Competition Policy and Market Regulation 'M1069 WORLDCOM/MCI'

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Presently merger cases are becoming quite important and legal systems produce the needed juridical backbone of the evolution of the market regulation. They are also important for the progress of the economic theory in the competition analysis and policies. This article will give a view of the decisions made by the European Commission, as well as, the US Department of Justice in the merger case of two telecommunication corporations such as WorldCom and MCI. It has one of the most important cases that determined the future development of the telecommunication and Internet industry worldwide.

The paper is divided into two major parts: (I) analytical part that takes most of the analysis and (II) theoretical part. The first part is comprised of the analysis of the US Department of Justice and especially FCC that has the authority for such cases. The profound opinion and conclusions of the European Commission of one questionable segment of the telecommunications market,

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is the Internet market that creates anticompetitive effects. The second part will give the predominant theoretical concepts used by the antitrust authorities.

Introduction

Nowadays high profile merger cases are becoming quite important and are taken as milestones of legal systems that produce the needed juridical backbone of the evolution of the market regulation. Additionally such cases are equally important for the progress of the economic theory in the domain of competition analysis and policies.

This study will give outlook of the decisions made by the European Commission, as well as, the US Department of Justice in the merger case of two telecommunication corporations-WorldCom and MCI. This case was one of the most important cases that determined the future development of the telecommunication and Internet industry worldwide. The main point of the case analysis is to consider the competitive effects produced by such possible merger and the possible solutions in case of anticompetitive outcomes.

The methodology used while writing the essay is based on two major parts: (I) analytical part that takes most of the analyses and (II) theoretical part. The first part is comprised of the analyses of the US Department of Justice and especially Federal Communications Commission that has the authority for such cases, as well as, the profound opinion and conclusions of the European Commission (DG Competition) of one questionable segment of the telecommunications market, the Internet market, that creates anticompetitive effects. The second part will give the predominant theoretical concepts used by the antitrust authorities.

I. Analytical Part

1. Federal Communications Commission / DoJ – United States of America

The merger case between WorldCom and MCI was analyzed by *Federal Communications Commission (FCC 98-225)* and *US Department of Justice* (DoJ). They prepared document that contains the reasons and the possibilities for and against such merger. The study is made in the light of United States market dimensions, but also significant part is dedicated to the international dimension of the merger.

The basic feature of the applicant *WorldCom* on the US market is that it is one of the largest US telecommunications companies (1997 revenues of $7.35 billion) and when added to that the vast international dimension of the company, the result is world prominent position of the company. On the other hand, MCI is the second largest US provider of long distance and international telecommunications services and also has high place on the domestic market.

Markets

Domestic Long Distance Services

In order to be examined the competitive effects of the merger on the *product market* of domestic long distance services, they have to be defined. According to this study there are two product markets that need to be considered while concluding. The first one is residential customers and small business (mass market), that is comprised of telephone and similar communication services offered to the end users. The second market in question is medium-sized and large business customers (larger business market), that offers services for other companies in the American economy.[1] The *geographic markets* are local and national.

The Commission determined more than 600 companies (1996) as *market participants* on the relevant market for domestic long distance services. But those that make the most of the market are seen through the classification of mass market or larger business market. In the light of the mass market the dominant market participants are AT & T with market share below 50% of the total market, fallowed by MCI, Sprint, LEC, GTE and Southern New England Telecommunications Corp. (SNET). The larger business market consists of mainly the same names AT & T, MCI, and Sprint which hold the predominant part of the market and WorldCom that has, as described, substantial part.[2]

The *analysis of competitive effects* was conducted on the grounds of many instruments. They gave results confirm that there will be an increase in market concentration (HHI Index), but they also showed decent, acceptable numbers in terms of competition. In addition of the study, the industry market trends seen through the transmission capacity of the new networks, showed barriers to entry, but because of the future impact of the new technology on transmission capacity, the conclusions confirm future healthy competition. Furthermore, there is possibility of WorldCom to lose its characteristic of 'maverick supplier' on the wholesale market. As final conclusion it was estimated "that the merger likely will not impair competition in the domestic, interstate, inter-exchange market. We therefore decline to impose any of the various conditions proposed by commenters."[3]

US International Services

The US international services' *product market* is determined by the transport capacities as its main characteristic. The transport makes available the international physical transmission, voice telephony and data traffic that flow through the optical cables. For that reason it is estimated that augmentation of international transport capacity as input of international telecommunications services will moderate "the increase in concentration and prevent any anticompetitive effects."[4] In addition, there are three regions as *geographic markets:* Atlantic, Pacific, and Caribbean/Latin America, which have to be taken in consideration.

The *market participants* are distributed across the geographic regions. The most important is the Atlantic region, where the leading company in respect of telecommunication transports (submarine cables), is Global Crossing wit a market share about 40 percent fallowed by WorldCom (17.2%). As far as the MCI is concerned, the estimations indicate around 6.1 %, which brings the merger to significant market position on the Atlantic's route. The Pacific region is the second most important region where the market is lead by AT & T's 12.1 %. As a comparison the merger companies on this route will have around 9.6 % together, which is rather moderate taken that the market is highly competitive. The last region that has been questioned is Caribbean/Latin American Region on which MCI/WorldCom combined will become second provider of services with around 12.1%, right behind Telecommunications Corp. (Batelco) that has 24.2%.[5]

At the end, there are final conclusions about the *competitive effects* of this merger on the market of *US International Services.* On the mass market as well as on the larger business market it was estimated that MCI/WorldCom 'is not likely' to have significant anticompetitive effect.[6]

Local Exchange and Exchange Access Services

The relevant *product market* for local exchange and exchange access services was split into mass market and larger business market. As far as the *geographic market* is being analyzed it is vital to stress that "the Commission found that each point-to-point market constituted a separate geographic market "[7] defining the market as local, national and regional depending on the point-to-point description.

Additionally, the *market participants* (AT & T, MCI, and Sprint) on the mass market, which is clearly competitive market, control irrelevant parts of the market. On the larger business market the situation is quite similar and the main competitors are *WorldCom* (never exceeding 6 %, *MCI)* which is relatively small share and other national and local providers.

In terms of *analysis of competitive effects* the findings show that on the mass market as well as on the larger business market "the merger of WorldCom and MCI ... is unlikely to result in unilateral or coordinated anticompetitive effects."[8]

Internet Backbone Services

The main element that was obstacle for competition and was extensively analyzed by the European Commission is the market for Internet Backbone Services. The *product market* is comprised of three key elements: end users, Internet Service Providers (ISPs), and Internet Backbone Providers (IBPs). The *geographical* distribution of the providers, in the study of the American Federal Communications Commission, is national and worldwide.

MCI as *market participant* has the lead place on this market, and is has both IBP and ISP, which means dominant position on the top-level Internet network and its functioning. Indeed, it is fallowed by WorldCom that has significant role on the domestic market owning three IBPs and majority part of a forth one. What is more it also controls a number of Network Access Points (NAPs) where IBPs interconnect (MAE-East (Washington DC), MAE-West (San Jose), MAE-Dallas, MAE-Los Angeles, and MAE-Chicago.)[9]

Without a doubt, the most important consequence of this merger might be creation *anticompetitive effects* on the internet market, or more precisely the Internet backbone services which are considered to be the chief and predominant determinant of the quality and availability of Internet in general. Furthermore, such merger will eventually produce over time increased concentration of assets. Even more, the discussed settlements-free peering from IBPs, will surely be in future important barrier to entry. As a result of such findings MCI proposed a divesture.

2. DG Competition - The European Commission

1. Markets

According to the European Commission on November the 9th 1997 two big American firms in the service industry, WorldCom and MCI, signed an agreement for merging into one company "MCI/WorldCom", which will be managed by WorldCom.[10] WorldCom and MCI are telecommunications companies with main domain of operation – services, functioning on national and international level. The base of the firms is in the United States; however it has subsidies in many of the counties in the European Union.[11]

