gas facilities, one can see the very high fixed-capital costs of building out complex wire or pipe networks. We do not see such high fixed costs for postal services. Because these fixed costs are not so high, the risk of future entry by other businesses would be high in a freely competitive scenario. This fact means that if the Post were privatized, then any tendency towards monopoly would be restrained by the possibility of future entry, thus obviating the need for excessive price controls.

The need for a state-granted monopoly in the postal sector is further reduced by the "vertical separability" of regular postal services. The main functions of postal services are pick up, various sorting procedures, and delivery. Data suggests that less time-sensitive delivery services, such as regular postal service, should tend to be less vertically integrated across these functions, because the transaction costs involved in contracting between them are relatively low. In express delivery, by contrast, the transactions costs involved in contracting for highly specific assets and services needed to accomplish reliable express delivery are relatively high, and generally preclude

such separability of functions among different providers.¹³ Thus, while higher-speed and higher-cost services naturally tend toward greater vertical integration, the lower-cost, lower-speed services provided by regular postal services can be shared among several different service providers. This presents opportunities to allow private companies to compete to share the workload involved in providing the service. Such worksharing would subject the service to competitive forces that would apply downward pressure to costs and encourage innovation. Vertical integration of this service, by contrast, results in extremely high inefficiency losses that ultimately impact the prices paid by consumers.

From a pro-poor standpoint, the letter mail monopoly acts to set a price floor in terms of delivery – deregulation might actually lead to greater choice and lower prices. The notion that the Post is somehow to be equated with very intensive capital cost industries such as electricity, telecommunications and gas is misleading. The industry instead is closer to trucking or airlines, where a large percentage of the costs is actually labor cost, as well as any legacy labor costs. Neither of these industries sinks much capital into a network. In the case of postal in the US, labor costs are 80% of the total costs. In the comparable industries of airlines and trucking, deregulation has taken place and has led to dramatic changes in pricing and cost structures. The Post does have to contend with inflated labor costs (at least in the US) and a large amount of political power derived from the size of the labor force.

Other ways of reducing costs include access pricing. Access pricing comes into play when it is possible for other companies to share the workload of the Post, thus reducing the Post's costs, and getting a better rate as a result. This would include, for example, where a company delivers mail to a central post office, thus eliminating one leg of the journey that the Post would have to engage in to lower costs. Discounts can also be applied for large pre-sort mailers in the case of the USPS. However, from the perspective of postal services, the more options are given to lower access charges, the greater the problem of stranded costs, as certain dedicated assets are left unutilized for greater periods.

Future mail delivery is a platform that admittedly now competes with other ways of sending out information, or, for example, paying bills. There are advantages to conventional "snail mail," compared with e-mail, such as privacy and identity theft concerns. It is likely in the future that postal bill paying may be competitive with e-bill paying. The important thing in terms of delivery of benefits to consumers is that these platforms are able to compete well against each other, following the theory of monopolistic competition.

5. Potential Barriers to Effective Competition

a. State Aids and Regulated Industries

State aid has deleterious effects by subsidizing certain national champions. Competition is not furthered by having some companies compete against certain companies that receive substantial government subsidies in regulated industries and that use such subsidies to create barriers for entry to competitors. Indeed, politicians might resort to state aids when the previously state-owned

¹³ Richard Geddes, *Patterns of Private Delivery*, in *The Last Monopoly; Privatizing the Postal Service for the Information Age* (Ed. Edward L. Hudgins, Cato Institute, 1996), at p. 84.

enterprise begins to feel the effects of competition in its regulated industry for the first time. This political impulse must be checked.

i State Aids and EU Law

The competition provisions of the EC Treaty are founded on the principle that a competitive market, rather than a state-controlled market or one that allows private monopolies, are the best means of securing economic efficiency, in terms of both the allocation of resources and efficient production – to the benefit of businesses and consumers alike. They ensure that all undertakings operating in the EU compete on a level playing field, and that any non-competitive practices by companies or national authorities do not hinder healthy competition. The prime motivating reason for the EU's competition disciplines are the history of state control and the urgent need to ensure that the "European project" was not thwarted because companies divided up markets and resurrected the borders the Treaty of Rome sought to reduce, using anticompetitive means.

State aids disrupt normal competitive forces, and therefore distort the competitive playing field. Neither the beneficiaries of state aid nor their competitors prosper in the long term. State aid distorts competition if it intervenes in an existing or developing competitive relationship between holdings or sectors of production and if the measure artificially modifies the conditions of competition among competitors.

The EU jurisprudence is useful as it sets out the basis for state aid regulation. Article 87 of the EC Treaty¹⁴ prohibits any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain firms or the production of certain goods. The aid in question can take a variety of forms as, for instance: state grants; interest relief; tax relief; state guarantee or holding; or the provision by the state of goods and services on preferential terms. The decision as to whether or not aid granted by Member States is compatible with the Common Market can be made only by a supranational and independent authority, such as the European Commission.¹⁵ The Commission's role is to monitor proposed and existing state aid measures by Member States to ensure that they are compatible with EU state aid legislation and do not distort intra-community competition. The Commission has the power to require that aid granted by Member States which is incompatible with the common market be repaid by recipients to the public authorities which granted it.¹⁶ The Member State must recover the aid immediately in accordance with domestic procedures. The Commission has adopted a number of "guidelines" or "frameworks" to clarify its state aid policy in a number of areas: regions lagging behind in terms of development; research and development; employment; protection of the environment; rescue and restructuring of firms in difficulty. The Commission has also adopted a number of "block exemption" regulations for state aid to: small and medium-sized enterprises; aid for training; and aid for employment. Aid granted in conformity with all the conditions set out in these regulations is automatically considered compatible with the common market.

¹⁴ Treaty Establishing the European Community (consolidated text), Dec. 24 2002, O.J. (C 325) 33, Art. 82 (2002).

¹⁵ *Id.* at Art. 88.

¹⁶ According to Article 89 of the EC Treaty, "The Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, may make any appropriate regulations for the application of Articles 87 and 88 and may in particular determine the conditions in which Article 88(3) shall apply and the categories of aid exempted from this procedure". Regarding general rules of procedures about state aids, see Council Regulation (EC) No 659/1999 of 22 March 1999, laying down detailed rules for the application of Article 93 (now Article 88) of the EC Treaty, O.J. L 83, March 27, 1999, at 1-9.

The EC Treaty, however, allows exceptions to the ban on state aid where the proposed aid schemes may have a beneficial impact in overall Union terms. Article 87 of the EC Treaty allows the following forms of aid: 1) aid having a social character, granted to individual consumers; 2) aid to make good the damage caused by natural disasters or exceptional occurrences; 3) aid designed to: a) promote the economic development of underdeveloped areas (regarded as particularly backward in accordance with EU Community criteria); b) promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State; c) facilitate the development of certain activities or areas, d) promote culture and heritage conservation (where, in the last two cases sub c) and d), such aid does not affect trading conditions and competition in the EU Community to an extent that is contrary to the common interest).

The European Court of Justice (ECJ) has repeatedly stated that the test in order to classify a state measure as a state aid is whether the recipient undertaking "receives an economic advantage which it would not have obtained under normal market conditions".¹⁷ This is the so-called "Market Economy Investor" principle. This test is employed in order to determine whether the advantage is one which would or could have been obtained from a private operator acting with a view to obtain a return.

Services of general economic interest are different from ordinary services in that public authorities consider that they need to be provided even where the market may not have sufficient incentives to do so. This is not to deny that in many cases the market will be the best mechanism for providing such services. Many basic requirements, such as for food, clothing, shelter, are provided exclusively or overwhelmingly by the market. However, if the public authorities consider that certain services are in the general interest and market forces may not result in a satisfactory provision, they can lay down a number of specific service provisions to meet these needs in the form of service of general interest obligations. The fulfillment of these obligations may trigger, even if not necessary, the granting of special or exclusive rights, or the provision for specific funding mechanisms.

The definition of a specific mission of general interest and the attendant service required to fulfill that mission need not imply any specific method of service provision. The classic case is the universal service obligation ("USO"), i.e., the obligation to provide a certain service throughout the territory at affordable tariffs and on similar quality conditions, irrespective of the profitability of individual operations.¹⁸ When such services of general interest are granted to regulated industry, they may be prone to abuse by companies. There is evidence that imposing universal service can be both a cost and a benefit. In the case of telecom, one should also consider what the universal service is intended to achieve. It may be cheaper to give people in rural communities access to wireless, rather than wire-line service. Hence granting a USO fund to the incumbent wire-line company is not necessarily advancing this cause. In addition, enabling the incumbent to price at levels below incremental cost means that consumers may seek wire-line services in cases where wireless would have been cheaper, but for the subsidy. This can prevent new technologies from developing and being generally available.

¹⁷ Case C-342/96 *Spain v Commission* [1999] ECR I-2459, paragraph 41; Case C-39/94, *SFEI and Others* [1996] ECR I-3547, paragraph 60; and, recently, Joined Cases T-228/99 and T-233/99, *WestLB v Commission* [2003] ECR II-nyr.

¹⁸ Services of General Interest - Communication from the Commission - OJ C 17, 19.01.2001, p. 4, paragraph 14.

On July 24, 2003 the ECJ delivered a judgment in the *Altmark* case¹⁹ with regard to the application of the State Aids rules to public services obligations (a notion within the broader category of services of general economic interest). The Court ruled on a long-disputed issue: whether subsidies representing compensation for public service obligations constitute state aid under the meaning of Article 87 (1) of the EC Treaty. The ECJ pointed out that, according to settled case-law (see *supra*), for a state measure to be classifiable as state aid within the meaning of the EC Treaty, it must be capable of being regarded as an “*advantage*” conferred on the recipient undertaking which that undertaking would not have obtained under normal market conditions.

The Court held that there is no such “*advantage*” where a state financial measure must be regarded as compensation for the services provided by the recipient undertakings in order to discharge public service obligations. However, for such compensation to escape classification as state aid in a particular case, four conditions must be satisfied.²⁰ First, the recipient undertaking *must actually have public service obligations to discharge* and those obligations must be *clearly defined*. Second, the parameters on the basis of which the compensation is calculated must be *established in advance* in an *objective and transparent* manner. Third, the compensation *cannot exceed what is necessary to cover all or part of the costs* incurred in the discharge of the public service obligations, taking into account *the relevant receipts and a reasonable profit*. Fourth, where the undertaking is not chosen in a public procurement procedure, the level of compensation must be determined by a comparison with an analysis of the costs which a typical transport undertaking would incur (taking into account the receipts and a reasonable profit from discharging the obligations).

Only if those four conditions are satisfied may it be considered that an undertaking has not enjoyed a real financial “*advantage*” that would have the effect of putting it in a more favorable competitive position than the undertakings competing with it, so that it is not therefore state aid within the meaning of the EC Treaty.

In the more recent *GEMO* case,²¹ Advocate General (“AG”) Jacobs proposed to make the distinction between measures directly linked to the service of general economic interest and those indirectly linked. The latter only would be considered as aid and thus would be subject to notification. This analysis was then subsequently adopted in *Enirisorse*.²² In the *Enirisorse* case, the ECR responded to the following issue: Does allocation to a public undertaking of a fund to the State by operators who do not receive services for that undertaking constitute special or exclusive rights given to the public undertaking under Article 87? It is clear that public undertakings are within the scope of Article 87. But services in the general economic interest should not be used as a shield for all state aid. It is necessary to ask what are the special characteristics that distinguish it from other economic activities, but even then the transfer of funds must be shown to be connected to that specific characteristic. It is important to note that the three cases *Altmark*, *GEMO* and *Enirisorse* were all pending before the ECJ at the same time. *Altmark* was the first to be decided. By that time, the advocate general in all three cases had rendered their opinion. The AG in *Altmark* considered that PSO compensations should be viewed as State aid while AG Jacobs in *GEMO* and the AG in *Enirisorse* considered at least certain compensation mechanisms to fall outside of the

¹⁹ Case C-280/00, *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nabverkehrs-gesellschaft Altmark GmbH* [2003] ECR I-7747.

²⁰ *Altmark*, paragraphs 88 *et seq.*

²¹ Case C-126/01, *Ministère de l'Économie, des Finances et de l'Industrie v GEMO SA* [2003] I-13769.

