Two Commission decisions on price abuse in the telecommunications sector

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During the first half of the year 2003, the Commission adopted two formal prohibition decisions pursuant to Article 82 EC-Treaty regarding abusive pricing for the provision of telecommunications services. Those are the first decisions of that kind since the telecommunications sector was fully liberalised in 1998, and even since 1982, when British Telecommunications, still acting under a State monopoly, had been found to abuse its dominant position by restricting the use of telex and telephone facilities. (1) These two decisions are particularly noteworthy, because they concern an economic sector subject to ex ante regulation, in which the Member states play an important role through the decision making practice of the national regulatory authorities. The rules of such regulation have been reformed in 2002 with the new Directives on Electronic Communications, and are about to shift towards concepts based on competition law.

1. The Deutsche Telekom case: margin squeeze

On 21 May 2003, the Commission adopted a decision under Art. 82 regarding Deutsche Telekom’s pricing strategy for local access to the fixed telephony network. (2) In that decision, the Commission found that Deutsche Telekom (DT) was engaging in a margin squeeze by charging new entrants higher fees for wholesale access to the local loop than what subscribers had to pay for retail lines. This discouraged new companies from entering the market and reduced the choice of suppliers of telecoms services as well as price competition for consumers. The Commission’s action was originated in 1999 by complaints from numerous new entrants in the German fixed-line telecommunications market.

1.1. The local access market

The local loop is the physical circuit between the customer’s premises and the telecommunications operator’s local switch. Traditionally it takes the form of pairs of copper wires. New entrants on the telecommunications markets need access on fair and non-discriminatory terms to the local loops (local loop unbundling) to be able to offer retail services to end-customers, as it would be impossible to replicate from the outset such a network built over a century. Effective local loop unbundling is key for the spread of electronic communications services. It was imposed on the incumbent operators by way of legislation at EU level. (3) In some Member States, such as Germany, local loop unbundling was imposed much earlier. Despite this clearcut regulatory obligation, local loop unbundling is not developing fast enough. (4) However, the regulatory framework is not the only tool available to solve competition problems in this area. The conditions of local loop unbundling, such as pricing, are also subject to scrutiny under the EU competition rules.

In Germany, DT offers local loop access at two different levels. Besides the retail subscriptions to end customers, DT also offers unbundled local loop access to competitors, which allows those to gain direct access to end-users. DT is thus active on the upstream market for wholesale local loop access to competitors and on the downstream market for retail access services to end-customers. Both markets are closely linked to each other. DT’s local access network is not the only technical infrastructure allowing for the provision of wholesale access services to competitors and of retail access services to end-users. However, the other alternatives, which include fibre-optic networks, wireless local loops, satellites, power lines, and upgraded cable TV networks, are not yet sufficiently developed and cannot be considered as equivalent to DT’s local loop network.

1.2. DT’s dominant position

Since the beginning of 1998, DT is legally obliged, under national law, to provide competitors access to its local loops. (1) In spite of this clear obligation, there still is very little effective unbundling of the local loops. DT indeed still holds a dominant position on the markets for both wholesale and retail access to the local loops in Germany. The Commission found that regarding wholesale access, DT is the only German fixed line operator having a network with nation-wide coverage. In order to provide a variety of services to end users, new entrants need access to this infrastructure on a wholesale basis. Regarding retail access, even after five years of competition, the Commission found that DT still has around 95% market share for providing both narrowband (analogue and ISDN) and broadband (ADSL) access services. In addition, the remaining 5% market share are divided up between a large number of competitors. Indeed, many new entrants have, since 1998, tried to compete with the incumbent operator, but none of them has been able to reach significant market share.

1.3. The margin squeeze test

A margin squeeze can be found to exist if a vertically integrated operator charges prices for wholesale access which are so high that competitors are forced to charge their end-users prices that are higher than the ones claimed by the vertically integrated operator from its own end-users for similar services. (2) If the wholesale charges are higher than retail charges, the competitors, even if they are at least as efficient as the dominant operator, can never make a profit, because on top of the wholesale charges they also have other costs to bear, such as marketing, billing, debt collection etc., before being able to make a comparable retail service offering.

DT has taken the view that there cannot be abusive pricing in the form of a margin squeeze in the present case, because the wholesale charges are imposed by the German regulatory authority (RegTP). According to DT, any margin squeeze must be the result of excessive wholesale prices or predatory retail prices, or a combination of the two, and it must be legally possible to terminate the squeeze by modifying either of those prices. However, the Commission has come to the conclusion that the margin squeeze is the relevant test in this case, and that it can exist with regard to regulated tariffs. Of course it has also to be shown that the undertaking subject to price regulation has the commercial freedom to avoid or terminate the margin squeeze on its own initiative. If the company has that freedom, the question if and how the prices are regulated ex ante is relevant only for the choice of the correct remedy to bring the margin squeeze to an end.

In the case of local access in Germany, the Commission found an abusive margin squeeze, because the difference between DT’s retail and wholesale prices was either negative or slightly positive, but insufficient to cover DT’s product-specific cost of providing its own retail services. Because of the insufficient spread, ever since local loop unbundling started in Germany and still at the date of the decision, new entrants had no scope to compete with DT for fixed line access to end consumers. In order to achieve a coherent comparison, the Commission used a weighted approach, taking into account the numbers of DT’s customers for the different access types at retail level. The Commission thus compared the tariffs for wholesale access to the local loops with those for a number of different retail offerings, namely analogue, ISDN and ADSL connections, at the end of every year since 1998 as well as in May 2003. The Commission’s assessment revealed, for the period from the beginning of 1998 until the end of 2001, that DT charged competitors more for unbundled access at wholesale level than it charged its own subscribers for access at the retail level. Such a negative spread constitutes a clear case of margin squeeze without any cost element to be taken into consideration. As from 2002, prices for wholesale access became lower than retail subscription prices, so that a positive spread occurred between both prices. However, even during this period, the new entrants could not compete with DT on fair terms. On the basis of information submitted by DT, the Commission found that the positive spread was still not sufficient for DT to cover its own product-specific cost for the supply of comparable end-user services. The Commission thus used DT’s own downstream cost as the relevant comparator in this case. This test provides evidence of the margin squeeze, insofar as it became obvious that DT itself could not have offered retail access services without making losses if it had to pay the same wholesale price as its competitors. (3) In applying this

(1) The EC regulation on local loop unbundling (see footnote 3 above) entered into force on 1.1.2001.
approach, the Commission found that even after the reduction of the monthly wholesale prices by RegTP as of 1 May 2003, the margin squeeze remained in place.

1.4. Company vs Member state responsibility

Any Commission decision stating the abuse of a dominant position by a company is subject to the demonstration that the abusive behaviour was not imposed on the company by way of public intervention. The Commission has therefore set out the conditions under which DT could have avoided the margin squeeze, notably by increasing the retail charges for analogue, ISDN and ADSL connections within the German price cap system. The fact that such scope existed is evidenced by the retail price increases actually introduced by DT in 2002. These tariff increases were steps in the right direction, but largely insufficient in volume to terminate the margin squeeze.

The initial price cap system set up by the Federal Ministry of Posts and Telecommunications gave DT sufficient scope, between 1998 and 2001, to restructure entirely its tariff system. Increases in retail access charges could be offset by reducing call charges. This price cap system did not limit the tariff reductions in number and scope, so that DT was free to increase access charges while reducing call charges by a corresponding amount. DT introduced six reductions of call charges between January 1998 and February 2000. Therefore an increase of the retail access charges was legally and economically feasible. In addition, DT could have further reduced the call charges at any time, in particular for local calls, thus gaining even more scope for increases of the monthly and one-off charges for analogue and ISDN connections. None of this was undertaken by DT.

Under the price cap system in force since 1 January 2002, DT has on the contrary almost entirely exhausted its freedom for access price increases. However, DT’s freedom to avoid the margin squeeze did not arise only from the access charges that are regulated under the price cap system, because the unregulated ADSL tariffs must also be taken into consideration. Indeed DT was free at any time to raise access charges for ADSL access in order to reduce the margin squeeze, without any prior approval by RegTP. Nevertheless, DT has left its ADSL charges almost unchanged. Even if DT might not have been able to use this possibility to entirely terminate the squeeze entirely, DT could have at least reduced the margin squeeze.

1.5. Follow-up to the decision

Since the decision was adopted in May, several steps have been taken by DT and RegTP, in order to reduce the margin squeeze. By decision of 30 June 2003, RegTP reduced the one-off wholesale fees for local loop unbundling by up to 20%. This was a first step in the right direction, especially since DT had initially requested higher fees than the ones finally authorised by RegTP. In addition, DT decided to increase the retail subscription tariffs for analogue lines by around 10% as of 1 September 2003. To that end, the price cap regime had first to be adapted by RegTP, which was achieved by decision of 22 July 2003.

This modified tariff structure of DT offers a better basis for more competition in the local loop. DT’s competitors now have to pay less at wholesale level and will thus be able to offer more attractive retail access prices. This will help them to better compete with DT for local loop access, especially since DT’s retail access prices have been increased.

In parallel to those measures taken or initiated by DT in order to comply with the Commission decision of 21 May 2003, DT has challenged this decision by lodging an appeal under Article 230 before the Court of First Instance (T-271/03).

2. The Wanadoo case: predatory pricing

On 16 July 2003, the Commission adopted a decision relating to a proceeding under Art. 82 of the Treaty regarding Wanadoo’s pricing strategy of its ADSL services. (1) ADSL is the main available technology in France for the provision of high speed internet access to residential and small office/home office (SOHO) customers. It allows to provide broadband services over the traditional telephone copper pair linking local exchanges to the customers’ premises. During the period covered by the decision nearly all ADSL lines in France were operated by the incumbent operator France Télécom. Television cable networks are theoretically an alternative platform for the provision of such services, but their footprint in France is limited, and no cable operator was in a position to roll out a national network comparable to France Télécom’s ADSL facilities. The first broadband

(1) Commission Press Release IP/03/1025, decision not yet published in the OJ.
services were marketed in 1998, but it is not until the end of 1999 that the market started to take off at a significant scale and pace.

2.1. Prices below cost

According to EC case law two tests are possible to find an abuse in the form of predatory pricing: where variable costs are not covered, an abuse is automatically presumed; where variable costs are covered, but total costs are not, the pricing is deemed to constitute an abuse if it forms part of a plan to eliminate competitors. (1) The two tests have been applied in the Commission’s decision, for the periods before and after August 2001. In this instance, the Commission carried out adjustments to costs and revenue so as to take account of the characteristics of a strongly growing market. In particular, customer acquisition costs, which in an expanding market account for a sizeable chunk of the total costs, were spread and written off over a number of years, thus being treated as if they had been capital expenditures. In addition, the Commission did not take on board the actual average proceeds per subscriber as booked in the firms accounting, but made a number of adjustments to correct the fact that the dynamics of the firm’s growth mechanically distorted the revenues per user. All these adjustments were favourable to the company, insofar as they increased the level of cost coverage, without altering the philosophy of the predatory pricing tests as laid down in the Akzo judgment.

From the end of 1999 to October 2002, Wanadoo, a 72% owned subsidiary of France Télécom, marketed its ADSL services known as Wanadoo ADSL and eXtense at prices which were below their average costs. It emerged from the Commission’s investigations that the prices charged by Wanadoo were well below variable costs until August 2001 and that in the subsequent period they were approximately equivalent to variable costs, but significantly below total costs. Since the mass marketing of Wanadoo’s ADSL services began only in March 2001, the Commission considered that the abuse started only on that date. Wanadoo suffered substantial losses up to the end of 2002 as a result of this practice. The practice coincided with a company plan to pre-empt the strategic market for high-speed Internet access. While Wanadoo was suffering large-scale losses on the relevant service, France Télécom, which at that time held almost 100% of the market for wholesale ADSL services for Internet service providers (including Wanadoo), was anticipating considerable profits in the near future on its own wholesale ADSL products.