The important thing for the European Union, and for the unit in charge of mergers and competition policy DG Competition (European Commission), is to estimate the "community dimension" of the merger, meaning the impact of the fusion of these companies on the competition in the internal market, and to react appropriately according to the Merger Regulation in order to keep the markets in equilibrium. The estimated impact, according to the Merger Regulation, is determined as allocation of turnover on a geographical basis. The methodology used for determination of the future aspects of the contract, showed that WorldCom and MCI each have Community-wide turnover exceeding ECU 250 million. WorldCom and MCI do not have more than two-thirds of their Community-wide turnover in one, same Member State.[12] After verifying that DG Competition has authority over the case "within the meaning of Article 3(1)(a) of the Merger Regulation",[13] coordination and exchange of information has been established with the Antitrust Division of the United States Department of Justice (DoJ).[14]

There are two main features of the *compatibility* with the common market: the carrier services and the internet-related services. DG Competition's testing is focused on the Internet as a main sphere of the study. The suppliers of the Internet services are called Internet Service Providers (ISPs) "offering Internet access services on a commercial basis".[15] In order, the ISPs, to provide Internet on a wide level they have to interfere between each other and exchange information by interconnection, which can involve either peering or transit services. The structure of the Internet is very important for this case because, as seen later, it will bring the key arguments for the divesture proposed and realized by MCI. So, there are two core levels of the Internet structure: the top-level networks and secondary peering ISPs. The definition of the top-level networks focuses the importance on the transit services' functioning, which indicates limitation to the internet exchanging process: "Traffic which is progressively defaulted to higher level networks will finally end up in the hands of an ISP who has no one else to whom to turn, and must either assume responsibility on its own account for delivering the traffic across peering interfaces, or return it undelivered. These networks are referred to hereon as "top-level networks" or "top level ISPs".[16]

Market Definition

The product markets that have to be seen are as fallows: host to point of presence access services, internet access services, top level or universal Internet connectivity. The point of presence services and their hosting (maintenance) are considered to have differentiated competition depending on levels of connection that varies form ISP level to low level. In addition, for the second category analyzed as a product market, the internet access services, the parties argued that these services can be easily substituted with other forms of data transmission service, but it does not appear to be such. The specificity of the Internet network is contained in the possibility to be reached by others, also connected on Internet, and the accent is given to the access to connection (barrier to entry), and thus exchange data and information. At the end, when explaining the third product market question rose is: weather "ISPs all compete against one another to provide the same connectivity services, or whether there are any distinct and narrower markets within the sector?"[17] As a consequence, the responsible for the case at DG Competition while analyzing the relevant product markets came up with a final conclusion which states that "the relevant market on which the merging parties are active is the market for the provision of top level or 'universal' Internet connectivity".

However, there has been an 'evolution of the market definition' that pushes the study in another direction. "The concept of 'top level network' might not represent today's economic reality, insofar as some of the players apparently capable of functioning as top-level networks are in fact paying for some or all of their peering. Others may benefit from the peering agreements when no longer will be possible to enter/paid, and therefore their status as top-level networks may be open to question. As a result, the numbers of firms actually capable of offering competitive constraints may be smaller than the concept of 'top-level networks' might imply.[18] On the other hand, the rapid development of fiber optics and cable technology projects a way to the future for the smaller Internet providers to offer top level and universal Internet. But, here it must be said that today that is not the case, so that would mean that the process is in early stages and the market definition applied to this merger case is not to be changed, "*but the fact that this is likely to happen should be borne in mind as a relevant factor when considering the market power of the parties.*[19]

In response, the parties argued that in case of price increase imposed by hypothetical monopolist, any ISP is capable to divert the internet traffic through consequent peering agreements enlarging the reach of its operation. In addition, they claimed that the ISPs 'in trouble' could tie contracts with other ISPs, and also that all of the operations will not reflect into unprofitable price increase by buying traffic.[20]

Relevant Geographic Markets

Assessing the relevant geographic markets DG Competition came up with three domains. The first market, corporate and traveler services is defined on national as well as at any other wider level, where as, the second, carrier services is at least regional, but also has international dimension. For the third one, Internet services, the geographic market depends of the level looked upon. So, it can be qualified as local, national, regional or worldwide.[21]