²² Joined Cases C-34/01 to C-38/01, *Enirisorse SpA v Ministero delle Finanze* [2003] I-14243.

scope of Article 87 (1). The court in *Altmark* therefore had three opinions on the same issue (and countless articles). The judgment was clearly influenced by AG Jacobs' opinion (in *GEMO*) without however using the latter's terminology of a "direct" and "indirect" link. After *Altmark*, the court consequently applied the 4-pronged "*Altmark* test" in *GEMO* and *Enirisorse*. In *Enirisorse* (where an Italian company challenged a port tax because the proceeds went to a public undertaking), the ECJ found on the basis of the facts of the case that the *Altmark* test was not met, i.e. the measures were State aid. The case also discussed whether exclusive or special rights had been entrusted in the public undertaking but this question was dealt with separately from the question of application of State aid law. We therefore see that the *GEMO* and *Enirisorse* cases are examples of how the *Altmark* conditions are interpreted in a very strict fashion.

In considering what services are in the general economic interest, and how the funds that support them should be evaluated, several key facts have emerged: (1) Has there been a purchase of goods by the state above market price? (2) Is there a financial advantage to certain undertakings (*i.e.*, if all the alleged aid does is offset the cost of discharging USO, it is not a real advantage to the undertaking that benefits from it). Applying this to regulated industries, one can see that there needs to be a clear link between the state financing and the USO itself, and the USO must be clearly defined (and overcompensation must be avoided). Interestingly, under the EU postal directive, it is recognized that deregulation will lead to an increase in demand which will partially solve the USO issue.²³ The Directive notes that the postal compensation fund contemplated in the directive *was* state aid which had to be notified, but we should note that the Directive was pre-*Altmark* and therefore the *Altmark* criteria would now be dispositive.

State aid rules are particularly important for countries that have had a history of state ownership and import substitution, but also for all sectors where there is a transition from regulation to competition. In such settings, governments are prone to use such aids in a market system because this has been the traditional form of state intervention. However, as developing countries become market economies, such aids have distorting effects that create costs to consumers and must be avoided.

ii U.S. State Action Exemption

The US is behind the curve in terms of disciplining public sector restraints of trade that harm competition. The issue turns on the approach to universal service obligations. As we have seen, in the EU, the carve-out from state aids disciplines for services in the general economic interest is limited by case law to cases where there is a direct linkage with clearly defined universal service obligations. US state action exemption law is approaching what we see in the EU with the market participant exemption to the state action exemption (*i.e.*, a state acting as a market participant is subject to the same rules as a private participant, see above).

²³ See recital 12 of Directive 2002/39.

Generally under U.S. law, when a state antitrust law is inconsistent²⁴ with federal antitrust law, the state law is preempted. If the state law, however, falls into the “state action” exemption²⁵ implicitly created by antitrust law, then the state law is not preempted.²⁶ Under the state-action exemption doctrine, certain actions of state and local government are immune from the federal antitrust laws even though they would not survive a preemption analysis.²⁷ The state-action exemption was set out by the Supreme Court in *Parker v. Brown*.²⁸ In *Parker*, the Supreme Court rejected the contention that the California raisin proration program violated the Sherman Act.²⁹ The Court found that the prorate program was not created to operate by force of individual agreement or combination, but rather than by the legislative command of the state and did “not intend to operate without that command.”³⁰ Therefore, the Court found that the law did not violate the Sherman Act because the Sherman Act was not created to limit the ability of state officials or legislatures to regulate commerce.³¹ The Court buttressed this holding in the sovereignty accorded to state legislatures under the Constitution, which could only be limited by Congress.³²

The Court did, however, place a limitation on the scope of the state-action exemption. The state-action exemption did not grant immunity to people or corporations who violated the Sherman Act under the guise of a state grant of authority.³³ The exemption also does not apply when the state or municipality becomes a party in a private agreement or combination that restricts trade.³⁴ Since the California statute set production limits but did not authorize private individuals or corporations to do so, the Court found that it was consistent enough with the Sherman Act to avoid preemption under the state-action exemption.³⁵

²⁴ While the term “inconsistent” has been given many definitions and is subject to various interpretations, it usually does not apply when the state law is more aggressive than the federal law. See *Arveda & Hovenkamp*, *supra* note 1, at 300. When the state law, however, attempts to authorize private parties to escape antitrust laws without any supervision, compels private firms to act in a manner forbidden by antitrust laws, or prevents competition clearly mandated by federal law, then there is a preemption problem. See *id.* at 304. The first two problems permit private firms to determine their own conduct and are often nothing more than a state’s compliance to a private firm’s request. See, e.g., *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384 (1951).

²⁵ There are some areas where the federal deference to state law is expressly stated. For example, in the area of insurance, the states have greater freedom to determine the antitrust regulations that apply. See McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011-12 (2000).

²⁶ “State-action” in the antitrust context is very different from the civil rights (Fourteenth Amendment) analysis. In the Fourteenth Amendment analysis, “state-action” is broadly defined, including some private actions that are “quasi-public” in character and can include action by state officials. See, e.g., *Marib v. Alabama*, 326 U.S. 501 (1946) (holding that a town, although privately owned, was public enough to bring it within the First Amendment realm). 42 U.S.C. § 1983 condemns acts by public officials who are acting under the color of state law. In contrast, “state-action” in the anti-trust context refers only to government policies that are clearly articulated so as to not leave doubt that it is a state sanctioned practice and not just a mistake or act reflecting the discretion of an individual official. See *Arveda & Hovenkamp*, *supra* note 1, at 356.

²⁷ See *Arveda & Hovenkamp*, *supra* note 1, at 355. Actually, the state-action exemption is part of the preemption analysis. If a statute appears to be preempted by federal law, the second step in the preemption analysis would be to determine if it qualifies as a state-action exemption. If it does, then the statute is saved; if it does not, then the statute is preempted. *Id.*

²⁸ *Parker v. Brown*, 317 U.S. 341 (1943).

²⁹ *Id.* at 350. Under the proration program, the California Agricultural Committee set production limits in order to maintain the price of raisins. See *id.* at 347.

³⁰ *Id.* at 350.

³¹ *Id.* “We find nothing in the language of the Sherman Act or its history which suggests that its purpose was to restrain a state or its officers or agents from activities directed by its legislature.” *Id.* The Sherman Act was enacted to regulate business corporations and prevent business combinations that would restrict competition. See *Parker*, 317 U.S. at 350. “Its purpose was to suppress combinations to restrain competition and attempts to monopolize by individuals and corporations, abundantly appears from its legislative history.” *Id.*

³² *Id.*

³³ See *id.* See also *N. Sec. Co.*, 193 U.S. at 332; *Rice v. Norman Williams Co.*, 102 U.S. 654, 662 (1982) (holding that upholding the validity of a state statute does not insulate a firm’s invocation of the statute from scrutiny under the Sherman Act).

³⁴ See *Parker*, 317 U.S. at 351-52. See also *Union Pac. R.R. Co. v. United States*, 313 U.S. 450 (1941).

³⁵ See *Parker*, 317 U.S. at 352.

In order to qualify for immunity under the *Parker* standard, “the challenged restraint must be clearly articulated and affirmatively expressed as state policy,” and “the policy must be actively supervised.”³⁶ In *Midcal*, the Court struck down a California statute because, although the price fixing restraint was clearly expressed as state policy, the state neither set the prices nor regulated the reasonableness of the price schedules.³⁷ Had California’s program completely controlled the distribution of liquor within the state, that comprehensive regulation would be exempt from the Sherman Act under the state-action doctrine.³⁸

State legislation that appears inconsistent with federal antitrust law can survive preemption if it qualifies as a state-action exemption.³⁹ A restraint unilaterally imposed by a state government does not qualify as a violation of the Sherman Act just because it has a coercive effect upon those who must obey the law.⁴⁰ Some restraints imposed by a legislature, however, are not unilateral but a hybrid because they are enforced by private regulatory schemes.⁴¹ If the statute grants private parties a degree of regulatory power, that statute is vulnerable to scrutiny under the Sherman Act.⁴² In order for the state-action exemption to apply, there must be an express or strong implication of the intent of the state to remove certain markets from antitrust scrutiny.⁴³

Clearly, in the United States, any set of disciplines that purported to apply competition policy to public sector restraints would have to grapple with the state-action exemption. Some precedent already exists for competition provisions in free trade agreements, which does apply some discipline to public sector restraints. These may be found in Chapter 15 of NAFTA,⁴⁴ in Article VIII of the General Agreement on Trade In Services (“GATS”)⁴⁵ or in the competition safeguards listed in the WTO Reference Paper on Basic Telecommunications.⁴⁶

Chapter 15 of NAFTA recognizes the importance of maintaining an effective competition policy in the Contracting Parties so as to promote trade and is an example of existing competition provisions that deal with public sector restraints at a regional level. In Article 1501, it states:

Each party shall adopt or maintain measures to
proscribe anti-competitive business conduct, and shall

³⁶ *City of Lafayette v. La. Power & Light Co.*, 435 U.S. 389, 410 (1978). See also *Cal. Retail Liquor Dealers Ass’n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980) (“*Midcal*”).

³⁷ See *Midcal*, 445 U.S. at 106. The California law required suppliers to set a resale price on liquor and dealers had to charge that price. The price was set by the suppliers, not the state. The Court found this to be a private price-fixing arrangement cloaked in state-action. *Id.*

³⁸ *Id.* at 106 n.9. See also *New Motor Vehicle Bd. Of Cal. v. Orrin W. Fox Co.*, 439 U.S. 96, 109 (1978); *State Board v. Young’s Mkt. Co.*, 299 U.S. 59, 63 (1936).

³⁹ See *Fisher v. City of Berkeley*, 475 U.S. 260, 265 (1986).

⁴⁰ See *id.* at 267.

⁴¹ See *id.*

⁴² See *id.*

⁴³ See *Areeda & Hovenkamp supra* note 1, at 363. For example, a state’s intent to eliminate competition in a particular market cannot be simply inferred from state approval of a firm’s conduct. If a state approves of certain firm conduct, it makes no direct statement about whether it wants the federal government to make that market or firm immune from antitrust regulation. *Id.*

⁴⁴ NAFTA, *supra* note 11, ch. 15.

⁴⁵ General Agreements on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, *Legal Instruments-Results of the Uruguay Round* vol. 31, 33 I.L.M. 1174, 1175 (1994) [hereinafter GATS].

⁴⁶ See World Trade Organization, WTO Reference Paper on Basic Telecommunications (1998) at <http://www.itu.int/newsarchive/press/WTPF98/WTORefpaper.html> [hereinafter *Reference Paper*].

take appropriate action with respect thereto, recognizing that such measures will enhance the fulfillment of the objectives of this Agreement. To this end the Parties shall consult from time to time about the effectiveness of measures undertaken by each Party.⁴⁷

GATS addresses competition issues that face public sector restraints at a global level. Article VIII addresses the issue of monopolies and exclusive service suppliers and specifically provides the following:

Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments.

The Council for Trade in Services may, at the request of a Member which has a reason to believe that monopoly supplier of a service of any other Member is acting in a manner inconsistent with paragraph 1 or 2, request the Member establishing, maintaining or authorizing such supplier to provide specific information concerning the relevant operations.⁴⁸

The WTO Reference Paper on Basic Telecommunications is yet another international agreement that includes competition provisions and binds the U.S., notwithstanding the state action exemption. This agreement requires Members to maintain measures that prevent major suppliers from engaging or promoting anti-competitive practices.⁴⁹ Furthermore, it includes a list of anti-competitive practices that should be particularly regulated. These practices include engaging in anti-competitive cross-subsidization, using data obtained from competitors in an anti-competitive manner, and not making available to other service suppliers technical information about important facilities and commercially relevant information which are needed for them to adequately provide services.⁵⁰

All of these agreements bind, *inter alia*, the United States, and all have been successfully concluded with extensive U.S. participation.

Japan's competition law, the Anti-Monopoly Act (the "AMA"), does not currently have Article 87-like provisions. Japan does have an Unfair Competition Prevention Law, which addresses

⁴⁷ NAFTA, *supra* note 11, art. 1501.

⁴⁸ GATS, *supra* note 94, at 1174-1175.

⁴⁹ See *Reference Paper*, *supra* note 95.

⁵⁰ *Id.*

issues such as trade secrets and intellectual property rights, and is administered by METI. Either (or both) of these laws could include Article 87-like provisions (refined and adapted for the Japanese context). Such provisions must adequately deal with the USO.

b. Cross-Subsidization

All businesses cross-subsidize. Not all of this activity is harmful to consumers. Indeed, many forms of cross subsidization are beneficial to consumers. Cross-subsidization is only harmful if it is anti-competitive. It is anti-competitive if it could lead to the elimination of competitors and then the increase in prices to supra competitive levels. One has to be extremely careful in ensuring that the discipline of competition is only used when behavior is genuinely anti-competitive and leads to consumer harm. The ordinary test of what is anti-competitive behavior is determined by an evaluation of whether the low price charged (the price in the market which is being subsidized by the higher price in the non-competitive market) is indeed below some measure of cost (which is required in determining whether there is the potential for anti-competitive pricing in the future). The theory is based on the fact that there can only be one reason for a price below cost, and that is to knock out competitors and recoup lost profit later.

This test was originally outlined in *Brooke Group v. Brown & Williamson*.⁵¹ The *Brooke Group* test has to be modified in the case of cross-subsidization by governmental entities or those that have legacy government ownership. For companies that are government owned, the key issue is that because governments are not profit maximizers the element of the Brooke Group test that requires lost profits to be capable of being recouped is not as important. Governments are at best revenue maximizers (and even this is doubtful – see USPS sponsorship of US cycling team, even though they already have a letter mail monopoly). Therefore, if there is below cost pricing, we would argue that this is prima facie evidence of anti-competitive cross-subsidization. Indeed the European Union cases on this issue assume anti-competitive cross-subsidization by governments, even absent a possibility of recoupment of lost profit. We will discuss the issue of costs and cross-subsidization in more detail after the case studies.

We analyze this issue in greater detail in the context of postal reform.

⁵¹ *Brooke Group v. Brown & Williamson*, 509 U.S. 209(1993).

6. Advocacy Role of the Competition Agency

Because other governmental agencies may lack the consumer welfare optimizing standards that the competition authorities bring to their work, the competition agency must serve as the watchdog to prevent the encroachment of anti-competitive actions and regulations by private and public actors. In particular a competition agency in a country with a significant number of recently privatized companies and SOEs must be vigilant to make sure that such companies do not engage in anti-competitive practices. In many cases, the restraints placed on trade by public sector actions present significant problems to the formation of a competitive market. The US Department of Justice ("DOJ") has competition advocacy guidelines that highlight the following factors that DOJ needs to consider going forward: (a) highlight the costs and benefits of the particular regulatory system from a competition standpoint, specifically a consumer welfare optimizing standpoint; (b) if regulatory scheme is an existing one, has regulation fulfilled its purpose; (c) is regulation well tailored and is it the least anti-competitive possible to achieve the regulatory purpose. The methodology used by DOJ is to testify to the executive branch with regard to legislation, to publish reports on particular industries, to intervene in regulatory agency proceedings, and sometimes to use litigation.

We have seen from International Competition Network ("ICN") reports that it is very difficult for competition agencies to advocate successfully, and early engagement is vital to the process.⁵² Where agencies wait until after the regulatory framework of a privatization for example has already been established, it becomes very difficult to actually impact that regulatory structure in a pro-competitive fashion. In the ICN meeting in Bonn in 2005, many of the participants in discussing the role of competition advocacy noted that the key was to advocate early. The reason this was specifically mentioned was because there are many examples where a failure to advocate early has resulted in an inability to effectively make the case for competition after the regulatory structure has been put in place. Applying this in the Japanese context, if the competition agency does not react prior to the completed process of postal privatization, assuming this happens, then it will find it extremely difficult to change the behavior of the postal company itself, post privatization. There are many examples in the case of telecoms where there is a lot of data on privatizations where competition has not been successfully introduced into the privatization program.

The competition agency must operate to ensure that the voice of consumers is heard throughout the privatization process, especially early in the privatization process, as regulation and competition are frequently in conflict. Sectoral regulators and competition regulators may go about implementation of policy in different ways – the former uses a centralized process to make decisions about prices, entry, investment, and service quality, while the latter is a decentralized process in which each competing firm makes independent decisions that are driven by the goal of profitability, and winning customers by offering them a superior combination of products, services and prices. Submissions to the sector regulator are required from the "guardian of competition," the independent competition agency, to prevent regulation from being destructive to competition and the overall goal of consumer welfare optimization. A common way to institutionalize competition advocacy is for the competition agency to intervene in regulatory proceedings. Only the competition agency has the institutional capacity to best understand the economic impact of regulation on competition and therefore is best suited to provide such guidance to other agencies. The issues raised in regulatory proceedings tend to involve the same types of questions that the

⁵² Comments of Alberto Heimler at ICN Annual Meeting, Bonn, 2006.

competition agency has to deal with, e.g., whether competition is feasible, whether an industry is naturally monopolistic, whether cross subsidies exist and, if so, whether they are desirable, whether economies of scale are substantial, and whether particular regulations are likely to accomplish their stated objectives.

As noted above, the goal of competition policy is to enhance consumer welfare. Competition leads to lower prices, a wider choice of goods, and technological innovation, all in the interest of the consumer. Competition laws have been structured to achieve this goal and it is through competition policy that public sector anticompetitive restraints can be countered. A country's competition agency needs to study the regulated sectors such as energy, telecommunications, financial services and postal services as part of its competition advocacy. This advocacy refers to activities conducted by the competition authority related to the promotion of a competitive environment for economic activities through its relationships with other governmental entities and by increasing public awareness of the benefits of competition.

Competition laws particularly are required to restrict anticompetitive business practices and prevent cross subsidization. Cross subsidies occur when a regulated part of a business subsidizes its competitive affiliates by shifting affiliate costs to the regulated portion of the business. When some of the affiliate's costs are paid by the regulated side (and built in to the cost structure for the regulated price through the use of accounting methods that do not accurately allocate costs), consumers will have subsidized the competitive affiliate and the affiliate will have a cost advantage relative to its competitors. Cross subsidization and its cost shifting distorts markets. Under such a system, the efficient allocation of resources and the development of competitive markets can be stymied. Adam Smith appreciated the efficiency that competition creates noting that, "[m]onopoly, besides, is a great enemy to good management, which can never be universally established but in consequence of that free and universal competition which forces everybody to have recourse to it for the sake of self-defense."⁵³

A previous report by the ICN notes that competition can be hampered by public regulations and rule making.⁵⁴ It further notes that while regulatory intervention is necessary in some sectors, such intervention may go beyond what is strictly necessary. The competition agency must become involved in the regulatory and the rule-making process to ensure that adequate consideration is paid to competition concerns. The report's Executive Summary specifies as follows:

Competition may not only be hindered by private anti-competitive conduct, such as collusion among competitors, anticompetitive mergers...but also...by public regulatory intervention and rulemaking. Such regulatory intervention may be warranted in sectors featuring extensive economies of scale or other market failures. In particular, without intervention, some markets may fail to provide minimal levels of service considered of public interest. However, regulatory intervention may go beyond what is strictly necessary and may impede competition in those sectors.⁵⁵

⁵³ Adam Smith, *An Inquiry into the Wealth of Nations*, 163 (R. H. Skinner & A. S. Skinner eds., 1976).

⁵⁴ *Capacity Building and Technical Assistance: Building credible competition authorities in developing and transition economies*, ICN Working Group on Capacity Building and Competition Policy Implementation (2003).

⁵⁵ *Id.*, Executive Summary.

Consequently consultation in the legislative process is one of the primordial tasks of the competition agency, and a key area of competition advocacy.⁵⁶ The ICN advocates mandatory or discretionary consultation mechanisms, but notes that the results in the case of mandatory consultation are better. Another relevant factor is whether the decisions of the competition agency are binding on the legislative process or sectoral regulator. Even if the results are not binding, at least having a binding requirement that forces the legislative process to justify why it has departed from the competition agencies' recommendation can have some useful effects. The key issue is to ensure that legislative bodies have to respond to advice given to them by competition agencies. This has been the case in many countries, where competition agencies, as part of a transparent process, make submissions on proposed legislation and regulations affecting sectors where competition concerns may be implicated.

To gain credibility with companies and attract investors, numerous governments have been simplifying and modernizing laws and regulations that affect regulated sectors. Effective regulators can go a long way toward ensuring that free markets operate fairly and do not disproportionately benefit certain producer elites. This is a crucial point in societies that are still adjusting to increased competition and where the social benefits of privatization and liberalization policies are not immediately apparent. When the regulator is also a market participant, the possibility of conflicts of interest arises. There is also an increased concern of regulatory capture. Enhancing the role of the competition agency is important because of the risk of regulatory capture of sector regulators.⁵⁷ This is less likely when the competition agency reviews sector regulations for anti-competitive effects. We advocate an approach that gives competition agencies the authority to give non-binding opinions and advise legislators, but does not give the competition agency the final say. We advocate that the competition agency's power should be concurrent with that of sector regulators. For example, if there is an issue related to the conduct of a regulated entity, both agencies will be involved in the review of such conduct.

7. Dealing with Legislators

In order for the competition agency to be effective, it must deal with legislators. It must be able to have credibility with legislators, and convince them of the benefits of competition. Although this can be done in a number of ways, reports are the most effective means of communicating credible, convincing evidence of the benefits of competition. Competition agencies would maximize effectiveness through the preparation reports on specific sectors. For example, at the recent ICN meeting, the European Commission announced that it would conduct sectoral studies on the electricity and energy sectors to ascertain possible anti-competitive practices, including those at the public sector level. Studies and reports can be very helpful advocacy tools. In the context of postal reform, the following study topics should be considered:

1. What model is to be used? Privatization, followed by liberalization in a sequenced fashion, or privatization accompanied by competition? What precisely will be the role of competition?

⁵⁶ *Id.*, at 61.

⁵⁷ OECD, *Regulatory Reform in Network Industries: Past Experience and Current Issues*, OECD Economic Outlook, June, 2000.

2. Independence of sectoral regulator. What role will the sectoral regulator have? What does independence mean? Frequently, independence means more than simply not being part of a ministry. Independence is a measure of the real ability of the regulator to face down the regulated entity in a non-cooperative game. It relies on credibility and political power.
3. Interaction. How is it envisaged that the competition regulator will interface with the sectoral regulator? What weight will be given to the views of the competition agency?

These studies and reports can be used to educate legislators on the key issues that impact postal privatization and the dangers of turning a public monopoly with regulation into a private monopoly without regulation. The purpose of this is to ensure that legislators who craft a particular framework or regulatory design understand the consequences of their actions.

8. Global Competition Advocacy

Competition advocacy is practiced by a number of countries throughout the world. We illustrate practices in the United States and Mexico, both of which have vigilant competition advocacy systems to promote consumer welfare and economic efficiency. These countries have noted success in competition advocacy and we illustrate their guiding principles.

As we discussed earlier, the United States DOJ is guided by four principles in its competition advocacy:

1. To eliminate unnecessary and costly existing regulation;
2. To inhibit the growth of unnecessary new regulation;
3. To minimize the competitive distortions caused where regulation is necessary by advocating the least-anticompetitive form of regulation consistent with the valid regulatory objectives; and
4. To ensure that regulation is properly designed to accomplish legitimate regulatory objectives.⁵⁸

These principles serve to guide US competition regulators to limit the effects of regulation that hurt consumers. In this sense, the approach that a competition agency must take in analyzing the need for new or continued regulation is to focus attention on the comparative benefits of free competition, on the one hand, and the proposed method of regulation on the other to prevent regulations that would lead to an anti-competitive result. To the questions that the DOJ asks, we would add an additional question:

“Is regulation based on normative principles of efficiency and consumer welfare, or is it designed to favor certain competitors at the expense of consumers?”

