

# Foreclosing Competition through Access Charges and Price Discrimination<sup>1</sup>

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February 2012

<sup>1</sup>This paper has benefited from helpful comments from Albert Banal-Estañol, Giulio Federico, Doh-Shin Jeon, Bruno Jullien, Gerard Llobet, Tommaso Valletti as well as conference participants at the XXIV Jornadas de Economía Industrial (Vigo, 2009), EARIE (Ljubljana, 2009), EEA (Barcelona, 2009), Conference on the Economics of ICT (Telecom ParisTech, 2009) and seminar audiences at FEDEA, IESE, Universitat Pompeu Fabra and the Florence School of Regulation. Ángel López gratefully acknowledges the financial support from the Spanish Ministry of Science and Technology under ECO2008-05155/ECON and from Juan de la Cierva Program.

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## **Abstract**

This article analyzes competition between two asymmetric networks, an incumbent and a new entrant. Networks compete in non-linear tariffs and may charge different prices for on-net and off-net calls. Departing from cost-based access pricing allows the incumbent to foreclose the market in a profitable way. If the incumbent benefits from customer inertia, then it has an incentive to insist in the highest possible access markup even if access charges are reciprocal and even in the absence of actual switching costs. If instead the entrant benefits from customer activism, then foreclosure is profitable only when switching costs are large enough.

# 1 Introduction

Telecommunication networks need access to rivals' customers in order to provide universal connectivity. This need for interconnection requires cooperation among network operators, who must agree on access conditions and, in particular, on termination charges (also called access charges). These wholesale arrangements affect the operators' cost of off-net calls and the revenues accruing from providing termination services, and thus have an impact on retail competition among the operators. This raises two concerns. The first is that cooperation over interconnection may be used to soften downstream competition; the second is that established network operators may use access charges to foreclose the market.

The former issue was first addressed by Armstrong (1998) and Laffont, Rey and Tirole (1998a), who show that high access charges indeed undermine retail competition when networks compete in linear prices and do not price discriminate on the basis of where the call terminates.<sup>1</sup> Laffont, Rey and Tirole (1998a) show however that access charges lose their collusive power when networks compete in other dimensions, as is the case of two-part tariffs, due to a waterbed effect.<sup>2</sup> An increase in the access charge inflates usage prices, but this makes it more attractive to build market share, which results in fiercer competition for subscribers and lower fixed fees: networks can actually find it worthwhile to spend the full revenue from interconnection fees to build market share, so that termination charges no longer affect equilibrium profits. This profit-neutrality result has since been further studied and shown to depend on three assumptions: full participation, no termination-based price discrimination and network symmetry.<sup>3</sup> López (2008) moreover extends the previous static analyses and shows that, in a two-stage model, even symmetric networks with full consumer participation can use (future) reciprocal access charges to soften competition.<sup>4</sup>

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<sup>1</sup>High termination charges raise on average the marginal cost of calls, which encourages operators to maintain high prices.

<sup>2</sup>The term "waterbed effect" was first coined by Prof. Paul Geroski during the investigation of the impact of fixed-to-mobile termination charges on retail prices. See also Genakos and Valletti (2011).

<sup>3</sup>For a review of this literature, see Armstrong (2002), Vogelsang (2003), and Peitz et al (2004).

<sup>4</sup>Since departing from cost-based termination charges adversely affects larger networks, this in turn reduces networks' incentives to build market shares.

In the case of termination-based price discrimination, Gans and King (2001), building on Laffont, Rey and Tirole (1998b), show that a (reciprocal) access charge below cost reduces competition. The intuition is that off-net calls being then cheaper than on-net calls, customers favour smaller networks; as a result, networks bid less aggressively for market share, which raises the equilibrium profits. However, in practice regulators are usually concerned that access charges are too high rather than too low, particularly for mobile operators. As stressed by Armstrong and Wright (2009), this may stem from the fact that “wholesale arbitrage” limits mobile operators’ ability to maintain high fixed-to-mobile (FTM) charges<sup>5</sup> alongside low mobile-to-mobile (MTM) charges, since fixed-line networks could “transit” their calls via another mobile operator in order to benefit from a lower MTM charge.<sup>6</sup> Jullien, Rey and Sand-Zantman (2010), Hoernig, Inderst and Valletti (2010), and Hurkens and López (2011) provide alternative explanations for why firms may prefer above-cost access charges.

The second traditional concern is that cooperation might be insufficient. This issue usually arises in markets where large incumbent operators face competition from smaller rivals, and may be tempted to degrade connectivity or use access charges to foreclose the market. Indeed, small mobile operators often complain that a high termination charge hurts their ability to compete in an effective way with large networks. Two arguments are normally used to motivate this concern. The first is a supply-side argument, whereby small operators face higher long-run incremental costs than larger operators due to scale economies.<sup>7</sup> European national regulatory agencies (NRAs) have for example relied on this argument to justify the adoption of asymmetric termination rates.<sup>8</sup>

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<sup>5</sup>Historically, fixed and mobile operators were not really competing against each other, and thus a traditional “one-way access” analysis applied. Termination charges between those two types of networks are moreover usually asymmetric, different termination costs and regulatory constraints leading to relatively low charges for mobile-to-fixed calls and substantially higher charges for fixed-to-mobile calls.

<sup>6</sup>If mobile operators must adopt the same termination charge for FTM and MTM calls, this uniform charge may then be above cost if the waterbed effect on FTM is limited or if operators set their own charges unilaterally.

<sup>7</sup>It is also argued that cost differences may be exacerbated by staggered entry dates, unequal access to spectrum and (lack of) integration between fixed and mobile services.

<sup>8</sup>See for example the decision of the Belgian NRA (*Décision du Conseil de l’IBPT*) of 11 August 2006, the Decision 2007-0810 of October 4 2007 by the French NRA (ARCEP), the decision (Delibera 3/06/CONS) adopted by the Italian NRA (AGCOM) in January 2006 or the three decisions adopted by the Spanish NRA (CMT) on 28 September 2006 (Decisions AEM 2006/724, AEM 2006/725 and AEM 2006/726). See also the review of mobile call termination by the regulator and competition authority for

The second argument, which is the focus of this paper, is the presence of demand-side network effects resulting from termination-based price discrimination. If for example the termination charge is above cost, then prices will be lower for on-net calls; as a result, customers favour larger networks, in which a higher proportion of calls remain on-net. Some European NRAs have also relied on this demand-side argument to call for asymmetric termination charges. For example, in its Decision of October 2007, the French regulator stressed the presence of network effects due to off-net/on-net tariff differentials that impede smaller networks' ability to compete effectively.<sup>9</sup> Similarly, in its Decision of September 2006,<sup>10</sup> the Spanish regulator argued that network effects can place smaller networks at a disadvantage, and that higher access charges can increase the size of such network effects. In the Common Position adopted on February 2008,<sup>11</sup> while the European regulators argue in favour of symmetric access charges, they also express the concern that, because of network effects, "an on-net/off-net retail price differential, together with significantly above-cost mobile termination rates, can, in certain circumstances, tone down competition to the benefit of larger networks".<sup>12</sup>

To explore this issue, we analyze the competition between two asymmetric networks, an incumbent and a new entrant. Customers are initially attached to the incumbent network and incur switching costs if moving to the other network. Thus, as in Klemperer (1987), to build market share the entrant must bid more aggressively for customers than the incumbent, which therefore enjoys greater market power. In particular, the incumbent operator can keep monopolizing the market when switching costs are large enough; as we will see, when switching costs are not that large, departing from cost-based termination charges can help the incumbent operator maintain its monopoly position and profit.

We first consider the case where networks not only compete in subscription fees and

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the UK communications industries (OFCOM Mobile Call Termination Statement, 27 March 2007).

<sup>9</sup>See section 4.2.2 of ARCEP Decision 2007-0810 of October 4 2007.

<sup>10</sup>Decision AEM 2006/726, p. 13, 14 and 33.

<sup>11</sup>See "ERG's Common Position on symmetry of fixed call termination rates and symmetry of mobile call termination rates", adopted by the ERG-Plenary on 28th February 2008, p. 96-102. Available at <http://www.erg.eu.int/>.

<sup>12</sup>The Common Position also stresses that these network effects can be exacerbated via incoming calls: as a high off-net price reduces the amount of off-net calls, it also lowers the value of belonging to the smaller network since less people will then call the customers of that network.

in usage prices, but can moreover charge different prices for on-net and off-net calls. Such on-net pricing creates price-mediated network effects and, as a result, the incumbent operator can indeed keep the entrant out of the market and still charge monopoly prices by setting a large enough mark-up (or subsidy) on the access charge, even if access charges are reciprocal. If the incumbent operator benefits from "customer inertia",<sup>13</sup> then it has actually an incentive to insist on the highest possible (reciprocal) access mark-up, so as to foreclose the market and exploit fully the resulting monopoly power. Customer inertia thus provides a form of "virtual" switching costs which, combined with high termination charges, is a good substitute for "real" switching costs: in the presence of customer inertia, the incumbent operator can corner the market and earn the monopoly profit even in the absence of any real switching costs. A second finding is that a large termination subsidy may also yield the same outcome; this means that in some cases "bill and keep" may allow the incumbent operator to foreclose the market; however feasibility constraints may limit subsidies, which may moreover trigger various types of arbitrage. The scope for foreclosure is more limited when the entrant benefits from "customer activism",<sup>14</sup> while the incumbent operator may still try to prevent entry, too high an access charge would allow the entrant to overtake it. The incumbent operator may then prefer to set an above- or below-cost access charge, and foreclosure strategies are profitable only when switching costs are sufficiently large.

Our analysis also extends the insight of Gans and King (2001) and shows that, as long as the two networks share the market, a small access subsidy generates higher equilibrium profits (for both networks) than any positive access mark-up. Yet, it does not follow that both networks will agree to subsidizing access, since a large enough access mark-up may instead allow the incumbent operator to corner the market, and higher levels might moreover allow the incumbent operator to earn the full monopoly profit. Another key finding is that limiting entry without deterring it entirely is never profitable. This

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<sup>13</sup>Since on-net pricing generates club effects, consumers face coordination problems and there may exist multiple consumer responses to a given set of prices. We will refer to "customer inertia" when, in case of multiple responses, consumers adopt the response that is most favourable to the incumbent.

<sup>14</sup>We will refer to "customer activism" when, by contrast to the case of customer inertia, in case of multiple responses consumers adopt the response that is most favourable to the entrant.

result has clear implications for policy. Finally, we show that termination-based price discrimination is a key factor in foreclosing competition. Indeed, absent on-net pricing, foreclosure strategies are never profitable – and moreover no longer feasible in a receiver-pays regime.

There are only few insights from the academic literature on the impact of mobile operators' termination rates on entry or predation. Calzada and Valletti (2008) extend Gans and King's analysis to a (symmetric) multi-firm industry; they stress that incumbent operators may favour above-cost termination charges when new operators face entry costs: for any given number of firms, increasing the charge above cost decreases the equilibrium profits but, by the same token, limits the number of entrants; overall, this allows incumbent operators to increase their own profits. This however requires incumbent operators to commit not to modify the termination charge if entry occurs; otherwise, entrants would anticipate that incumbent operators have incentives to decrease the termination charge once entry occurs, and an above-cost termination charge no longer deters entry. In our model, we allow instead the entrant to remain "in the market" even if it is not active; thus, our foreclosure results do not depend on such commitment assumption. Hoernig (2007) analyzes predatory pricing in the presence of call externalities (i.e., taking into account the utility of receiving calls) and termination-based price discrimination, for given termination charges. He shows that call externalities give the incumbent operator an incentive to increase its off-net price in order to make a smaller rival less attractive (as it will receive fewer or shorter calls), and this incentive is even higher when the incumbent operator engages in predatory pricing and seeks to reduce its rival's profit. Calzada and Valletti (2008), and Hoernig (2007) thus study how incumbent operators can reduce rivals' profitability in order to limit entry, at the expense of a (possibly temporary) loss in their own profit. In contrast, we study how the incumbent operator can manipulate the termination charge (even when it is reciprocal) to *increase* its own profit at the expense of the entrant.

The article is organized as follows. Section 2 describes the model. Section 3 analyses retail competition for a given, reciprocal, access charge. It first characterizes shared-

market equilibria and extends the insight of Gans and King to asymmetric networks; it then studies under what conditions one network may corner the market. Section 4 draws the implications for the determination of the access charge and shows that, despite Gans and King's insight, an incumbent network may favour a high access charge in order to foreclose the market. Section 5 analyses the case of no termination-based price discrimination under both the caller-pays and the receiver-pays regime. Section 6 concludes.

## 2 The model

There are two networks: an incumbent,  $I$ , and an entrant,  $E$ . Both networks have the same cost structure. It costs  $f$  to connect a customer, and each call costs  $c \equiv c_O + c_T$ , where  $c_O$  and  $c_T$  respectively denote the costs borne by the originating and terminating networks. To terminate an off-net call, the originating network must pay a reciprocal access charge  $a$  to the terminating network. The access mark-up is thus equal to:

$$m \equiv a - c_T.$$

Networks offer substitutable services but are differentiated à la Hotelling. Consumers are uniformly distributed on the segment  $[0, 1]$ , whereas the two networks are located at the two ends of this segment. Consumers' tastes are represented by their position on the segment and taken into account through a "transportation" cost  $t > 0$ , which reflects their disutility from not enjoying their ideal type of service. For a given volume of calls  $q$ , a consumer located at  $x$  and joining network  $i = I, E$  located at  $x_i \in \{0, 1\}$  obtains a gross utility given by:

$$u(q) - t|x - x_i|,$$

where  $u(q)$  denotes the variable gross surplus, with  $u' > 0 > u''$  and  $u'(0) < +\infty$ . Throughout the paper, we will assume that  $u(0)$ , the fixed surplus derived from being connected to either network, is large enough to ensure full participation.<sup>15</sup> Finally, we

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<sup>15</sup>This surplus may for example reflect the benefits from complementary services such as SMS, data



assume that consumers switching to  $E$ 's network incur a cost  $s > 0$ .

Each network  $i = I, E$  offers a three-part tariff:

$$T_i(q, \hat{q}) = F_i + p_i q + \hat{p}_i \hat{q},$$

where  $F_i$  is the fixed subscription fee and  $p_i$  and  $\hat{p}_i$  respectively denote the on-net and off-net usage prices.

Let  $\alpha_i$  denote network  $i$ 's market share. Assuming a balanced calling pattern,<sup>16</sup> the net surplus offered by network  $i$  is (for  $i \neq j = I, E$ ):

$$w_i = \alpha_i v(p_i) + \alpha_j v(\hat{p}_i) - F_i, \quad (1)$$

where

$$v(p) \equiv \max_q u(q) - pq$$

denotes the consumer surplus for a price  $p$ .

In a first step, we will take as given the reciprocal termination charge and study the subsequent competition game where the networks set simultaneously their retail tariffs (subscription fees and usage prices), and then consumers choose which network to subscribe to and how much to call. In a second step we discuss the determination of the termination charge. Before that, we characterize the consumer response to networks' prices and provide a partial characterization of the equilibrium prices.

**Marginal cost pricing.** As usual, networks find it optimal to adopt cost-based usage prices. Network  $i$ 's profit is equal to:

$$\pi_i \equiv \alpha_i [\alpha_i (p_i - c) q(p_i) + \alpha_j (\hat{p}_i - c - m) q(\hat{p}_i) + F_i - f] + \alpha_i \alpha_j m q(\hat{p}_j). \quad (2)$$

Adjusting  $F_i$  so as to maintain net surpluses  $w_I$  and  $w_E$  and thus market shares constant,<sup>17</sup> services or the ability of receiving calls, which are not explicitly modeled here. See also the discussion in footnotes (21) and (30).

<sup>16</sup>This assumption implies that the proportion of calls originating on a given network and completed on the same or the other network reflects networks' market shares.

<sup>17</sup>As already noted, on-net pricing can generate multiple consumer responses to a given set of prices.

then leads network  $i$  to set its prices  $p_i$  and  $\hat{p}_i$  so as to maximize

$$\alpha_i \{ \alpha_i [(p_i - c)q(p_i) + v(p_i)] + \alpha_j [(\hat{p}_i - c - m)q(\hat{p}_i) + v(\hat{p}_i)] - w_i - f \} + \alpha_i \alpha_j m q(\hat{p}_j),$$

which yields marginal-cost pricing:

$$p_i = c, \hat{p}_i = c + m.$$

Thus, both networks always charge usage prices that reflect the perceived cost of calls: the true cost  $c$  for on-net calls, augmented by the access mark-up  $m$  for off-net calls. As a result, while each network  $i$  must pay  $\alpha_i \alpha_j m q(\hat{p}_i)$  to its rival, there is no net interconnection payment; since both networks charge the same off-net price ( $\hat{p}_i = \hat{p}_j = c + m$ ), neither the incumbent nor the entrant has a net outflow of calls:  $\alpha_i \alpha_j m (q(\hat{p}_j) - q(\hat{p}_i)) = 0$ , whatever the networks' market shares.

**Network Externalities and market shares.** Since the off-net price,  $c + m$ , increases with the access mark-up, departing from cost-based termination charges generates tariff-mediated network externalities. For example, if the access mark-up is positive, prices are higher for off-net calls ( $c + m > c$ ) and the subscribers of a given network are thus better off, the more customers join that network. As a result, there may exist multiple consumer responses to given subscription fees  $F_I$  and  $F_E$ .

If consumers anticipate market shares  $\bar{\alpha}_I$  and  $\bar{\alpha}_E = 1 - \bar{\alpha}_I$ , then they expect a net surplus

$$w_i = \bar{\alpha}_i v(c) + \bar{\alpha}_j v(c + m) - F_i. \quad (3)$$

from subscribing to network  $i$ , for  $i \neq j = I, E$ . A consumer located at a distance  $x \in [0, 1]$  from network  $I$  is therefore willing to stay with that network when  $w_I - tx \geq w_E - t(1 - x) - s$  and prefers to switch otherwise. In a shared-market outcome, the actual

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We assume here that changing tariffs so as to keep net surpluses constant does not trigger consumers to switch to alternative responses, if they exist.

consumer response,  $\hat{\alpha}_i$ , as a function of consumers' expectation  $\bar{\alpha}_i$ , is therefore given by

$$\begin{aligned}\hat{\alpha}_i(\bar{\alpha}_i) &= \frac{1}{2} + \sigma(w_i - w_j + \delta_i s) \\ &= \frac{1}{2} + \sigma(F_j - F_i + \delta_i s) + 2\sigma\left(\bar{\alpha}_i - \frac{1}{2}\right)(v(c) - v(c + m)),\end{aligned}\quad (4)$$

where  $\delta_I \equiv 1$ ,  $\delta_E \equiv -1$ , and  $\sigma \equiv 1/2t$  measures the substitutability between the two networks. Note that the function  $\hat{\alpha}_i$  has a constant slope, equal to

$$\frac{d\hat{\alpha}_i}{d\bar{\alpha}_i} = \frac{v(c) - v(c + m)}{t}.$$

Let

$$\tau(m) \equiv t - [v(c) - v(c + m)]$$

summarize the balance between product differentiation, measured by  $t$ , and the network externalities stemming from on-net pricing, measured by  $v(c) - v(c + m)$ .

We will assume that, having observed the prices, consumers have self-fulfilling expectations, implying that market shares constitute a fixed point of the "reaction to anticipations",  $\max\{0, \min\{1, \hat{\alpha}(\cdot)\}\}$ .<sup>18</sup> When  $m$  is small, the relative preferences over the two networks prevail:

$$\tau(m) > 0, \quad (5)$$

in which case the slope  $d\hat{\alpha}_i/d\bar{\alpha}_i$  is lower than 1 (and is even negative for  $m < 0$ , as network externalities then yield a bonus for the *smaller* network), implying that there exists a unique consumer response to any given fixed fees (see Figure 1). The fixed point  $\bar{\alpha}_i = \hat{\alpha}_i(\bar{\alpha}_i)$ , which from (4) is characterized by

$$\alpha_I = 1 - \alpha_E = \frac{1}{2} + \frac{F_E - F_I + s}{2\tau(m)}, \quad (6)$$

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<sup>18</sup>We thus assume here that expectations respond to pricing deviations. Hurkens and López (2011) consider instead the case of *passive* self-fulfilling equilibrium expectations, which do not respond to deviations. They find that this attenuates the so-called waterbed effect (the extent to which higher termination revenues are passed on to consumers through lower subscription fees), and even annuls it in case of duopoly.

determines the networks' market shares  $\alpha_I$  and  $\alpha_E$  when it lies in  $(0, 1)$  (Figure 1.A). When instead it exceeds 1 (so that  $\hat{\alpha}_i(1) \geq 1$ ), network  $i$  corners the market (Figure 1.B); finally, when it is negative (so that  $\hat{\alpha}_i(0) \leq 0$ ), the other network corners the market (Figure 1.C).

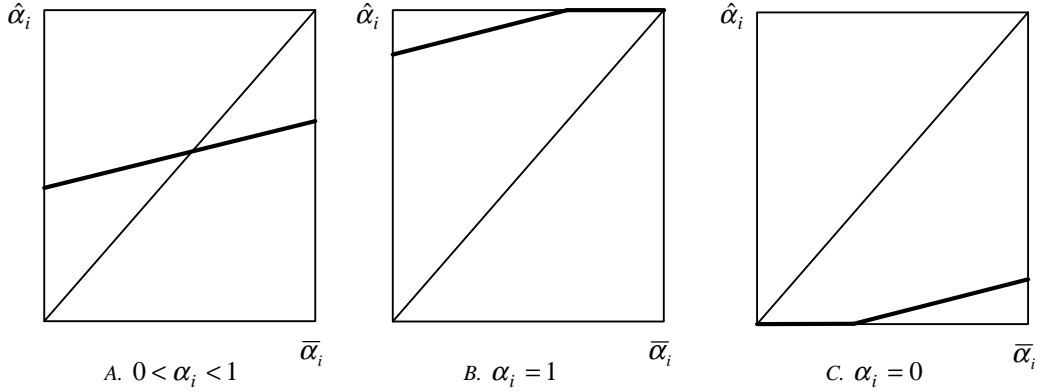


Figure 1: Unique and stable consumer response:  $v(c) - v(c + m) < t$ .

As  $m$  increases, off-net calls become more expensive, which generates greater network externalities in favor of the larger network; as a result,  $\tau(m)$  decreases and may even become negative for  $m$  large enough. There may then exist multiple consumer responses, as illustrated in Figure 2.A, where two cornered-market outcomes co-exist with a shared-market one: off-net calls being much more expensive than on-net calls, customers prefer to join the larger network, regardless of its other characteristics; the network externalities from on-net pricing prevail over the relative preferences for the two operators, and either network can then corner the market.

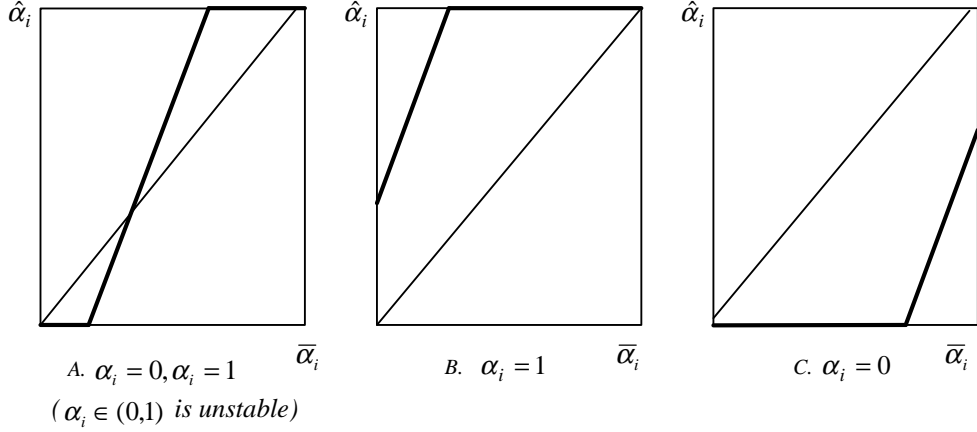


Figure 2: Cornered-market stable consumer responses:  $v(c) - v(c + m) > t$ .

The shared-market outcome is moreover unstable: a small increase in the market share of any network triggers a cumulative process in favour of that network, and this process converges towards that network cornering the market.<sup>19</sup> In contrast, the two cornered-market outcomes are stable. In particular, starting from a situation where all consumers are with the incumbent, a few customers making a "mistake" and switching to the entrant would not trigger any snowballing in favour of the entrant; the customers would thus regret their mistake and wish to have stayed with the incumbent. Since customer inertia may favour the incumbent, in the case of multiple consumer responses it may be reasonable to assume that the stable outcome where consumers stick to the incumbent network is the most plausible outcome. Yet, throughout the paper, we will also take into consideration the possibility of alternative consumer responses and study under what conditions the incumbent can make sure to keep the rival out of the market.

### 3 Price competition

We now characterize the equilibrium fixed fees, given the consumer response determined in the previous section.

<sup>19</sup>Notice that  $\tau(m) > 0$  amounts to  $1 - 2\sigma(v(c) - v(c + m)) > 0$ , which is the stability condition introduced in Laffont, Rey and Tirole (1998b, p. 52).

## Shared-market equilibria

In the light of the above analysis, a price equilibrium yielding a stable shared-market outcome can exist only when (5) holds, in which case the consumer response is moreover always unique. We denote by  $\alpha_i(F_I, F_E)$  the corresponding market share of network  $i = I, E$ . Since usage prices reflect costs, network  $i$ 's profit can be written as (for  $i \neq j = I, E$ ):

$$\pi_i = \alpha_i(F_I, F_E) [F_i - f + \alpha_j(F_I, F_E) mq(c + m)]. \quad (7)$$

**Best responses.** Given the rival's fee  $F_j$ , we can use the market share definition (6) to express  $F_i$  and  $\pi_i$  as a function of  $\alpha_i$ :

$$F_i = F_j + \tau(m) + \delta_i s - 2\tau(m) \alpha_i,$$

$$\pi_i(\alpha_i) = \alpha_i [F_j + \tau(m) + \delta_i s - f + mq(c + m) - 2\varphi(m) \alpha_i], \quad (8)$$

where

$$\varphi(m) \equiv \tau(m) + \frac{mq(c + m)}{2},$$

and  $\delta_I = -\delta_E = 1$ . The first-order derivative is

$$\frac{d\pi_i}{d\alpha_i} = F_j + \tau(m) + mq(c + m) + \delta_i s - f - 4\varphi(m) \alpha_i, \quad (9)$$

while the second-order derivative is negative if and only if:

$$\varphi(m) > 0. \quad (10)$$

When this second-order condition holds, we have:

- if  $F_j + \tau(m) + mq(c + m) + \delta_i s - f \leq 0$ , network  $i$ 's best response is to leave the market to its rival (i.e.,  $\alpha_i = 0$ ), and any  $F_i^r(F_j) \geq F_j + \delta_i s + \tau(m)$  is thus a best-response to  $F_j$  (see the dashed areas in Figure 3);
- if  $F_j + \tau(m) + mq(c + m) + \delta_i s - f \geq 4\varphi(m)$ , network  $i$ 's best response is to corner

the market ( $\alpha_i = 1$ ), and thus  $F_i^r(F_j) = F_j + \delta_i s - \tau(m)$  (45° lines in Figure 3),

- if  $4\varphi(m) > F_j + \tau(m) + mq(c+m) + \delta_i s - f > 0$ , network  $i$ 's best response entails a shared-market outcome,  $\alpha_i \in (0, 1)$ :

$$\alpha_i = \frac{F_j + \tau(m) + mq(c+m) + \delta_i s - f}{4\varphi(m)}, \quad (11)$$

that is, network  $i$ 's best response is given by (middle zone in Figure 3):

$$F_i^r = \frac{(\tau(m) + mq(c+m))(F_j + \delta_i s) + \tau(m)(f + \tau(m))}{2\varphi(m)},$$

where the denominator is positive as long as the second-order condition holds.

**Equilibrium.** Solving for the first-order conditions yields:

$$F_i = f + \tau(m) + \frac{\tau(m) + mq(c+m)}{3\psi(m)} \delta_i s, \quad (12)$$

where

$$\psi(m) \equiv \tau(m) + \frac{2}{3}mq(c+m).$$

Substituting (12) into (6), equilibrium market shares are given by

$$\alpha_I = 1 - \alpha_E = \frac{1}{2} \left( 1 + \frac{s}{3\psi(m)} \right). \quad (13)$$

It is easy to check that  $\psi(m) > 0$  in any candidate shared-market equilibrium,<sup>20</sup> which implies that the market share  $\alpha_I$  exceeds 1/2 and increases with  $s$ . Therefore, it corresponds indeed to a shared-market equilibrium (i.e.,  $\alpha_i < 1$ ) when and only when  $s$  is small enough, namely, when

$$\psi(m) > \frac{s}{3}. \quad (14)$$

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<sup>20</sup>When subscription fees are (weak) strategic complements ( $\partial F_i/\partial F_j \geq 0$ , or  $\tau(m) + mq(c+m) \geq 0$ ), (5) implies  $\psi(m) > 0$ , since  $3\psi(m) = 2(\tau(m) + mq(c+m)) + \tau(m) > 0$ ; when subscription fees are instead strategic substitutes ( $\partial F_i/\partial F_j < 0$ , or  $\tau(m) + mq(m) < 0$ ), the candidate equilibrium is stable (i.e.,  $\partial F_i/\partial F_j > -1$ ) if and only if  $\psi(m) > 0$ .

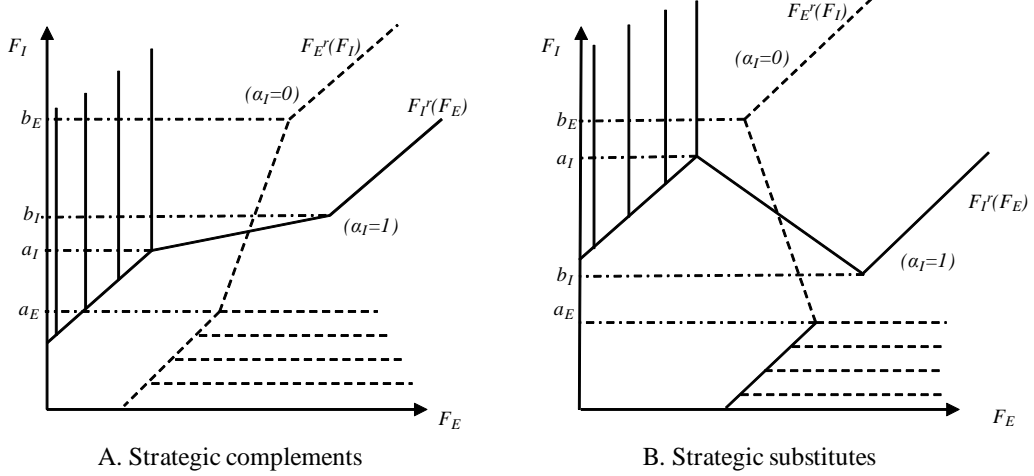


Figure 3: Shared-market equilibria.  $a_I = f - mq(c + m)$ ,  $b_I = f + 2\tau(m) + mq(c + m)$ ,  $a_E = f + s - \tau(m) - mq(c + m)$ ,  $b_E = f + s + 3\tau(m) + mq(c + m)$ .

When  $m \geq 0$ , (5) implies (10) and  $0 < \partial F_i / \partial F_j < 1$ . When instead  $m < 0$ , (5) is always satisfied and subscription fees remain strategic complements (i.e.,  $\partial F_i / \partial F_j > 0$ ) as long as  $\tau(m) + mq(c + m) > 0$ , in which case (10) also holds and  $\partial F_i / \partial F_j < 1$ . Therefore, in those two situations, whenever the shared-market condition (14) holds there exists a unique price equilibrium, as illustrated by Figure 3.A; this equilibrium involves a shared market characterized by (12), strategic complementarity and stability. If instead  $m < 0$  and  $\tau(m) + mq(c + m) < 0$ , subscription fees are strategic substitutes. However, the shared-market condition (14) then implies (10) and  $\partial F_i / \partial F_j > -1$ ; therefore, the price equilibrium is again unique and stable, as illustrated by Figure 3.B, and involves again a shared market characterized by (12). In all cases, (5) moreover implies that consumer responses to prices yield a stable market outcome. Thus, we have:

**Proposition 1** *A stable price equilibrium yielding a stable shared-market outcome exists, in which case it is the unique price equilibrium, if and only if (5) and (14) hold.*

Proposition 1 shows that a stable shared-market equilibrium exists when either the termination charge or the substitutability of the two networks is not too high (condition (5)), and switching costs are moreover moderate (condition (14)). For example, for cost-based access charges ( $m = 0$ ), such an equilibrium exists when  $s < 3t$ .<sup>21</sup> When this

<sup>21</sup>As mentioned earlier, the utility derived from being connected to either network is suppose to be



condition is satisfied, a shared-market equilibrium also exists (and is then the unique equilibrium) when the termination mark-up is positive, as long as (5) and (14) remain satisfied.

**Comparative statics.** We now study the impact of the access charge on shared-market equilibrium profits. Gans and King (2001) show that symmetric networks prefer access charges below marginal costs. Intuitively, when  $m$  is positive, off-net calls are priced above on-net calls, so consumers prefer to join larger networks, all else being equal. Consequently, networks bid more aggressively for marginal customers. Networks prefer instead to soften competition by setting the access charge below cost. The next proposition confirms that, as long as the two networks share the market, price competition is softened when  $m$  decreases below zero, independently of networks' sizes.

**Proposition 2** *In the range of termination charges yielding a shared-market equilibrium:*

- (i) *both networks' equilibrium profits are higher for a cost-based termination charge ( $m = 0$ ) than for any positive termination mark-up ( $m > 0$ );*
- (ii) *there exists a termination subsidy ( $m < 0$ ) that gives both networks even greater profits.*

**Proof.** See Appendix. ■

Proposition 2 extends the insight of Gans and King to asymmetric networks. It however only applies to termination markups that are small enough to yield a shared-market equilibrium. As we will see, networks may actually favour more extreme termination markups that allow them to corner the market and charge high prices.<sup>22</sup>

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large enough to ensure full participation. Under cost-based access charges, the marginal consumer' net utility is equal to:

$$v(c) - F_I - t\alpha_I = v(c) - f - \frac{3t + s}{2}.$$

Therefore, a sufficient condition for full participation is  $v(c) > f + 3t$ , since then the marginal consumer obtains a positive net utility whenever a shared-market equilibrium exists, i.e., whenever  $s < 3t$ .

<sup>22</sup>The same comment applies to the case of symmetric operators considered by Gans and King (which corresponds here to  $s = 0$ ). While they show that networks' symmetric shared-market equilibrium profits are maximal for a negative mark-up, more extreme mark-ups (including positive ones) may induce cornered-market equilibria that generate greater industry profits.

## Cornered-market equilibria

We now study under what conditions a network operator can corner the market.

Suppose first that (5) still holds, ensuring that there is a unique consumer response to subscription fees. From the above analysis, a cornered-market equilibrium can then exist only when condition (14) fails to hold.

In a candidate equilibrium where network  $i$  corners the market, the consumers located at the other end of the segment must prefer to stick to  $i$ 's network; that is, for  $i \neq j = I, E$ :  $v(c) - t - F_i \geq v(c + m) - \delta_i s - F_j$ , or:  $F_i \leq F_j - \tau(m) + \delta_i s$ . Furthermore, if this inequality holds strictly then  $i$  can increase its subscription fee and still corner the market. Therefore, a necessary equilibrium condition is:

$$F_i = F_j - \tau(m) + \delta_i s. \quad (15)$$

In addition: (i) network  $i$  should not prefer to charge a higher fee and increase its margin at the expense of its market share; and (ii) its rival should not be able to attract consumers and make positive profits. The precise interpretation of these two conditions depends on the concavity of the profit functions.

**Concave profits.** When (10) also holds, each operator's profit is globally concave with respect to its own price; the relevant deviations thus involve marginal price changes leading to a shared-market outcome. A candidate equilibrium satisfying (15) is therefore indeed an equilibrium if and only if:

- Network  $i$  does not gain from a marginal increase in its fee;<sup>23</sup> given the previous analysis of best responses, this amounts to  $F_j + \tau(m) + \delta_i s - f + mq(c + m) \geq 4(\tau(m) + mq(c + m)/2)$ , or:

$$F_j \geq f + 3\tau(m) + mq(c + m) - \delta_i s, \quad (16)$$

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<sup>23</sup>Note that this condition ensures that  $i$  obtains a non-negative profit – otherwise, a small increase in  $F_i$  would reduce its loss. Indeed, (15) and (16) imply  $F_i > f$  when the second-order condition (10) holds.

- The rival network  $j$  does not gain from a marginal reduction in its fee or, equivalently, cannot make a positive profit by attracting its closest consumers; this amounts to:

$$F_j \leq f - mq(c + m). \quad (17)$$

Network  $j$ 's fee must therefore lie in the range

$$f - mq(c + m) \geq F_j \geq f + 3\tau(m) + mq(c + m) - \delta_i s, \quad (18)$$

which is feasible only when

$$\psi(m) \leq \frac{\delta_i s}{3}. \quad (19)$$

For the incumbent ( $i = I$ , for which  $\delta_I = 1$ ), this condition is satisfied whenever (14) fails to hold. Any pair of subscription fees  $(F_I, F_E)$  satisfying

$$F_I = F_E - \tau(m) + s \quad (20)$$

and

$$f - mq(c + m) \geq F_E \geq f + 3\tau(m) + mq(c + m) - s \quad (21)$$

then constitutes a price equilibrium where  $I$  corners the market. Among those equilibria, only one does not rely on weakly dominated strategies for  $E$ , and is therefore trembling-hand perfect: this is the one where

$$F_E = f - mq(c + m), F_I = f + s - \tau(m) - mq(c + m). \quad (22)$$

By contrast,  $E$  can corner the market only if

$$\psi(m) \leq -\frac{s}{3}. \quad (23)$$

It follows that  $E$  cannot corner the market if  $m \geq 0$  (since the left-hand side is then

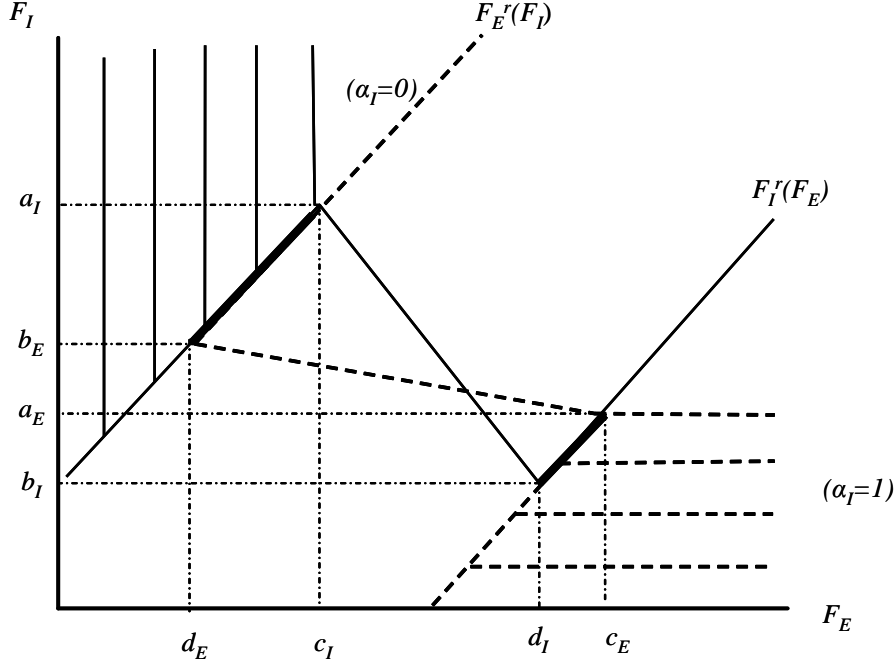


Figure 4: Cornered-market equilibria.  $a_I = f - mq(c + m)$ ,  $b_I = f + 2\tau(m) + mq(c + m)$ ,  $a_E = f + s - \tau(m) - mq(c + m)$ ,  $b_E = f + s + 3\tau(m) + mq(c + m)$ ,  $c_I = f - s - \tau(m) - mq(c + m)$ ,  $d_I = f - s + 3\tau(m) + mq(c + m)$ ,  $c_E = f - mq(c + m)$ ,  $d_E = f + 2\tau(m) + mq(c + m)$ .

positive under (5)); however, the left-hand side may become negative and possibly lower than  $-s/3$  when  $m$  is largely negative, in which case there can be a continuum of equilibria in which  $E$  corners the market by charging

$$F_E = F_I - \tau(m) - s, \quad (24)$$

including a unique trembling-hand perfect equilibrium where  $I$  sets  $F_I = f - mq(c + m)$  and  $E$  thus charges  $F_E = f - \tau(m) - mq(c + m) - s (> f)$ .

Note finally that, since (19) is more demanding for  $E$  than for  $I$ ,  $I$  can corner the market whenever  $E$  can do so (that is, both cornered market equilibria exist whenever  $E$  can corner the market).<sup>24</sup> Figure 4 illustrates this case.

