



# A Review of de Fontenay, Savin and Kiss

**Presented by: Professor Neil Quigley  
Charles River Associates (Asia Pacific)  
November 2003**

# Introduction

**de Fontenay assert that**

- **Vertical integration is inefficient, and serves to protect Telecom from competition with Telstra**
- **Unbundling will therefore increase competition and improve efficiency**
- **There are no efficiency trade-offs to consider**

# *Necessary Conditions*

The de Fontenay assertions require that

- **Telecom obtain monopoly rents from vertical integration**

And that

- **These rents are larger than the efficiency gains Telecom would obtain from vertical disaggregation.**

# Vertical Integration and Monopoly Profits

**There is a very large literature on vertical integration and vertical foreclosure in the last 15 years – no reference to it in de Fontenay**

- *It is clear that vertical integration can unambiguously increase efficiency and output. These benefits can form the motivation for a firm to adopt a vertical integration strategy. They can also lead to lower prices if the firm does integrate. In addition, they explain how vertical mergers and contractual vertical integration can increase efficiency and consumer welfare. (Salop)*

# Vertical Foreclosure

## The Vertical Foreclosure literature

- **Vertical integration reduces efficiency only under special circumstances**
  - i. The input supplier is not a monopolist
  - ii. Competition in the input market is imperfect  $\Rightarrow$  limited response to the use of market power.
- **Vertical integration may serve as a means of raising rivals costs and precluding entry**

# Implications

- **If Telecom is a monopoly (as de Fontenay claim) vertical integration cannot increase its profits**
  - Telecom can only take its monopoly profits once
- **If Telecom is not a monopoly, then the only problem can be coordinated action**
  - Co-ordinated action does not imply unbundling as a solution.

# Barriers to Entry

- **Vertical integration is only a barrier to entry if Telecom's network is the only viable means of entry**
- **de Fontenay equates advantage to Telstra in leasing Telecom's network with a competition problem**
- **If there are other viable entry technologies then Telstra's desire to use Telecom's network is Telstra's problem not a competition problem.**

# Efficiency Trade-Offs

- **Property rights: unbundling confiscates the property rights of the incumbent**
    - (exclusive use; exclusion of use by others)
  - **No methodology for setting the efficient price – risks for investor, option for entrant.**
- ⇒ **Negative implications for incentives to invest. There must be dynamic efficiency losses against which to offset any gains.**

# Interpretation of the Literature

- **References and quotations taken out of context**
- **There is no empirical or theoretical support for de Fontenay's assertions about vertical integration or the benefits of bitstream unbundling**
- **The US has had unbundling for 7 years. If there is any empirical evidence to support the assertions of de Fontenay it should be available in the US.**
  - **De Fontenay fail to provide any empirical evidence to show that unbundling in the US has promoted vertical disaggregation or increased efficiency.**