Like the United States, the Mexican Federal Competition Commission (“CFC”), has adopted a proactive role in advocating for the integration of competition policy and regulatory reform. The CFC issues opinions on the impact of proposed regulations on competition conditions that prevail in a regulated market and applies competition policy to specific institutional, legal and economic

⁵⁸ DOJ Antitrust Division Manual, Chap. 5.

conditions in specific regulated sectors that characterize each regulated market. Recent examples of the CFC's efforts include involvement in the drafting of the revisions to the telecommunications law and issuing opinions regarding natural gas regulations.

We now look at two regulated sectors which are of great importance to the competitiveness of Japanese economy. As mentioned before, the communications infrastructure is the key to an efficient and globally competitive business sector. Many of the gains of the New Media Economy would be lost if a competition communications infrastructure is not in place.

9. Telecommunications

Competition can be stifled through a dominant participant exerting its market power and other anti-competitive practices to extinguish weaker participants and consequently control the market. Therefore, it is important that the competition agency have some power to review anti-competitive conduct in order to protect consumers. When an agency does not have the power to enforce its decisions, it is incapable of preventing ongoing abuses. The case study of Teléfonos de Mexico SA ("Telmex") in Mexico demonstrates this.

a. Teléfonos de Mexico

After its privatization, Telmex's activities were regulated under the 1990 Telmex Concession, which allowed for competition in certain sectors, in particular the international long-distance sector, while other sectors such as inter-urban and local were insulated from competition. Telmex was to be regulated in this manner until it could be shown that Telmex had a dominant position in any of these sectors under the Mexican competition law. At this point the regulatory environment changed and an alternative regulatory system was required. In 1998, the CFC did rule that Telmex was dominant in five markets where there was inadequate competition. This ruling was largely ignored by Cofetel (the telecoms regulator), who continued to apply the 1990 Telmex Concession. The problem was worsened, because the CFC had no power to intervene in the decisions of other regulators. The real problem was that cross-subsidization was allowed by the 1990 Telmex Concession since every time foreign entrants lowered prices in the competitive international long-distance segment, Telmex was able to price at predatorily low levels in this sector, and recoup its losses by supra-competitive pricing in the local markets where there was inadequate price competition. As the head of the CFC observed, "Regulation has not been able to diminish the dominance of Telmex, and is not being applied concretely. There are a lot of points that are still not applied."⁵⁹ The cure to this problem in Mexico would have been that the CFC had greater power to enforce its judgments.

This has resulted in a US request for consultation to the WTO regarding Mexico's violation of several GATS articles in the Telmex situation. The complaint, filed August 29th of 2000, stated five main complaints:⁶⁰

1. Mexico enacted and maintained laws, regulations, rules and other measures that deny or limit market access, national treatment, and additional commitments for service suppliers

⁵⁹ *Cofetel, CFC Shift Telecom Blame*, Business News Americas, July 20, 2001.

⁶⁰ WT/ DS 204/ 1, 20 August 2000, Mexico - Measures Affecting Telecommunications Services.

seeking to provide basic and value-added telecommunications services into and within Mexico;

2. Mexico failed to issue and enact regulations, permits, or other measures to ensure implementation of Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico;

3. Mexico failed to enforce regulations and other measures to ensure compliance with Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico;

4. Mexico failed to regulate, control and prevent its major supplier, Telefonos de Mexico (Telmex), from engaging in activity that denies or limits Mexico's market access, national treatment, and additional commitments for service suppliers seeking to provide basic and value-added telecommunications services into and within Mexico; and

5. Mexico failed to administer measures of general application governing basic and value-added telecommunications services in a reasonable, objective, and impartial manner, ensure that decisions and procedures used by Mexico's telecommunications regulator are impartial with respect to all market participants, and ensure access to and use of public telecommunications transport networks and services on reasonable and non-discriminatory terms and conditions for the supply of basic and value-added telecommunications services.

Telmex prevented US suppliers from supplying cross-border telecoms services, from obtaining competitive rates for termination in Mexico, and from leasing lines. Termination rates are the rates charged for calls made from abroad whose final destination is Mexico. A USTR press release highlights two problems with call termination in Mexico: price, as well as the mechanism for determining the price of call termination. The structure in Mexico allows for only the dominant carrier - who has an incentive to keep prices as high as possible - to negotiate an international termination rate. All other carriers in the country must accept this rate, protecting the rate from competition. This has resulted in termination costs in Mexico being 19 cents a minute, whereas in the US, Canada and Chile, termination costs are six cents a minute.⁶¹

Another serious problem mentioned in both the WTO filing and press release concerns interconnection. By their nature, telecom services have network characteristics. The more significant the network characteristic is, the more consumers will be attracted to the firm with the largest market share. For this reason, interconnection is crucial.⁶² On certain occasions, Telmex has outright refused to provide interconnection. Even where it has provided for interconnection, however, the situation is less than ideal. While interconnection rates in the US, Canada and Chile are at half a US cent, Telmex charges 4.6 cents in Mexico.⁶³

⁶¹ U.S. to Request WTO Consultations With Mexico Regarding Telecommunications Trade Barriers, USTR, 2000.

⁶² D. Daniel Sokol, *Barriers to Entry in Mexican Telecommunications: Problems and Solutions*, 27 Brooklyn J. Int'l L. 1 (2001).

⁶³ U.S. to Request WTO Consultations With Mexico Regarding Telecommunications Trade Barriers, USTR, 2000.

Furthermore, the complaints against Telmex for anti-competitive behavior read like a textbook of anti-competitive strategy. These include: anti-competitive cross-subsidization, anti-competitive pricing, discriminatory tariffs to regions where Telmex maintains a monopoly, unregistered tariff and discount plans, requiring competitors to lease unnecessary private lines, discriminatory billing and collection practices, use of information obtained from competitors towards anti-competitive ends, failure to make available technical information necessary for operation, refusal to provide private lines and circuits, denials of private lines to internet service providers, and discriminatory treatment for calls to internet service providers by Telmex. Though the opinion itself has not yet been released in the case, the results from the case have been reported and show that Telmex was guilty of various anti-competitive practices.

Telmex's anti-competitive cross-subsidization has served to prevent other providers from effectively competing in the long-distance market. The irony is that because of the consequences of these anti-competitive problems, AT&T Latin America was recently sold to its rival Telmex.

b. Other Telecom Issues

There are other areas where similar competition concerns exist regarding the regulations that apply to other regulated industries centered around specific issues related in particular regulated industries.

In the case of telecom where there has been extensive work done, particular problems are (a) network access and (b) anti-competitive cross-subsidization. In the leading cases, such as *AT&T v. MCI*, the court noted that mere pervasiveness of a regulatory scheme did not immunize an industry from anti-trust liability. In that case, *AT&T* asserted that its public interest assertions should offset any anti-trust liability. In terms of prevention of anti-competitive cross-subsidization, the challenge is to avoid predatory pricing where the measurement of cost is on an incremental (rather than a fully distributed costs basis). However, as noted below, if it is the state that is engaged in predatory pricing, then we must bear in mind that governments tend to be at best revenue maximizers, not profit maximizers.

The great challenge in dealing with cross-subsidization issues turns on whether it can accurately be detected. This in turn depends on how extensive the SOE's internal accounting system is. Certain things are critical to ensuring that cases of cross-subsidization can be detected. These are summarized below:

i. Structural Separation

Structural separation refers to the process where different lines of business are not structurally separated, it is much easier for businesses to engage in anti-competition cross-subsidization. A price cap over each line of business prevents one line of business being used to subsidize others, since the potential cross-subsidizer cannot increase its prices in one area in order to support below-cost pricing in another area.

ii. Accounting Separation

Another critical component of monitoring and preventing cross-subsidization is accounting separation. This is an important part of understanding the cost base of the cross-subsidizer. Without this knowledge, it is very difficult to bring a cross-subsidization case.

All of the above methods are designed to ensure that where some markets are reserved to a monopolist, the monopolist, be it private or public, does not abuse its monopoly position and create an anti-competitive spill-over effect in another related or unrelated market.

10. Postal Regulation

Regulation of the postal sector must be pro-competitive and must ensure that levels of competition increase. In particular, regulation must be sensitive to the fact that any damage to the competitive process in the express delivery or other sectors related to the postal monopoly will have a negative impact on consumers. A competition authority must have a role in the regulation of the postal sector to ensure that there is no abuse of the dominant position by the universal service provider.

In examining how regulation in postal affects competition, it is the interplay between regulated postal services and unregulated express delivery services where the possibility for anti-competitive behavior in the regulated sector exists. Express delivery is a method of communication and transportation that serves to get items from door to door within a definite period of time. The key elements of this service stem from the integrated nature of the service. Integrated express service providers understand and cater to the time sensitivity of the commercial business. Given the rapidly globalizing economy that utilizes a just-in-time production schedule, express delivery of parts has become essential to global operations of businesses. Further, express delivery offers faster delivery of business documents, thereby promoting more rapid transactions for services. It also allows small and medium-sized businesses to compete in the global marketplace by giving them access to an international distribution system. A well functioning express delivery market that allows for all express delivery operators to compete without government distortions in favor of a preferred carrier allows for the more rapid development of the Japanese economy and infrastructure. This development will ensure that Japanese businesses will be made more globally competitive.

Express delivery requires a robust service system that involves air and ground transport, distribution centers, delivery, and the use of advanced technologies in all facets of its business to track items and provide information. Express delivery services consist of the expedited collection, transport, and delivery of documents, printed matter, parcels, and/or other goods, while tracking the location of, and maintaining control over, such items throughout the supply of the service. Services provided in connection with express delivery services include, but are not limited to, customs facilitation and logistics management. Express delivery services may include one or more value added elements, such as collection from an address designated by the sender; release upon signature; guarantee of delivery within a specified time; electronic and/or other advanced technologies; and ability of the sender to confirm delivery. Many WTO Members classify postal services separately because they are performed by postal administrations. The Central Product Classification system (CPC), used by numerous countries, generally classifies services performed by postal administrations separate and apart from any other services. Postal services lack these value added services. In

contrast, postal services include the shipment of letters and parcels both domestically and internationally.

Competition and regulation interact in this regard when express delivery services are at a competitive disadvantage when postal companies use Universal Service Obligation ("USO") requirements to anti-competitively cross subsidize their unregulated services (such as express delivery) using revenue provided by their monopoly services. Because of the dominant position of Japan Post, the JFTC must ensure that Japan Post does not abuse this position and engage in anticompetitive conduct. Furthermore in view on the impending privatization of Japan Post, the JFTC retains an important advocacy role in the regulatory shape of the privatization.

a. Arguments in Favor of Postal Privatization

Perhaps the most important argument in favor of postal privatization is often lost when the issue is discussed. While the argument that the postal company will become more efficient, with resulting benefits for investors is often raised, the impact on consumers of privatization is often ignored. This is a pity as the benefits to consumers are the most valuable benefits for society as a whole provided that the privatization is accompanied by competition as well as liberalization.

The benefits of privatization are that public sector monopolistic entities tend not to be as efficient as private entities. It is to be hoped that privatization will lead to more efficiencies, because managers will be able to keep costs down and quality up. Managers will be able to maximize worker output and minimize waste. These are things that are not easily done in a public sector context. But these greater efficiencies do not just arise because of the fact of privatization. They arise because of the restraints that competition imposes on managers to perform and also get the most out of their workforce. Postal prices have generally risen in countries where the postal service is a government owned monopoly. This is in contrast to other sectors where prices in communications and transportation have fallen. There is evidence in the US that this number translates into a significant cost imposed on consumers – as much as \$4bn - \$12bn per year.⁶⁴ Studies of the US postal system also demonstrate that not only have prices gone up, but quality of service has declined. Between 1967 and 1987, mail delivery became 15 percent slower.⁶⁵

In the US, there have been a number of postal reorganizations that have not led to beneficial changes. The reasons that these reorganizations have all failed is because none of them have actually unleashed the forces of competition, and led to the kinds of systemic internal changes that we have referred to above. It is the absence of the competitive impulse that meant increasing costs simply translated to increasing prices. The lack of competition also creates a risk-averse mentality at all levels of the workforce, leading to much less innovation. The rewards of innovative activity do not flow to the business that is not facing the white heat of competition. One source of problems for USPS has been the manner of regulation; in particular, the fact that the USPS must seek approval from the Postal Rate Commission for any innovative activity.