**Convex profits.** When (10) fails to hold, each operator's profit is convex with respect

<sup>24</sup>As usual with network effects, different expectations yield multiple consumer responses, which in turn may sustain multiple equilibria. The network effect arises here from on-net pricing rather than traditional club effects. In a different context, Matutes and Vives (1996) show that different expectations about the success of banks and coordination problems among depositors can result in multiple shared- and cornered-market equilibria (and even in a no-banking equilibrium).

to its own subscription fee. The relevant strategies then consist in either cornering the market or leaving it to the rival. Thus, in a candidate equilibrium where  $I$  corners the market, it must be the case that:

- $I$  does not gain from "opting out", i.e., it should obtain a non-negative profit:  
 $F_I \geq f$ .
- $E$  does not gain from lowering its subscription fee so as to corner the market, i.e., from charging  $F_E$  satisfying (24):  $F_E = F_I - \tau(m) - s \leq f$ .

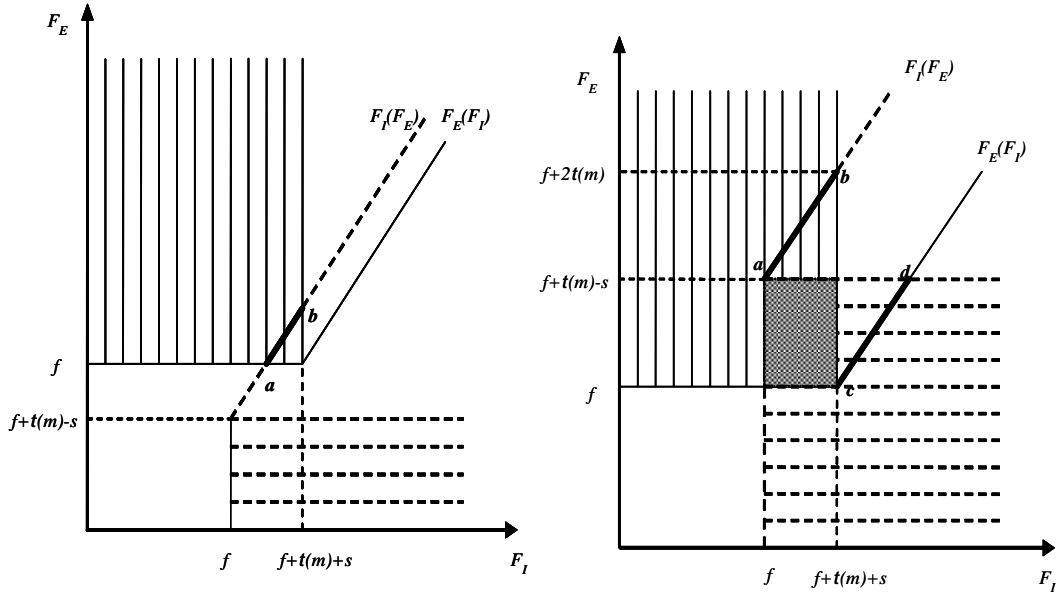


Figure 5: A) Only the incumbent corners the market:  $s > \tau(m)$ . B) The incumbent or the entrant corners the market:  $s < \tau(m)$ .

It follows that  $I$ 's equilibrium price must satisfy:

$$f + \tau(m) + s \geq F_I \geq f, \quad (25)$$

where the left-hand side is indeed always higher than the right-hand side under (5). Any combination of fees satisfying (20) and (25) constitutes an equilibrium in which  $I$  corners the market.

We can similarly study under what conditions  $E$  can corner the market: condition (24) must hold,  $E$  must obtain a non-negative profit (i.e.,  $F_E \geq f$ ) and  $I$  should not be

able to make a profit by cornering the market, i.e.:  $F_I = F_E - \tau(m) + s \leq f$ . Thus, in this equilibrium  $E$ 's equilibrium fee satisfies:

$$f + \tau(m) - s \geq F_E \geq f,$$

and such an equilibrium thus exists if and only if  $s \leq \tau(m)$ . It follows that when  $E$  corners the market,  $I$ 's equilibrium price lies in the range  $[f + \tau(m) + s, f + 2\tau(m)]$ .

Figure 5 summarizes this analysis. When  $s > \tau(m)$ , only  $I$  can corner the market and it can achieve that while charging any price between  $f$  and  $f + \tau(m) + s$ . When instead  $s \leq \tau(m)$ , however,  $E$  may also corner the market.

**Multiple consumer responses.** Last, we turn to the case where (5) does not hold (i.e.  $\tau(m) \leq 0$ ), in which case there is never a stable shared-market consumer allocation, and there may be multiple cornered-market outcomes:

- when

$$F_E > F_I - \tau(m) - s, \tag{26}$$

there is a unique consumer response, in which  $I$  corners the market ( $\hat{\alpha}_i(0) > 0$ , Figure 2.B);

- when instead

$$F_I - \tau(m) - s \geq F_E \geq F_I + \tau(m) - s, \tag{27}$$

there are two stable consumer responses, in which either  $I$  or  $E$  corners the market ( $\hat{\alpha}_i(0) < 0$  and  $\hat{\alpha}_i(1) > 1$ , Figure 2.A);<sup>25</sup>

- finally, when

$$F_E < F_I + \tau(m) - s, \tag{28}$$

there is again a unique consumer response, in which  $E$  corners the market ( $\hat{\alpha}_i(1) < 1$ , Figure 2.C).

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<sup>25</sup>As mentioned, we discard the third consumer response in which the two networks share the market, as it is unstable.

Obviously, a network can corner the market more easily when consumers favour that network in case of multiple responses to prices.

Suppose first that customer inertia, say, systematically favours the incumbent in the "middle" case corresponding to (27). Then  $I$  wins the whole market as long as  $F_I - F_E \leq s - \tau(m)$ , otherwise  $E$  wins the market. Since  $s - \tau(m) > 0$ ,  $I$  benefits from a competitive advantage in this Bertrand competition for the market and therefore corners the market in equilibrium. Moreover, ignoring weakly dominated strategies for  $E$ , the equilibrium is unique and such that  $F_E = f$  and  $F_I = f + s - \tau(m)$ , giving  $I$  a positive profit,  $\pi_I = s - \tau(m)$ , which moreover increases with  $m$ .<sup>26</sup>

Suppose now that customer activism, say, is instead favourable to the entrant, i.e., consumers stick to  $E$  in case of multiple consumer responses. Then  $I$  wins the market only when  $F_I - F_E \leq s + \tau(m)$ ; therefore:

- When the switching cost is large enough, namely

$$s \geq -\tau(m),$$

then  $I$  still enjoys a competitive advantage and corners again the market in equilibrium; ignoring weakly dominated strategies, in equilibrium  $E$  sells at cost ( $F_E = f$ ) and  $I$  obtains a profit,  $\pi_I = s + \tau(m) (< s)$ , which decreases with  $m$ .

- When instead the switching cost is low ( $s < -\tau(m)$ ), the tariff-mediated network externalities dominate and customer activism gives a competitive advantage to  $E$ ; as a result, in all equilibria  $E$  corners the market.<sup>27</sup>

*Recap.* The above analysis can be summarized as follows. When  $m = 0$ , conditions (5) and (10) hold; therefore, from the above analysis,  $E$  cannot corner the market (this would require  $s < -3t$ , a contradiction), whereas  $I$  can corner the market only if the switching cost is prohibitively high, namely:  $s \geq 3t$ . When the switching cost is not

<sup>26</sup>If  $\tau(m)$  is sufficiently negative,  $I$  obtains the monopoly profit.

<sup>27</sup>In the limit case where  $s = -\tau(m)$ , both  $I$  and  $E$  can corner the market in equilibrium, but earn zero profit anyway.

that high,  $I$  may still corner the market when the termination charge departs from cost; however,  $E$  may then also corner the market. More precisely:

**Proposition 3** *Cornered-market equilibria exist in the following circumstances:*

- *Unique consumer response ( $\tau(m) > 0$ ):*
  - *Concave profits ( $\varphi(m) > 0$ ): there exists an equilibrium in which  $I$  corners the market when  $\psi(m) \leq s/3$ ; there also exists an equilibrium in which  $E$  corners the market when  $\psi(m) \leq -s/3$ .*
  - *Convex profits ( $\varphi(m) \leq 0$ ): there always exists an equilibrium in which  $I$  corners the market; there also exists an equilibrium in which  $E$  corners the market when  $\tau(m) \geq s$ .*
- *Multiple consumer responses ( $\tau(m) \leq 0$ ):*
  - *Customer inertia favourable to the incumbent: there exists a unique equilibrium, in which  $I$  corners the market.*
  - *Customer activism favourable to the entrant: there generically exists a unique equilibrium; in this equilibrium,  $I$  corners the market when  $\tau(m) > -s$ , whereas  $E$  corners the market when  $\tau(m) < -s$ .*

## 4 Strategic choice of the access charge

Under a cost-based termination charge ( $m = 0$ ), consumer response to prices is always unique and operators' profits are moreover concave (since  $\varphi(0) = \tau(0) = t > 0$ ). Yet, even in that case,  $E$  cannot obtain a positive market share if switching costs are too large – namely, if  $\psi(0) = t \leq s/3$ . In what follows, we thus assume that  $s < 3t$ , and study  $I$ 's strategic incentive to depart from cost-based termination charges in order to foreclose the market and increase its profit.<sup>28</sup>

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<sup>28</sup> $I$  can however benefit from raising  $m$  even when  $s \geq t/3$ , as this weakens the competitive pressure from its rival in the resulting cornered-market equilibrium (as long as (5) and (10) continue to hold).