Wanadoo’s policy was deliberate, since the company was fully aware of the level of losses which it was suffering and of the legal risks associated with the launch of its eXtense service.

2.2. Effect on the market

The abuse on which the Commission has taken action was designed to take the lion’s share of a booming market, at the expense of other competitors. From January 2001 to September 2002, Wanadoo’s market share rose by nearly 30 percentage points to between 65% and 75% on a market which saw more than a five-fold increase in its size over the same period. This level of market penetration by Wanadoo is roughly what Wanadoo was expecting by 2004. The level of losses required in order to compete with Wanadoo had a dissuasive effect on competitors. At the end of the period during which the abuse was committed, no competitor held more than 10% of the market, and Wanadoo’s main competitor at the time the abuse began had seen its market share tumble. One ADSL service provider (Mangoosta) went out of business in August 2001. The effects of Wanadoo’s conduct were not confined to competitors on the ADSL segment, but extended to cable operators offering high-speed Internet access.

The abuse came to an end in October 2002, with the entry into force of new wholesale prices charged by France Télécom, more than 30% down on the previous prices charged. Since then, the French high-speed Internet access market has been growing much more rapidly and in a more balanced way as far as the various competitors are concerned. Market growth picked up strongly subsequently, with the ending of the abuse, and the number of Internet subscribers grew more between September 2002 and March 2003 (seven months) than between March 2001 and August 2002 (seventeen months).

2.3. Recoupment of losses

The Wanadoo case raised a classical question in EC competition law, namely how to distinguish between the normal behaviour of a company simply actuated by legitimate objectives and an abusive behaviour. Wanadoo claimed that by selling its services below costs, it had acted in a

rational manner, with the objective of developing a new market and to reach profitability in the medium term.

In particular, the company submitted calculations designed to prove that for each new subscriber the discounted cash-flows of the services sold at a loss would be positive over a period of less than five years. The Commission did not accept that these calculations, although inspired by classical standards of investment decision making, are a relevant tool to assess whether the behaviour of a dominant company amounts or not to predatory pricing. Indeed, the recoupment of initial losses over a certain period of time is in the most common settings the very objective of a predatory pricing behaviour. The firm expects, after evicting or disciplining its rivals, to be in a position to increase its profit margin in order to make up for the losses incurred during the predatory pricing period. Demonstrating that acquiring an ADSL customer is rational since it provides a positive deflated income over five years simply shows that the predatory pricing strategy will pay off. Admitting Wanadoo’s reasoning in this respect would have led to the conclusion that by essence predatory pricing can simply not exist.

Another reason for the Commission to reject Wanadoo’s contention was linked to the specificities of the case. It appeared that Wanadoo’s attempt to demonstrate the profitability of its products was biased by an optical flaw. Even if the discounted cash-flows generated by a single subscriber was indeed to be admitted as positive in the medium term, the ongoing volume of acquisition costs on an expanding market are such that the whole activity (all subscribers together, whatever their date of entry) may well continue for a long time to be unprofitable. Indeed, what counts for the firm and its shareholders is not the individual net revenues produced by a single subscriber, but the overall assessment of the financial situation of the activity at stake.

The Wanadoo decision restates that the behaviour of a company, though apparently financially rational, may in fact be abusive, because it ignores the special responsibility of the dominant firm.

2.4. Emerging markets

The Wanadoo case raised another interesting question, as to whether it was timely and opportune for the Commission to intervene on a market at a nascent stage. At the end of the year 2000, the high speed Internet market in France numbered around 200 000 customers and was well beyond the initial phase of pure technical and marketing experiments. Since mid-2000 it had engaged on a path of accelerated growth. However, it is true that this market will continue to grow and that it definitely had not reached a phase of maturity at the date the decision was taken. In fact, this question can be subdivided into two parts. Firstly, as a matter of principle, is a competition authority entitled to step-in and sanction a company’s behaviour at this early stage of development of a mass market? Secondly, were the losses incurred by Wanadoo inevitable in the context of a relatively new activity?

On the first point, the Commission considered that nothing in Article 82 or in the case law provides for an exception to the application of the competition rules to sectors which are not yet fully mature or which are considered to be emerging markets. To subordinate the application of the competition rules to a complete stabilisation of the market would be to deprive the competition authorities of the power to act in time before the abuses established have exerted their full effect and the positions unduly acquired have thus been finally consolidated. On the contrary, it must be possible to sanction predatory pricing whenever there is a risk that competitors will be eliminated. The aim to maintain undistorted competition set out in Article 3(g) of the Treaty excludes that the Commission waits until such a strategy leads to the actual elimination of competitors. (1)

The intervention of the Commission in this case was all the more justified as first-mover advantages are considerable in such a sector. Indeed, one of the aims of the predation strategy carried out by Wanadoo was to be the first to conquer the high-speed market and to be in the eyes of the general public the one that succeeds in introducing technological innovation. As a matter of fact, Wanadoo, even after the end of the abuse period, is still in a position to cash in on these reputation effects and other first mover advantages. From a policy point of view, the intervention of the Commission in this case was all the more necessary as high-speed Internet access plays a key role in the achievement of the objectives of the Lisbon strategy.

On the second point, it is worth noting that in the context of the development of ADSL products, the objective of rapid profitability was not beyond reach despite the newness of the products in question. France Télécom, Wanadoo’s majority shareholder, expected to achieve on its ADSL services a positive net margin on full costs very rapidly. It

(1) Above-mentioned judgment in Case C-333/94 Tetra Pak, paragraph 44.
should be recalled that it was France Télécom that undertook the technical deployment of ADSL and not Wanadoo Interactive, which simply retailed France Télécom’s product. Thus, the parent company of the Wanadoo group, which was the chief architect of the ADSL industrial process, expected to attain positive net margin levels very quickly, whereas Wanadoo’s net margin levels for 2001 and 2002 were far lower. The data provided by France Télécom to the Commission show that, contrary to what could have been expected, the newness of ADSL services in no way precluded the attainment of an objective of fairly rapid profitability. The incurring of substantial losses on a new type of product such as ADSL could therefore by no means be considered as either inevitable or necessary.

2.5. Promoting Internet use is not a justification

A last question worth mentioning was whether Wanadoo’s pricing under costs could not be justified by a legitimate objective of helping to increase awareness of high-speed Internet, which would in turn have benefited Wanadoo’s competitors and the market, inter alia by reducing network costs.

The Commission considered in this instance that this argument was deficient in one essential respect: there is no proof that the strategy pursued by the company would alone have made it possible to attain the desired objective of increased broadband use in France. The positive effects linked to market growth could have been brought about had the market developed under conditions of equilibrium among service providers. If it had really been the France Télécom group’s intention to develop the high-speed market for the benefit of all operators, France Télécom could have priced all its wholesale products — from shared or full unbundled access to the local loop to IP/ADSL access and routing services — at low levels encouraging the entry of competitors.

Wanadoo has challenged the Commission’s decision by applying for an annulment by the Court of First Instance (T-340/03).

3. Conclusion

With these two decisions, the Commission has shown that it is ready to act forcefully against cases of price abuse, even in a scenario where the prices under examination are subject to sector-specific regulation. Both decisions set out the conditions for the relevant tests to be carried out. Predatory pricing requires a straightforward comparison between prices and the underlying cost and triggers an obligation to increase the abusive prices. The margin squeeze test starts with a comparison between wholesale and retail prices and only if the latter are higher than the former includes also the underlying downstream cost. Such an abuse can be remedied at either level, i.e. by reducing wholesale or by increasing retail tariffs. Both tests bear important precedent value for other future cases of price abuse in network industries, both for the Commission and for national regulators as well as national competition authorities.