In Japan, the current plan to privatize Japan Post has the strong support of Prime Minister Junichiro Koizumi, who has promoted the idea of postal reform since 1979 when he served as a

⁶⁴ Robert W. Hahn and John A. Hird, *The Costs and Benefits of Regulation; Review and Synthesis*, 8 Yale Journal on Regulation 233, 264 (1990).

⁶⁵ U.S. Postal Service, *Origin-Destination Quarterly Statistics Report*, FY 1988, Quarter 1, pg. 7 (note that these are the Post Office's own figures and only take into consideration the time between post office to post office and not to the final destination).

junior finance minister, and who made it a focal issue in the special elections held last September. Postal reform has been at the very “heart of the reforms” that the Prime Minister has advanced since taking office in 2001 in line with the policies of “no growth without reform” and “leave to the private sector what it can do.”⁶⁶ The Prime Minister thus understands that privatization will lead to “more diverse and better products and services [to be] developed and provided through ingenuity and knowledge.”⁶⁷ The Prime Minister’s strong support for these policies will add important credibility for competition advocates against those opposed to bringing about the benefits of a competitive postal sector.

b. Costs in Private Firms

There is strong evidence that there is upward pressure on costs in SOEs, leading to higher prices, unless some form of subvention or subsidy is applied. Unlike in private companies, there is no share price reduction element to discipline behavior. The twin threat of bankruptcy or takeover that changes the behavior of a private firm simply does not exist in the case of an SOE. Data suggests that in the U.S., the monopoly of USPS itself accounts for \$2.5bn in excess costs to mailers in the third class bulk regular mail service.⁶⁸

c. Reserved Sector Analysis

Based upon the premise that universal service in the postal sector constitutes a public good, postal privatizations in other countries typically have reserved to the incumbent SOE a limited sector of postal services in which the SOE remains the monopoly provider. The goal here generally has been to ensure that, at some basic level of service, all customers in all regions retain access to postal services at affordable prices. Because private companies are restricted from competing within this reserved sector, however, the reserved sector remains unaffected by market forces that apply downward pressure on prices and encourage innovation in competitive sectors of the postal service.

A key issue, therefore, is the appropriate scope of the reserved sector, as a larger reservation than necessary could have a very negative impact on competition in the market. Typically postal companies reserve as part of their postal monopoly all goods up to a certain weight limit. This weight limit varies considerably around the world (among postal agencies). Recent European directives set the reservation at 100g, declining to 30g over time.

Clearly a reservation that is significantly broader than this will have competitive impacts. Such reservations can lead to the following effects:

1. Where there is competition between the postal company and other providers of non-postal services. The reservation prevents the non-postal service providers from functioning in the market at all.

⁶⁶ General Policy Speech by Prime Minister Junichiro Koizumi to the 163rd Session of the Diet (September 26, 2005), available online at http://www.kantei.go.jp/foreign/koizumispeech/2005/09/26shoshin_e.html.

⁶⁷ *Id.*

⁶⁸ Thomas M. Lenard, *The Efficiency Costs of the Postal Monopoly: The Case of Third Class Mail*, 6 *Journal of Regulatory Economics* 421 (1994).

2. The fact that there is a reservation enables the postal company to lower its costs in the non-reserved sector. This can distort the market for provision of services in the non-reserved sector.

We believe that the appropriate weight limit for the reserved sector should be a maximum of 100g progressively reduced over time and this should be reduced over time. The reserved sector should also take into account other factors besides just weight.

d. Universal Service Issues in Postal

As noted above, a Universal Service Obligation (USO) often is retained as part of the postal privatization process based upon the assumption that postal service – at least at some level – constitutes a public good to which all citizens must be granted access. Therefore, within a limited reserve sector, the incumbent SOE typically retains a legal obligation to provide the defined service to every customer that requests it. In return for assuming this service commitment, the universal service provider typically enjoys protection from competition within the reserved sector (as discussed above) as well as USO funding intended to ensure that (i) the cost of the service remains affordable to all customers, and (ii) that the universal service provider does not lose money in providing the service.

The Japanese Cabinet Decision on Basic Policy on Postal Privatization (Sept 10, 2004) (the “Cabinet Decision”) stated that “Preferential measures shall be established if necessary to maintain universal service”. This statement presents a number of problems as our studies of the universal service concept in a number of different areas demonstrate. Our studies show that the universal service commitment may actually lead to cost advantages for the incumbent that is subject to universal service obligations. This is because the universal service obligation means that the Post has a built-in infrastructure that can be used to lower costs for the provision of certain services outside the reserved sector. For example, the Post can use its infrastructure to lower the costs associated with sending packages through express mail, if it has an express mail arm. Instead of having to pay costs of C for utilization of infrastructure which the private competitor must build out, the Post must pay only C-X (the cost of elements that are needed but have already been built out under the USO).

This reduction of costs means that the Postal Company is at a cost advantage over the private competitor. The USO therefore becomes more like a State Aid to use the language of European competition law. Applying the concepts that are applicable under European State Aid law, the USO becomes a governmental benefit that alters the cost base of the Post. Under European terms, the aid is an “economic advantage which it would not have obtained under normal market conditions.” European law also provides an exemption for services of general economic interest, although this benefit is not without limits.

In the *Altmark* case, the court ruled that in order for a benefit to be classifiable as a state aid, it must be capable of being regarded as an “advantage” conferred on the recipient undertaking which that undertaking would not have obtained under normal market conditions.⁶⁹ As we discussed, there are four conditions which must be applied for a state financial measure to escape

⁶⁹ *Altmark Trans GmbH and Regierungspraesidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH*, [2003] ECR I-7747.

classification as a state aid if it is for services to a recipient to discharge public service obligations. First, the recipient undertaking must actually have public service obligations to discharge and those obligations must be clearly defined. Second, the parameters on the basis of which compensation is calculated must be established in advance in an objective and transparent manner. Third, the compensation cannot exceed what is necessary to cover all or part of the costs incurred in the discharge of the public service obligations, taking into account the relevant receipts and a reasonable profit. Fourth, where the undertaking is not chosen in a public procurement, the level of compensation must be determined by a comparison with an analysis of the costs which a typical undertaking in the same sector would incur (taking into account the receipts and a reasonable profit from discharging the obligations). In other words any USO that exceeds this level would be a state aid under the *Altmark* test. This would mean that any USO Fund which is based on a tax that competitors of the postal company would pay would almost automatically violate the *Altmark* principles because a fixed tax rate would be contingent on the variable of the revenues of the companies from which it is accrued, and that would have nothing to do with the actual cost of providing the universal service. Similarly a fund that was given to JPCo as a result of proceeds of privatization would also be a violation, unless it was clearly reduced to the minimum required.

The allocation of such funds could, under European law, also constitute special and exclusive rights under Article 87 of the Treaty on European Union ("TEU"). In ascertaining whether the services are in the general economic interest, it is necessary to ask whether the service has special characteristics that distinguish it from other economic activities, and the transfer of funds must be shown to be connected to that specific characteristic. One of the relevant factors is a financial advantage beyond the cost of covering the USO being given to one of the undertakings. Hence, in order for a USO fund not to be caught under these provisions, it would need to be clearly defined.

Even if a political decision is taken to impose a Universal Service Obligation and obtain monies for that obligation from other parties, this has to be carefully handled in order to make sure that the incumbent company does not hide behind the USO as a way to engage in more anti-competitive practices. This has been dealt with in numerous ways across multiple network industry sectors. In general a number of themes emerge:

1. ***The Universal Service Obligation has certain benefits***, such as name recognition associated with providing the service or built out infrastructure, as well as certain costs, such as setting up the infrastructure. The costs and the benefits must be weighed against each other. The historical Universal Service Obligation in the case of the Post Office will be an advantage as it has enabled the Post Office to build out the necessary infrastructure in rural and remote areas in Japan.
2. ***The Universal Service Obligation should be supported by those who benefit from it.*** Clearly, people in the rural areas themselves benefit from the Universal Service Fund. However, equally clearly, people in rural areas cannot be expected to support the Universal Service Fund entirely on their own. The obligation should therefore rest with taxpayers more generally. It must be clear that taxpayers are paying the USO. The more hidden the subsidy is, the larger the SOE can engage in predatory behavior by using the subsidy, as taxpayers will only complain if they see that their taxes are being abused. Indeed, there is a direct link between how long the SOE is capable of sustaining predatory conduct and how non-transparent the particular regulation is.

3. ***Universal Service Fund obligations should not be imposed generally on competitors or potential entrants to market.*** This is because this damages competitive markets. These public sector restraints are effectively state aids to the Post Office which may be used to help it compete against other new entrants in sectors that are broadly competitive.

11. Ensuring Privatization Leads to Competition

We have established that one of the major purposes behind privatization is to unleash the forces of competition and generate the efficiency and management gains for the benefit of consumers of the service. One of the challenges that are typically faced by the Post is that it has very high labor costs, brought about by a high level of powerful public sector unions. Employee ownership therefore may be a way of minimizing labor concerns, while at the same time ensuring that the conditions for privatization result in a more productive workforce.

It will be important in any contemplated privatization to ensure that the newly privatized Post cannot continue to engage in anti-competitive practices. These include the following:

1. *Deterring entry of new competitors.*
2. *Use of legacy privileges to secure a better competitive position.* Competition agencies should look for special tax breaks, customs privileges, even things like parking privileges that have an impact on the overall cost base.
3. *Predatory or exclusionary practices.* Agencies will have to be sensitive to the possibility that post services may elect to charge for certain services below cost to knock out competitors in certain areas, using the legally mandated monopoly in other areas to do so.

Many of these problems could be solved by a series of regional postal companies. Such a divestiture also helps the issue related to labor changes, because it will de-concentrate the power of labor unions, and thereby allow the downward pressure on labor costs that competition brings to be effective.

The Japan Privatization Bill (the "Bill") does contemplate a separation between the various lines of business of Japan Post. This is very important, and it is good that separation of these revenue streams is in the Bill. It also will be important to include similar safeguards against cross subsidization in the regulations implementing the Bill. De jure and de facto separation, including having separate price caps, if price caps are contemplated, and rigid accounting separation between these entities would also be required.

The Postal Privatization commission does not currently have within its number representatives of the competition agency. This would be very important to ensure pro-competitive concerns are addressed in the privatization process itself. There are also special exemptions that are contemplated in the privatization during the preparatory period for Japan Post. These include the ability of Japan Post to provide financing for international cargo transport. There are provisions that provide that this must be approved by the Privatization Commission, and that this activity must not unfairly harm those who provide like activities. This needs to be more clearly spelled out in the implementing regulations and the competition agency needs to be involved more closely in this area.

The language used here is woolly and needs to be tightened up - a consumer welfare oriented approach, as opposed to the quasi-trade test that appears to be applied here, needs elaboration. Where the bill refers to the fact that the new postal companies will not do anything to damage the interests of companies that provide like services, the competition agency needs to weigh in with its views regarding precisely what this means in a competition context.

There are other areas such as insurance and financial services where the provisions are to ensure that the competitive relationships with other providers are not adversely affected. This is slightly clearer language, but it is important to ensure that the JFTC's views are actively sought in the crafting of the implementing regulations.

The key areas where some competition safeguards are mandated are as follows:

1. Use of the USO as a shield for anti-competitive practices. Frequently, as noted above, the USO is so used.
2. A rigorous accounting separation mechanism among the various businesses is required to ensure that any anti-competitive cross-subsidization is limited. In considering the costs for provision of a service, we recommend using a hypothetical private firm, and adding to that cost base the benefits accrued from being government owned, including all exemptions from taxes, licenses or any other regulatory process that private firms would have to engage in. All these costs should be added to the hypothetical benchmark. If the Post is charging below these costs, then a case can be made for anti-competitive cross-subsidization.

12. Potential Issues in Japanese Postal Privatization

a. Evaluation of JPCo's Cost Base

It is clear that Japan Postal Company ("JPCo") (one of the companies that will exist after the privatization separates the postal company from the financial services and insurance arms of Japan Post) has benefited from having already built out its infrastructure. JPCo therefore clearly will benefit from this legacy governmental ownership. Meanwhile, there are a number of domestic express companies, such as Yamato and others that might be interested in providing postal services. The problem for them would be that they would have to compete against the much lower cost, already built-out infrastructure of JPCo. JFTC would have to develop a methodology to deal with this cost differential, by assigning a hypothetical benchmark cost for provision of postal service, and by developing accurate ways of evaluating the cost of the individual network elements. A careful and accurate evaluation of cost is particularly important as the SOE can engage in below-cost pricing which would be below the real cost of provision of the service (if those costs are properly allocated) but may be below the hypothetical and artificially created cost, which arises from the perks and privileges of government ownership.