## Foreclosure through high termination charges

Our extension of Gans and King's insight shows that raising the termination charge above cost degrades both operators' profits as long as the market remains shared; our equilibrium analysis shows further that this is the case as long as  $\tau(m) > 0$  and  $\psi(m) > s/3$ , where, letting

$$\bar{m} \equiv u'(0) - c,$$

denote the termination markup for which the demand for calls becomes zero, and

$$\Delta \equiv v(c) - v(\infty)$$

measure the scope for network externalities,  $\tau(\cdot)$  and  $\psi(\cdot)$  decrease from  $t$  to  $t - \Delta$  as  $m$  goes from 0 to  $\bar{m}$  (and remain constant afterwards). We can therefore distinguish two broad cases:

**Case 1 (small network externalities):**  $\Delta < t$ . In that case,  $\tau(m)$  is always positive (for any  $m$ ), and both  $\varphi(m)$  and  $\psi(m)$  are also positive for  $m \geq 0$ ; therefore, any positive termination mark-up leads to a unique equilibrium, in which either the two networks share the market (if  $\psi(m) > s/3$ ) or  $I$  corners the market (if  $\psi(m) \leq s/3$ ). More precisely:

- if  $s < 3(t - \Delta)$ ,  $\psi(m) > s/3$  for any  $m \geq 0$ : thus,  $I$  cannot increase its profit by raising the termination charge above cost, as networks keep sharing the market;
- if instead  $s \geq 3(t - \Delta)$ ,  $\psi(m) \leq s/3$  for a high enough termination mark-up, namely, for

$$m \geq \check{m} \equiv \psi^{-1}\left(\frac{s}{3}\right),$$

in which case  $I$  corners the market and obtains

$$\pi_I^C(m) \equiv s - \tau(m) - mq(c + m), \tag{29}$$

which increases with  $m$  as long as demand remains positive (that is,  $m < \bar{m}$ ):

$$\frac{d\pi_I^C}{dm} = -mq'(c+m) > 0.$$

Foreclosing the market in this way is profitable for  $I$  when the maximum profit that it can obtain,  $\bar{\pi}_I^C \equiv \pi_I^C(\bar{m}) = s - t + \Delta$ , exceeds the profit that it could obtain by sharing the market for  $m = 0$ , which is equal to

$$\pi_I^0 = \frac{t}{2} \left(1 + \frac{s}{3t}\right)^2.$$

This amounts to  $s > \bar{s} \equiv \left(2 - \sqrt{1 + 2\Delta/t}\right) 3t (> 3(t - \Delta))$ .

We thus have:

- for  $s \leq \bar{s}$ , it is never profitable for the incumbent to foreclose the market by raising the termination charge above cost;
- for  $s > \bar{s}$ ,<sup>29</sup> the combination of network externalities and switching costs makes it instead profitable for  $I$  to foreclose the market in this way.

**Case 2 (large network externalities):**  $\Delta > t$ . Increasing the termination charge above  $\hat{m} \equiv \tau^{-1}(0)$  then ensures that consumers always prefer to be all on the same network ( $\tau(m) < 0$ ); the profitability of this foreclosure strategy however depends critically on which network is more likely to win the market when there are multiple consumer responses. For the sake of exposition, we will focus on two polar cases, where either customer inertia systematically favours the incumbent, or customer activism systematically favours the entrant.

*Customer inertia.* When  $I$  benefits from customer inertia, it can keep  $E$  out and better exploit its market power by raising further the termination charge above  $\hat{m}$ ;  $I$  still wins the market and can charge up to (the superscript  $CI$  standing for "customer

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<sup>29</sup>This amounts to  $\alpha_I^0 \left(= \frac{1+s/3t}{2}\right) > \frac{3-\sqrt{1+2\Delta/t}}{2}$ , where the right-hand side lies above  $\frac{3-\sqrt{3}}{2} \simeq 63\%$  as long as  $\Delta < t$ ;  $I$  should thus keep at least about two-thirds of the market under cost-based termination charges.

inertia")

$$F_I^{CI}(m) = f + s - \tau(m),$$

which increases with  $m$  as long as demand remains positive:  $\frac{dF_I^{CI}}{dm} = q(c + m) \geq 0$ . Therefore, the incumbent has an incentive to set  $m$  as high as possible, in order to extract consumer surplus without fearing any competitive pressure from the entrant. The only limitations come from consumer demand: raising  $m$  above  $\bar{m}$  does not increase  $I$ 's profit any further, as consumers stop calling (that is,  $dF_I^{CI}/dm = 0$  for  $m > \bar{m}$ ). Yet, if the demand for calls is large enough, raising the termination charge allows  $I$  to eliminate any competitive pressure from  $E$  and charge monopoly prices. For example, if consumers' surplus  $v(c)$  is large enough, a monopolist would maintain full participation<sup>30</sup> and use the subscription fee to extract the full value from the farthest consumer:  $F^M = v(c) - t$ . Setting the termination charge above  $m^M$ , such that  $F_I^{CI}(m^M) = F^M$ , or  $v(c + m^M) = f + s$ , would then allow  $I$  to achieve the monopoly profit. Customer inertia can thus be interpreted as a "virtual" switching cost, which can allow the incumbent to corner the market and earn the monopoly profit even in the absence of any real switching costs.

*Customer activism.* If instead customer activism favours the entrant in case of multiple consumer responses, then  $I$  never benefits from increasing the termination charge beyond  $\hat{m}$ : as shown above,  $E$  would then sell at cost ( $F_E = f$ ) and  $I$  would obtain a profit,  $\pi_I = s + \tau(m)$ , which is lower than  $s$  and moreover decreases with  $m$ . Furthermore, for  $m < \hat{m}$ , either the networks share the market (if (14) holds, that is, if  $m < \check{m}$ ), or  $I$  corners the market (if  $m \geq \check{m}$ ), in which case  $I$ 's profit increases with  $m$  as long as  $m \leq \hat{m}$ ; therefore, the best foreclosure strategy is to adopt  $m = \hat{m}$ , which yields a profit equal to

$$\hat{\pi}_I = s.$$

Foreclosing the market in this way is profitable if this profit exceeds the profit that can be achieved by sharing the market for  $m = 0$ ,  $\pi_I^0$ , which (noting that  $\hat{\pi}_I = \bar{\pi}_I^C|_{\Delta=t}$ ) amounts to  $s < \bar{s}|_{\Delta=t} = (2 - \sqrt{3})3t$ .

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<sup>30</sup> This is the case whenever  $v(c) \geq f + 2t$ .

## Foreclosure through large termination subsidies

Alternatively,  $I$  can try to foreclose the market by adopting a large subsidy ( $m \ll 0$ ). For  $m < 0$ , the stability condition (5) always holds, implying that there is a unique, stable, consumer response to prices (the issue of customer inertia or favoritism thus becomes irrelevant). Moreover,  $\varphi(m) = \psi(m) - mq(c+m)/6 \geq \psi(m)$ , which implies that profits are concave ( $\varphi(m) > 0$ ) whenever the shared market condition ( $\psi(m) > s/3$ ) is satisfied.

For a sufficiently large subsidy, one may have  $\psi(m) \leq s/3$ . However, as long as profits remain concave,  $I$ 's profit coincides again with  $\pi_I^C(m)$  and thus decreases when the size of the termination subsidy increases (in addition,  $E$  may as well corner the market if  $\psi(m) \leq -s/3$ ). Yet,  $I$  may benefit from increasing further the size of the subsidy, so as to make profits convex (i.e.,  $\varphi(m) \leq 0$ ); there is an equilibrium in which  $I$  corners the market and can charge up to  $F_I^{Conv} = f + \tau(m) + s$ , which increases with the size of the subsidy:  $\frac{dF_I^{Conv}}{dm} = -q(c+m) < 0$ . Hence there may exist cases in which "bill and keep" allows the incumbent to deter entry. Nevertheless, foreclosing the market therefore requires subsidies that are large enough to make profits convex (i.e., to ensure  $\varphi(m) \leq 0$ ), which may be difficult to achieve:

- First,  $\varphi$  may remain positive: starting from  $m = 0$ , introducing a small subsidy *increases*  $\varphi$ , since  $\varphi'(0) = -q(c)/2 < 0$ ; while  $\varphi'(m) = (mq'(c+m) - q(c+m))/2$  may become positive for larger subsidies, there is no guarantee that this happens, and even in that case, there is no guarantee that  $\varphi$  may become negative for large enough subsidies.
- Second, the size of subsidies may be limited by feasibility considerations; even "bill and keep" – i.e.,  $m = -c_T$  – may not suffice to generate a large enough subsidy.
- Third, very large subsidies and convex profits may allow the entrant, too, to corner the market; to avoid this, the incumbent should choose a termination charge satisfying  $\tau(m) < s$ , which, since  $\tau'(m) < 0$  for  $m < 0$ , imposes an additional restriction on the size of the subsidy (in particular, this restriction may be incompatible with  $\varphi(m) \leq 0$ ).

- Finally, subsidizing termination may generate abuses and, moreover, offering lower prices for off-net calls may not fit well with marketing strategies.

Despite these difficulties, large subsidies may in some cases allow the incumbent to corner the market and increase its profit. For example, if  $\varphi(m) < 0$  for the termination subsidy such that  $\tau(m) = s$ , then adopting this subsidy (or a slightly lower one) ensures that  $I$  corners the market and obtains a profit equal to  $s + \tau(m) = 2s$ , which is twice the maximal profit that  $I$  can obtain by foreclosing the market through a positive termination mark-up when customer activism benefits the entrant.

## Recap

The following proposition summarizes the above discussion:

**Proposition 4** *Suppose that  $s < 3t$ , so that cost-oriented access pricing would allow the entrant to share the market. While both networks would favour a small reduction in the access charge over a small increase in the access charge, the incumbent might increase its profit by departing further away from cost-based access pricing in order to corner the market; assuming that network externalities are large enough (namely,  $\Delta > t$ ):*

- *If the incumbent benefits from customer inertia in case of multiple consumer responses, then it would have an incentive to increase the access charge as much as possible and could earn in this way up to the monopoly profit.*
- *If instead the entrant benefits from customer activism, then by foreclosing the market through a positive termination mark-up, the incumbent can earn a profit at most equal to  $s$ , which it can achieve by adopting  $m = \hat{m}$ , such that  $\tau(m) = 0$ .*

*The incumbent may also benefit from foreclosing the market through a large enough termination subsidy, although feasibility, strategic (equilibrium multiplicity) and marketing considerations tend to limit this possibility.*

**Illustration: linear demand function.** Suppose that the utility function takes the form

$$u(q) = aq - \frac{b}{2}q^2,$$

with  $a, b > 0$ . The demand function is then linear,  $q(p) = (a - p)/b$ , while consumer's surplus is  $v(p) = (a - p)^2/2b$ . We adopt the parameter values of De Bijl and Peitz (2002, 2004):  $a = 20$  euro-cents,  $b = 0.015$  euro-cent,  $c_T = 0.5$  euro-cent,  $c = c_O + c_T = 2$  euro-cents,  $f = 0$  and  $t = 35$  euros.<sup>31</sup> The feasible range for the termination mark-up is thus  $m \geq -c_T = -0.5$  euro-cent and, in this range, it can be checked that  $\varphi$  and  $\psi$ , as well as  $\tau$ , are all decreasing in  $m$ . In particular, condition (5) is satisfied for  $m < \hat{m} = 3.2014$  euro-cent, in which case the second-order condition  $\varphi(m) > 0$  is also satisfied. In addition, the shared-market condition (14),  $\psi(m) > s/3$ , amounts to  $m < \check{m}(s)$ , where  $\check{m}(s)$  decreases with  $s$ . Therefore, for any  $s < 3t$  (so as to ensure that the market would be shared for  $m = 0$ , that is,  $\check{m}(s) > 0$ ), the market is always shared whenever access is subsidized ( $m < 0$ ) or moderately priced (that is,  $m < \min\{\hat{m}, \check{m}(s)\}$ ); the incumbent can however corner the market by insisting on a large enough access mark-up ( $m > \min\{\hat{m}, \check{m}(s)\}$ ).<sup>32</sup> It can moreover be checked that, in the limited admissible range of negative values for  $m$ , the incumbent's (shared-market) equilibrium profit decreases with  $m$ ; "bill and keep" (that is,  $m = -c_T = -0.5$  euro-cent) thus constitutes the most profitable access agreement in this range. Below we compare this profit with the profit that the incumbent can achieve by cornering the market through large access markups. To complete the welfare analysis we also study the impact of the access charge on consumer surplus ( $CS$ ), net of fixed fees and switching and transport costs:

$$\begin{aligned} CS &= \alpha_I(\alpha_I v(c) + \alpha_E v(c + m) - F_I) + \alpha_E(\alpha_E v(c) + \alpha_I v(c + m) - F_E) \\ &\quad - \int_0^{\alpha_I} tx dx - \int_{\alpha_I}^1 t(1 - x) dx - s\alpha_E. \end{aligned}$$

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<sup>31</sup>In De Bijl and Peitz (2002),  $t = 60$  euros, whereas in De Bijl and Peitz (2004),  $t = 20$  euros. Since this parameter is difficult to measure, its value is based on experience obtained in the test runs of their model. Adopting  $t = 35$  euros ensures full participation ( $v(c) > 3t$ ; see footnote (21)).

<sup>32</sup>By contrast,  $E$  cannot corner the market in the absence of customer activism, since (5) here implies (14).

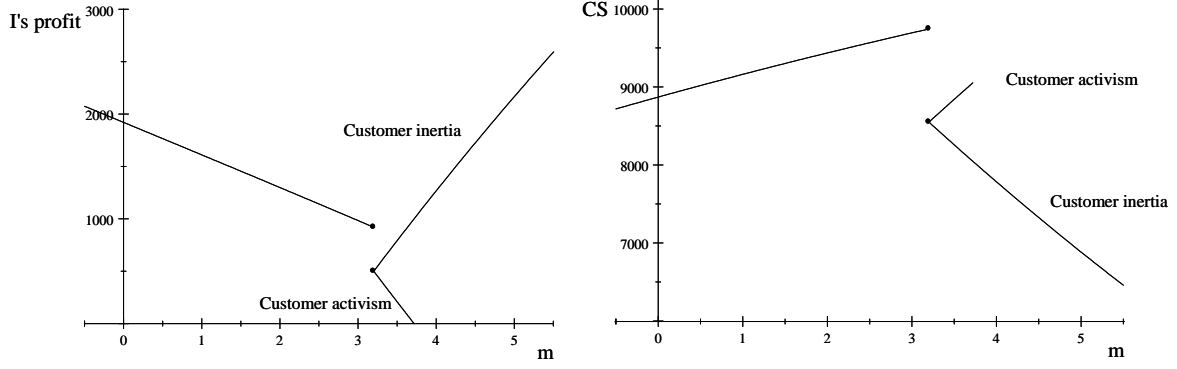


Figure 6: Incumbent's equilibrium profit for small switching costs:  $s = 5$  euros.

For illustrative purposes, we consider two polar cases: *i*) small switching costs:  $s = 5$  euros; *ii*) large switching costs:  $s = 70$  euros.

- Small switching costs: We have  $\check{m}(s) = 6.98 > \hat{m} = 3.2$ . Therefore, for  $m < \hat{m}$  the market is shared between the two networks whereas for  $m \geq \hat{m}$ , there are multiple consumer responses. In that latter range,  $I$  corners the market; if it moreover benefits from customer inertia, its profit increases with  $m$  and, for  $m$  large enough, exceeds the profit achieved when sharing the market under lower access charges. In case of customer activism, however,  $I$ 's profit decreases with  $m$ , as illustrated in Figure 6 – and  $E$  moreover corners the market when  $m$  becomes large enough (namely, when  $m \geq 3.72$ , where  $\tau(m) \leq -s$ ). In addition,  $I$ 's profit from cornering the market through  $\hat{m}$ ,  $\pi_I = s$ , is lower than in any shared-market equilibrium. Thus,  $I$  would here choose to foreclose the market through large access markups only when it benefits from customer inertia.
- Large switching costs: We now have  $\check{m}(s) = 2.71 < \hat{m} = 3.2$ . Therefore, for  $m < \check{m}$  the two networks share the market, whereas for  $m$  between  $\check{m}$  and  $\hat{m}$   $I$  corners the market (even though there is a unique consumer response and profit functions are concave) by charging  $F_I = f + s - \tau(m) - mq(c + m)$ . In this equilibrium,  $I$ 's profit increases with  $m$ . For  $m > \hat{m}$ , there are multiple consumer responses and  $I$  still corners the market, although its profit increases with  $m$  only if it benefits from customer inertia, as illustrated by Figure 7.  $I$ 's profit from cornering the market

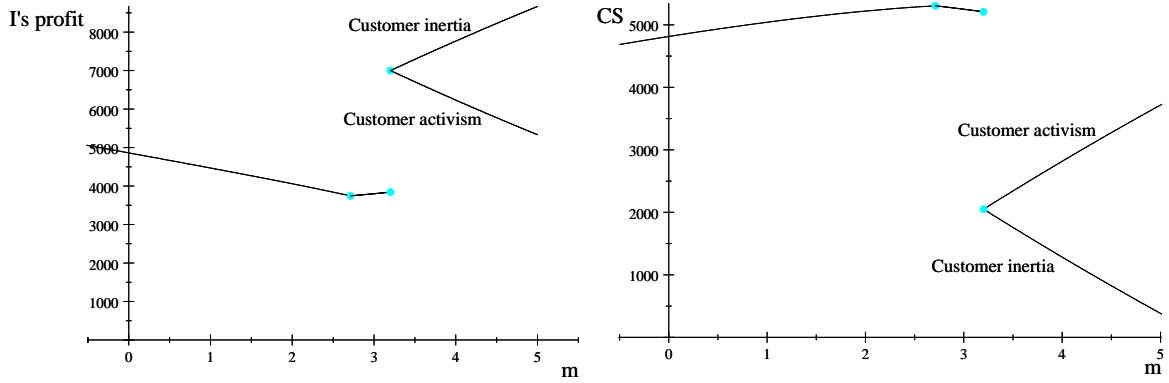


Figure 7: Incumbent's equilibrium profit for large switching costs:  $s = 70$  euros.

with  $m = \hat{m}$  is now higher than in any shared-market equilibrium (even with "bill and keep"), however. Therefore, even in case of customer activism,  $I$  will here prefer to corner the market with a large enough access mark-up (namely,  $\hat{m}$ ) rather than sharing the market with lower or below-cost access charges.

*Consumer surplus.* In both cases (for small and large switching costs), consumer surplus increases with  $m$  as long as the networks share the market. The reason is that competition is more aggressive for higher access charges. Also, in both cases, the incumbent corners the market when  $m \geq \hat{m}$  and consumer surplus then decreases (respectively increases) with  $m$  in the presence of customer inertia (activism), since a higher  $m$ , reduces (increases) the competitive pressure of the entrant. Finally, in the case of large switching costs, the incumbent also corners the market when  $m$  lies between  $\check{m}$  and  $\hat{m}$ , and in this range increasing the access charge reduces the competitive pressure, allows the incumbent to charge a higher fixed fee and thus results in lower consumer surplus.

## 5 No termination-based price discrimination

So far we have considered the case of termination-based price discrimination. This section, in contrast, assumes that networks cannot charge different prices for on-net and off-net calls. We will first examine whether the incumbent can deter entry under the caller-pays regime. Then, we will explore the case of the receiver-pays regime.



## Caller-pays regime

In this section we examine whether the incumbent can foreclose competition through access charges when there is no termination-based price discrimination. Network  $i$ 's profit is then (for  $i \neq j = I, E$ ):

$$\pi_i = \alpha_i[(p_i - c)q(p_i) + F_i - f + \alpha_j m(q(p_j) - q(p_i))].$$

A detailed analysis of shared-market equilibria can be found in Carter and Wright (2003) and López (2008). Market shares are given by:

$$\alpha_I(w_I, w_E) = 1 - \alpha_E(w_I, w_E) = \frac{1}{2} + \sigma(w_I - w_E - s),$$

where  $w_i = v(p_i) - F_i$  denotes the net surplus that operator  $i$  offers its customers. We can interpret network  $i$ 's strategy as offering a price  $p_i$  and a net surplus  $w_i$  and, given network  $j$ 's strategy, network  $i$ 's best response moreover entails

$$p_i = \tilde{p}_i(w_i) = c + \tilde{\alpha}_j(w_i) m. \quad (30)$$

Therefore, given network  $j$ 's strategy, we can write network  $i$ 's profit as

$$\tilde{\pi}_i(w_i) = \tilde{\alpha}_i(w_i) [v(\tilde{p}_i(w_i)) - w_i - f + \tilde{\alpha}_j(w_i) m q(p_j)],$$

with

$$\begin{aligned} \tilde{\pi}'_i(w_i) &= \sigma [v(\tilde{p}_i) - w_i - f + (\tilde{\alpha}_j - \tilde{\alpha}_i) m q(p_j) + \tilde{\alpha}_i m q(\tilde{p}_i)] - \tilde{\alpha}_i, \\ \tilde{\pi}''_i(w_i) &= -\sigma [2 + 2\sigma m (q(p_j) - q(\tilde{p}_i)) + \tilde{\alpha}_i \sigma m^2 q'(\tilde{p}_i)]. \end{aligned}$$

For  $m = 0$ ,  $\tilde{\pi}''_i(w_i) = -2\sigma < 0$  and second-order conditions therefore hold; first-order conditions yield  $p_I = p_E = c$  and

$$\alpha_I^s(0) = \frac{1}{2} \left( 1 + \frac{s}{3t} \right),$$

so a shared-market equilibrium exists provided that  $s < 3t$ , in which case the incumbent's profit is equal to

$$\pi_I^s(0) = \frac{t}{2} + \frac{s}{3} \left(1 + \frac{s}{6t}\right).$$

We also know from the previous papers that any small departure from  $m = 0$  lowers the incumbent's profit.

Consider now a candidate equilibrium in which  $I$  corners the market. In the light of the above analysis, it follows that  $p_I = c$  and  $p_E = c + m$ . For this to be an equilibrium, even the consumers closest to  $E$  must prefer to stay with  $I$ , that is,  $v(c) - t - F_I \geq v(c + m) - s - F_E$ ; and since  $I$  maximizes its profit, this inequality cannot be strict, therefore:

$$F_I = F_E - \tau(m) + s. \quad (31)$$

Moreover,  $I$  should not gain from a marginal increase in its fee:

$$0 \leq \tilde{\pi}'_I(w_I)|_{\alpha_I=1} = \sigma [F_I - f + m(q(c) - q(c + m))] - 1,$$

that is:

$$F_I \geq f + 2t - m(q(c) - q(c + m)). \quad (32)$$

In addition,  $E$  should not make any profit by stealing a few customers, that is:

$$F_E - f + mq(c) \leq 0. \quad (33)$$

Using (31), we can rewrite conditions (32) and (33) as:

$$f - mq(c) \geq F_E \geq f + 2t + \tau(m) - s - m(q(c) - q(c + m)). \quad (34)$$

Any  $F_E$  in the above range can support a cornered-market equilibrium if second-order conditions are moreover satisfied; eliminating weakly dominated strategies singles out the equilibrium in which  $F_E = f - mq(c)$ ,  $F_I = f - \tau(m) - mq(c) + s$  and network  $I$ 's profit

is equal to:

$$\pi_I^c(m) = s - \tau(m) - mq(c).$$

This expression is maximal for  $m = 0$ , where it is equal to  $\pi_I^c(0) = s - t$ . Therefore, when  $s > 3t$ , in which case there is no shared-market equilibria and thus  $I$  always corners the market,  $I$ 's profit is maximal for  $m = 0$  (and the above-described cornered-market equilibrium indeed exists, since second-order conditions are always satisfied for  $m = 0$ ). We now show that, when  $s < 3t$ ,  $I$  cannot gain from departing from  $m = 0$  in order to corner the market. It suffices to show

$$\pi_I^c(0) = s - t < \pi_I^s(0) = \frac{t}{2} + \frac{s}{3} \left(1 + \frac{s}{6t}\right),$$

which amounts to:  $\lambda(s) \equiv \frac{s}{3} \left(2 - \frac{s}{6t}\right) - \frac{3t}{2} < 0$ . Since  $\lambda(3t) = 0$  and  $\lambda'(s) > 0$  (when  $s < 3t$ ), it follows that  $\lambda(s) < 0$  for  $s < 3t$ .

Consider now a candidate equilibrium in which  $E$  corners the market, then  $p_I = c + m$  and  $p_E = c$ . Moreover, the pair of prices  $(F_I, F_E)$  must satisfy

$$v(c + m) - F_I \leq v(c) - F_E - s - t.$$

In addition,  $I$  should not make any profit by attracting a few customers, i.e.,

$$F_I \leq f - mq(c).$$

But combining those two conditions yields

$$\pi_E = F_E - f \leq v(c) - v(c + m) - mq(c) - s - t,$$

where the right-hand side is maximal for  $m = 0$ , where it is equal to  $-s - t < 0$ . Therefore, in the absence of termination-based price discrimination the entrant cannot corner the market.

## Receiver-pays regime

In most European countries mobile operators do not charge subscribers for receiving calls even if it is not explicitly forbidden by NRAs. In contrast, in the United States mobile network operators usually charge subscribers for the calls they receive. The reason may be an endogenous price response to the level of the termination charge, i.e., low termination charges in the U.S. may induce networks to charge their subscribers for receiving calls so as to recover their cost – indeed Jeon, Laffont and Tirole (2004), and López (2011) show that network operators only find it profitable to charge for incoming calls when the access charge is below cost. This result is also in line with that of Cambini and Valletti (2008), who develop a model of information exchange between calling parties.

Jeon, Laffont and Tirole (2004) and López (2011)<sup>33</sup> show that, when networks compete in three-part tariffs of the form  $\{F_i, p_i, r_i\}$ , where  $r_i$  denotes a per-unit reception charge, then in equilibrium they charge call origination and call reception at the off-net cost<sup>34</sup>:

$$p_i = c + m, \quad r_i = -m.$$

Moreover, López (2011) shows that when setting usage prices at the off-net cost,  $i$ 's profit writes as  $\hat{\pi}_i = \alpha_i(F_i, F_j)[F_i - f]$ , which does not depend on  $m$ . In other words,  $m$  affects the usage prices but it does not affect the competition in fixed fees. As a result the access charge has not impact on the equilibrium profit. Therefore, in the absence of termination-based price discrimination, networks cannot use access charges to soften or foreclose competition when they charge for incoming calls.

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<sup>33</sup>López (2011) generalizes the framework of Jeon, Laffont and Tirole (2004) by allowing a random noise in both the callers' and receivers' utilities, by removing the assumption of a given proportionality between the utility functions and by allowing asymmetry between firms with respect to the installed market shares.

<sup>34</sup>López (2011) show that this equilibrium exists and is unique even if the random noise of the utilities does not vanish, and thereby receivers can hang up. Cambini and Valletti (2008), and Jeon, Laffont and Tirole (2004), however, consider the case of vanishing noise, where the caller determines the volume of calls 'most of the time'.

## 6 Conclusion

We have studied the impact of reciprocal access charges on entry when consumers face switching costs, and networks compete in three-part tariffs, charging possibly different prices for off-net calls. The analysis shows that when the incumbent benefits from customer inertia, it has an incentive to insist on the highest possible (reciprocal) access mark-up, so as to foreclose the market and exploit fully the resulting monopoly power; a large termination subsidy could also achieve the same outcome, although subsidies may in practice be limited by feasibility constraints and moreover trigger various types of arbitrage.

The scope for foreclosure is more limited if the entrant benefits instead from customer activism; while the incumbent can still wish to manipulate the termination charge in order to prevent entry, too high access charges might then allow the entrant to overtake the incumbent. As a result, optimal foreclosure strategies rely either on limited access markups or on access subsidies, and are profitable only when consumers' switching costs are large enough.

Irrespective of whether customers tend to favour the incumbent or the entrant in case of multiple potential responses to networks' prices, foreclosure strategies are profitable here only when they result in complete entry deterrence: while the incumbent can increase its market share by insisting on above-cost reciprocal charges, this also results in more intense price competition and, as a result, both operators' equilibrium profits are lower than when the reciprocal access charges are at or below cost. In other words, limiting entry without deterring it entirely is never profitable. This result has clear policy implications.

Finally, the network effects created by termination-based price discrimination appear to be a key ingredient for profitable foreclosure strategies. Indeed, in the absence of on-net pricing, neither the incumbent nor the entrant find it profitable to manipulate the access charge so as to foreclose competition. In addition, in a receiver-pays regime, neither operator can use the access charge to foreclose competition.

Further research can extend the analysis in at least two directions. First, in our model

there is only one incumbent and one entrant. As we usually observe tight oligopolies, our analysis could be extended to allow for an incumbent (possibly symmetric) oligopoly fighting the arrival of a new entrant. Second, it would be interesting to allow for the arrival of new customers who are not attached to the incumbent network. In this context, the incumbent network may find it profitable to set the access charge so as to keep cornering its customer base while sharing the segment of new consumers.

## 7 APPENDIX

**Proof of Proposition 2.** Using (8) and (12), network  $i$ 's profit can be written as

$$\pi_i = \frac{\varphi(m)}{2} (2\alpha_i)^2,$$

where  $\varphi(m) > 0$  (from (10)). Replacing (13) into this expression yields

$$\pi_i(m) = \frac{\varphi(m)}{2} \left( 1 + \frac{\delta_i s}{3\psi(m)} \right)^2. \quad (35)$$

For the sake of exposition, we will assume that  $q(c+m)$  remains positive; it is easy to extend to the case  $q(c+m) \geq 0$ .<sup>35</sup>

It is straightforward to check that, for  $m > 0$ , both  $\varphi$  and  $\psi$  decrease with  $m$ . It follows that  $E$ 's profit decreases with  $m$  when  $m > 0$  (since both  $\varphi$  and  $2\alpha_E = 1 - s/3\psi(m)$  decrease with  $m$ ).

We now show that  $I$ 's profit satisfies  $\pi_I(m) < \pi_I(0)$  for any  $m > 0$ . Since  $\delta_I = 1$  and  $\psi(m) = \varphi(m) + mq(c+m)/6 > \varphi(m)$ , we have:

$$\pi_I(m) = \frac{\varphi(m)}{2} \left( 1 + \frac{s}{3\psi(m)} \right)^2 < \Psi(m) \equiv \frac{\psi(m)}{2} \left( 1 + \frac{s}{3\psi(m)} \right)^2,$$

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<sup>35</sup>For  $m$  large enough,  $q(c+m)$  may become zero;  $\tau$ ,  $\psi$ ,  $\varphi$ ,  $\alpha_i$  and  $\pi_i$  then remain constant as  $m$  further increases and the analysis below still applies to the range of  $m$  over which  $q(c+m) > 0$ .

where

$$\Psi' = \frac{d}{d\psi} \left[ \frac{\psi}{2} \left( 1 + \frac{s}{3\psi} \right)^2 \right] \psi' = \frac{1}{2} \left( 1 + \frac{s}{3\psi} \right) \left( 1 - \frac{s}{3\psi} \right) \psi' = 2\alpha_I (1 - \alpha_I) \psi' < 0,$$

since  $\alpha_I \in (0, 1)$  and  $\psi'(m) = -[q(c+m) - 2mq'(c+m)]/3 < 0$ . Therefore,

$$\Psi(m) < \Psi(0) = \pi_I(0).$$

Similarly, for  $m < 0$  we have  $\psi(m) < \varphi(m)$  and thus:

$$\pi_I(m) > \Psi(m).$$

Since  $\Psi(0) = \pi_I(0)$  and  $\Psi'(0) = -2\alpha_I(0)(1 - \alpha_I(0))q(c)/3 < 0$ ,  $\pi_I(m) > \pi_I(0)$  for  $m$  slightly negative. ■

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