Competitive Assessment

DG Competition focused on three relevant points while assessing the competitive effects of the merger. The points in question are: carrier services, Internet access services and top level or universal internet connectivity. The market for carrier services on European level (according to the parties) is controlled about 95% by European telephone operators. WorldCom has been trying to set networks in every big city, and MCI has no significant influence. On transatlantic level the company MCI/WorldCom would have around 23% of the US market.[22] As far as the

Internet access services are concerned, the study shows that there is substantial competition at retail level and low barriers to entry. Furthermore, the most important market that needs to be seen deeper is top level or universal Internet connectivity. During the competitive assessment of top level or universal Internet connectivity were used a couple of techniques and methods in order to prove the dominant and unacceptable position of the company to be made after the merger. The data showed that in terms of the number of connections MCI /WorldCom would have around 55% to 68%. In addition, the estimations about possible revenue pointed out 45-55% of the market earnings to go to the newly formed company. The traffic flow was also analyzed with two methodologies. According to the methodology of a hypothetical monopoly MCI/WorldCom would have 75-85% of the traffic flow. However the second methodology based on 12 networks gave rather moderate data, placing the MCI/WorldCom's share around 42-52% of the total traffic flow.[23]

The Chief Operating Officer of WorldCom stated that" having a big network is a huge barrier to entry for competitors".[24] Therefore, the conclusions are that "the combined network would be *significantly larger* than the size of its nearest competitor (Sprint), on either revenue or traffic flow, bearing in mind that the next competitor, the GTE group, is about half the size of Sprint."[25]

Impact of Merger on Competition

The impact of the merger on the competition in the domain of Internet is seen as anticompetitive. The authorities claimed that the amalgamation of leading Internet networks of WorldCom and MCI will produce a network that will have magnitude of behaving independently and thus will influence customers worldwide and in Europe. Reinforcement of the market position of the merged company (MCI/WorldCom) can be done by perusing different aggressive strategies and control the market imposing different peering agreements. Moreover, the company could influence the costs and the quality of the Internet services and also could be controlled the quality of the connector's service (peering partner). The growth of MCI/WorldCom will bring possibility for this company to reduce the independence of incumbent competitors and behave independently of its customers. As a response the parties claimed that multi-homing can be used as an alternative. To that the Commission responded with the fact that there is competitive limitation. The possibility of potential competitors was considered and the conclusion is that the barriers to entry can be augmented easily for the competitors that want to enter at top-level network. As a result '*the merger might well create a 'snowball effect' in that MCI WorldCom would be better placed than any of its competitors to capture future growth through new customers*".[26] Having this in mind, the customers might try to act against MCI/WorldCom and contradict, but unless their actions are united there will not be any pressure nor effect on making the situation more competitive.[27]

3. MCI's Divestiture

MCI proposed divesture that had to reduce or even eliminate the suspicions about the "competitive" crater of the merger. Thus this meant that MCI by merging with WorldCom will lose the Internet business and will have to transfer number of contract to the newly formed company (NewCo – DG Competition or C & W – DoJ) that had to be inevitably sold to a 'purchaser'[28] Furthermore, "*NewCo will be an independent business with 100% of the Internet traffic and 100% of the Internet revenues of the iMCI Business.*"[29]

During the transaction MCI had to transfer to C & W *assets and employees* (22 nodes ; over 15,000 interconnection ports; and all the routers, switches, and other equipment dedicated to the backbone...), *ISP customers* (1,300 domestic and international ISP customers), as well as, *retail customers* (Internet service, web-hosting, managed firewall, and Real Broadcast Network services).[30]

After assessment of the undertakings promised by MCI, there was approval of the merger by DG Competition (European Commission), as well as, by US Department of Justice by authorization of the Federal Communications Commission. Afterwards final exchange of letters and decisions were executed. After the fulfilled divesture the merger has been "declared compatible with the common market and the functioning of the EEA Agreement"[31] and that the merger will "will serve the public interest, interest, convenience, and necessity".[32]