In studies of the cost of the universal service obligation, a common theme emerges. The USO has both cost and benefit characteristics. Many studies conclude that any cost characteristics are outweighed by the benefit characteristics, and any cost savings by limiting the USO are dwarfed by savings from, for example, reducing the premium wage of government postal employees, who tend to be paid significantly more than private sector counterparts in comparable jobs. This is borne

out even by a study on universal service in the U.S. authored by a number of Postal Rate Commission members.⁷⁰

In this study, the authors note that the USO does not necessarily mean ubiquitous counter service. There are many ways of delivering the counter service, including providing mobile counters by postal couriers on their rounds (especially effective on rural routes). The study noted that, in the US, there were 38,000 postal facilities, many of which sat idle for large parts of the day. Closing some 7,000 of these would only provide a saving of the order of 0.6 percent of total costs. Cost savings could also be incurred by reducing the delivery days on non-business routes (a 5 day service which is the norm in many countries would give rise to a 3 percent cost saving). The biggest saving by far, however, would be from equalizing postal workers with comparable private sector counterpart wage levels. In the US, where postal worker wage levels are 21-35 percent higher than comparable private sector workers, the saving would be between 12 and 20 percent of total costs. The reason the wage premium is sustainable is the lack of competition, so once competition is introduced the Post Office would likely benefit from these major savings quickly. In most privatizations, substantial workforce reductions occur – (40 percent between 1988 and 2001 in New Zealand, 15 percent between 2002 and 2005 in the UK). These reductions and cost savings dwarf tinkering with the USO. However, the significant benefit of the USO is the fact that the Post Office already has built out infrastructure as a result of the USO.

The USO is often regarded as a set of obligations fixed in stone. We would argue that this is not the correct way of analyzing the USO. The USO is a living obligation which may change with time and with liberalization. For example, the notion of the USO requiring a certain number of counters, if technology supersedes the use of counters for sorting, must itself be altered to take into account these dynamic changes.

This is best illustrated by looking at the telecoms example. Here, the notion of a USO tied to an incumbent wire-line company does not make sense when technology and cost reduction have totally transformed the way that basic telecoms services are delivered to consumers. Wireless telephony has lower cost than wire-line, and a USO that applies to wire-line incumbent companies can distort the market by making wire-line costs artificially lower than wire-less costs. Even newer technologies like Voice Over Internet Protocol (“VOIP”) are dramatically changing the very business model for the provision of telephony services. For VOIP, distance and duration of calls does not give rise to cost consequences. If consumers could be connected via VOIP, any USO for the incumbent would be damaging to the up-take of this new technology.

A recent study by the UK’s telecoms regulator, the Office of Communications (OFCOM), has shown again that the USO can be both benefit and burden. Specifically, the OFCOM study found that the incumbent – British Telecom (BT) – could receive the following benefits from the USO:

1. Enhancement of corporate reputation.
2. Marketing and brand recognition.
3. Information on how the telephone system is used by customers.
4. Benefits associated with customer life cycles.

⁷⁰ Robert Cohen *et al.*, *The Cost of Universal Service in the US and Its Impact on Competition*, (Proceedings of Wissenschaftliches Institut für Kommunikationsdienste GmbH, November 17-19, 2002).

5. Benefits associated with ubiquity
6. Avoidance of business loss because carrier is deemed to discourage or even disconnect customers.
7. Avoidance of disconnection costs, and planning costs (because the carrier has to provide service and cannot engage in modeling and planning to determine where to provide service).

OFCOM calculated that USO costs were in the region of £58m - £89m. The net benefits of the above were in the region of £54m to £64m, suggesting an actual USO net cost of only £4m - £25m. OFCOM therefore decided that these numbers were not significant enough to merit a USO subsidy for BT.⁷¹

The International Telecommunication Union (“ITU”) has published a set of Draft Model Universal Service/Universal Access Policies, Regulations and Procedures.⁷² These policies, regulations and procedures are intended to ensure that there is access to information and communication technologies (“ICTs”), while also recognizing the importance of opening up the market to competition, as a way of “stimulat[ing] network development, encouraging the spread of innovative technologies and promote high quality, affordable service.”⁷³ The ITU Draft notes that universal service funds are not the only means of reaching service/access goals, and that rapid technological change has laid the foundation for alternative technologies (such as mobile telephony) to provide access to information without the necessity of guaranteeing a particular service.⁷⁴ The ITU Draft further notes that “it is generally recognized that . . . the *market* is proving to be the best mechanism for serving nearby all levels of user needs.”⁷⁵

According to the ITU Draft, there also is a need for interim measures to deal with the fact that market-based remedies tend to help the higher end of the spectrum (businesses and wealthier consumers) while market solutions may take time to percolate down to the poorer people. These points underline Universal Service Funds (USE) and Telecommunications Development Funds (“TDFs”) principles. The ITU Draft goes on to state that it believes that “it is a fundamental right of all citizens to have access to diverse and unrestricted sources of information and means of communications.”⁷⁶ This language is potentially problematic as making something a *fundamental right* opens up the potential for services market distortions to occur. The ITU principles also note, however, that the “first objective of this policy shall be the provision of access to a basic level of telephone service in all rural and low-income urban areas.”⁷⁷ Note the emphasis on the provision of *access*, not necessarily service. This ties-in to the Chilean approach, which is discussed below.

⁷¹ See UK OFCOM, *Review of Universal Service Obligation* (June 30, 2005). OFCOM plans to follow this review with a more comprehensive study of USO costs and benefits in 2006.

⁷² International Telecommunication Union and Commonwealth Telecommunications Organisation Model Universal Service/Access Policies, Regulations and Procedures, Draft of November 26, 2002 (“ITU Draft”).

⁷³ *Id.* at 2.

⁷⁴ *Id.* at 3.

⁷⁵ *Id.* at 1.

⁷⁶ *Id.* at 3.

⁷⁷ *Id.* at 4.

The ITU Draft also suggests language requiring all licensed or authorized operators or service providers to contribute to the Fund.⁷⁸ However, there is no discussion of whether this approach leads to pro-competitive market solutions. Perhaps to counter this statement, the ITU Draft goes on to say that USF funds should not be used to the competitive advantage or disadvantages of any one private operator. In emphasizing market oriented, non-discriminating principles it proposes the following sample language:

“To the greatest extent possible, USF funds will be employed to facilitate investment in market-oriented, sustainable operations, which *will not require public subsidy* following initial start-up funding.”⁷⁹

Again this stresses the temporary nature of the USF. The ITU Draft does suggest that the most competitively neutral practice is to require all market participants to contribute an “equivalent” amount by setting a fixed percentage of designated revenues. However, the ITU does not consider the anti-competitive effects of this policy. The practice of requiring the private sector firms that compete against the universal service provider in competitive markets to fund its USO subsidy can distort market signals with respect to the services provided by each. This distortion occurs by sending inaccurate price signals to consumers deciding whether to use competitive services in place of the regular postal offered by the universal service provider, thereby resulting in inefficiencies and higher overall costs for all.

Additionally, requiring funding from private market participants has the effect of amplifying any cross-subsidization by the universal provider to the detriment of competition in the competitive markets. This occurs where the universal service provider competes against the private companies in the competitive markets with artificially low prices that are cross-subsidized from the USO fund, while the private companies themselves must bear the additional cost of contributing to the USO fund. Throughout the ITU Draft, there is no attention paid to the costs of the USF and from where it is drawn. Indeed, it is almost as if the ITU Draft’s principles are based on the notion that the USF is virtually costless, which of course is a fallacy.

The ITU Draft does call for careful accounting procedures, but again nowhere does the ITU document deal properly with the risk that USF monies may be used to cross subsidize services in competitive markets.

In looking at the costs side of the equation, the Australian experience is instructive. The costs must be only those in producing standard service and payphones. In the Australian case, non-standard services are excluded from the costs calculation. The Chilean case is instructive because it shows that the USO can be bid out competitively.

The Chilean approach is interesting in the telecoms area because, unlike electricity and water, it is universal access, not universal service that is contemplated. In the telecoms context, universal access is achieved by the creation of a Telecommunications Development Fund. The Fund’s mission was to promote the installation of payphones, available 24 hours a day in areas where there was limited or low telephone density. This in contrast with some countries that have focused on

⁷⁸ *Id.* at 7.

⁷⁹ *Id.* at 6.

universal service and providing a telephone in every house. The initial goal of installing 6,000 phones in rural areas was quickly achieved, and the next goal was to install telecom centers in each of the 341 counties. Subtel, the Chilean telecoms regulator would oversee the application of a subsidy which should be carefully calibrated so as not to exceed the estimated investment value. Techniques were used to find the minimum cost solution. Once technical solutions were found for certain projects, they were put out for competitive tender and awarded to the bidder seeking the lowest subsidy. Commentators on the Chilean system have noted that the Subtel estimate of the subsidy was likely to represent the upper level of what is needed. The reason for this is that the Subtel estimate did not take into account existing infrastructure.⁸⁰ In any event, in the first year the total committed subsidy was \$23.1m, a very low amount. Firms on average requested only 60 percent of the maximum subsidy. The subsidy on each rural phone was \$3,800 as opposed to \$12,000 before the fund. This was largely brought about by the competitive bidding process. The impact of the fund has been very significant with 93% of the rural population having access to telecom services by 2002, as opposed to only 10% in 1995.

Serra has commented that mobile phones have become more popular with poorer consumers, especially with pre-paid phone cards. This dynamic has also affected the notion of universal service with regard to landline telephony. Serra points out that greater competition is itself a way of satisfying the Universal Access Obligation, as more competition lowers price and thus makes services more generally available. For example, long distance prices have fallen by over 80% since 1994 after deregulation. In electricity generation, prices fell by 50 percent (and it should be noted that instilling competition in the generation area is notoriously difficult).

Serra also looks at whether cross-subsidies actually help the poor. The cross-subsidy that normally accompanies a USO fund was meant to make local telephony more accessible (on the basis that the poor would particularly need this kind of service, whereas businesses would use long-distance and international services). However, he notes that in the Chilean example, the average family's phone bill increased from \$9.30 to \$25.10, even as the number of lines increased by a factor of six. Subsidies that are funded from taxes, as opposed to from competitors or from the proceeds of a privatization are more likely to lead to efficiency enhancing uses that actually target the poor. Serra notes that in Chile's public utilities, cross-subsidies have been virtually eliminated, and any subsidies remaining are funded out of the national budget. This is a very significant achievement that should not be under-estimated.

The studies suggest that company-specific data should be avoided and hypothetical or proxy costs should be used. How should these proxy costs be calculated? The FCC has noted that the least cost, most efficient and reasonable technology should be used. However this may not be accurate – these technologies may not be immediately available and frequently take time to be rolled out.

Studies certainly appear to show that consumers and entrants lose in the event of a Universal Service Fund operated by a tax. Imposing a tax on other market participants naturally increases costs for those participants. This not only increases prices for their customers, but also can impede or even prevent entry by additional market participants, to the detriment of competition in those markets. This policy furthermore distorts market signals to consumers by artificially increasing

⁸⁰ Pablo Serra, *Subsidies in Chilean Public Utilities*, Policy Research Working Paper No. 2445, The World Bank (Sept. 2000).

prices, which in turn leads to inefficiencies that increase costs for all consumers. Finally, to the extent that the tax is based on arbitrary definitions to determine which providers will be taxed, how much they will be taxed, and which ones are eligible for support, the tax can alter the actions of the providers (including those of the SOE) so that they can either avoid taxes or gain access to subsidies. This creates further distortions that can lead to costly inefficiencies as well as restrictions on competition.⁸¹

In determining the costs of providing the USO, regulators have naturally adopted different standards. In Australia, the costs of provision of non-standard service were excluded from the calculation. The Chilean regulator, meanwhile, allowed the USO to be bid out competitively. This was a useful exercise since a competitive bid generally applies downward pressure on costs.

