CASE ASSOCIATES

Margin Squeezes in Telecoms

Cento Veljanovski
Managing Partner, Case Associates
cento@casecon.com

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The European Court of First Instance's (CFI) decision in Deutsche Telekom[1] (DT) has vindicated the European Commission's approach to margin squeezes under competition law.[2] This case was an appeal by DT against the European Commission's finding that that it had administered an illegal margin squeeze against its downstream competitors. The oddity of the case was that both DT's wholesale and retail prices were regulated and approved by the German telecoms regulator (RegTP). This defence was not accepted by the Commission or the Court. The CFI's message is clear – complying with regulation is no defence to a competition law investigation.

The DT decision raises a number of important issues on the interrelationship between sector specific regulation and competition law in the telecommunications sector. Some of these are explored below.

Deutsche Telekom decision

The DT decision is one of a number of investigations by the European Commission[3] and national competition authorities into alleged margin squeezes

[1] Case T-271/03 - *Deutsche Telekom AG v. Commission* (2008).
[2] Case COMP/C-1/37.451, 37.578, 37.579 - *Deutsche Telekom* (2003).
[3] Prominent among these is Case COMP/38.784 - *Wanadoo España v Telefónica* (2007); and appeals to the CFI - Case T-336/07 -*Telefónica and Telefónica de España v. Commission*; Case T-398/07 - *Spain v. Commission* (both undecided).

in the telecommunications sector. A margin squeeze simply defined is where a dominant vertically integrated network operator sets it's wholesale and/or retail prices at levels that do not give a reasonable margin to its downstream competitors.[4] It is designed to 'squeeze' out the downstream competitor and reduce downstream competitive pressures (so-called exclusionary conduct). Many see the margin squeeze as the greatest inhibition to competition in the telecommunication sector, and it has led to frequent calls for radical reforms such as the separation of network and retail operations.

In the DT case the alleged margin squeeze came not as one would expect from an excessive wholesale/access price for an essential input (access to the fixed local loop) but a low retail access price. As already stated both these prices were regulated by the German telecoms regulator – the wholesale prices at a cost-oriented level, and a bundle of retail prices were capped. The EC Commission, affirmed by the CFI, found that despite the dual price controls, DT's action of lowering its retail price made the service unprofitable for its downstream rivals. DT's pricing strategy was therefore unlawful and it was fined €12.6 million

DT argued that its prices did not give rise to an unlawful margin squeeze because they were imposed by the regulator. Indeed the regulator had considered the potentially anticompetitive effects of low retail access prices. The CFI rejected this claim: "the fact that the applicant's charges had to be approved by RegTP does not absolve it from responsibility under Article 82 EC". The case turned on the fact that that within the retail price cap DT had flexibility to set its retail charges to end or reduce the margin squeeze.

Thus the legal position is now clear(ish). Regulatory compliance with price controls is not sufficient to avoid competition actions under Article 82 (abuse of a dominant position) of the EC Treaty where the network operator has flexibility in setting retail prices.

The CFI's decision clarified another important matter – how to calculate an abusive margin squeeze. This test – known as an imputation test – can be calculated in a number of ways. The EC Access Notice[5], which sets out competition law principles on access in the telecommunications sector, identifies two different imputation tests:

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[4] P. Crocioni and C. Veljanovski, 'Price Squeezes, Foreclosure and Competition Law – Principles and guidelines', *Journal of Network Industries,* Vol. 4, 2003, pp. 28-60.
[5] EC Commission, *Notice on the application of competition rules to access agreements in the telecommunications sector – Framework, Relevant Markets and Principles*, OJ C265, 22 August 1998.

Test 1: The downstream division of the vertically integrated operator could not trade profitably if it were to buy the upstream input at the price charged to its downstream competitors.

Test 2: A reasonably efficient downstream service provider paying the wholesale input price cannot earn a reasonable margin.

The CFI stated that the Commission's use of Test 1 was appropriate – increasing referred to as the "equally efficient" or "just as efficient" standard. This makes practical sense since a dominant operator can only determine its costs, prices and margins, and hence whether it has breached the law, rather than those of a hypothetical efficient downstream competitor. However, it should be noted that from an efficiency viewpoint this is not the correct test as one should use efficient costs, and where the downstream rivals have higher costs than the dominant operator they may be squeezed but not illegally. Notwithstanding this there was considerable dispute over which costs, services and prices/revenues were to be used in the calculation of DT's margins.[6]

Wider Policy Considerations

The CFI's decision raises a number of important legal and policy issues which go well beyond the particular facts of the case.

First a dominant network operator appears now to be subject to 'double jeopardy' even when in full compliance with its regulatory obligations. The case law requires a dominant network operator to ensure that all its regulated margins over which it has some pricing flexibility allow equally efficient competitors to make an adequate return. If this is not done, and the regulator refuses to act, then the operator will infringe competition rules and will be open to fines and possible damage claims from its downstream rivals who have been harmed. On the other hand imposing liability of dominant operators protects regulators from errors arising from not doing their jobs properly. The CFI's decision also undermines the effectiveness of price caps which are explicitly designed to give a network operator flexibility in setting individual retail prices within the cap presumably because this serves regulatory objectives. The rather perverse aspect of the case is that had the regulator fixed rather cap retail prices, then there would have been no competition infringement and no redress for the downstream firms from an alleged margin squeeze. This would have simply been treated as an unfortunate regulatory error. Consistency would seem to

[6] Casenote, Testing for Price Squeezes – A critical review of recent competition law cases, May 2004. http://www.casecon.com/data/pdfs/casenote36.pdf.

require that both regulator and network operator be subject to the same competition rules, and perhaps joint and severally liable for the harm.

The second issue relates to the proper role of competition law in a heavily regulated sector, and specifically in relation to price abuses. This is particularly important for the current regulatory framework, although the DT decision relates to a previous (ONP) EC regulatory framework. Under the present EC New Regulatory Framework (2003) the justification for sectoral regulation of the telecommunications sector is the inadequacy of competition law. That is sectoral *ex ante* remedies and price controls are used because a) *ex post* competition law is claimed to be too slow and uncertain to provide an effective remedy; and b) it is not a legitimate goal of competition law to regulate prices. Further, the New Regulatory Framework is based on competition law principles (market definition, dominance *aka* Significant Market Power (SMP) and bottom-up competitive assessments). The DT decision turns the justification for separate sectoral regulation of the telecommunications sector on its head. Regulation which is supposed to fill the gaps arising from inadequate competition rules, is subject to competition law to plug regulatory gaps. In the DT case if it is correct that the regulator got it wrong, the simple solution was not to make new law but for it to be required to revise the retail price cap.

There is another related concern that the Commission is increasingly turning EC competition law into *de facto* price regulation. This is vehemently denied by the Commission but the recent Microsoft (2004)[7] decision shows that the Commission is now actively engaged in price setting – by 'setting' fair, reasonable and non-discriminatory royalties for interoperability protocols. In margin squeeze cases the Commission is also administering price controls. This area of law remains a mess despite the Commission's much heralded Article 82 Discussion Paper[8] which has languished for the last three years.

The case has another unsatisfactory aspect. The Commission and the CFI used the imputation test to find that DT had abused its dominant position. That is there was no analysis of whether the structure of prices had or was highly likely to exclude competitors and reduce the level of downstream competition. This formalistic approach jars with the modernisation of EC competition law in other areas which has moved to an economics, effects based approach.

A fourth issue is whether margin squeezes should be applied to cases involving low retail prices. These, in the author's view, are not why margin squeezes raise

[7] Case COMP/C-3/37.792 *Microsoft* (2004).

[8] See the stalled Commission's reforms of Article 82 which deal mainly with pricing issues - DG Comp, *Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses*, December 2005.

significant competition concerns in the telecoms sector (even though it appears the legal position). Margin squeezes raise a concern because the network operator leverages its monopoly of an essential input to overcharge its downstream rivals i.e. access to the network or core unbundled network elements. Such an operator can abuse its position by raising access/wholesale charges to levels where an efficient competitor cannot make a reasonable margin. However, where an alleged margin squeeze arises from excessively low retail prices very different concerns arise. The abuse is not due to the vertical leveraging of the dominant operator's control of an essential input. This is ruled out by upstream price controls - as in the DT case.

Further, a margin squeeze test is more stringent than that applied to identify what would otherwise be predatory retail pricing. The standard test for predatory pricing is retail prices set below average variable (AVC) or average avoidable costs (AAC), or in a developed regulatory system Long Run Average Incremental Costs (LRIAC). Applying a margin squeeze test to the same facts would result an abuse which was not predatory i.e. because retail prices were above AVC, AAC or LRIAC, and downstream firms were still earning positive but not necessarily reasonable margins. It is not surprising that DT argued that the alleged abuse should have been subject to a predation and not imputation test.

Sixth, and related to the previous point, is that the impact of a retail-induced margin squeeze is very different from a wholesale-induced one. The dominant operator who raises wholesale prices increases its revenues and profits, even though its downstream operations suffer a profit reduction. Thus overall a wholesale margin squeeze is unlikely to generate a loss, particularly as demand for an essential input is (by definition) inelastic. Further, consumers are harmed by a wholesale price squeeze if downstream rivals raise their retail prices. Both these effects differ from those of a retail price induced margin squeeze. A dominant operator who reduces its retail prices suffers an immediate and possibly substantial profit loss but increases consumer benefits by providing cheaper services. Thus a retail price squeeze is costly to a dominant network operator and less harmful to consumers in the short run – the very opposite of the effects of a wholesale induced margin squeeze. On these grounds alone it should be treated differently.

Conclusion

The concept of a margin squeeze has expanded beyond its traditional concerns of excessive wholesale/upstream prices. It is now used as a generic term for any manipulation of prices which adversely affect a dominant network's rivals. This expansion of the concept is unfortunate because it blurs the central features of a

price squeeze as an exclusionary abuse arising from the leveraging of upstream market power, and makes it difficult to identify the necessary and sufficient conditions for its existence. There are strong grounds for restricting margin squeezes to excessive wholesale prices, and applying an *ex post* predation test to those arising from low retail prices. Moreover, the use of an imputation test to find an abuse jars with an effects-based competition approach.