II. Theoretical Part

1. The approach of the European Commission

The European Commission bases its approach on the Council Regulation (EEC) No 4064/89 (amended by Regulation (EC) No 1310/97) of 21 December 1989[33] and decides to give a pass to the merger after fulfillment the needed divesture by MCI. In order to be identified the scope of the merger, it is used the definition of concentration within the scope of Article 3 of the same regulation which states that "a concentration shall be deemed to arise where: (a) two or more previously independent undertakings merge."[34] Consecutively to the finding that there is in fact a merger the Commission uses the Article 6(1)(c) to determine that the concentration "falls within the scope of this Regulation and raises serious doubts as to its compatibility with the common market, it shall decide to initiate proceedings."[35]

The theoretical bases of the methodology of the European Commission were changed with the reform in 2004, when the test was changed into *substantive 'carbon test*'.[36] Until then the Commission, while solving the merger cases, was relying on "the *concept of dominance:* a merger must be blocked if it creates a dominant position, and therefore would likely result in higher prices, less choice and innovation."[37] This test was used in the case of the merger MCI/WorldCom. The economic analyses to explain the case uses the so-called 'tacit collision effects or cooperative effects', meaning that "the merging parties will be able to raise price even without the cooperation of rival firms. This corresponds broadly to the legal concept of single-firm dominance."[38] This way of deciding was also known as theory of 'concentrations with conglomerate nature'.

2. The Approach of the US Federal Communications Commission/DOJ

The regulation about dominant position and abuse of a dominant position in the United States is regulated with two acts : Section 2 of the Sherman Act and Section 2 of the Clayton Act (1914) and added to that Robinson-Patman Act (1936) (Europe – Art. 82 (ex. Art. 86) of the Amsterdam Treaty, meaning abuse of monopoly power).[39] When determining the thresholds of dominance the antitrust policy in the United States the antitrust authorities are guided by the definition stating that monopoly is "power to exclude competitors".[40] The author agrees that the definition used by US is in fact close to the one used by the European authorities. However, when determining the dominance on the market the analyses must go beyond just the market shares and have to be seen other factors that might contribute to the possibility of raising prices by the concentration in question, whereas in Europe high market share is still considered to be enough for accusing of having dominance.

The Federal Communications Commission in the case of MCI/WorldCom, while determining the market power uses the "antitrust laws, including the DOJ and Federal Trade Commission *1992 Horizontal Merger Guidelines* and the April 8, 1997.[41] Indeed, the analytical framework for assessing competitive effects is relying on the "*1992 Horizontal Merger Guidelines* suggest that market shares should be assigned to each firm currently participating in the market and then the pre-merger and post-merger levels of concentration should be calculated, using the *Herfindahl – Hirschman Index (HHI)*."[42]

However, here must be stressed that future projections of the development of the market must be taken in sight, because the picture which today's market shares create about the competitive position of the concentration is not clearly to be kept in future – the company's competitive importance might be understated or overstated.

Conclusion

It is clear that the US authorities based their findings on a bit more different grounds then their European equivalents. Their approach examines predominantly the effects on the national market, with an attitude of reluctance towards the international dimension, although they recognize that what happens on the international market directly influences the positions of their companies on the regional and the domestic market. The main difference would be the methodology used, which on one hand is more econometric based, but on the other hand, the US authorities give much more weight on the future earnings and expectations of the development of the industry and different segmented markets within the analyzed industry. At the end they come up with more or less the same conclusion as the European Commission about the anticompetitive effects of the merger, so together they coordinated the implementation of the divesture proposed by MCI.

When one studies the used methodology and technique of the European Commission, one notices that the European authorities are little bit more vigilant. The possible reasons for acting that way might be many, but manly: the tests, the economic and econometric analyses, unfinished or ever evolving institutional framework, etc. However, the most important is the approach used by DG Competition and that is the concept of dominance. The authorities are primarily concerned about the possible dominant position seen from 'today's perspective', while determining the bottom line of the future developments as not quite secure. They recognize the importance of the future market solutions (in this case the rapid development of technology and most notably fiber optic cables), but they seem to be more bias to solutions like 'snowball effect'. That is probably why there was serious need to be enforced a reform of the competition policy and merger regulation, that took place later on.

In conclusion it must be said that, both authorities did justify the merger and came up with more or less the same conclusions. Even though the used slightly different approaches, they both were first and foremost concerned about their own interests and areas of influence, so the merger was resolved with a favorable outcome for all major sides involved.

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