As the population becomes denser, so the Post Office benefits from economies of scope and economies of density. It has been shown that as the number of delivery points increases, the number of letter-carriers does not increase (because the same letter-carrier can easily service those increasing areas). Hence, the USO does not lead to costs rising with delivery points, since the bulk of the costs are in the letter-carrier itself. Yet Post Offices often argue that increasing volumes mean increasing USO costs. This example shows that USO cost, far from being proportional to increasing volumes, may actually be inversely proportional to volumes depending on the precise spread of the delivery points.

b. Auctioning off Reserved Sector?

One method of stimulating competition in postal would be to auction the reserved sector, as one auctions spectrum in the telecommunications world. The problem with this approach is that it is not clear who would actually make competitive bids, especially since there would have to be an obligation to service the less profitable markets as a condition of the auction. Still, Chile's telecom privatization stands as an example of a successful process in which the telecom reserved sector was assigned by auction to private sector bidders, which bids had the effect of allowing market forces to identify the minimum USO subsidy needed to provide service to the relevant areas.

Economists have considered the potential for franchise bidding particularly in rural regions. As early as 1968, Demsetz wrote about the concept of franchise bidding, but the concept dates from the 19th century.⁸² Franchise bidding requires the following: (i) Low sunk costs – many network utilities do not lend themselves to franchising because their sunk costs are very high, however the advantage in the postal sector is that sunk costs are modest; (ii) Severability of network elements-regional separation applies in the case of post or rail. Postal monopoly franchises could be awarded in different regions. The idea would be that these franchisees would have a franchisor-franchisee relationship with the Postal incumbent. Such a relationship would require monitoring for quality standards as would be the case with any franchise relationship. However, commentators have expressed the concern that there are significant transactions costs associated with franchise bidding which may make it less attractive.

⁸¹ Gregory L. Rosston and Bradley S. Wimmer, *The ABC's of Universal Service: Arbitrage, Big Bucks, and Competition*, 50 *Hastings L.J.* 1585, 1587 (1999).

⁸² Harold Demsetz, *Why Regulate Utilities*, 11 *Journal of Law and Economics* 55 (1968).

Mail delivery does lend itself to these kinds of franchise arrangements. It is useful to describe exactly how mail is collected, sorted and delivered. Mail is generally received from customers at multiple points. It is then transferred to a node, and sorted. It is then transferred to another node where it is re-sorted for onward delivery to specific customers. The service lends itself to competition because a) there are very low levels of sunk costs (unlike other network industries), and b) quality is easily observable - delivery times can be easily monitored. Transport capacity can also be leased in small portions without appreciable cost disadvantages. Postal operators have also not been responsible for built out infrastructure in the transportation area. Postal operators use roads and airways that already exist, and so the transportation cost is limited to vehicles (unlike in gas, telecom or electricity, where there are substantial sunk costs).

Under franchise bidding, the inward and outward sorting of mail would be retained by the incumbent JPCo. JPCo would be subject to price regulation in this area. The transportation of mail between the nodes would be subject to competition. The transportation of unsorted mail to and from the nodes would be part of the franchise bid. The successful bidder would win both the collection from and delivery to a certain region, thus enabling monopolies of scope to be leveraged. The franchise bid would only apply in rural areas, so that the incumbent would continue to serve urban areas. In the Chile telecommunications privatization, there were auctions for both the rural areas as well as the USO that accompanied them. The companies that bid on certain segments also bid an amount representing what fund they would need to support universal service. The winner was the company with the lowest universal service requirement (all other things being equal). The advantage of this mechanism is that it applies continuous downward pressure on costs, and thus lowers the real cost of providing the universal service obligation.

Commentators have evaluated the possibility of auctioning the reserved sector and the USO. One of the more recent studies on the precise auction mechanism which could be used is an auction where small geographic areas would be put up for auction, along with the USO.⁸³ These studies suggest that the current model of USO which is used in many countries does not properly take into account some very important dynamics. These include the fact that costs vary over different areas, and so the actual cost of providing universal service is not uniform. Yet many USO funds assume that these costs are uniform. By ignoring the lack of uniformity of costs, fixed USO funds do not liberate forces that will drive USO costs down. Since costs of providing universal service vary from customer to customer, the ideal world would be one where the USO provision for each customer most closely mirrors the actual cost of providing that service to that customer. Anything else is market-distorting. However, this market distortion cannot really be avoided, but it can be minimized. The advantage of the auction process is that (a) it is the market and not the regulator who decides how much funding is required to satisfy the service it deems to be required and (b) it will lead to the application of downward pressure on costs. The regulator will also be disciplined to ask questions as to what level of universal service is truly required.

In the Global Symposium for Regulators 2002, the ITU considered minimum subsidy competition auction mechanisms. In considering what the maximum subsidy ought to be, the ITU recommended that a financial cost model be used, or that the market be allowed to determine the final amount of the required subsidy through competitive bidding. In the latter case, the maximum subsidy could be announced prior to the action, and bidders then would identify in their bids the

⁸³ See, e.g., *Auctions for Universal Service Obligations*, Dennis Weller, presented at the Twelfth Biennial Conference of the IIS, Stockholm, June 1998.

minimum subsidy they would require in order to provide the service. All else being equal, the bid would be awarded to the bidder with the lowest subsidy requirement. Thus, competitive bidding would have identified the minimum subsidy actually required for a qualified service provider to provide the service.

c. Interconnection and Access Pricing

Another idea that has been suggested to make the postal sector more competitive is that there should be interconnection between the new entrants into the network of JPCo. This would avoid the inefficient duplication of already built out infrastructure. Again this is an interesting notion, but the problem would be the interconnection fee. If the Post is able to charge a prohibitively high interconnection fee, then we would simply replicate problems we have seen in the telecoms area. A number of cases in the telecoms area, such as Telmex (already discussed) have shown us that excessive interconnection fees are very difficult to control when the incumbent possessed bottleneck facilities.

The difference in postal arises from the question of how difficult it is to build postal infrastructure. Since much of the postal cost is in labor costs, and the facilities needed are not complex, it may be possible to build out infrastructure and that this infrastructure would not be unnecessarily duplicative. This would be analogous to having a number of express delivery pick-up facilities. This kind of infrastructure is to be differentiated from other networks where fixed capital cost is substantially greater, such as telecommunications, or electricity. While no-one considers it odd that there are a number of different express delivery pick up facilities, it would be very strange (and more importantly a waste of resources) to have multiple electricity grids (although even this area no longer exhibits the natural monopoly characteristics that it once did, due to competition from other sources of energy, and new technologies for delivering electrical energy).

Weighed against this is the concern that interconnection with JPCo will be a one-sided negotiation with all the power in the hands of the Post. This is likely, if past experience is anything to go by to lead to a very high interconnection rate. It is unlikely that JFTC would be able to successfully discipline such a powerful actor, and this could lead to adverse market effects. In particular, a delay in being able to correct anti-competitive practices can have significant market effects for the new entrants in this market.

A significant difference between telecom interconnection and postal interconnection is that while postal interconnection can be limited, it cannot be denied totally, as there is nothing to stop users sorting and using the postal network in a bulk fashion, albeit at single piece rates. The question is what is the most efficient form of sanctioned access, and how should it work. One can have interconnection into upstream facilities, such as the mail-sorting equipment or downstream at delivery points. In the case of upstream, interconnection theories usually rely on some variant of the essential facilities doctrine. In the case of postal, these facilities are not truly essential in the antitrust sense. They can be duplicated with relative ease (or improved with innovation) and to require interconnection may not give rise to the most competitive solution in the long run. Given that the facility is not truly essential, normal competition rules should apply. If the Post Office increases the price, the new entrant may well develop its own solution, thus restraining the Post's pricing. However, this does not take into account the economies of scope and historic government ownership of the Post Office. Downstream access would allow new entrants to deliver on some

mail routes. The problem here is how to avoid cream skimming where new entrants simply leave the Post with all the high cost routes.

One question that arises is what should be the cost of access pricing if a parcel delivery company needs to use the network. Most postal reform requires the unbundling of downstream access – so-called unbundled access at reasonable prices. The key question is naturally what constitutes a reasonable price. Another question is to what extent should the postal service factor in its USO in considering what that price should be (as some commentators have suggested).

We would argue, based on the fact that the USO may have both benefit and costs characteristics, that the access price should not factor in the USO, otherwise access pricing simply becomes another USO subsidy. Instead the access price should be a cost-based access price, based on the unbundled elements that actually constitute the real cost of provision of the particular service. This would be analogous to the cost-oriented interconnection charges that are mandated by the WTO Basic Telecoms Agreement. It is important to note that the language used in the WTO Agreement – cost-oriented, as opposed to cost-based – is the result of a compromise. Hence it is very important that a consumer welfare enhancing goal is achieved by cost-based access pricing.

POSTCOMM in the UK has identified six different sectors within postal services that may need to be accessed by private providers:

- (i) Collection
- (ii) Outward sorting
- (iii) Transportation
- (iv) Inward Setting
- (v) Delivery
- (vi) Support activities

The above elements omit certain key issues such as marketing and sale of stamps. Of these, delivery takes up the highest attributable cost, but this is largely because its cost tends to be inflated because of the Universal Service Commitment. One significant issue is that the incumbent company has economies of scope and size, not because it has out-competed its competitors in an open marketplace, but rather because it has been given a statutory grant of a monopoly.

Article 12 of the European Postal Directive sets out the rules for setting access prices in the EU. The three general principles from which one can choose are (1) incremental pricing, (2) retail minus, or efficient component pricing, or (3) Ramsey pricing. Retail minus access pricing tends to be favored by incumbents, since it is the furthest from a cost-based pricing mechanism. However, retail minus is not strictly necessary for the survival of the universal service obligation.

There is also a question as to which of these elements in the network the incumbent must grant access. We would argue that access must be granted anywhere in the network at any one of the network elements.

Access pricing has been studied extensively in the context of the UK Postal system. Indeed when UK Mail, Ltd (a new postal operator) entered into an access agreement with Royal Mail to use

its network, Postcomm made comments designed to focus on the impact this agreement would have on competition in the postal sector.⁸⁴ In this case, UK Mail wanted to inject mail into Royal Mail's Inward Sorting Centers. The two companies agreed to use weight-based prices for this interconnection. In negotiating the access price, Postcomm was anxious to make sure that the access price did not damage the ability of the Royal Mail to satisfy its Universal Service Commitments. Postcomm believed that the access price should be based on a reasonable allocation of profit, rather than a retail-minus system. In other words, the access price should be cost- and not price-based. Postcomm noted that using a retail-minus regulatory scheme would be discriminatory as it would favor the Royal Mail's upstream business.

In determining the appropriate measure of costs for setting the weight-based access price, Postcomm adopted a volume-weighted average of first- and second-class tariffs as a proxy product whose costs were determined be about the same as the costs that the Royal Mail would incur. Postcomm was careful to ensure that upstream and downstream costs were properly allocated in this scheme, and also added a reasonable profit element. While Postcomm itself did not set the rate, it commented on the access agreement and was an important party in the negotiation process. Postcomm was not persuaded by UK Mail's argument that the costs should be based upon the lower second-class tariff, rather than a hybrid of both the first-class and second-class tariffs, noting that Royal Mail should base the access price on the geographic area where the other party was located. If the universal service subsidy was threatened in a high-cost service area, Postcomm recommended a rural charge fee.

Interestingly, Postcomm noted that postal service does not entail significant sunk costs, as most of the costs invested can be re-deployed elsewhere in the economy. Postcomm also noted that costs naturally increase as the access point moves further upstream, and the incumbent postal company has to expend more resources to complete its delivery.

d. Impact of Work Sharing

Even in countries where there is a regulated monopoly, such as the US, worksharing has led to some cost reductions. Cohen et al (2001) estimate that worksharing saved the USPS about \$15bn in costs. Work-sharing in essence is a form of access pricing, in which a private competitor may provide certain elements of the postal network, in conjunction with those still provided by the regulated monopoly.

