Opinions and comments

Margin squeeze in the Spanish broadband market: a rational and profitable strategy

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On 4 July 2007, the European Commission adopted a decision against the Spanish incumbent telecoms operator Telefónica for a very serious abuse of its dominant position in the Spanish broadband market (2). The fine imposed on Telefónica amounted to €151 875 000. The Commission found that Telefónica imposed unfair prices in the form of a margin squeeze between the wholesale prices it charged to competitors and the retail prices it charged to its own customers from 2001 to 2006. In so doing, Telefónica weakened its competitors, making their continued presence and growth in the market difficult: competitors were forced to make losses if they wanted to match Telefónica’s retail prices. This resulted in considerable consumer harm in the form of retail prices that are among the highest in EU-15 and low broadband penetration.

This is the third Commission decision on price abuse since the telecommunications sector was fully liberalised in 1998. On 21 May 2003, the Commission fined Deutsche Telekom for abuse of dominant position in the form of a margin squeeze in German telecommunications markets (3). On 16 July 2003, the Commission fined Wanadoo, the internet arm of France Télécom for abuse of a dominant position in the form of predatory prices in the French retail broadband market (4).

1. The control of the broadband value chain in Spain by Telefónica

1.1. The broadband value chain in Spain

Broadband access is a key element of the information society. The main technology used in Spain to provide broadband internet access services is ADSL (5), which provides high-speed internet access using a telephone line and represents 80% of broadband internet connections. The incumbent Telefónica is the only Spanish telecommunications operator that has a nation-wide fixed telephone network. It rolled out this local access network over significant periods of time protected by exclusive rights and was able to fund investment costs through monopoly rents from the provision of voice telephony infrastructure and services.

It is uneconomical to duplicate Telefónica’s local access network. Therefore, Telefónica’s competitors wishing to provide broadband internet access to end-users have no other option but to contract wholesale broadband access. Three non substitutable types of wholesale broadband access services are available to them, all of which are built on Telefónica’s local access network:

— Unbundled access to the local loop (6) ("ULL") requires being physically present in the 6836 main distribution frames that Telefónica has throughout Spain. This involves significant network roll-out investments. Since the beginning of 2001, Telefónica is legally obliged under Community law (7) to provide ULL.

— Wholesale access at regional level ("WAR") concentrates the traffic at 109 regional points of interconnection and therefore still requires rolling out a network reaching those regional points of presence. Since March 1999, Telefónica is legally obliged under Spanish law to provide wholesale access at regional level. Spanish regulation also obliges Telefónica to ensure that its retail prices are replicable on the basis of its regional wholesale product. From 2001 to 2006, Telefónica’s regional wholesale prices were only subject to a maximum level.

— Wholesale access at national level ("WAN") concentrates the traffic at one point of interconnection and enables operators to offer retail broadband services without having to roll out any network. Since April 2002, Telefónica is legally obliged under Spanish law to provide wholesale access at national level. From 2001 to 2006, Telefónica’s national wholesale prices were at no time regulated.

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(5) Asymmetric Digital Subscriber Line

(6) The local loop is the physical circuit between the customer’s premises and the telecommunications operator’s main distribution frame ("MDF"). Traditionally it takes the form of pairs of copper wires.

Because of the necessity to reach a minimum critical size before incurring the heavy and risky investments necessary to use WAR or ULL, Telefónica’s competitors have entered the retail market on the basis of purchasing WAN from Telefónica. As their customer base has increased, they have gradually rolled out their network allowing to contract successively WAR and ULL in some limited areas of Spain (densely populated areas). It is only from the last quarter of 2004 that some competitors have started offering retail services on the basis of ULL while progressively rolling-out their networks. However, despite the clear-cut regulatory obligations, there have been significant problems with the effective availability of ULL which were sanctioned by the Spanish Regulatory Authority (“Comisión del Mercado de las Telecomunicaciones” or “CMT”) (8).

1.2. Telefónica’s dominant position

The Commission defined three relevant product markets, the retail broadband “mass” market and two different wholesale broadband markets, namely the market for wholesale broadband access at regional level and the market for wholesale broadband access at national level. The delineation of the wholesale markets is mainly based on the heavy network roll out investments required when switching from the different wholesale products.

Telefónica is dominant on both relevant wholesale markets: WAR is exclusively provided by Telefónica and WAN is provided by both Telefónica and competing operators. The latter are nonetheless dependant upon Telefónica for the inputs required to supply WAN. In 2004, 98% of retail ADSL lines were based on Telefónica’s WAN or WAR. In 2006, 87% of retail ADSL lines were based on Telefónica’s WAN or WAR.

Case-law does not require to demonstrate that Telefónica is dominant in the retail market for proving the existence of a margin squeeze. However, the Commission has also established that Telefónica is dominant in the retail market.

The cable TV operators are not dependent on Telefónica for wholesale inputs for retail broadband access in the areas where they rolled out their own network. However, they never exercised sufficient constraint on Telefónica’s ability to leverage its dominance in the wholesale markets into the retail market as a result of (i) Telefónica’s strong pricing power in the retail market, (ii) cable networks’ limited footprint and (iii) the cable operators’ inability to roll out a national network comparable to Telefónica’s and exercise sufficient pricing discipline in the retail market as illustrated by their continuously declining market shares since 2001.

2. The abuse

A margin squeeze is an insufficient margin between the price of an “upstream” product A and the price of a “downstream” product A+B of which A is a component. An abusive margin squeeze can

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(8) On 16 November 2006, the CMT fined Telefónica €20 million on the grounds that at least between January 2004 and April 2005 it infringed the procedures and conditions under which it has to provide the services included in its reference unbundling offer (“RUO”).
be found to exist if a vertically integrated company which is dominant in the upstream market sets the upstream price it charges to its downstream competitors and the downstream price it charges to the end users at such a level that downstream competition is likely to be restricted (9). The Commission’s decision concerns Telefónica’s price structure as reflected by the difference between Telefónica’s wholesale and retail prices. It is this difference and not the specific level of the retail and/or wholesale prices which is decisive in margin squeeze cases.

The Commission’s assessment revealed that, from September 2001 to December 2006, the margin between Telefónica’s retail prices and the prices for wholesale broadband access at both the national and regional levels was insufficient to cover the incremental costs that an operator as efficient as Telefónica would have to incur to provide retail broadband access. The abuse ended with the Spanish regulator’s decision to reduce Telefónica’s wholesale prices between a range of 22% to 61% (depending on the speed of the offer).

The Commission used different methodologies:

— The period-by-period method assesses Telefónica’s profitability every year from 2001 to 2006

— The Discounted Cash Flows method allows below cost pricing in the initial phase of an expanding market (learning effects, economies of scale) but requires Telefónica to be profitable over a reasonably long period. The Commission’s calculations revealed that the net present value ("NPV") of Telefónica’s downstream activity was negative over 2001-2006.

In addition, Telefónica’s initial business plan of 2001 shows explicitly that the company knew it would engage in a margin squeeze: while Telefónica expected rapid achievement of profitability on an end-to-end basis (10) (break-even EBITDA and EBIT in 2002, positive NPV over 2001-2006), Telefónica’s initial business plan indicated that its downstream arm was expected to still make losses in 2006, that the NPV over 2001-2006 was

negative and that the downstream losses incurred during 2001-2006 would not be recovered by any hypothetical profits from 2007 to 2011.

According to Telefónica, the practices concerned by the decision, i.e. margin squeeze, constitute a constructive refusal to supply and therefore the Commission should have proved that the criteria applied in the Oscar Bronner case (11) are fulfilled. However, the factual, economic and legal circumstances of this case fundamentally differ from those in Oscar Bronner. In the present case, Spanish regulation compatible with Community law imposes on Telefónica an obligation to provide wholesale access at regional and national level. This duty has been established with a view to promoting competition and consumer interest and results from a balancing test made by the public authorities between the incentives of Telefónica and its competitors to invest and innovate and the need to promote downstream competition in the long term. In any event, Telefónica’s expectation to invest in its infrastructure have never been at stake in the present case: Telefónica’s upstream network is to a large extent the fruit of investments that were undertaken well before the advent of broadband in Spain and in a context where Telefónica was benefitting from special or exclusive rights that shielded it from competition.

2.1. Impact of Telefónica’s conduct

2.1.1. Telefónica’s conduct was likely to have anticompetitive foreclosure effects

The margin squeeze was likely to restrict competition in the relevant markets. It was likely to constrain the ability of ADSL operators to grow sustainably in the retail market because ADSL operators had to undercut Telefónica’s retail prices in order to gain customers and there was no viable substitute to Telefónica’s WAR and no viable substitute to Telefónica’s WAN with national coverage. What is more, Telefónica’s regulatory obligations have structured the Spanish broadband market in an irreversible manner: alternative operators have incurred considerable investments, which have contributed to create a relationship of reliance of the rivals on Telefónica’s wholesale products.

The establishment of foreclosure effects does not mean that rivals are forced to exit the market: it is sufficient that the rivals are disadvantaged and consequently led to compete less aggressively. In the case at hand, there was likely foreclosure because the margin squeeze affected Telefónica’s competitors’ ability to enter the relevant market.


(10) i.e. aggregating costs and revenues all over the broadband value chain, thereby allowing the subsidisation of downstream losses by upstream profits

and exert a competitive constraint on Telefónica. The margin squeeze restricted competition by imposing unsustainable losses on equally efficient competitors: they were either ultimately forced to exit or in any event constrained in their ability to invest and to grow. Even if they met Telefónica both on prices and marketing expenditure, they were poorly placed in the long run to offer a vigorous competitive challenge to Telefónica as a result of their continuing losses. As a result, Telefónica’s conduct was likely to delay the entry and growth of competitors. In theory, due to the margin squeeze, the only viable entry would have been by duplicating Telefónica’s regional wholesale product on the basis of LLU. However, this option is in any event not a substitute to Telefónica’s other wholesale inputs, is extremely expensive and risky and has only been available with significant delays. Telefónica’s conduct was likely to delay as long as possible the arrival of ADSL operators at a level of economies of scale which would have justified investments in their own infrastructure and the use of LLU.

The immediate harm to consumers was likely to be significant: absent the distortions resulting from Telefónica’s margin squeeze in this case, the retail market for broadband services would have been likely to have witnessed more vigorous competition and would have delivered greater benefits to consumers in the form of lower prices, increased choice and innovation. Other than in a predatory pricing scenario, in a margin squeeze case, consumers may suffer both in the short run and in the long run. This is because a margin squeeze may involve a high retail price (relative to end-to-end costs) in the short-run as well as the long run, which would arise because of the high charge set for the wholesale service.

2.1.2. The harm to consumers was considerable

The Commission also establishes that the margin squeeze has had concrete foreclosure effects in the retail market and a detrimental impact for end users.

There is convincing evidence showing that due to the margin squeeze, sustainable entry and growth in the retail market has not been possible, and this containment of competition has allowed Telefónica (i) to benefit from growth rates surpassing by far that of its competitors and thus (ii) to remain by far the largest broadband operator in Spain, in contrast with the situation it held in the narrowband internet access market.

There is also evidence showing that the margin squeeze led to high retail prices which are well above (by 20% at least) EU average and among (if not) the highest in the EU-15 (12), affecting millions of end-users. According to the Spanish regulator CMT (13), retail prices in Spain are exceptionally high and 25% above EU average (14). Prices are critical to the development of the market. Thus it is symptomatic that, whereas Spain was in the top of the EU Member States in terms of number of broadband internet subscribers at the end of 2001, broadband penetration in Spain now ranks below the EU-15 and EU-25 average. The increase of that rate is also below the EU-15 and EU-25 average.

Telefónica acknowledged that a simple comparison of retail prices among Member States leads to the conclusion that Spanish retail prices are the second highest in EU-15 over the period 1999-2005 and 20% above EU-15 average. However, Telefónica claimed that the high level of retail prices in Spain is the result of some country-specific circumstances (population density, per capita GDP, number of young inhabitants, PC penetration, etc) in Spain. Telefónica submitted an econometric study to support its allegations. However, the Commission found that this analysis was seriously flawed and in fact showed that none of the demand or supply factors presented by Telefónica can adequately explain the high level of the Spanish retail prices. It follows that Telefónica’s conduct has led to significant consumer harm.

2.1.3. The margin squeeze has been a rational, profitable strategy for Telefónica

Telefónica’s pricing strategy has been rational and subsequently profitable in three ways:

Firstly, Telefónica’s conduct was designed to foreclose its ADSL competitors and be able to sustain supra competitive retail prices. Telefónica stood to benefit the most from the foreclosure of its retail ADSL competitors. This is because neither cable operators nor the late and progressive development of ULL could neutralise the likely effects of Telefónica’s conduct on end users. Indeed, although Telefónica does not control the cable operators’ access to wholesale inputs, the latter have not exercised a pricing discipline on Telefónica in the retail market. The profits extracted from a high level of retail prices surpassed by far the forsaken

(12) OECD Communications Outlook 2007; Comreg, Quarterly Key Data Report, December 2006; OCU, Las tarifas españolas, muy altas respecto a Europa, May 2005.
(13) See El coste del ADSL en España es un 25% superior a la media de la UE, El país, 12.07.06. See also La CMT constata el insuficiente crecimiento de la banda ancha en España, El mundo, 11.07.06.
(14) CMT decision RO 2004/1811 of 16.11.2006 (page 130).
profits related to the forsaken wholesale sales as a result of the high wholesale prices (relative to the retail prices).

Secondly, creating and maintaining a leading position in the fast growing market of retail broadband access allowed Telefónica to protect its position in adjacent retail mass markets like fixed telephony. Indeed, the provision of retail broadband access services has a loyalty effect on the traditional fixed telephony services. End users are more likely to choose the same provider for all electronic communications services, i.e. fixed telephony, broadband internet, television over broadband and also mobile telephony.

Moreover, many of these services, in particular voice over IP and television over broadband are rapidly growing, and Telefónica’s conduct therefore allowed it to be in a position to pre-empt these future booming retail markets.

2.2. Objective justification and efficiencies

Telefónica’s behaviour is not objectively justified and did not produce efficiencies.

2.2.1. As a vertically integrated company, Telefónica was profitable. Therefore the losses imposed on competitors were not inevitable.

Telefónica alleged that Telefónica’s downstream losses are, in the context of a non mature market, investments with a view to achieve future profits. This argument is invalidated by Telefónica’s initial business plan of 2001 which shows that the company expected rapid achievement of profitability on an end-to-end basis and estimated that the break-even volume for end-to-end profitability was 1 million ADSL end users which was achieved on February 2003. This means that the company did not rely on projected growth from 2003 to achieve profitability (on an end-to-end basis). The business plan of the company indicates that the broadband activity of the company was expected to generate a positive net present value during the period 2001-2006 but would have expected to generate a negative net present value if the company had had to pay the wholesale prices charged to competitors.

2.2.2. Promoting Internet use is not a justification in this case.

Telefónica claimed that low retail prices were indispensable to increase awareness of broadband and thereby stimulate demand, which would in turn have benefited its competitors and the market in general. Telefónica’s argument is deficient in one essential respect: if it had really been Telefónica’s intention to develop the broadband market, Telefónica could have priced all its wholesale products at low levels encouraging the entry of competitors (avoiding a margin squeeze while still being profitable). Telefónica chose instead to oblige its retail competitors to incur losses, thereby diverting the market growth to its advantage. It cannot therefore cogently be maintained that Telefónica was guided by a desire to develop the market for the benefit of all stakeholders. Above all, Telefónica’s argument is invalidated by the fact that, as already established, its conduct allowed it to sustain the highest retail prices in Europe, thereby negatively affecting consumers and the market as a whole, with a below EU average rate of penetration.

2.2.3. Telefónica’s retail prices did not change since 2001.

Telefónica also claimed that it was forced to align itself on the retail prices charged by its downstream competitors (meeting competition defence). It is true that a dominant operator is not strictly speaking prohibited from aligning its prices with those of competitors. However, the Commission considered that the meeting competition defence may not legitimise a margin squeeze that enables the vertically integrated company to impose losses on its competitors that it does not incur itself. The meeting competition defence may not legitimise a behaviour whose effect is to leverage and abuse an upstream dominance. Telefónica’s conduct was certainly not indispensable in order to defend its commercial and economic interests because Telefónica could have lowered its wholesale prices without increasing its retail prices and still be profitable overall. Also, Telefónica’s nominal retail prices are those which were defined by the company in its initial business plan of 2001 and have not been changed since that date. Therefore, it cannot be considered that the margin squeeze is a response to low pricing by competitors. Moreover, the mere fact that the initial business plan of the company shows that the net present value of its broadband business generates a positive net present value on an end-to-end basis while its downstream activity generates a negative present value is a strong evidence that the objective aim of Telefónica’s conduct was to foreclose competitors.

3. Liability of Telefónica

Telefónica has taken the view that prices applied on the Spanish broadband market have been supervised by the CMT and that it therefore lacked autonomy in setting the relevant prices.

However, ex ante regulation did not preclude Telefónica for avoiding the margin squeeze on its own initiative by decreasing its wholesale prices.
or increasing its retail prices. Firstly, Telefónica’s national wholesale prices (which represented approximately 70% of the wholesale products covered by the Decision in 2006) were never regulated during the period of infringement. Therefore, Telefónica’s argument would only, if at all, be relevant for its regional wholesale prices. Secondly, ex ante regulation of prices for regional wholesale access was limited to maximal prices and Telefónica has always been free to apply for a reduction of its prices.

It is important to note that the CMT imposed a maximum level of Telefónica’s regional wholesale prices on the basis of estimates and never on the basis of Telefónica’s historical actual costs. In particular, CMT’s interventions were not based on the accounting data known to Telefónica and which has been accessible to the Commission during the investigation. The Commission did not find that Telefónica submitted false information to the CMT (despite the mismatch between the information supplied and the data of its own business plan). However, Telefónica could not have been unaware of the limited and necessarily approximate information used by the CMT in its ex ante model, and should have been vigilant as to the evolution of actual data. Telefónica could not have been unaware of the fact that its business plan showed that they would engage in a margin squeeze and that the data accumulated every month in its scorecard not only indicated that the estimates made by the Spanish regulator were not matched by actual cost data but also that the company knew it was engaging in a margin squeeze. Seen in the most favourable light for the company, any continued reliance of Telefónica on the accuracy of the CMT’s estimates and calculations, despite the accumulation of actual data to the contrary, is –at the very least — seriously negligent behaviour.

4. The fine

Telefónica committed a very serious abuse of a dominant position for which there are precedents. In particular, the Deutsche Telekom decision clarified the conditions of application of Article 82 EC to an economic activity subject to sector specific ex ante regulation. As the Commission indicated in Deutsche Telekom, the type of abuse committed by Telefónica jeopardises the objective of achieving EU-wide establishment of an internal market for telecommunications networks and services with undistorted competition, and can certainly be ranked as a very serious infringement (15).

In determining the gravity of the infringement, the Commission took into consideration the fact that the relevant markets are markets of considerable economic importance and which play a crucial role in the development of the Information Society. Broadband connections are a prerequisite for the provision of a variety of on-line commercial and public services to end-users. The Commission also took into consideration the fact that Telefónica’s conduct led to significant consumer harm.

5. Conclusion

With this decision, the Commission has shown that it is ready to act forcefully against cases of price abuses, even in a scenario where the industry under examination is subject to sector-specific regulation.

(15) See footnote 3: Deutsche Telekom, paragraph 203-204.