

Margin Squeeze and the BT/Wanadoo case

Paolo Palmigiano

Head of Competition and Regulatory Law

BT Group plc, London

Oxford Competition Policy Conference

RPI, Oxford, 3 July 2007

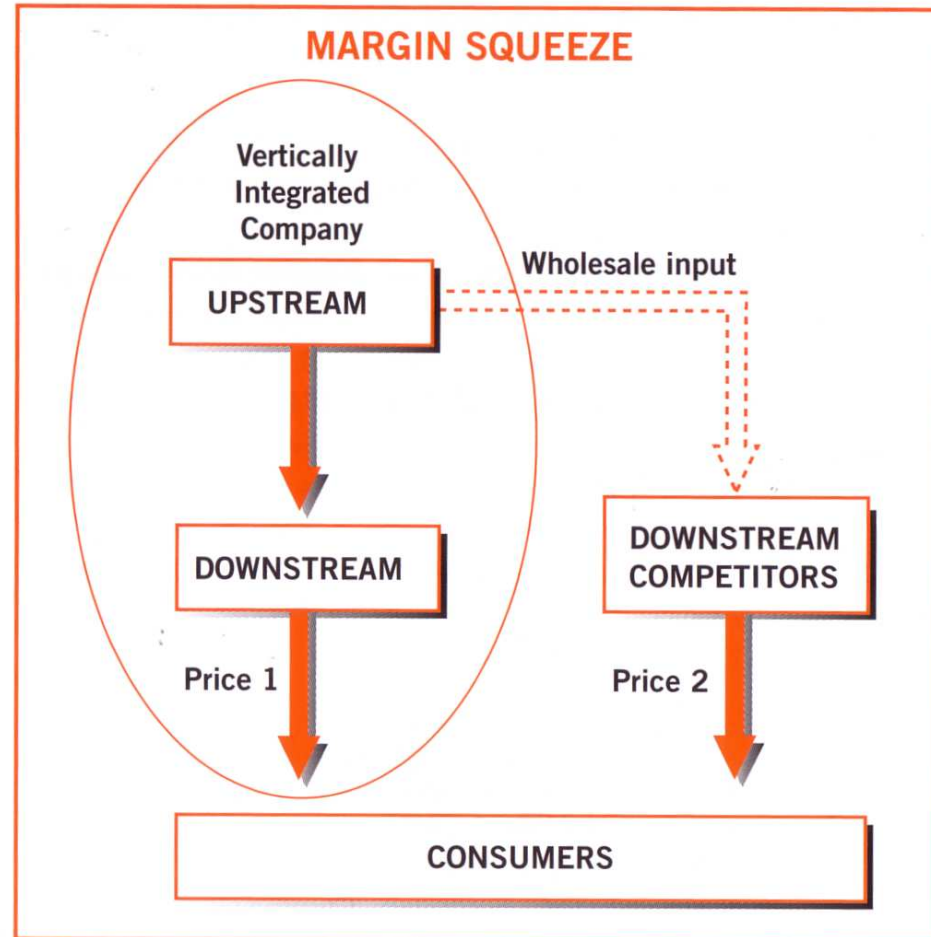


Summary

- Margin Squeeze
- Key issues
- Relevant cases
- The BT/Wanadoo margin squeeze case
- The difficulties of applying Article 82 in emerging markets
- Conclusions

A vertically integrated firm holding a dominant position in the upstream market prevents its non-vertically integrated downstream competitors from achieving an economically viable margin

Downstream competitors are also customers of the dominant firm at the wholesale level



What is a margin squeeze

- Firm is dominant in an upstream market
- Firm supplies upstream product/service to third party which operate in a downstream market
- Firm also competes in that downstream market
- Firm sets its prices at a level where competitors in the downstream market are unable to make a profit
- Firm may still be profitable end to end
- It could be demonstrated by showing that the Firm's downstream operations could not trade profitably on the basis of the price charged upstream to competitors

Key issues surrounding a possible margin squeeze abuse

- Should the 'input' be essential to downstream competitors?
- Test: equally efficient or reasonably efficient operator?
- Should the dominant company control both upstream and downstream prices?
- Need to show anti-competitive effects?
- What costs and revenues to take into account?
- How to calculate costs? AVC or other?
- Is there a rational explanation?



The old cases

- National Carbonising (1975)
- British Sugar / Napier Brown (1988)
- Industrie des poudres sphériques (2000)

- MS theory developed in a series of cases that involved mature industries where competition was limited both for the inputs provided and for the downstream market. In each case the input provided was the most important input in creating the product downstream
- Now applied to rapidly evolving markets

The recent cases

- Deutsche Telekom (EU Commission)
 - decision (appealed)
- Telefonica (EU Commission)
 - statements of objections (and decision of infringement expected)
- Telecom Italia (AGCM)
 - decision
- British Telecom (Ofcom)
 - statements of objections

Many national cases (Italy, France, Denmark, Sweden, UK etc.)



