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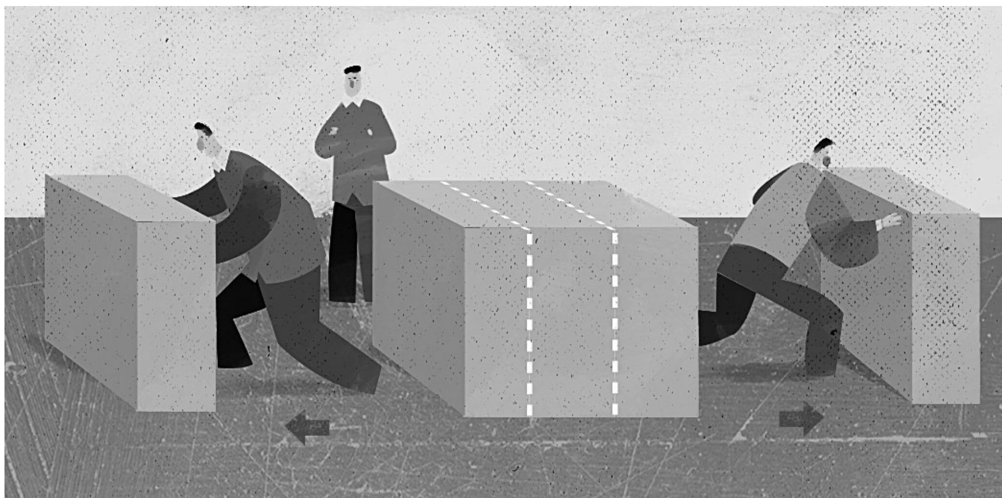

Forced unbundling for greater competition

A process of separating two industries is easier to enforce than fighting an integrated utility trying to hamper access to a new entrant

SNAKES & LADDERS

AJAY SHAH

Firms always look for related lines of business, and profitable partnerships. This leads to a bundling of products and exclusive contracts. Sometimes, this raises concerns about unfair trade practices. Improving competitive conditions in the markets is a key objective for the government. There are a few situations where forcing a separation between two industries is the cleanest way to achieve more competition. This is the economic principle underlying net neutrality, where the government seeks to keep the content business separate from the pipes business.

Economies of scope are about utilising a customer relationship to sell an adjacent product, and about the reduced cost of producing an adjacent product. As an example, IndiGo has a deal with Business Standard through which a tabloid version of the newspaper is provided to each passenger; this contract benefits both.

When governments prevent a firm from doing adjacent things, they are generally in the wrong. As an example, the Indian financial markets were forcibly cut up into three sub-industries: commodity futures, regulated by the Forward Markets Commission; equities and long-dated corporate bonds, regulated by the Securities and Exchange Board of India; currencies, government bonds and short-dated corporate bonds, regulated by the Reserve Bank of India. Firms in each silo were prohibited from doing business in the other two silos. This was a silly arrangement, which hampered economies of scale and of scope. With the merger of SEBI and FMC, financial firms within this domain will be free to choose their business activities as they like. The RBI silo still stands separate, as the Budget initiatives of February 2015 were rolled back.

In some situations, bundling and tying raises concerns about competition policy. As an example, consider the Life Insurance Corporation of India, which has a dominant position in the brand awareness and distribution of insurance products. Suppose a new firm is born, with high skills in the production side of insurance products. This firm would not be able to reach consumers, as LIC has a lock on distribution and sales. LIC can get away with very poor manufacturing, as it owns the distribution.

Unbundling manufacturing from distribution can solve this problem. Consider the New Pension System (NPS). Project OASIS, led by Surendra Dave, saw that the overall pensions problem contained three distinct industries: managing money, owning customers, and record-keeping. It suggested an unbundled architecture, where pension fund management was separated from interaction with customers. Record-keeping was centralised to harness economies of scale and ensure that it was easy for consumers to switch from one pension fund manager to another.

This design caters to heightened competition. On the strength of better fund management, a new pension fund manager can steal customers, as switching is always possible. Similarly, the front end firms would live or die based on their friendliness to customers, and not on the quality of their fund management.

In the conventional world, finance professionals generally focus on the deal-making required to get a new product to the customer. These finance professionals are a little shocked when, in the NPS environment, incumbent manufacturers do not control the distribution. All distributors are equally keen to push all products; all manufacturers have equal access to all distributors.

Similar arguments are found in electricity, where governments have pushed in favour of breaking up monolithic electricity utilities into three distinct industries: generation, transmission and distribution. This creates opportunities for entrants in generation and transmission. Until this unbundling was done, the firm that owned the distribution was the only game in town when it came to transmission and generation.

Unbundling is a harsh intervention. What was the alternative, softer strategy? Suppose a new generation company came up, and was denied access by an old-style integrated electricity utility. It could have used conventional competition law to litigate, and could have won, on the surface. However, there are too many levers through which the monolithic utility could have rigged the game to disfavour the new entrant. It would take very high state capacity for a Competition Commission of India to track down such misbehaviour and enforce against it.

When state capacity is low, simple and transparent interventions are favoured. A simple unbundling rule is easier to articulate and enforce, when compared with the complexity of fighting with an integrated utility that is trying to hamper access to a new entrant.

At heart, net neutrality regulation is about forcing an unbundling between the content industry and the data pipes. The content industry is analogous to a manufacturer. What's best for society is that content firms slug it out against each other to produce better content. Under net neutrality, content firms are not allowed to do deal-making with the data pipes in order to create privileged distribution for themselves. Similarly, data pipe companies must slug it out against each other to give us fatter pipes at lower prices. But they are not allowed to do deal-making with content companies in order to create complicated bundles of content and pipes for customers. The separation protects competition in both industries.

A firm that invents a new biscuit puts 10 per cent of its effort into the biscuit and 90 per cent into figuring out distribution. Incumbents always have deep pockets, are entrenched in the distribution, and try to choke off competitors. Every practitioner living in this world treats these anti-competitive barriers as an everyday reality. The Internet is a unique open market; the moment a new storefront comes up, it is instantly connected to all customers who are on the Internet. This implies superior competitive conditions when compared with the old economy. A new e-commerce firm puts 100 per cent of its effort into innovation, as it knows that all pipes are equal access. Net neutrality regulation is about keeping it this way.

It is important to do such central planning with great hesitation. Most of the time, when governments try to do central planning, and design production arrangements, this goes wrong. I have been persuaded on such intervention three times: with the NPS, electricity, and net neutrality.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi