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Chapter 1

Completing the transition to a competitive domestic economy

The stalled income convergence and the economy's high reliance on international trade point to a need for a more balanced and stable income convergence process. This requires the development of a strong domestic economy, implying a substantial expansion of one of the smallest private service sectors in the OECD. This would constitute a growth driver as well as an improvement in international competitiveness as more competitively priced services are intermediate inputs in manufacturing production and contribute to stimulating innovation processes and product diversification. Promoting a competitive private service sector relies on the effective implementation of competition policy. Over the past couple of decades, many impediments to entrepreneurship have been dismantled and the foundations of a competitive market based economy established. The competition authority and its tools are close to best practice, but still have to uncover any domestic hard core cartels, pointing to a need for a review of its resources and some of its key tools, such as the leniency programme. Many of the network sectors remain dominated by vertically integrated state-owned incumbents, requiring additional measures to restrict public sector interference and securing non-discriminatory access to networks.

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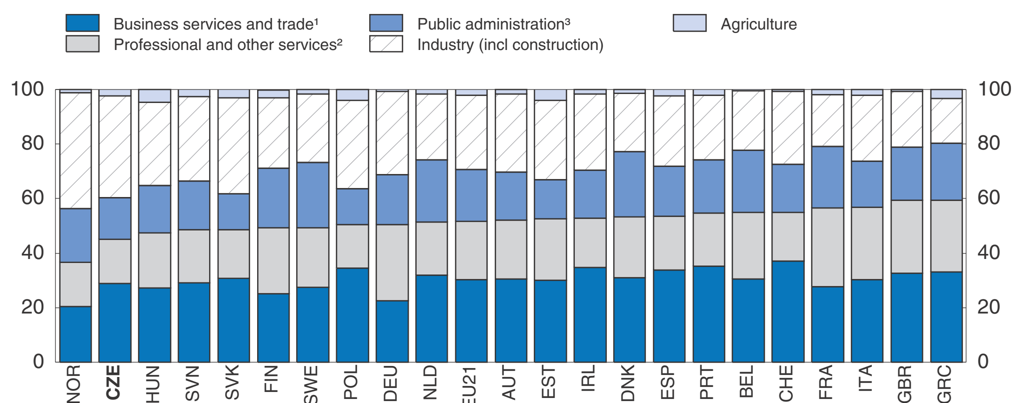
The Czech Republic's reliance on international trade makes it highly dependent on external sources of growth. A more balanced and stable income convergence process requires an equally strong domestic economy. This basically means putting policies in place to allow a strengthening of the private service sector, which is one of the smallest in OECD Europe (Figure 1.1). Fostering growth and, more importantly, productivity in domestic sectors of the economy has several benefits: it increases employment and output; it contributes to international competitiveness because of a positive relationship between services-sector reforms and the performance of domestic firms in downstream manufacturing sectors; and it helps to promote diversification. This chapter looks at the instruments for achieving this rebalancing, in particular by a more comprehensive application of competition policy instruments. Over the past couple of decades, many impediments to entrepreneurship have been dismantled and the foundations of a competitive market-based economy have been established. But judging by the relative performance of the Czech economy in a number of domains, much more needs to be done with respect to the regulatory and competition-policy environment.

Figure 1.1. **Relative size of the service sector, by value added**

In percentages of total gross value added, 2012



1. Wholesale and retail trade, transport, accommodation, food service activities, information, communication, financial and insurance activities.
2. Real estate activities, professional, scientific and technical activities, administrative and support service activities, arts, entertainment, recreation and other service activities.
3. Public administration, defence, education, human health and social work activities.

Source: Eurostat.

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The first section of this chapter identifies potential problem areas. At the aggregate level, competitive distortions are indicated by a combination of excess returns on capital, low productivity and high prices. These indicators are a useful starting point for an

investigation into potential problem areas, but need to be cross-referenced to indicators of firm size and market power. Then institutional encouragements or barriers to competition are identified: the degree of competition is negatively related to the regulatory and administrative barriers, which prevent market entry and firm development, as well as to the extent of state-ownership. The succeeding sections discuss the application of competition law, both in general and in the regulated network sectors.

In many sectors consumer welfare can be boosted by passing on productivity gains

Deficient competition is associated with high profit margins and prices and low productivity (OECD, 2002). In the Czech case, several sectors have profit margins above the EU average: telecommunications, civil engineering, manufacturing, retail trade and transportation (Figure 1.2, panel A). Other, not fully compatible, evidence shows sectors with high margins also have high prices (panel B). Below-average productivity performance is associated with relatively low gross operating rates and many service sectors (real estate, professional, technical services, etc.) fall into this category. Here, competition problems may be growth constraining. High productivity and low margins tend to suggest the absence of competition problems in the energy sectors: electricity and gas generation and distribution.

The EU's Consumer Markets Scoreboard assesses consumer conditions on the basis of six criteria: comparability, trust, problems and complaints, satisfaction, as well as choice and switching. All relate to the ability of consumers to make informed choices and of markets to reward efficient and innovative businesses. The overall assessment of market performance in the Czech Republic is below the EU average, and has declined sharply in the past 2 years, from being the second highest in 2010 to 22nd in 2012 (European Commission, 2012a) (Figure 1.3). However, there are large sub-sectoral differences with particularly poor performance in areas, such as telephone services and retail services.

Linking profits, productivity and price performance to the sectoral size and composition of firms may give a first indication of where competition problems might originate. A sectoral breakdown in turnover by firm size (measured by employment) gives a proxy measure of either concentration or dominance and shows that the sectors identified above as benefiting from above-average profits and prices are (mainly) those where large firms (those with 250+ employees) dominate (Figure 1.4, panel B). These include ITC, civil engineering, the retail trade and the manufacturing sector, all to a greater extent than the EU at large (Eurostat, 2013). These are sectors where size and economies of scale are important for productivity, but where consumers and/or end-users have not necessarily benefited price-wise to the extent they might have. Conversely, sectors relating to personal services, building construction and wholesaling are more fragmented and more price competitive, but also less productive. In between are the (regulated) network sectors, where the energy industry is concentrated, productive and relatively price competitive (but where mining is even more concentrated but unproductive and price-unfriendly) and the transport industries.

Thus, in important segments of the economy, size and/or dominance have helped raise productivity, but also profits and prices, suggesting that the welfare gains have not been fully shared by consumers and/or end users. On the other hand, smallness is associated with inefficiencies which reduces consumer welfare, but a dynamic undergrowth of SMEs can often boosts choice and innovation. In either case, policies which

Figure 1.2. **Productivity and gross operating rate by sector**

Note: Classification of economic activities follows NACE Revision 2.

1. Wage-adjusted labour productivity (WALP) is defined as value added divided by personnel costs (expressed as a ratio in percentage terms). This indicator is based on expenditure for labour input (rather than a headcount of labour input) and is more relevant for comparisons across activities (or countries) with very different incidences of part-time employment or self-employment. The gross operating rate (GOR) is the ratio of gross operating surplus to turnover (%).
2. Excluding the financial sector.
3. Excluding motor vehicles.

Source: Eurostat and OECD calculations.

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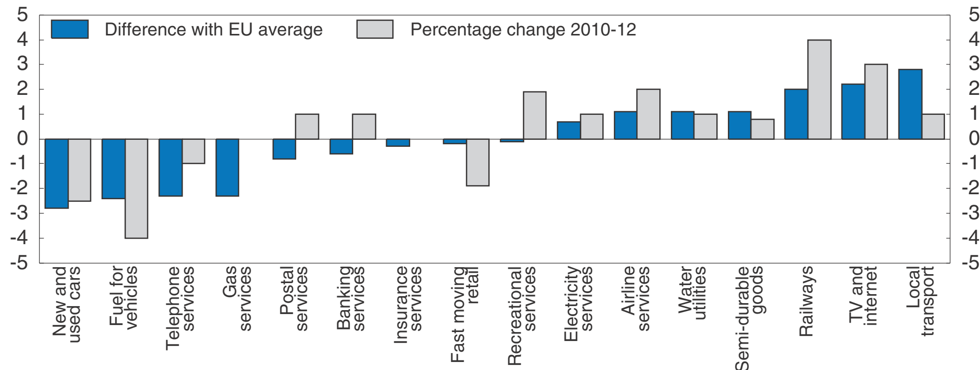
reduce the effects of dominance and facilitate SME growth – more effective competition surveillance in the first place and reduced regulatory entry barriers in the second – are likely to be consistent with more balanced and welfare-enhancing growth. At the same time, areas with high concentration and productivity growth have benefited consumers via lower prices – an effect that probably depends on the quality of regulatory oversight.

Figure 1.3. **Consumer market scoreboard: Czech Republic versus EU average**

Percentage change or change in market performance index (MPI)



Source: European Commission, Directorate-General for Health and Consumers (2012), "Consumer Markets Scoreboard: Making markets work for consumers".

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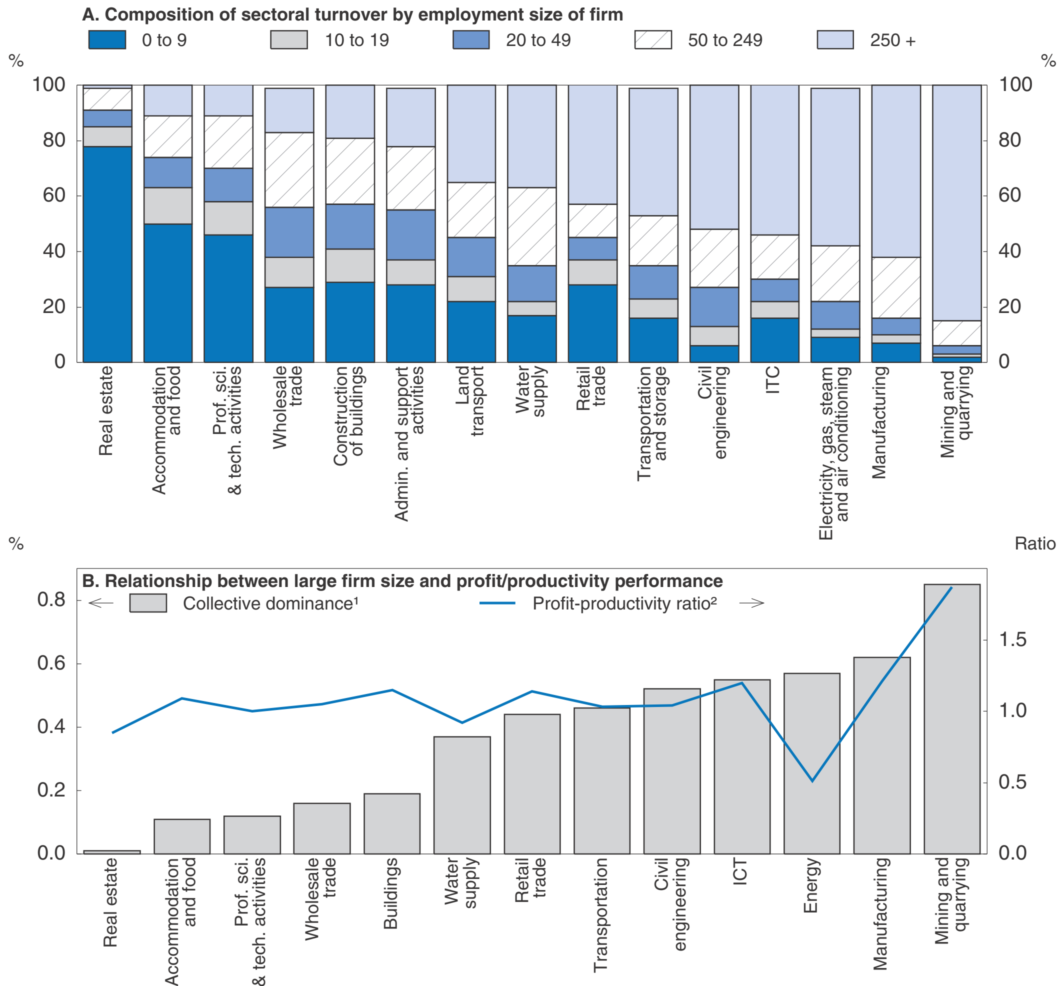
Figure 1.4. **Proxy measures of sectoral dominance**



1. Percentage of firms over 250 employees in total turnover.
2. Ratio of gross operating rate to productivity.

Source: OECD calculations based on Eurostat data.

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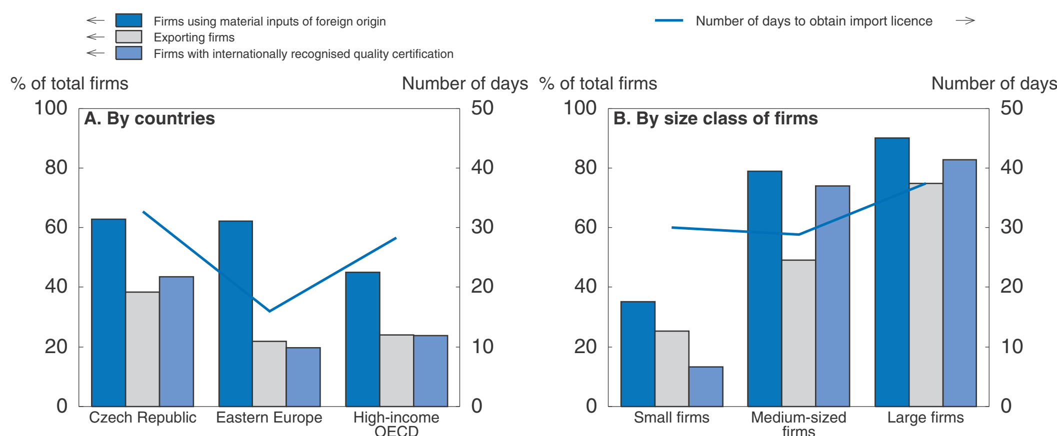
Reducing regulatory and administrative barriers

Czech firms are well integrated into the international supply chain, with 90% of large firms active in the export market, a proportion falling to half for mid-sized enterprises and quarter for small firms (World Bank and IBRD, 2009). A relatively high proportion of all firms use material inputs/supplies of foreign origin (Figure 1.5). In terms of FDI restrictiveness, the Czech Republic is slightly less liberal than the top 10% of the OECD economies, and remaining restrictions are concentrated in agriculture, transport and real estate (Kalinova et al., 2010). On the other hand, the World Bank's *Ease of doing business* indicators show considerable room for facilitating trading across borders, particularly in terms of improving documentation requirements, administrative delays and costs (World Bank and IBRD, 2013), which would support the export sector and facilitate the entry of SMEs into export markets.

Figure 1.5. **International openness**



Source: World Bank and IBRD (2013), *Doing Business 2014, Economy Profile: Czech Republic, www.doingbusiness.org/~/media/giawb/doing%20business/documents/profiles/country/CZE.pdf.*

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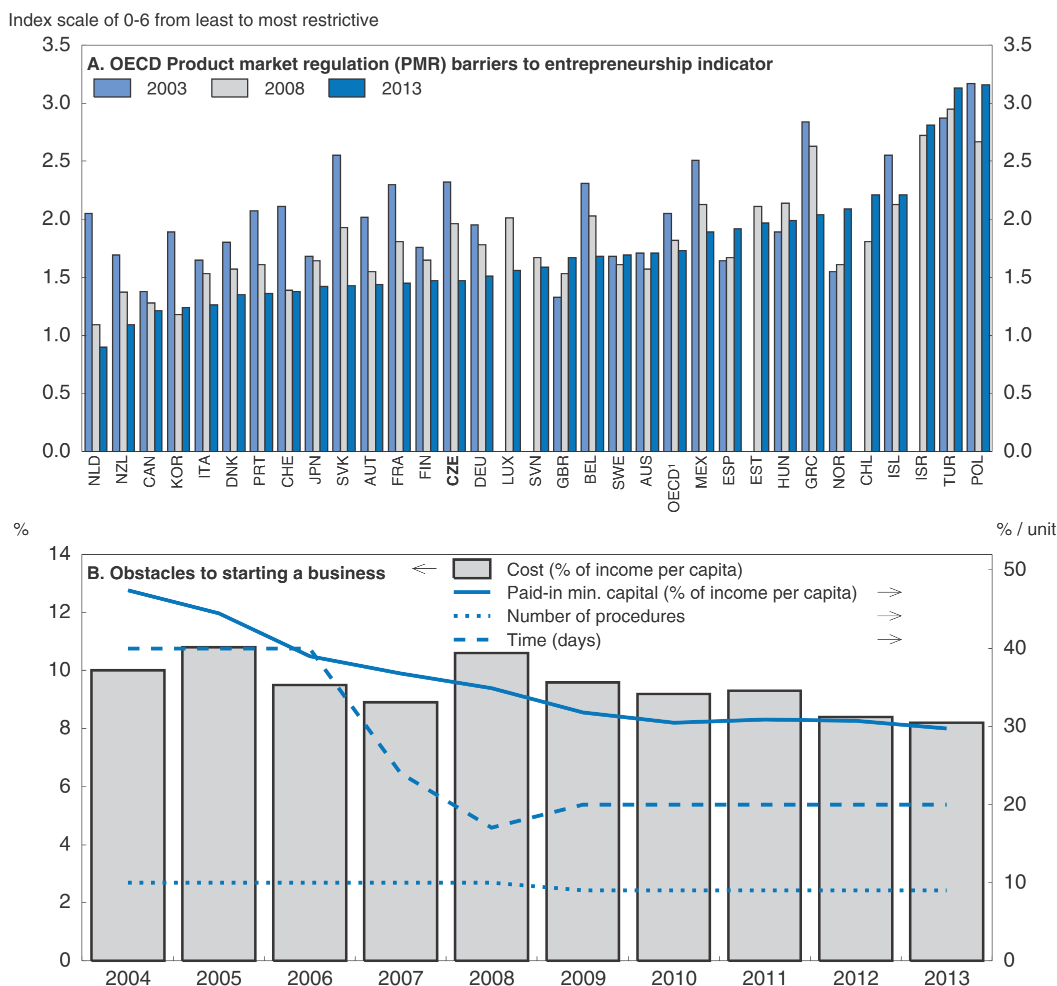
Significant barriers to entrepreneurship remain according to the recently updated OECD Product Market Regulation Indicator (Figure 1.6, panel A). In the domestic market, construction permits have become substantially easier to obtain as a result of reductions of bureaucratic delays in processing the registration of new plots, while property registration has also been streamlined (World Bank and IBRD, 2009). The cumbersome regulation of business start-ups for sole proprietors and new companies has improved with a substantial cut in the time required for registering new enterprises. Moreover, the costs involved were significantly above the OECD average because of minimum capital requirements (panel B). In early 2014, the latter was reduced from CZK 200 000 to CZK 1.

The enterprise birth rate is relatively high, while the survival rate for firms is below average (Figure 1.7). To some extent, this could indicate flexibility. In this perspective, market entry and exit may be encouraged by the newly improved bankruptcy regime. On the other hand, the relatively low survival rate probably reflects the exiting of least productive firms as well as residual operational impediments. Progress towards a lighter regulatory regime has been slower at local level, and in many areas the processes that provoke the most complaints are often handled by municipalities. The cost of doing

Figure 1.6. **Barriers to entrepreneurship**



1. Average of the OECD countries for which data are available in 2013.

Source: OECD, "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", ECO/CPE/WP1(2013)14; World Bank (2013), *Ease of Doing Business*.

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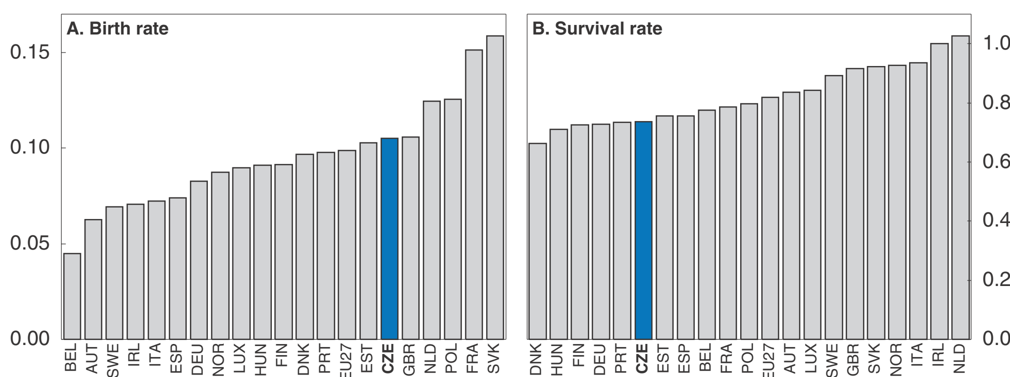
business may be further inflated by the difficulties of obtaining legal recourse for breach of contract, investor protection or liquidation (World Bank and IBRD, 2009). The judicial system scores relatively highly for integrity, but can be slow and expensive. Moreover, cost estimates of contract enforcement, in terms of both time and money, are high compared with most of the EU. Reducing legal delays with respect to contract enforcement should be a priority, as should reducing local authority interference with business.

A common complaint from Czech business is about "gold-plating" regulation, where the Czech implementation of European regulations exceeds the terms of European Community directives. There is no official policy in the Czech Republic related to "gold plating" *per se*; however, generally, the requirements of EC law are strictly kept and national standards are usually above the minimum standard level. This can lead to industry competitiveness impairments if this leads to more burdensome regulation than in other EU countries. Against this background, and following practice elsewhere in the OECD,

Figure 1.7. **Birth and survival rates for enterprises**

In percentage of active enterprises



Source: Eurostat.

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procedures have been put in place to analyse legislation *ex ante* for its regulatory impact. Regulatory impact assessments (RIA) were first adopted in 2007. However, the original process had several weaknesses; including a formalistic approach and verbal evaluation of regulatory alternatives, preventing *ex ante* and notably *ex post* efficiency assessment of the proposed and adopted regulations and a weak level of independence in assessing quality (Vitek, 2012). Another weakness was the option to perform only a reduced version – the so-called small RIA – which required only a qualitative assessment without comparing benefits and costs of various options.

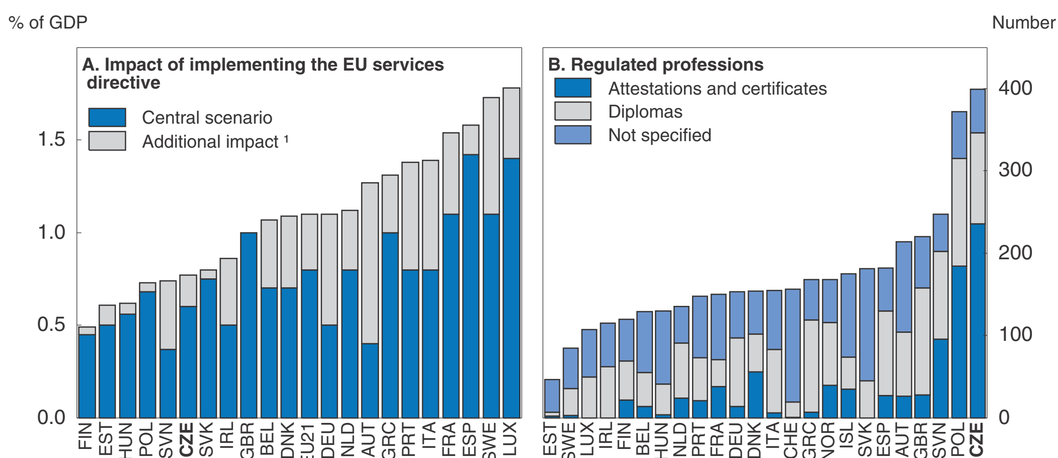
In December 2011 the rules and institutions of RIA were reformed with a view to reducing the formality of the RIA process, removing exemptions from the obligation to carry it out, bringing forward RIA to the initial stages of the debate – summary impact assessments must be carried out even before the work on a new regulation is initiated – and strengthening the independence of the RIA committee. Regulatory impact is still assessed mainly *ex ante*, but results from 2012 indicate a shift in a positive direction, both in terms of the quality of the processed RIA by individual departments and in their approach to RIA (fewer exemptions being allowed, with greater understanding of the process as a way to improve regulation). The Committee is now staffed only by experts (notably academics) outside of the state administration and its activities are overseen by the secretariat of the Office of the government. A definitive assessment of the effectiveness of the rules in reconciling non-economic regulations with legitimate business concerns about the commercial burden of compliance requires more time. However, the strengthening of the Committee's independence should provide a means to make the regulatory impact assessment process more effective.

Many of the regulatory barriers to entry into services, as defined under the EU Services Directive (in force since end-2009) have been abolished. The full implementation of the services directive is projected to yield benefits of 0.6% in terms of GDP growth and employment – slightly less than the EU average. Moving beyond the services directive and achieving the level of restrictions of the five best countries would bring additional gains of ¼ per cent of GDP (Figure 1.8, panel A) (European Commission, 2012b). In terms of the

severity of barriers, the Czech Republic is amongst the member states with the highest number of regulated professions (Figure 1.8, panel B).

The most problematic aspect of regulation of professions is confusing legislation, arising from the fact that many professions are regulated by separate legislation for individual sectors (World Bank and IBRD, 2013). According to the survey, the desired way forward should be to prioritise practical skills and outcomes over formal education (e.g. by introducing minimum quality requirements), and to streamline and clarify job requirements. At the same time, demands for the quality of professions should not be lowered. There have been already some tangible results of the survey: several regulated professions were merged into a more general one (e.g. revision of electrical appliances and maintenance of these into just one profession) with another 13 mergers in the pipeline. The Czech Republic could go further in reducing domestic barriers to entry in services, including opening up sectors not covered by the Services Directive. More profound changes are particularly required in some professional services, which would require changes in legislation.

Figure 1.8. **Services liberalisation**



1. Effects of reducing service restriction to the level of the five best countries in the European Union.

Source: EU Single Market Regulated Professions Database.

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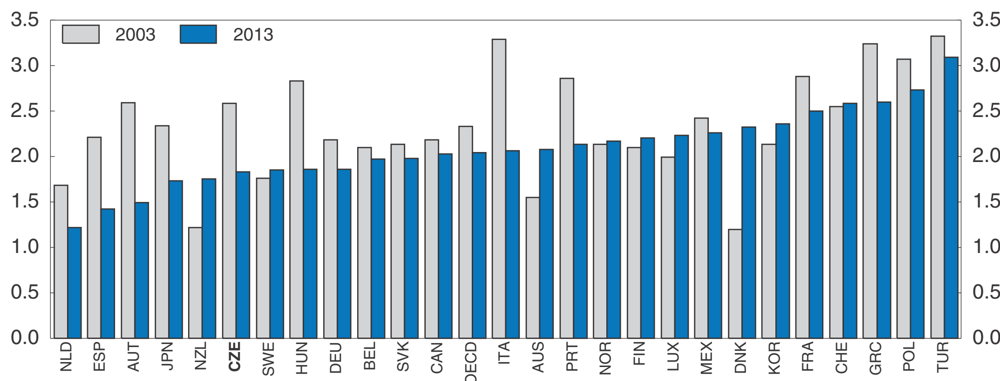
State ownership and market interference is still significant in a number of sectors

The state-owned enterprise sector has been reduced by successive waves of privatisation, but public ownership remains substantial. Telecoms, banking and gas are now in private hands, but there is still significant state ownership in the energy and transport sectors (railways, airports and the airline industry) (Figure 1.9). There are also a significant number of smaller SOE's, some of which are involved in commercial activities – most notably the brewing industry and military equipment and engineering production – and others involved in administering state assets, such as the management of the state-owned *Forests of the Czech Republic*. Municipalities may also be involved in quasi business operations, such as waste disposal. From a competition point of view, the presence of SOEs in commercial market raises issues of level playing fields, including problems of implicit subsidies, cross-subsidies from protected to market activities, and political risks – all acting as barriers to entry.

Figure 1.9. **State-owned enterprises**

OECD Product market regulation (PMR) state-control indicator, index scale of 0-6 from least to most restrictive



Note: The OECD average includes only countries for which data are available in 2013.
Source: OECD, "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries" (ECO/CPE/WP1(2013)14).

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Czech SOEs have had governance problems with negative impacts on competitive conditions in the public procurement market. State-owned enterprises' executive and supervisory boards are effectively controlled by political nominees (at times with multiple positions), many of whom have few qualifications or experiences in this area. Contrary to the OECD recommendations, there are no rules for securing transparent and responsible appointments and replacements. The Supreme Audit Office (SAO) finds that among the most serious shortcomings in the management of state assets are disadvantageous contract settlements, uneconomical approaches to outsourcing consultancy, advisory, legal and other services and manipulation of tender conditions – frequently with the division of public contracts into two or more independent small-scale contracts to avoid a tender (SAO, 2013).

State enterprises engaged in commercial activities should either divest such activities or themselves be divested. The governance of the remaining SOEs needs to be more effective and public control more transparent. In particular, state-ownership policy needs to define measurable goals of these enterprises, establish legal accountability of managers and criteria for rewarding them. A harmonised management model respecting competitive neutrality (OECD, 2012), in line with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, could help to address these problems. In particular, the responsibility for corporate governance of SOEs should be moved from line ministries to a single authority, which should focus on a hands-off corporate governance system with professional boards and management and requirements of profitability that are in line with those prevailing in the sector.

The public procurement market has been distorted by corrupt anti-competitive behaviour, through the breach of procedures and standards during the awarding procedure, suppressing of economic criteria and calculated misuse of legal exceptions. Issues related to irregularities in public tendering have increased since 2010 (OPC, 2012). In 2011, the Competition Authority (responsible for oversight of the Public Procurement Act) received a record number of petitions and submissions to initiate administrative proceedings and issued a near-50% higher number of fines. Contracting authorities were most frequently

guilty of failing to observe rules and regulations, setting discriminatory and non-transparent tender terms and conditions, and requiring inappropriate qualifications. In recent years, the state has spent a significant share of resources on public ICT contracts, which have tended to be awarded in the form of negotiated procedure without publication (NPWP) – increasing the risks of cost ineffectiveness, restriction of competition and discrimination. These risks are enhanced by insufficient contract specification, failure to use pricing directives and breaches of the prohibition to discriminate against bidders.

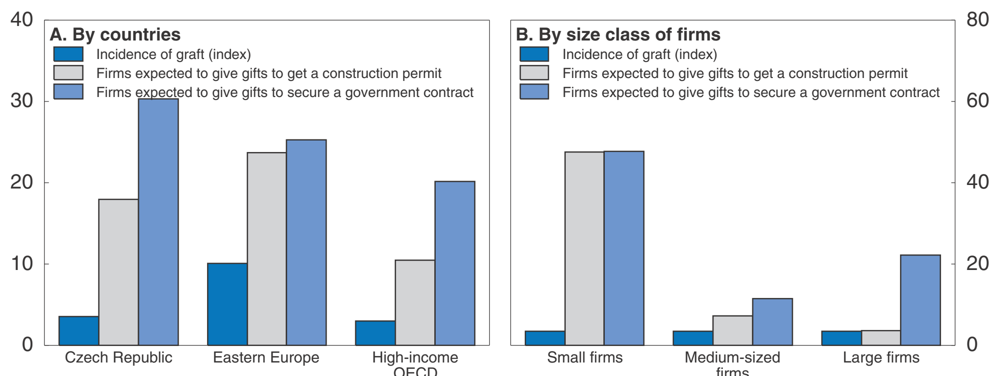
Irregularities in public procurement partly arose from a lack of transparency in the tendering process itself. Amendments to the Public Procurement Act in April 2012 aim at making the tendering process more open to invigilation in order to make corruption easier to deter and detect as well as opening up for greater co-operation between contracting authorities, tenderers and line ministries to create a more competitive and transparent tender environment. Key changes include an obligation for the contracting authority to publish tender documentation, the price actually paid for an entire contract and the role of subcontractors. As a result, surveillance should become more effective, but administrative demands on both contracting authorities and suppliers have increased and difficulties in implementation have been reported by local authorities. While a strengthening of competition oversight is to be welcomed, this comes at the risk of added implementation problems, which have blighted, for example, the disbursement of EU structural funds: since 2007, only slightly more than half of the allocated EU funds have been paid out. Improving spending efficiency in this area has necessitated the adoption of an action plan to strengthen the management and control system for the implementation of EU funds, to counter complaints about complicated and lengthy administration and other barriers to realisation of projects. Ensuring efficiency and value for money in public contracting remains an important ongoing challenge.

Irregularities in the disbursement of public funds also concern the professional integrity of civil servants, pointing to a need for a new Public Servants Act to separate political appointees from non-political staff, guarantee independence of state officials and create a well-functioning career system to reduce high staff turnover. Moreover, the Czech Republic has an unfavourable ranking in Transparency International's corruption index (Figure 1.10) as is the case with the scores concerning perceptions and actual experiences of corruption reported in a recent EU report (European Commission, 2014). Also, there is low awareness of international bribery risks as addressed by the OECD anti-bribery convention (OECD, 2013a).

Prison sentences for bribery were raised in 2011 and police have been given expanded investigation tools, such as wiretap authority, to investigate bribery. These changes have increased prosecutions of high-level public corruption. Also, new senior leadership in the state prosecutor service in 2011 and 2012 has significantly improved its effectiveness and reduced its susceptibility to political pressure. However, achieving convictions is difficult due to the absence of a system for granting immunity to persons willing to testify, the lack of a specialised prosecutorial body, inadequate legislation with respect to disclosure of source of assets and the use of anonymous bearer bonds – tools that have been used to hide the true ownership of companies winning public contracts (USDS, 2013). The 2006 Conflict of Interest Act obliges legislators, members of the Cabinet, and other selected public officials to make annual asset declarations, but they are often general in nature and lacking in detailed information, and third parties can only view such declarations in person based on a written request.

Figure 1.10. **Transparency International corruption index, 2009**

In percentage of total firms



Source: World Bank and IBRD (2009), *Enterprise Surveys: Czech Republic.*

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Competition law and its enforcement

Czech competition law is fully harmonised with EU competition rules (Box 1.1). It has three basic provisions: the *ex ante* vetting and approving of mergers; the prosecution of cartels involved in collusive anti-competitive behaviour, and the prosecution of abuses of dominant market positions. The agency responsible for competition enforcement is the Office for the Protection of Competition (OPC) (OPC, 2012b). Agency resources are somewhat inferior to the OECD average (OECD, 2008). However, a more salient issue is the skewed allocation of resources: the OPC allocates three quarters of its 200 staff to public procurement, state aid and abuse of significant market power (typically an issue in network sectors), leaving only a quarter on fighting cartels, investigating notified mergers and reviewing other competition issues. An additional concern is that the staff tends to be relatively young (with an average age of 35) and turnover quite rapid as average tenure is 5 years. Hiring outside experts is complicated as contracts exceeding CZK 750 000 have to be approved (as is the case for all government entities) by the government. Overall, competition policy enforcement has faced resource problems, requiring some increase in its capabilities in recent years. In 2012, OPC was expanded with 12 new staff, which together with an increased budget, could suggest that enforcement is in the process of becoming more rigorous.

There is a right of appeal against decisions of the competition authority and a possibility of judicial review by the Administrative Regional Court in Brno. However, the process of competition law enforcement can become very long and drawn-out, especially when the OPC and the court have markedly different opinions, as for example is the case over the definition of the relevant market. Indeed, the rate of success of the OPC in the courts has gone down at the same time as delays have gone up: the Court is currently reviewing cases from 2001. Until 2010, a single judge was responsible for all competition cases, but these are now allocated equally between the Court's chambers. Whether this will make it less difficult to tackle large complicated cases in an effective and timely manner remains to be seen. Moreover, as discussed below, the OPC is adopting a more economic and less formal approach to competition law enforcement, which may not reduce the scope for judicial debate. Under all circumstances, a more effective competition policy requires a markedly shorter judicial review process.

Box 1.1. **Anti-trust legislation and enforcement in the Czech Republic**

Legislative framework for competition policy

Competition legislation includes three basic provisions: the duty to notify mergers and have them cleared before they can be executed; the prohibition of anti-competitive agreements and the prohibition of abuses of dominant positions.

With respect to *mergers, the* Competition Act imposes the so-called SIEC (Substantial Impediment to Effective Competition) test, a combination of the SLC (Substantial Lessening of Competition) test and a dominance test. The key element is whether there is a significant impediment to competition as a result of a concentration. Concentrations are seen as not liable to impede effective competition if a combined market share of undertakings concerned does not exceed 25%. To measure concentration levels, the Office applies the Herfindahl-Hirschmann Index (HHI) and its pre-merger to post-merger change ("delta") as first indications of an alteration in competitive constraints in the market following the merger, similar to EU practice.

Anti-competitive agreements: Prohibitions include direct or indirect price fixing (including resale price maintenance); direct or indirect fixing of other terms and conditions; restrictions on production, sales, purchases, R&D or investment; division of markets or sources of supply; the application of dissimilar conditions to identical or equivalent transactions with other undertakings; tying clauses, and group boycotts. Prohibited agreements exclude agreements that contribute to an improvement in the production or distribution of goods and allot an adequate part of the advantages resulting from it to consumers.

Abuses of dominant positions: The Competition Act prohibits abuse of dominant position, including direct or indirect enforcement of unfair conditions in agreements with other participants in the market, especially contracts which are conspicuously inadequate to the counter-performance provided. An assumption is made that an undertaking that does not exceed a combined market share of 40% does not hold a dominant position in the relevant market. Moreover, it is not prohibited *per se* by the Competition Act and the undertaking has no obligation to inform the OPC of such a position. Only conduct that may be classified as exploitative, exclusionary (predatory) or structurally abusive is prohibited.

Enforcement

The Office for the Protection of Competition (OPC) has extensive powers to request documentation and information, while its employees have the power to enter premises, inspect commercial documentation, etc., including dawn raids. It may require that an infringement is stopped; order interim measures; accept commitments; and impose fines of up to 10% of the net turnover. From January 2010, prison sentences of up to three years can be imposed for price fixing, market sharing or other (horizontal) agreements with anti-competitive effects (increased to between six months and five years if such act has been committed as part of an organised group or has been repeated, or considerable damage or profit for the guilty party was made). In practice, fines have been infrequent because concluded cases have been infrequent – there was only one anti-cartel verdict in 2012, leading to a fine of EUR 3.7 million. There have not been any cases leading to the actual use of criminal sanctions.

Mergers and concentration

No merger transaction for which notification is mandatory can be executed until cleared by the OPC. Transactions carried out in breach of the notification duty are null and void; the Office can even issue demerger orders (although this has never happened). Merger control proceedings have been simplified in recent years, with fewer requirements if the parties are not active on the same relevant market or their joint market share is below 15% (or in the case of vertical integration below 25%). Above that level, the so-called SIEC (substantial impediment to effective competition) test is imposed to reveal if there is a significant impediment of competition as a result of a concentration. When assessing possible impacts, the OPC takes into account the benefits to productive efficiency, via innovation, development and creation of new products, etc. This makes for a flexible and effective approach, as the Office is not strictly bound to the criterion of the creation or the strengthening of a dominant position and therefore the process is less vulnerable to erroneously prohibit welfare-enhancing mergers.

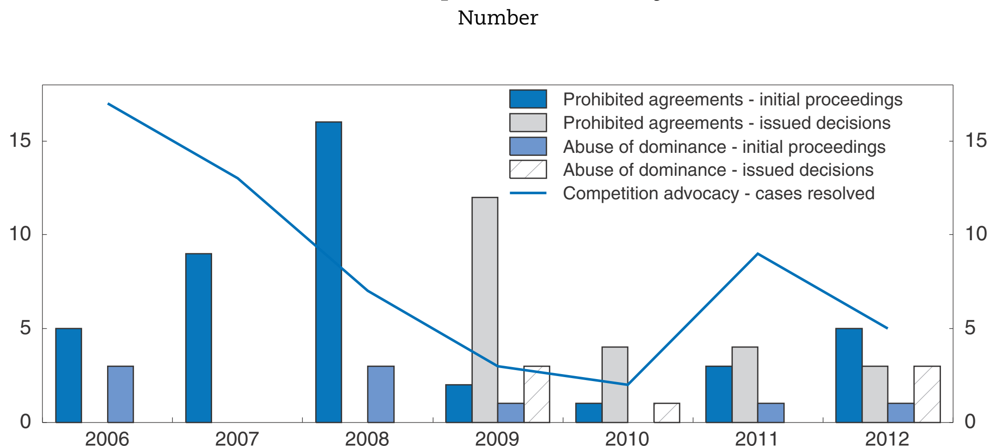
Overall, merger control operates at or near to best practice (OECD, 2008, 2009 and 2011). The criteria for assessing concentrations under the SIEC test are quite well-established and OPC's merger management is regarded as being highly competent by legal circles, the division tending to review deals in a "timely and appropriate" manner (GCR, 2013). The number of merger notifications has been running at around 50 per year in the last three years and of these around 6% led to in-depth review and 7% were challenged. In 2012, none of the challenged mergers were blocked or abandoned, though a majority were resolved with remedies. This acceptance rate cannot be considered as symptomatic of a bias towards erroneously cleared welfare-reducing or competition-reducing mergers, though there may be a bias towards larger firms in certain sectors with possible adverse implications for consumer prices (as discussed above). But it is difficult to be categorical in the absence of *ex post* impact assessments, which are not mandated by legislation. As the OPC's brief is evolving towards a more economic approach, with an emphasis on the impact on the market rather than the conduct in question, *ex post* impact evaluation studies become essential to the illumination of the *ex ante* decision finding process (Budzinsky, 2012). Retrospective assessments would also enhance transparency.

Prohibited agreements: Enforcing anti-cartel rules

The institutional background to anti-cartel horizontal agreements is also near to best practice (OECD, 2008). However, in practical terms the OPC has been criticised for focusing on easier cases and for being ineffective in addressing "real" cartels. Over the past 4 years, on average three administrative proceedings against prohibited agreements were initiated (Figure 1.11) and most were focused on bid rigging in public tenders. A leniency programme has been in operation for more than 10 years, but was not integrated with other legislation (the Administrative Procedure Code and Criminal Code), implying no real influence on the final court decision and little value in promises of leniency. Unsurprisingly, the programme has not unearthed any domestic cartels and the few applications for leniency have been related to EU antitrust proceedings. In 2012, the leniency programme was amended to increase its efficiency by making it an integral part of the Competition Act and applying it to individuals (who are subject to criminal sanctions). In addition, the redesigned programme grants individuals co-operating with the agency full protection from criminal prosecution and introduces the possibility of reduced fines for second, third and fourth leniency applicants, making the leniency programme a more powerful tool for unearthing cartels.

Figure 1.11. **Administrative proceedings initiated, decisions issued and competition advocacy**

Number



Source: Office for the Protection of Competition (OPC) (2012), *Annual Report 2011*.

StatLink http://dx.doi.org/10.1787/888933007658

The increased attention given to fighting hard-core cartels is combined with a growing emphasis on resolving cases by "competition advocacy": where the OPC decides not to initiate administrative proceedings in less serious cases, such as those with limited effects on competition or where participants were unaware of breaches, as long as the undertaking voluntarily commits to measures that eliminate the competition problem. On top of the existing *de minimis* rule on market shares, the OPC has gained greater discretion not to proceed against cases it considers less damaging, even where there is evidence of a prohibited agreement. To reduce the time needed to conclude administrative proceedings, the Competition Act now allows a competitor to admit responsibility for and cease anti-competitive conduct in exchange for a reduced fine. A danger here is that if the OPC never issues hard sanctions, firms may come to believe that everything can be negotiated and deterrence become weaker, particularly if enforcement is seen as subjected to industrial policy considerations. A recent revision of advocacy tools (see below) helps in countering this danger.

Better prioritisation, a higher staffing level, bigger fines and the strengthening of the leniency and settlement programmes could pave the way for more active and effective enforcement. As a sign of a tougher approach, the Office conducted a total of 18 dawn-raids in 2012. There is, nevertheless, a problem in that the investigatory rights of the OPC sometimes conflict with due process, such as protecting the privacy of legal entities (competitors) against the unannounced inspections of officials and against self-incrimination. Proving anti-cartel behaviour will thus remain difficult and ensuring a balance between the deterrent effect of enforcement and the protection of the rights of the affected parties remains a challenge.

The increased focus on bid-rigging may have significant effects. According to OPC estimates, the existence of a bid rigging agreement can typically make a public contract 10-50% more expensive. In the absence of agreement, each additional bidder in a tender reduces prices by up to 5%. The 2011 Public Procurement Act stipulates that the procurement process is suspended (i.e. no procurement takes place) if there are fewer than two tenders available for evaluation. At the same time, the OPC initiated the project Education and Transparency of Public Contracting Authorities to increase the awareness of

bid rigging behavioural patterns among public procurement suppliers. As of 2012, suppliers are required to submit an extract from the Corporate Criminal Register as part of fulfilment of their basic qualification prerequisites. The increased awareness of the profile of corrupt bids, together with severer sanctions, is an essential first step in bringing the problem of bid-rigging under control.

Identifying abuse of dominant position

The OPC initiated 12 cases against abuse of dominant position during 2005-11, a relatively small number (Figure 1.11) (Box 1.1). The OPC responds to complaints of abuse, such as predatory pricing. In 2011, it dealt with 171 submissions objecting to abuse of dominant position, but initiated administrative proceedings in only one of these cases. Abuse, particularly where it is collective, is difficult to prove. In evaluating whether a dominant position exists, the OPC examines whether there are legal or other barriers to enter the market, the market structure and the size of the market shares of the undertakings' immediate competitors. Generally, the OPC refers to decisions of the European Commission in order to define a relevant market, the juridical definition of which is a necessary prerequisite for resolving a case: importantly, there is a tendency to extend the relevant geographic market beyond the borders of the Czech Republic. The low ratio of case initiation to complaints presumably reflects a misunderstanding about the principle and definition of dominance on the part of the complainants, as well as enforcement difficulties related to insufficient market information.

Enforcement difficulties related to insufficient market information can be repaired by market, or sectoral, studies, which in other countries are considered an important part of competition advocacy and a tool to uncover abuses. In the Czech Republic, market studies have been few, but have become one of the priorities of the Office (as in the EU), aimed at identifying and subsequently eliminating long-term competition problems, especially in markets with a traditionally high concentration of large enterprises. The retail sector has been one of the first to be investigated, while a study of the brown coal market is now under way and a new inquiry into the gasoline retail market is under preparation.

A sector inquiry is a powerful tool for unearthing abuses of competition law. Econometric techniques based on large scale data – compiled from compulsorily provided enterprise data – can be used to identify both regulatory failures and competition law abuses (Box 1.2). They can thus be used as a basis for identifying structural reform needs and legal pursuit – as has proved the case in EU enquiries into the energy and pharmaceutical sectors. The principal drawbacks are the potential compliance costs to businesses and the due process problems of requiring information that can be self-incriminating. Provided these drawbacks can be overcome, the use of sector inquiries to bolster competition law enforcement is welcomed for its effects in identifying and eliminating existing abuses and in acting as a deterrent.

Box 1.2. **Sector inquiries**

Market studies and sector inquiries have become a common competition policy tool for the majority of competition authorities to investigate the functioning of markets or sectors when there are high prices or other symptoms of inadequate competition, but no specific evidence of collusion or abuse. A sector inquiry usually concerns the whole market and all its participants, and includes a wide scale of topics and relies on micro data, usually compiled by means of questionnaires, to identify market aberrations via econometric techniques. Depending on the specific circumstances, the authority may subsequently try to eliminate the identified regulatory barriers to competition by competition advocacy or commence an inquiry focused on a particular company for a specific suspected anti-competitive behaviour. EU experiences with inquiries have revealed that they can have policy and legal implications, the former leading to legislation to correct structural obstacles to competition, the latter leading to prosecutions for breaches of competition law by the relevant market participants.

The OPC enjoys considerable liberty and rights with respect to initiating inquiries. It is authorised to require the provision of information, commercial books, and records, relating to the subject of the inquiry, in any quantity and form (electronic or paper) as well as to conduct dawn raids in commercial (or private, subject to court permission) premises of the competitors in order to collect any commercial records located in these premises. A competitor who has failed to provide the required information or assistance during a dawn raid may be fined up to 1% of its annual turnover. As this fine is of a procedural nature, it may be imposed repeatedly, reaching 10% of the annual turnover in total.

However, unclear rules for the selection of sectors, the commercial costs of inquiries and the unlimited legal powers of competition authorities have led to criticisms. In particular, the grounds for deciding to commence a sector inquiry in a specific area need to be transparent and the costs incurred by businesses in supplying large data files for its economic and econometric tests need to be taken into account. The OECD has calculated that, in a model sector inquiry conducted by the UK OFT, the costs incurred in connection with such an inquiry may amount to up to EUR 7 750 million. There is an additional problem of due process: the current legislation for sector inquiries conducted by the OPC does not guarantee that the information obtained from an undertaking during a sector inquiry will not be used against them in subsequent administrative proceedings (Havel Holasek Partners, 2011).

Encouraging private enforcement

As is the experience of other EU countries and at the EU level, private enforcement of the antitrust law has faced difficulties, particularly in proving the facts, and is limited by the lack of provision in the competition law for third-party claims. The EU Court of Justice has recognised the right for all victims of antitrust infringements to be compensated for the harm suffered. However, due to procedural obstacles and legal uncertainty, few victims actually manage to obtain compensation. Indeed, determining the exact amount of damage suffered by consumers and businesses is often costly and difficult. Moreover, in the Czech Republic there appears to be a general distrust of the court system, due to its slowness and the low quality of judgments, particularly when it comes to stating lost

profit, which leads to an unwillingness to pursue claims in civil courts. This situation particularly affects consumers and SMEs, which most often do not engage in legal action for reparation.

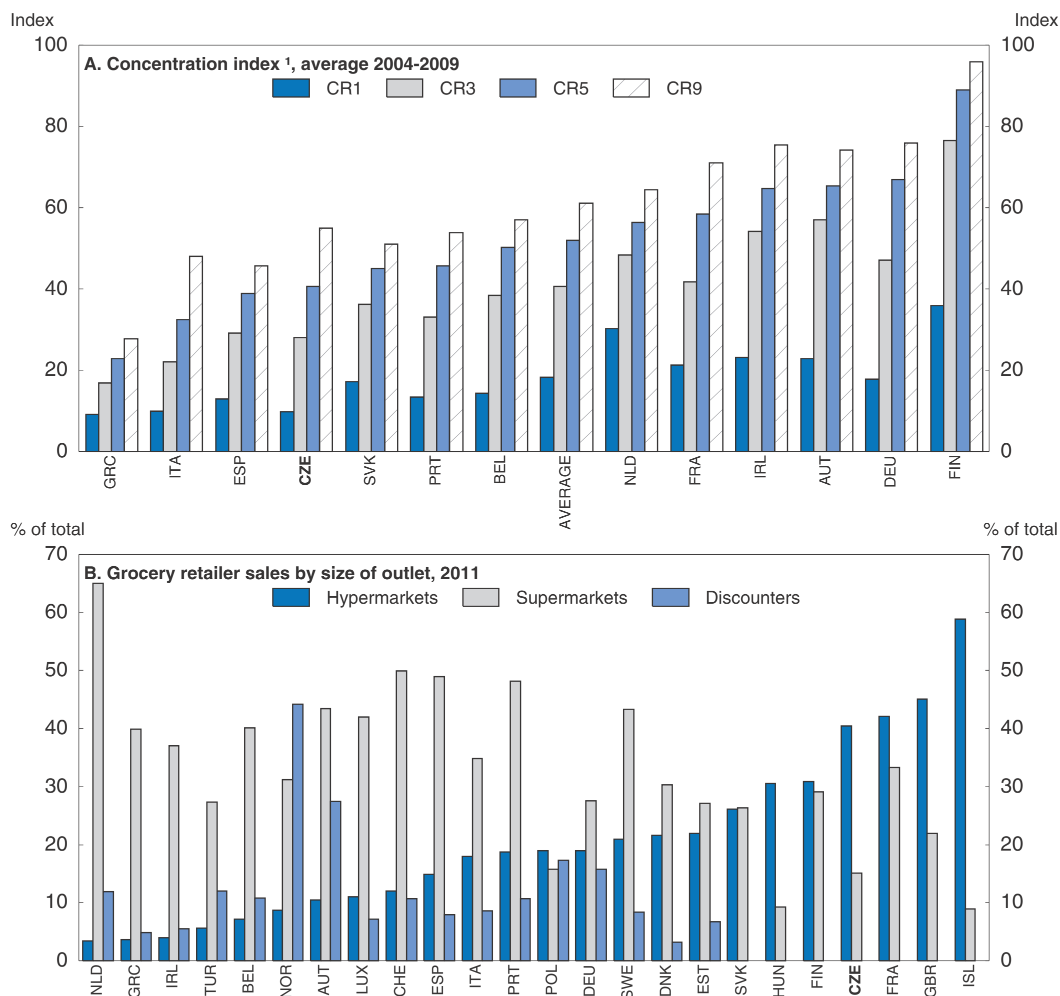
The OPC has a goal of increasing the use of private enforcement, while the Czech legislature is awaiting an EU Directive on the subject, after which member states will have two years to implement its provisions. The EU Commission proposals from mid-2013 aim to remove the practical difficulties which victims face when trying to receive compensation for damages, including giving national courts the power to order companies to disclose evidence, allowing decisions by national competition authorities to constitute automatic proof before the national courts and easing the time limits for third parties initiating procedures. In addition, rules to facilitate consensual settlements, together with (non-binding) guidance for assessing damages, allow a faster and less costly resolution of disputes. In parallel, the Commission has adopted a recommendation encouraging member states to set up collective redress mechanisms (European Commission, 2013). Overall, the proposals do not seek to leave the punishment and deterrence to private litigation, but rather aim to facilitate full and fair compensation for victims once a public authority has found and sanctioned an infringement. A problem in this respect is how the proposals interact with the leniency rules, as there is an inherent conflict between granting leniency and awarding compensation.

Application of the competition law to the retail sector

The retail sector, and more precisely the agro-food chain, has been the subject of a relatively high degree of competition policy activity, as elsewhere in the EU (ECN, 2012). Between 2004 and 2011, European competition authorities undertook a total of 182 antitrust cases in this sector, of which 9 in the Czech Republic were related to collusion (vertical and horizontal) and to abuse of dominant position within the producer/distributor supply chain (ECN, 2012). The OPC has taken the view that the modernisation process based on foreign direct investment (by the mid-2000s foreign firms accounted for over 40% of turnover) (ECB, 2011) and a switch to larger outlets (Figure 1.12), has allowed consumers to benefit from scale economies and rapid productivity growth (European Commission, 2009a), while leaving sufficient number of players for robust competition. The largest retail chains have a lower market share than in most other EU countries. In addition, none of the large retail chains has a market share above 15%, as compared with 20 to 30% in many other EU countries, and most Czechs live in districts where at least seven retail chains are active.

A cause of concern, however, is that relatively high retail-sector gross operating margins reflect a widening gap between producer and retail prices and is associated with a deteriorating market performance indicator for the fast-moving retail sector (as discussed above). As elsewhere, the atomistic farming sector is the weakest link in the supply chain, while the retail chains have acquired significant upstream market power. As a result, the retail sector has been criticised for keeping producer prices low while increasing margins (Bukeviciute et al., 2009). This has prompted an extended debate about market failures in the food sector, particularly relating to farmers obtaining a decreasing share of the wealth generated by the sector. This debate has led to competition policy in the retail sector being increasingly focused on producer-distributor relations rather than consumer interests.

Figure 1.12. **Concentration in the grocery sector**



1. A concentration ratio (CR) is a measure of the total output produced in an industry by a given number of firms in the industry. CR1, CR3, CR5 and CR9 concentration ratios refer to the market shares of the largest, three largest, five largest and nine largest firms respectively.

Source: ECB (2011); Euromonitor International, *European Market Data and Statistics 2013*.

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In 2012 the Supreme Administrative Court issued a cartel judgment in a case (initiated in 2002) concerning an agreement between two retail chains on the purchase prices for goods and the commercial terms they applied in relation to their suppliers. This is a reminder that undertakings that operate within a business relationship on the purchase side are not exempted from competition rules. The 2009 introduction of sector specific regulation (the *Act on Significant Market Power in the Sale of Agricultural and Food Products and Its Abuse*) aimed at curbing the market power of large food retailers (defined to effectively include many medium-sized retailers as any distributor with a CZK 5 billion net turnover is presumed to have significant market strength) *vis-à-vis* small suppliers of food and other agricultural products. The most important prohibitions are requiring listing fees, bearing of the retailer's marketing costs, sale below purchase price, or unjustified and sudden termination of a long-term commercial relationship. Violation can leads to suppliers

claiming damages and fines up to 10% of turnover. The new Act is rather prescriptive and brings a multiplicity of actions within the purview of competition law, including non-payment of invoices within 30 days of delivery, *ad hoc* changes to contractual terms, upfront payments for entry to negotiations, etc.

The Act is disruptive and may damage those it is intended to protect. Its effect has been to increase tensions between the retail chains and their suppliers. The OPC conducted a survey of the retail sector that did, indeed, unearth problems of payment delays, discount demands and complex and unclear systems of reductions and bonuses on the part of the chains (OPC, 2012). Currently, four administrative proceedings for violations of the Act are under way, looking at abusive terms in contracts. In addition, the OPC is considering more than 30 proceeding requests from market participants. All the cases require relatively wide-ranging investigations involving gathering information from a very large number of entities. This reflects that the Act is administratively unwieldy and has increased legal insecurity and uncertainty about its application. In addition, many retailers prefer to avoid potential problems by minimising their dealings with small suppliers and sourcing supplies from large organisations or requiring suppliers to sign non-dependence declarations. The regulation should not be part of the competition policy framework. Legitimate concerns over consumer protection should be addressed through health and safety regulation. Industrial policy and sector concerns should also be addressed directly. Contractual imbalances associated with unequal bargaining power should be tackled through other policy tools, such as contract and unfair commercial practices laws.

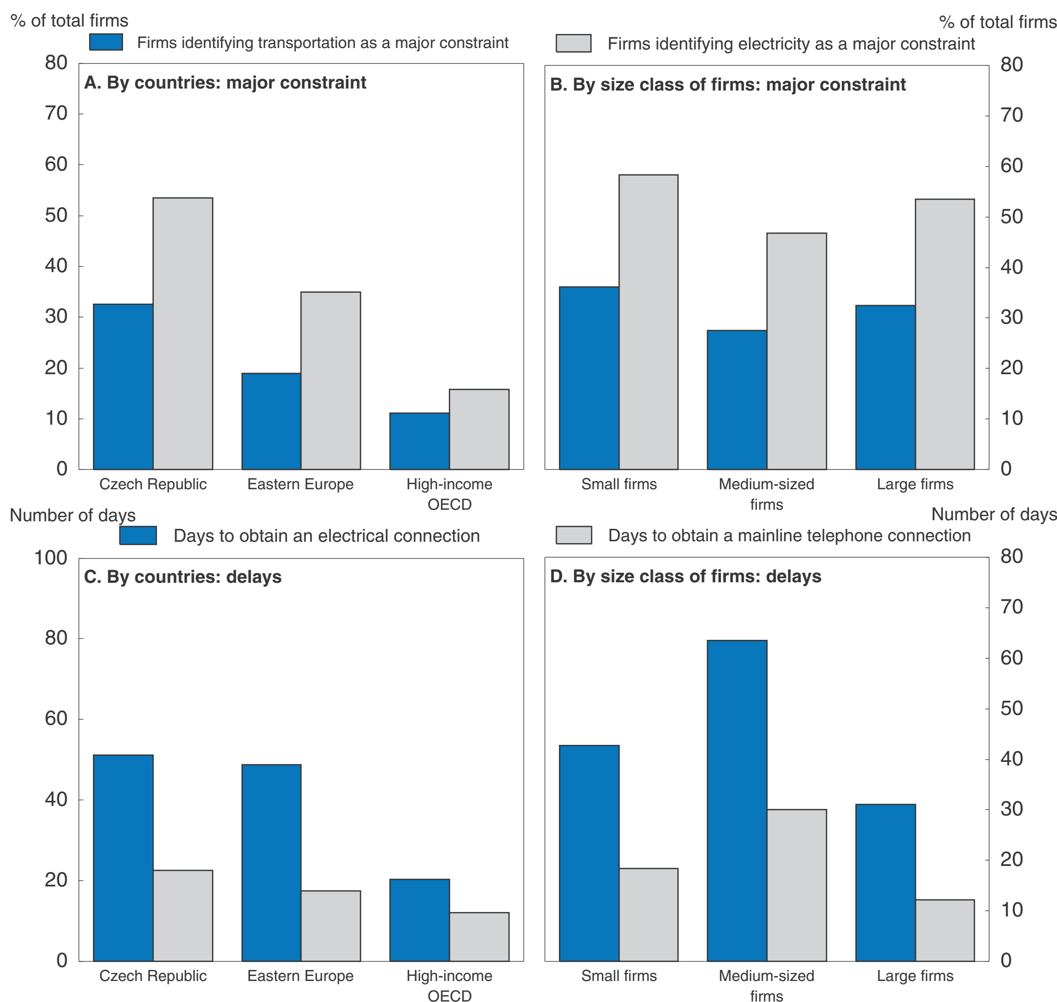
Ensuring competition in the network sectors

Because of strong natural monopoly elements, network sectors need special attention to promote competition in areas that are not natural monopolies and to prevent abuses of dominant position in natural monopoly areas. In the Czech Republic, the sectors (particularly transport, electricity and telecommunication) are frequently cited as problem areas with respect to infrastructure access (Figure 1.13). There is also a popular perception that some of these industries have been performing poorly with respect to consumers' interests (as discussed above). The OPC has a duty to oversee investigate abuses of dominant positions in the regulated sectors, but its jurisdiction has been somewhat blunted by overlapping mandates with the sector regulators. Indeed, a problem is that at times the OPC and the network regulators come to different conclusions concerning the degree of competition in the market. A related issue has been the lack of effective independence, accountability and transparency of some regulators, which may sometimes lead to them implementing changes without having a prior open consulting process or a lack of action due to the natural antipathy between public ownership and market contestability. Some of the state-owned enterprises are under the responsibility of individual line ministries, who also are responsible for some sector regulators, leading to political risks for new entrants, particularly if sector regulators appear to be engaged in industrial policy.

The electricity market is highly concentrated

The Czech Republic is the third-largest net electricity exporter in the European Union and with well integrated wholesale markets with neighbouring countries, ensuring a high degree of market discipline. To prevent cross-subsidisation, the energy regulator requires cost reporting directly allocated to each regulated activity. However, pre-tax prices for

Figure 1.13. **Problems in infrastructure delivery**



Source: World Bank and IBRD (2013), *Doing Business 2014, Economy Profile: Czech Republic*, *www.doingbusiness.org/~/media/giawb/doing%20business/documents/profiles/country/CZE.pdf*.

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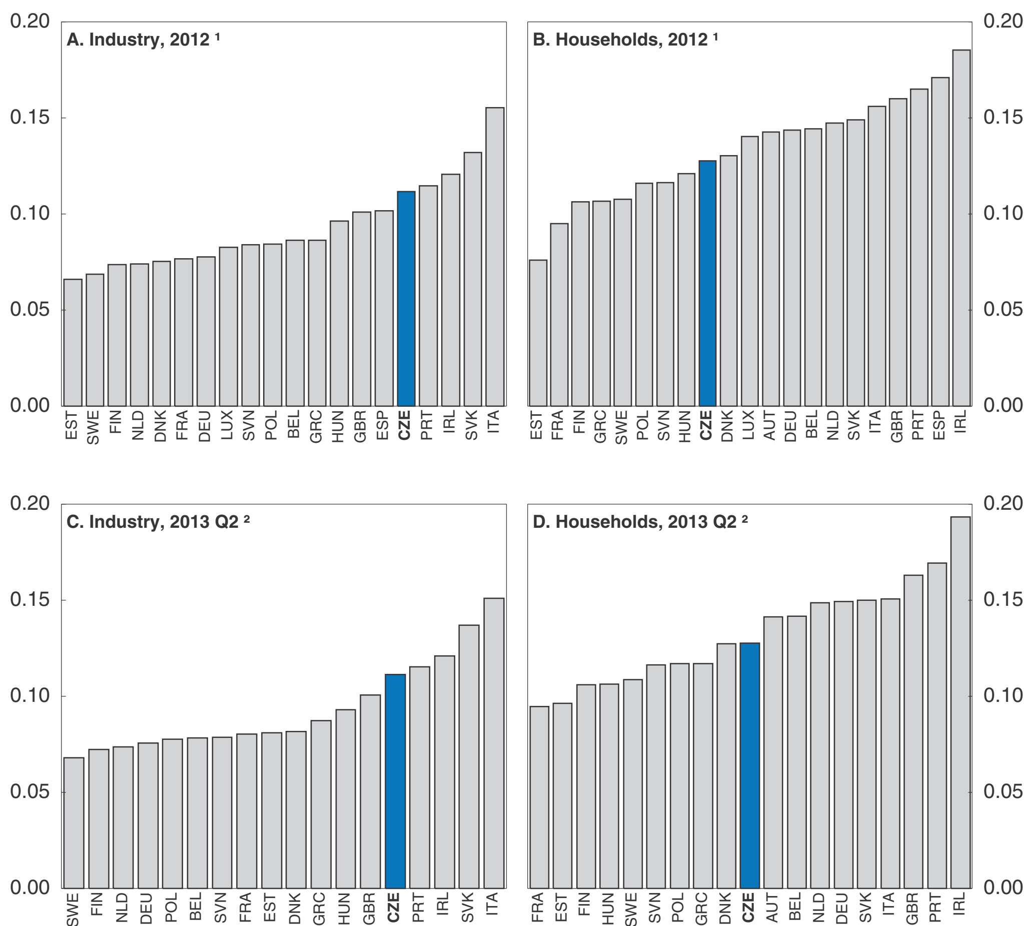
industry are relatively high (particularly when compared with neighbouring countries), while post-tax prices are in line with those in neighbouring countries, suggesting that the public purse is compensating for a lack of competition (Figure 1.14). In addition, surveys show that over half of Czech firms see electricity infrastructure pricing and provision as a major business constraint. For consumers, pre-tax prices are at par with the EU average and post-tax prices are relatively low, helping to explain that consumer surveys suggest that households have no particular problems with electricity provision. Moreover, in most countries prices for industry are lower than for households, reflecting relative cost of provision, while in the Czech Republic prices are very similar, indicating effective cross-subsidisation.

Competition may be impaired by the high concentration of the Czech electricity market, which is dominated by three vertically integrated companies whose subsidiaries hold licences for both electricity distribution and electricity trading. In addition, there are dozens of other traders. As for distribution system operators (DSOs), their combined share

Figure 1.14. **Electricity prices**

Price in EUR per kWh, 2012[1]



1. 2011 data for Spain.

Source: *IEA Energy Prices and Taxes Database* and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933007373

of the electricity market accounts for more than 95% of final consumption; in the case of customers connected to the low voltage level their share is more than 99%. Within this structure, the incumbent CEZ, which is 70% owned by the state, controls five out of eight local distribution companies, serving two-thirds of final customers (Table 1.1). Because of this concentration, prices for transmission, distribution and ancillary services are regulated, but commercial activities related to electricity supply to final customers are fully subject to market mechanisms since 2007 (ERO, 2013).

EU Directives require the separation of networks from generation and supply activities. In the Czech Republic, this has been achieved through legal separation, fulfilling the requirements in the EU third energy packages, which is a relatively weak form of unbundling compared with ownership separation (van Koten and Ortmann, 2007). Only the transmission system operator is ownership unblundled. The weak unbundling puts CEZ in a position to influence the overall market in a non-competitive way (World Bank, 2013); on the retail side, it could also potentially deny non-discriminatory access to its low-voltage

Table 1.1. **Concentrated and vertically integrated electricity market**

	Lignite mining	Generation	Transmission	Distribution	Supply
CEZ	54% 25.1 million tons	72% 63.3 TWh	100% 58.7 TWh	5 out of 8 distribution regions 61% of customers	39% 23 TWh
Others	46% 21.5 million tons	28% 24.3 million tons		39% of customers	61% 35.7 TWh
	CEZ fully owns the largest Czech mining company (SD) covering 63% of CEZ's lignite needs		The Czech transmission grid is owned and operated by CEPs, 100% owned by the Czech state		
	Remaining 2 coal companies are privately owned	Other competitors – individual IPPS			Other competitors E.ON, RWE/enBW

networks. The market power of the incumbent has been weakened by the entry of new energy distribution companies with consequent considerable supplier switching among customers (*Working Group Report on Transparency in EU Retail Energy Market*, 2012), but not sufficiently to secure similar prices for industry as in neighbouring countries in the integrated wholesale markets, such as Germany. Another concern, given the complaints about infrastructure, is whether the regulatory system ensures adequate incentives to invest in the distribution network.*

Another problem is CEZ's dominance (accounting for nearly three-fourths) of the generation market, which has allowed it to influence prices in certain supply and demand situations via capacity blocking or withholding. In 2009, the European Commission started to investigate CEZ on suspicion of anticompetitive behaviour, following a pan-European enquiry into the energy sector in 2005-07. The allegations against CEZ included deliberately reserving future transmission grid capacity for intended CEZ-owned gas-fired generation, thereby shutting out competing generators; preventing competing generators from building new generation capacity and deliberately withholding lignite from them. Of these, the EC continued the investigation into the blocking of transmission capacity. In 2012, to forestall a possibly damaging anti-trust investigation, CEZ proposed certain commitments, including the sale of one of its generation assets.

The fact that there has been no instance of domestically instigated competition investigations could be interpreted as a symptom of weak competition oversight. Previously, this reflected the fact that the electricity regulator (ERO) could not sanction anti-competitive behaviour. The 2011 amendment of the Energy Act boosted the ERO's independence and effectiveness while enhancing OPC's capacity to investigate competition abuses (ERO, 2012a and 2012b). The Act's new section provides for the ERO's co-operation with the OPC, the two Offices being obliged to provide suggestions and information to one another, and to collaborate. The reform took place when the relevant provisions of the EU third energy package were transposed into law, an aim of which is to achieve more effective regulatory oversight. This included the establishment of an agency

* The regulatory formula for distribution is based on a revenue cap which depends heavily on the regulated asset base (RAB). One objective of the RAB system is to reduce the cost of capital by reducing the risk of stranded assets. However, investment depends more heavily on where the regulated return is set. There have been complaints that CEZ invests too much abroad.

for the co-operation of national energy regulators (ACER), which should help bolster the effectiveness of regulation in this area.

These measures should result in greater competition policy effectiveness in downstream markets, but problems have been accumulating in upstream activities. The OPC has initiated an inquiry into the brown coal sector, where a long-term issue is a recent 60 years agreement between the incumbent electricity generator and the dominant coal producer, which seems to have important lock-in effects. Since ČEZ is both the dominant generator and the mining company's sole shareholder, this can hardly be called an arm's-length transaction. However, competition issues are not the dominant ones here. The main fear of the regulator (or Czech state as the case may be) in regard to opening the competition in this sector has been the social impact of a free energy market. Currently there is growing pressure on the government to revoke the decrees dating from the early 1990s that limit coal mining on environmental grounds.

The situation is further complicated by the impact of green energy policies on the input mix and national self-sufficiency (Box 1.3). Generous subsidies for solar power plants have not just been linked to energy supply-price distortions, but also to lapses in regulatory and financial control: in one instance, the regulator set excessive prices for purchasing

Box 1.3. **Energy policies and competition policy enforcement**

A factor making competition oversight difficult has been the promotion of green energy. At the retail level, a major issue has been the charge to cover the extra costs incurred in support for electricity production from renewable energy sources, where a state-support-induced boom in the installation of photovoltaic plants, as well as plants generating energy from biomass and biogas, has had a significant upward impact on electricity prices, despite a budgetary subsidy of CZK 11.7 billion.

At the generation level, the problem of competitive distortions has been brought to a head by disruptive cross-border energy flows, linked to renewable energy policies in Germany. Generation prices have been under downward pressure, as the market has been preferentially flooded with green electricity *based increasingly on photovoltaic solar and onshore wind* power, mainly from Germany. More fundamentally, the implementation of sustainable energy generation makes generation more dependent on weather-dependent generation, raising issues about energy security and transmission grid capacity, while relative price signals become distorted, making future investment planning difficult. The economic return on investments of conventional sources of energy has decreased heavily, but the need for reliable base load capacity to fill in gaps in solar- and wind-based generation capacity has actually increased.

Negative public perceptions of the costs of green energy have been increasingly linked to the debate about the need for national energy self-sufficiency, making the energy policy background increasingly volatile and leading to uncertainty being used to extract new economic rents. With respect to nuclear energy expansion, for example, CEZ is demanding the establishment of a stabilisation mechanism under which the company would receive funds from the government should market prices fall. The Ministry of Industry and Trade is resisting and lack of agreement on this issue could halt the construction of the new nuclear reactors. Market dominance could mean that the extension of the nuclear power plant Temelin is disadvantageous for taxpayers or energy consumers, but may be very advantageous for producer interests.

energy from solar farms. An important recipient of the support system for renewable sources of energy has actually been CEZ. In fact, the impact of competition distortions on the electricity price is of second order compared with the effects of support for renewable energy resources with the costs per capita among the highest in the world (ERO, 2012a). Fees for renewables are part of regulated distribution tariffs charged to final customers. The ERO has started preparations for stopping subsidies to renewable energy as from 2014 on the grounds that they were beyond the limits of the Czech Republic's economic capacities.

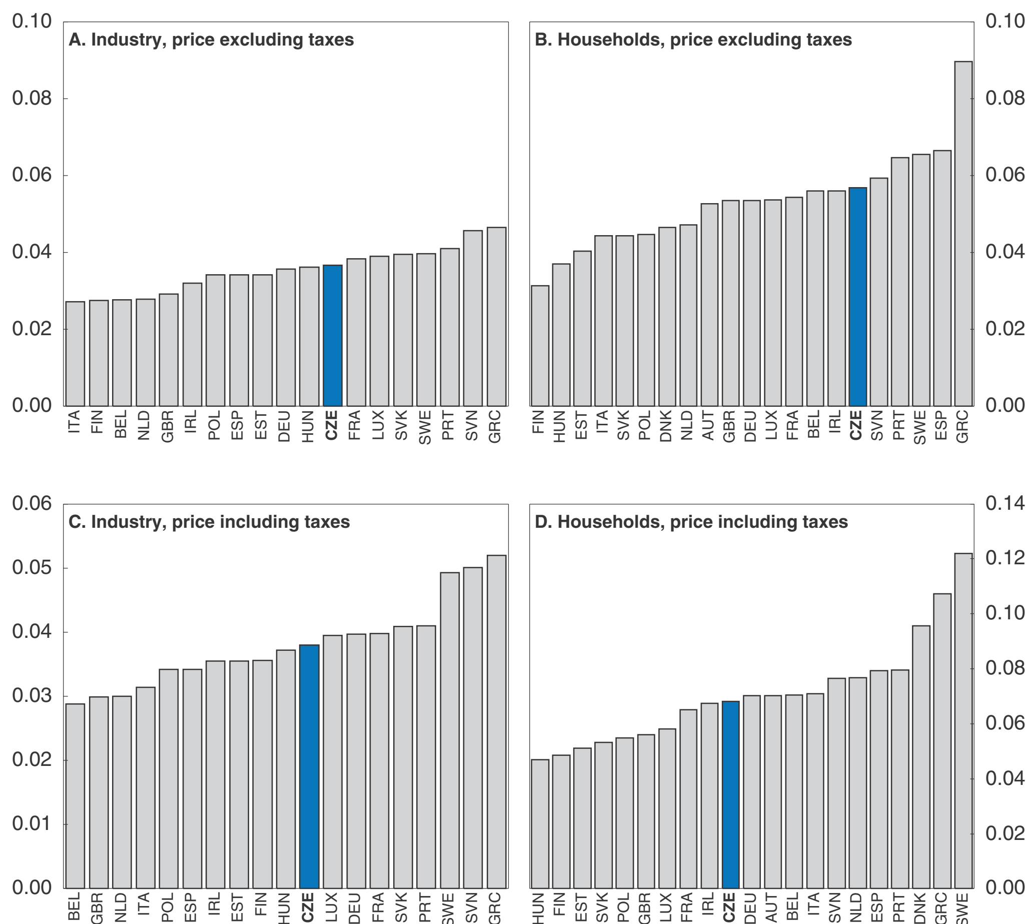
The gas market

The Czech gas market has been one of the fastest developing in the European Union, following the initial competition difficulties associated with market opening. Privatisation resulted in a highly concentrated and vertically integrated market which, though fully legally unbundled since the end of 2006, has been dominated by a single private player, RWE. Both the energy regulator (ERO) and OPC were active during the mid-to-late 2000s, ensuring that the dominant player did not hinder market access via its control over the majority of regional distribution companies and national storage facilities. These interventions, which included temporary caps on the gas trade and storage prices, fines and administrative proceedings, appear to have been successful in creating a competitive market, though most recently the ERO has had to introduce a Code of Conduct to eliminate unfair and illegal selling practices. Since the opening of the gas market in 2007, an increasing number of gas suppliers and/or additional gas importers is competing with the dominant incumbents at the local distribution level, stimulating a significant increase in supplier switching. A counterpart to the switching is a somewhat below-average consumer satisfaction with gas services and a relatively high pre-tax price for households, and noticeably so when compared with neighbouring countries, albeit post-tax prices are similar, while industrial customers enjoy relatively low prices (Figure 1.15).

The stable and transparent conditions for gas trading have been very favourable in comparison with the other countries. The industry has been characterised by low but reliable returns, which has brought inward investment from long-term financial investors and increasing ownership diversification: RWE has now divested its gas transmission business because of pressures on margins. Most recently, however, the regulator has decided that gas revenues, and hence prices, have been allowed to rise too fast. End user prices are composed of a regulated transmission and distribution part and an unregulated gas and storage part. The ERO proposed to cut short the current regulatory agreement for gas at the end of 2013, after four years instead of five, to curb allegedly excessive earnings by gas market players accused of re-valuing their assets to increase the book value of their investments (i.e. the regulated asset base, RAB) and therefore the regulated earnings they could qualify for. A regrettable proposal as the effectiveness of a RABs system as a regulatory commitment device for infrastructure industries depends heavily on the security of the regulatory setting (Stern, 2013). In the end, the proposal was not accepted and it is important to remain vigilant that regulatory interventions do not undermine the credibility of the regulatory system as it may raise the cost of capital and deterring future investment in the sector.

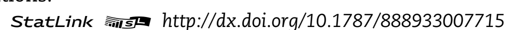
Figure 1.15. **Natural gas prices**

Price in EUR per kWh, 2012[1]



1. 2010 data for Italy.

Source: *IEA Energy Prices and Taxes Database* and OECD calculations.

StatLink  *http://dx.doi.org/10.1787/888933007715*

Telecommunications

Mobile phone prices were among the highest in the OECD in mid-2012. Since then prices have come down, but remain well above the most competitive telecommunications markets in the OECD (Figure 1.16, panel A). Also, standard subscriptions for packages with unlimited voice and SMS and limited data are still considerably higher than in competitive markets like France. Combined with a relatively high mobile phone subscription rate, this indicates a relatively large loss in consumer welfare. The fixed-line broadband market is not particularly well developed, as the number of subscribers is relatively low despite relatively low charges and the quality is poor (panels B and C). Indeed, the take-up of very high speed broadband lines is lower than the EU average with only 4.5% of fixed broadband connections having speed of at least 30 Mbps and only 0.3% with at least 100 Mbps, compared to the EU average of 7.2% and 1.3% respectively (European Commission, 2012c). In addition, according to media reports only 3% of Czech businesses are connected to high-speed internet (download capacity of +30 MBits/s) and only 30% are connected to fibre optic or cable networks; the majority rely on wireless connections.

Figure 1.16. **ICT coverage and charges**

Subscriptions per 100 inhabitants | USD

A. Mobile phone subscriptions and cost

← Mobile phone subscriptions [1] | Mobile phone charges in USD [2] →

GRC EST GBR POL FRA TUR MEX AUT ITA ISL KOR DNK NOR FIN SVK SWE SVN AUS IRL BEL USA **CZE** NLD DEU NZL LUX JPN ESP ISR PRT CAN HUN CHL CHE

Subscriptions per 100 inhabitants | Subscriptions per 100 inhabitants

B. Fixed (wired) and wireless broadband subscriptions, June 2013

Fixed (wired)
Wireless

AUS FIN SWE JPN KOR DNK USA EST NOR NZL LUX GBR ISL OECD IRL NLD AUT **CZE** ESP POL ITA CHE FRA ISR CAN GRC SVK DEU BEL SVN PRT CHL TUR HUN MEX

USD | USD

C. Fixed broadband prices in USD, September 2013 [3]

HUN KOR SVK POL SVN TUR **CZE** EST MEX ISR DEU JPN ITA GRC DNK PRT AUT BEL FIN GBR FRA IRL CHL NZL NLD AUS USA ESP SWE CAN ISL CHE LUX NOR

1. Mobile phone subscriptions per 100 inhabitants, December 2011.
2. OECD basket of mobile telephone charges, 100 calls, per month, VAT included, November 2013.
3. The OECD basket of fixed broadband services includes the total charges for a subscription of an average low usage with a minimum speed of 15 Mbit/s and 11 GB of usage per month, September 2013.

Source: *OECD Broadband statistics.*

StatLink http://dx.doi.org/10.1787/888933007734

The structure and history of the sector suggest that oligopolistic behaviour may be an issue. Nearly two thirds of telecommunication revenues are generated in the mobile market – a higher share than in most other OECD countries (OECD, 2013b). The Czech Republic has three main mobile network operators, among which the former state-owned monopoly. The latter was formerly fully owned by the Spanish Telefónica and recently sold to a domestic investor. Compared with more developed and competitive markets in EU15, both concentration (particularly for the three largest operators) and operating income are relatively high (and investments are lower than in most other OECD countries) (APMS, 2012; Information Institute, 2012; OECD, 2013b).

The powers of the OPC over the sector were strengthened in 2007, when parliament repealed a provision of the telecommunications law that had effectively prohibited OPC from taking action where the sectoral regulator had the power to set fines or regulate conduct. Subsequently, the sector has been the subject of a number of competition policy investigations for abuse of dominance in telecoms and broadband sectors, one such investigation being currently under way (OPC, 2013). However, cases, including long-term contracts and margin squeeze, tend to be very slow-moving and difficult to prove. Where the OPC has acted, there have also been differences of legal interpretation between the various judicial levels – first instance (OPC), regional and Supreme Administrative Courts. This has made the application of competition law protracted (see above). A 10-year long case of Telefónica luring customers into contracts with limited possibilities for termination landed three times before the Regional Court in Brno and three times before the Supreme Administrative Court before being concluded. The Office then increased the fine imposed in its original decision, which is once more under appeal.

The definition of the "relevant market" has taken on great importance and is subject to widely different interpretation: for example, the infrastructure owner has argued that with Wi-Fi growing rapidly dominance on fixed wires is of diminishing consequence for competition in the overall telecoms market. Meanwhile, the resistance to new entrants on the part of the incumbent is being tested by private actions in the court as a competitor has declared it is suing for damages in a case from 2005, where an OPC investigation about abuse of dominant position started in March 2011.

Until spring 2013, there was only a single mobile virtual network operators (MVNOs), i.e. wireless communications services providers that purchase bulk access from a *mobile network operator* and then resell. Since then the number of MVNOs has expanded rapidly and by end-2013 there were 50 registered MVNOs. However, the combined market share of active MVNOs remains at less than 0.5% of telecommunication traffic, reflecting a relatively new and dynamic market as well as the fact that the MVNOs have little data transmission. Effectively, the market depends on the mobile network operators. The effectiveness of competition among these three is questionable. Particularly as the network regulator considers the three to have joint market power, as is the case in some other EU countries (CTU, 2013). The Czech Telecommunications Office (CTU) planned to reserve a block of spectrum for a new entrant when auctioning its 4G licences. In the end, three licences were granted as the fourth bidder took over the incumbent operator (Telefónica Czech Republic). Thus, the market structure remains unchanged.

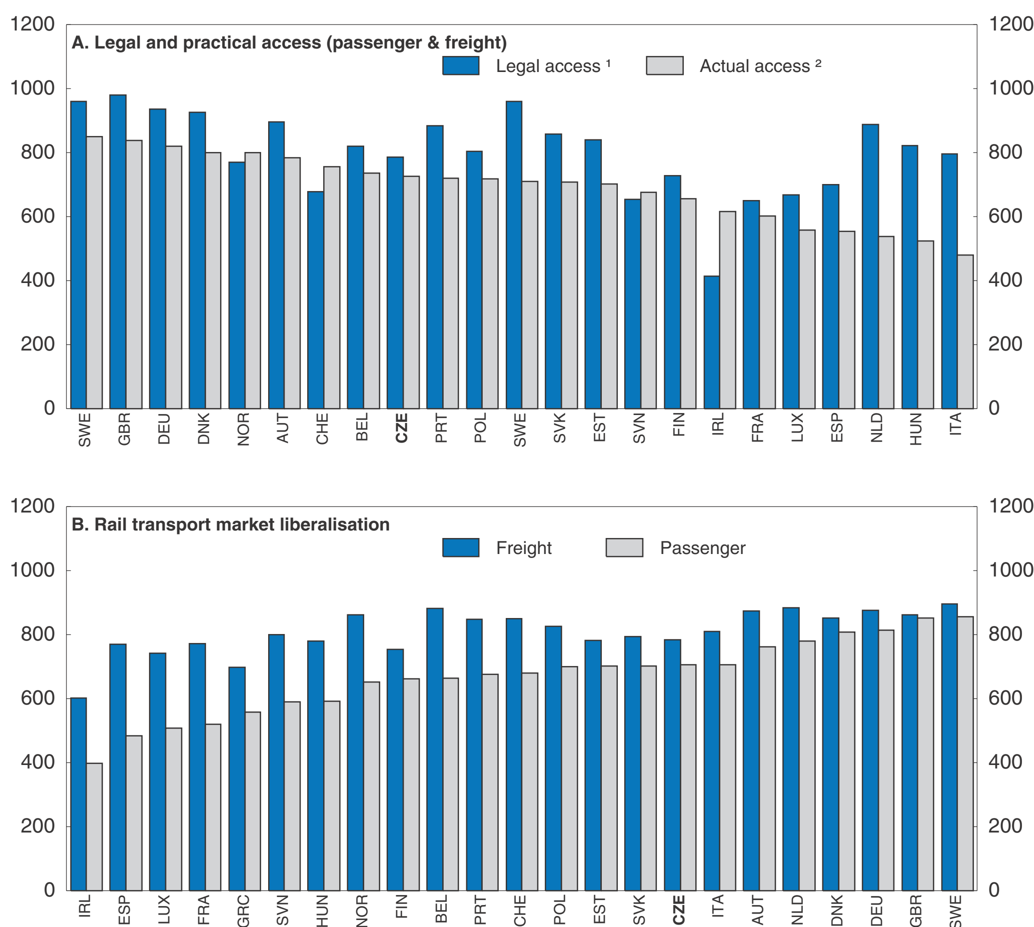
Given the impediments to rapid competition law enforcement, the onus of ensuring robust competition in the absence of a fourth operator needs to fall on structural measures, such as securing non-discriminatory access for MVNOs, either through regulation or investigations of abuse of dominant position. The introduction of MVNOs in the Czech telecom market is a positive development. So far, however, no Full-MVNOs have developed that manage their own Mobile Network Codes (MNCs) and can change host network without having to issue new SIM-cards to their customers. The government is advised to investigate whether there are regulatory or competitive barriers that preclude MVNOs to choose to become Full MVNO independent of their host network. In addition, the same regulations should enable non-telecom companies such as car companies, energy companies and the central government to become independent of mobile operators.

Transport infrastructure

The Czech Republic is classed as 'on schedule' as far as EU-driven railway market opening is concerned (Figure 1.17): i.e. in terms of organisational structure of incumbent, regulation of market access and competencies of the regulatory body (IBM, 2011). Markets for rail freight services have been fully opened to competition since January 2007 and those for international passenger transport services as of January 2010. EU law allows that national domestic passenger markets remain closed, and the Czech Republic is one of a few countries (including Denmark, Germany and Sweden) that have opened up for competition. The benefits of opening up the rail network are currently reflected in fierce competition for passengers that is driving down ticket prices on a few main lines.

Figure 1.17. **Railways liberalisation**

Indexes, 2011



1. Legal access: Organisational structure of incumbent (25%), regulation of market access (45%), competencies of the regulatory body.
2. Actual access: Information barriers (5%), administrative barriers (20%), operational barriers (45%), share of accessible domestic market (25%), sales services in passenger transport (5%).

Source: IBM Global Business Services (2011), *Market Opening: Rail Markets of the Member States of the European Union, Switzerland and Norway in comparison.*

StatLink http://dx.doi.org/10.1787/888933007753

There remain severe obstacles to competition in railway services. Domestically, information asymmetries, technical and safety regulations, and operational barriers restrict the practical level of access in passenger services (IBM, 2012). For example, the incumbent (*České dráhy* – ČD) is allowed to charge commissions of up to 25% of new entrants' ticket sales for running the nationwide ticketing systems.

Structural impediments to competition arises from the ambiguous separation of the infrastructure from the train operations makes ČD's pricing structure opaque in terms of how much of the price reflect the infrastructure charge and how much the transport service provided. Indeed, securing competition in network industries hinges on infrastructure charges that secure non-discriminatory access. The opaque price structure also means that the competition authority has problems of investigating complaints of predatory pricing, as ČD claims that it is impossible to establish the cost of provision on specific lines.

In 2011, the Czech Republic separated infrastructure management from railway operations, in line with EU rules. However, the incumbent service provider remains in control of exercising day-to-day train traffic management and can influence infrastructure developments, which has an inherent risk to competition as these powers can be used to covertly discriminate against newcomers (European Commission, 2013). Moreover, infrastructure managers may not always react to the needs of the market and evidence from users suggests that the current governance system does not provide sufficient incentives for them to respond to their needs (European Commission, 2012a).

Moreover, the lack of effective separation creates a persistent risk of cross-subsidisation, with assets or operational funds being diverted to provide a competitive advantage to the transport activities of ČD. Ownership unbundling would be the first-best option, but a back-up option could be the creation of a holding structure that would clarify the financial separation of fixed assets and operational infrastructure would be a step towards preventing such cross-subsidisation and creating a level playing field for new entrants (Høj et al., 2007). The EU's fourth railways package points to institutional separation (ownership unbundling) as the simplest and most transparent way to achieve the necessary independence and if a vertically integrated or "holding structure" is chosen, then financial separation of all activities should be designed in a way to counter the risk of cross-subsidisation. The Transport Ministry has proposed selling all the railway stations and property of ČD to the Railway Infrastructure Administration (SŽDC) or municipalities and regions. The regulator should ensure that ČD is not using the revenues from selling its non-transport assets to disadvantage the operations of new entrants. Another regulatory issue is the fact that the regulatory body is located within the railway authority, which reduces its independence, accountability and transparency.

Coach transport provides the rail sector with competition: its share of all passenger kilometres is about half that of rail (European Commission, 2009b). There is little European legislation applying to the bus or coach sectors and, as a result, there are significant differences in the regulatory environment within which the bus and coach sector operates in different member states. In the Czech Republic, the OPC reached its first decision to penalise predatory pricing in 2010, the culprit being the dominant operator of public passenger coach services between the two largest Czech cities, Prague and Brno. The decision was reversed by Administrative Regional Court in Brno, but subsequently confirmed by the Supreme Administrative Court, who returned the case to the Regional

Court for further assessment. As in other sectors (telecommunications for example), whether a market is narrowly or broadly defined to include near-competing modes makes an important difference to how predatory pricing, and hence market access, is treated.

The Czech airline sector is fully integrated into the EU single market. Compared with other sectors, air transport has been a relatively easy industry to liberalise – monopolies in air transport have always been legal rather than "natural". While the industry features network effects and economies of density, it is not subject to large economies of scale or barriers in the form of huge sunk investments. The Czech Republic has thus not been at any inherent disadvantage over size of location and it ranks relatively high in terms of air connectivity according to the World Bank Index (ACI). Over the past four decades, the cost of air transport services has fallen and the market has expanded rapidly. Liberalisation has increased competition from low-cost carriers, which together with the economic crisis and high fuel costs has driven the state-owned carrier Czech Airlines (CSA) close to bankruptcy, requiring state aid. Subsequently, Korean Air took a 44% stake in Czech Airlines, but is prevented by EU rules from a full take-over. The state thus remains liable for potential losses and further restructuring is needed to generate efficiency improvements. Complete privatisation should be pursued to avoid more state aid with potentially distortions to competition.

In most EU member states, postal services were to be completely liberalised as of 1 January 2011, but some, including the Czech Republic, were afforded a two years postponement. From January 2013 the monopoly held by the state enterprise Czech Post (CP) over deliveries of postal items that weigh up to 50 grammes with stamps up to EUR 0.7 was removed. In the next five years, Czech Post will be the sole holder of the postal licence, responsible for the universal service obligation, after which the postal licence will be awarded by tender. Competing businesses may only provide the more profitable postal services, such as offering their services to bigger cities. As a result, the postal licence holder may find it difficult to generate profit. Based on the decision of the Czech Telecommunications Office, other postal services providers may be obliged to contribute to the reimbursement of costs for the postal licence holder. Depending on the level at which this tax or subsidy is set, the new scheme may limit or expand the number of new postal services providers that enter the market. In other countries, such as Sweden, incumbents have foregone such compensation as the value of having a nation-wide network was considered larger than the cost of universal service provision.

This is an example of network liberalisation where the incumbent is struggling, with a danger of cross-subsidisation from profits in monopoly areas to competitive markets. CP has been contending with significant year-on-year declines in mail volume for the last few years, as customers switch to electronic communications. However, the sector has not undergone the same modernisation (closing down offices and provide services through other outlets) as in many other countries. Instead, CP is providing an increasing range of non-postal services, such as paying out pensions and banking, and is branching out into ICT services to public sector organisations. At the same time, the company has responded to market liberalisation with a new pricing strategy and product innovations, including in parcel delivery. With profitability increasingly depending on diversification from its core activities, it will be a difficult challenge for the regulator to ensure a level playing field for potential market entrants.

Main competition policy recommendations

Create a completely open and competition-friendly market

- Lower the regulatory burden for business by reducing legal delays with respect to contract enforcement and local authority regulatory interference as well as achieve best practice with respect to documentation, administrative delays and costs. Further reduce domestic barriers to entry in services, including professional services. Strengthen the RIA Committee's independence to make the regulatory impact assessment process more timely and effective.
- Improve the managerial integrity of remaining state-owned enterprises by concentrating control within a single authority that focusses on professional corporate governance and agreed performance targets. Privatise and divest business-related state-owned enterprises and activities.
- Bring in a new Public Servants Act to separate political appointees from non-political staff.

Reinforce competition law enforcement

- Enhance enforcement and deterrence by monitoring the leniency programme to ensure it is working effectively in unearthing cartels, improve the scope for private litigation, and increase administrative awareness of and sanctions for bid-rigging, tackle the problem of anonymous share-holders in tendering companies, and use sector inquiries to bolster competition law enforcement.
- Remove the special sector regulation for food retailing from the competition policy framework Further increase the reliance on competition policy by introducing *ex post* merger impact assessments.

Ensuring competition in the regulated network sectors

- Secure effective independence of all network regulators, improve the co-ordination between the competition authority and sector regulators and have a common approach to what constitutes a proper definition of market dominance.
- Tackle vertical constraints on competition via effective ownership unbundling or – as a second best solution – via holding structures. The latter approach requires financial separation of all activities that are designed in a way to counter the risk of cross-subsidisation.
- In telecommunication, secure cost-based rental prices for MVNOs through regulation or subjecting the incumbents to investigations of abuse of dominant position. Investigate if there are regulatory or competitive barriers that preclude MVNOs and non-telecom companies to choose to become Full MVNO independent of their host network.
- Ensure that entry into the liberalised postal market is not distorted by the subsidisation of the public service obligation or cross-subsidisation of market based activities.

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