In the UK, the postal reforms that will apply to the Royal Mail in the coming year (2006) do involve licensed operators interconnecting into the Royal Mail's existing distribution system. In the UK, Britain's postal system will be fully liberalized from January 1, 2006. Under the postal reform in the UK, licensed companies will be able to collect, transport, and deliver letters and charge customers. There are a number of additional barriers that must be removed in the UK. Royal Mail is the sole postal company that does not have to pay Value Added Tax. There are also a number of other privileges that the Royal Mail enjoys that need to be eliminated, and that will be part of an ongoing process of reform.

⁸⁴ See Postal Commission Report (March 2004)

13. Further Cost Considerations: How to Avoid the Cross-Subsidization Problem

While we have already set out the general cross-subsidization test (see above), we have noted that it needs to be modified on the case of state-owned companies. Because we are dealing with a State-Owned company, there are many factors that must be addressed. The *Brooke Group* test, which generally applies in predatory pricing situation, requires the following two elements to prove predatory pricing:

1. Price below costs. Typically average variable cost is used as a proxy for marginal cost.
2. Predator must be able to recoup lost profits. In order for this to occur, predator must have market power.

In the contest of State-owned companies, we need to unpack these two tests further.

a. Below-Cost Pricing

In order for below-cost pricing to occur, there must be an agreed measure of cost. We have noted that state ownership, or legacy government ownership, can have a profound impact. We will now analyze some of these impacts.

The usual measure of cost in determining competitive pricing is marginal cost. Marginal cost, being difficult to compute, is usually proxied by average variable cost. The precise measure of cost used is absolutely key to the determination of whether pricing constitutes an anti-competitive practice. This measure then will drive the entire determination of whether there has been an anti-competitive practice.

In order to ensure that the market and related markets are kept competitive, it will be necessary to be extremely careful in the analysis of costs. The following factors must be borne in mind as we analyze costs.

1. *Shared Infrastructure Cost.* In the case of the Post, there are a number of shared costs, which can be attributed both to the letter mail monopoly infrastructure as well as the parcel service. This issue of shared infrastructure cost was considered in the case of *Deutsche Post v. Commission*,⁸⁵. In that case, in looking at the costs of providing services, Deutsche Post (“DP”) argued that it needed the 33 freight centers that were used in the postal system to provide its parcel service. It therefore sought to include in the cost calculations the capital cost of setting up the freight centers. There is also some shared staffing between these two functions. It was also found in the DP case that some dedicated B-to-B parcels were delivered jointly with B-to-C parcels in standard delivery rounds. In other words, there were a number of areas where DP’s express arm benefited from certain sunk cost items that it had as a result of its letter mail system. Since that system was a monopoly, its express delivery arm had artificially lower costs than a hypothetical competitor would have. Hence these costs must be added to the stated cost of providing the service. It will be necessary in the case of JPCo to ascertain how it conducts its parcel delivery arm, and whether it uses some

⁸⁵ *Deutsche Post v. Commission*, [2002] ECR I-247/27 (the “DP Case”).

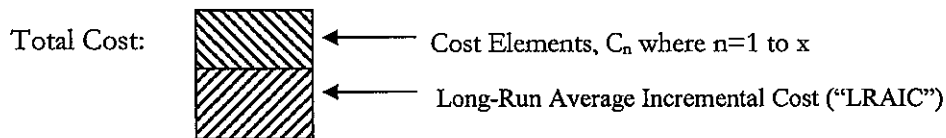
of the letter mail infrastructure to perform these services. In the DP case, the mail-order service costs could be specifically attributed to the mail order function. There is also a question as to the cost of running the capital, maintenance, and supplies of the network, and how these costs should be apportioned between the postal and express arms.

2. *Historical legacy of government ownership.* It is necessary to track back to establish the real impact of the historical legacy of government ownership. There may be transfers of assets, real estate, or other property to the formerly state-owned company, perhaps even as part of the privatization process. The British Post Office, which intervened in the DP case, maintained that the transfer of any property to the public postal service constituted unlawful state aid. In the DP case, there were also transfers of funds from the DB-Telekom to DB-Postdienst which allegedly constituted state aid. In the case of the privatization of the JPN, a question will be whether there are any funds or property transfers which could constitute both anti-competitive aid, but also would lead to the reduction of the costs of providing the express delivery service. We understand that as part of the privatization process, the Universal Service Fund will be met from the proceeds of the sale of the constituent parts of the JPN. This is a very important area which needs to be carefully monitored by the JFTC. This is because these funds could be regarded as transfers as defined above. They could be problematic from a competition and market distortion standpoint. An assessment would also have to be made about any other funds that have been transferred to JPCo from other branches of JPN prior to, or as part of the privatization.
3. *Historic costs associated with government ownership.* In the DP case, DP maintained that it had historic costs that private competitors did not have - these included above average wages, redundancy payments, government sponsored programs such as affordable housing for its employees and so forth that together constituted an atypical cost element.⁸⁶ It is likely that JPCo would make similar arguments to justify anti-competitive activity. It is important to note that many of these alleged atypical components are not really higher cost than private competitors would have, and to the extent they are usually dealt with in prior transfers of assets from State to the Post (as they were in the DP case).
4. *Targeted rebates.* The DP gave rebates to major users. These rebates were partially funded out of its revenues from the letter mail monopoly, and from other revenues. One of the problems for DP was that it was clear from the documents that the rebate strategy was designed to deal with DP's declining market share and not to deal with any concept of a universal service component.
5. *Legacy-based privileges and benefits.* JPN's legacy as a state-owned monopolist may mean that the JPCo has certain privileges and benefits that it has as part of its government status. These can include preferential tax status, parking privileges and preferential customs status when sending packages across national boundaries. These kinds of benefits must also be added to the cost of the provision of the service.
6. *Interaction between Universal Service Obligation, Reserved Sector and costs of service provision.* In the DP case, DP maintained that it had a Universal Service Obligation for delivery of all postal

⁸⁶ *Deutsche Post v. Commission*, [2002] ECR I-247/27.

parcels up to 20 Kg. This is a very high weight limit. The notion of what the universal service function covers is naturally linked to what is covered by the Reserved Sector. The Universal Service Obligation should only cover what truly constitutes essential mail - hence we advocate that a 30g target. Allowing the reserved sector size to increase will allow the Universal Service Obligation to be used to defend anti-competitive activity and to lead to a calculation of costs attributed to provision of the express service that understates the actual costs. This will in turn make it much harder to demonstrate that pricing on the express sector is below some measure of cost.

While average variable cost is generally a proxy for marginal cost, incremental cost may be a proxy for cost evaluations in the case of network industries. Costs will be average incremental cost, plus elements to account for various government privileges, including the USO benefit. This can be described by the following schematic:



$$\text{Total Cost} = \text{Hypothetical Benchmark Cost (\"HBC\")} = \text{LRAIC} + \sum_{n=1}^x C_n$$

where C_1 =USO benefit(as described),⁸⁷ C_2 = parking privileges, C_3 = tax privileges etc.

and $\sum_{n=1}^x C_n$ is the summation of Cost Elements relating to Governmental Benefits (\"CEGB\")

In order for below-cost pricing to be maintained, it must be below the Hypothetical Benchmark Cost. In practice, there will be many cases of pricing above LRAIC but below HBC. The greater the CEGB, the greater will be the difference between HBC and LRAIC (Δ (HBC-LRAIC)). Some elements of CEGB will be relatively easy to compute. Other benefits will be much more difficult to compute. However, the CEGB cost elements must include all privileges and benefits that accrue from the state-ownership. This includes any benefits that the SOE derives from the taxpayer. In the case of the Japan postal privatization, we understand that the proceeds of the privatization will partially be used to create a universal service fund. These amounts may be significant (of the order of billions of dollars) and hence constitute a significant USO benefit for JPCo. CEGB will therefore include an element C_{uso} that represents the benefit of this particular fund.

b. Market Power and Recouping Costs

The second limb of the *Brooke Group* test is the presence of market power, and the associated ability to recoup the costs incurred in below-cost pricing. Here, market share typically is used as a proxy for market power. If an entity has market power, then, under the second limb of the *Brooke*

⁸⁷ The USO benefit includes such benefits as greater brand awareness, enhancement of corporate reputation, benefits associated with customer life cycles, etc.

Group test, it is capable of knocking out competitors or raising price after a predator. If a company does not have market power, then it will not be capable of such activity, and its conduct is not predatory. Market power is therefore a very important determinant of whether a company can actually raise prices and engage in activity that damages consumers. Without this power, low prices charged by the alleged predator would simply invite others into the market.

In the US, Section 2 of the Sherman Act prohibits the abuse of monopoly power once acquired as well as attempts to monopolize. It is important to note that there is no antitrust bar to simply attempting to increase market share even to 100%. The cases interpreting Section 2 of the Sherman Act have suggested that market share of greater than 70% rises to the level of being problematic from this perspective.⁸⁸ A snap-shot analysis of the market has usually been used to establish the level of market share at any given time. However in markets that are rapidly changing, such as after a privatization, a fixed (in time) reference for market share does not make much sense. Instead the dynamic view we suggest is more accurate. Market power is important, as without it, there would be no ability for the SOE to recoup lost profits. Its low prices would only invite others into the market, and these would discipline its price-hiking tendencies.

In the case of SOEs, there are also different factors that need to be considered, based on their status as government entities. They are as follows:

(i) Government as revenue-maximizer can sustain predatory prices for longer than can a private company. It can do this because the threat of bankruptcy is not as real – governments tend to bail-out their failing enterprises. SOEs also receive other aids and hand-outs from government. These benefits need to be factored into the analysis above, but they also mean that SOEs with lower than 60 percent market share can still be engaged in harmful predatory conduct.

(ii) The other factor to consider is the impact that such behavior is having on market share. If $M(x)$ is the market share of SOE x , then $(dM(x))/dt$ – the rate of change of market share – will help determine the true dynamic market power of SOE x . Where $(dM(x))/dt$ is large, and particularly in cases where $(d^2M(x))/dt^2 > 0$, then even relatively low levels of $M(x)$ can lead to market power, that can enable an SOE (or indeed a private competitor) to engage in and sustain harmful predatory conduct.

14. Prevention is Better Than Cure

In our experience, around the world, once an incumbent is allowed to engage in anti-competitive practices, it is very difficult to discipline the incumbent because of its significant political power. It is much better to ensure that the regulatory design precludes anti-competitive practices, and monies are not available to JPCo from the outset to engage in such behavior. This is why it is important to limit the size of the reserved sector, to ensure that the postal sector is competitive as possible, and to make certain that opportunities for the exploitation of bottleneck facilities are very strictly limited.

⁸⁸ See, e.g., *United States v. E.I. DuPont de Nemours & Co.*, 351 U.S. 377 (1956) (75% market share sufficient to show market power); *Tops Markets, Inc. v. Quality Markets, Inc.*, 142 F.3d 90 (2d Cir. 1998) (market shares of over 70% sufficient).

15. Conclusion

There is clearly a strong link between the approaches of competition agencies and regulatory agencies. There is demonstrable evidence that competition agencies have an important role to play in ensuring pro-competitive regulation, i.e. regulation that maximizes overall consumer welfare and efficiency. This is particularly true where privatization and regulation of former SOEs is taking place. Through this role, competition agencies can ensure that regulatory reform will create a more competitive marketplace. This is part of a larger role that the JFTC should play in privatization and pro-competitive regulatory reform in Japan. The goal must be competition in the postal, insurance and express delivery markets in the case of Japan Post but liberalization more generally as well. A pro-competitive regulatory approach in telecom is also likely to yield substantial consumer and business gains. The most recent US-Japan Regulatory Reform and Competition Policy Initiative⁸⁹ offers a number of recommended areas for further liberalization to create a more competitive environment: telecommunications, information technologies, energy, medical devices and pharmaceuticals, financial services, competition policy transparency, privatization, legal systems reform, commercial law and distribution. We hope that a more active JFTC role in competition advocacy in the Japan Post privatization process will continue into these other areas as well.

Shanker A. Singham
Chairman, International Roundtable for Trade &
Competition Policy, Inc.
Partner, Squire Sanders & Dempsey L.L.P.
Dated: February 13, 2006

⁸⁹ Annual Reform Recommendations from the Government of the United States to the Government of Japan under the U.S.-Japan Regulatory Reform and competition Policy Initiative, Oct. 14, 2004.