Deutsche Telekom - 21 May 2003

- Insufficient margin between prices that DT charged competitors for access to its local network (unbundled local loop) and the price it charged end-users for access to its fixed network.
- DT argued that tariffs had been approved by RegTP and subject to a regulated price cap - therefore action against Germany (art. 226)
- Competition rules may apply where sector specific regulation allows commercial discretion - different approach from US Trinko
- Analysis
 - Cost : average weighted price for retail services compared to LLU (input)
 - Revenues from lines only. Revenues from calls excluded. Competitors might have a different revenue structure
 - By proving the existence of margin squeeze the Commission has done enough to establish the existence of abuse - (but analysis of negative effects on the market)

Telefonica - February 2006

- SO in February 2006 and decision in 2007
- Key issues
 - Use of the “equally efficient competitor” test
 - No need to demonstrate significant market power in the downstream market
 - Use of LRAIC in network industries
 - Customer acquisition costs spread over a longer period
 - Increasing number of ‘special offers’ in the retail market
 - Alignment with prices of competitors rejected
 - Strategy to keep competitors out of the infrastructure market (investment ladder)

BT / Wanadoo chronology

- Begun in 2002. Two decisions of non infringement and 3 SOs
 - March 2002 Complaint by Freeserve to Oftel : broadband
 - May 2002 Oftel's case closure summary (no infringement)
 - Sept 2002 Freeserve's appeal of case closure summary
 - Competition Appeal Tribunal's decisions
 - Nov 2002 decision on admissibility
 - April 2003 decision on validity
 - Oftel's two investigations
 - Historical investigation : prices from March to May 2002
 - Investigation of current prices (May to December 2002) : ongoing
 - Nov 2003 Oftel's decision on the historical investigation (appealed and stayed)
 - Today Ofcom - from 2004 3 statement on objections on current prices

Oftel's non infringement decision of Nov 03

- Oftel examined whether BT's pricing policies for broadband amounted to a margin squeeze and concluded that
 - “the balance of evidence does not support the conclusion that BT was operating a margin squeeze”
 - For completeness, Oftel considered the issue of effect on competition : “no material effect”.

Since there was no infringement

- no need to decide dominance at the wholesale level;
- no finding of dominance against BT at the retail level
- Oftel determined that “the retail market was competitive”.



Oftel's conclusions

“Oftel has concluded in this decision that the margin between BT downstream consumer broadband prices... and BT's upstream services... is sufficient to cover its downstream costs. Put differently, Oftel has concluded that the above margin is sufficient to allow an equally efficient retail competitor to compete effectively with BT's consumer broadband services”. (para 7.1)

“The assessment was conducted on the basis of information which could have been reasonably available to BT at the time the relevant pricing decisions were made, announced and implemented”. (para 5.58)



How the assessment was carried out

- No historical data (as BT business had been operating only for 2 months and there was no reliable data)
- Losses
- Oftel examined BT's expected profitability
- Profitability analysis based on DCF and cohort analysis
- Complex test that required 8 months of investigation
- Mix of positive and negative results but under a number of assumptions BT recovered all its costs and earned a profit



Assessment of future profitability

- How do you assess profitability in the future?
- Oftel tested the reasonableness of the assumptions made by BT in its business case
- Oftel looked at alternatives and made some adjustments: “Revised business model”
- Range of adjustments
- Issue of legal certainty (difference of opinion?)



New and emerging markets : policy issue

- “How far a firm allegedly dominant in one market may incur ‘start-up losses’ or losses resulting from measures to stimulate demand, when entering a neighbouring market, without infringing Article 82?” (para 243 CAT)
- it would not be appropriate to take action if a strategy would have been profitable on the basis of reasonable ex ante forecasts but in the event turns out to be over-optimistic and so loss making (Ofitel)



New and emerging markets : difficulties

- Need for clear and administrable rules
- Lack of useful precedents
- How to distinguish between anti-competitive conduct and normal dynamic pricing
- Dilemma for competition authorities
 - To wait (but it might be too late)
 - To act (but chilling effects)
- Commission : Authority should intervene



Reliance on business case to assess abuse?

- What if
 - Insufficient 'historic' financial data is available
 - No documentary evidence of actual anti-competitive intent?
- One possibility that some Competition Authorities have considered is to look at the company's business case

» BUT.....



The relevance of the business case

- Inherent contradiction for regulators
- Guidelines on the application of the CA to telecoms
 - Evidence of abuse if business case is based on assumptions which are “unjustified and implausible” (para 7.23)
 - Knowledge of the decision-taker at the time when the decision is made and not with the benefit of hindsight
- Accounting methodologies: historical, DCF, cohort
 - Irreducible elements of uncertainty
 - Depends on assumptions
 - Standard of proof: “strong and convincing evidence”
- Danger of chilling effects and false convictions

Conclusions

- Easier to apply a formula mechanically but from a competition policy perspective, showing a price squeeze should not be enough
- Novel theories
- Old cases and recent cases
- Danger of chilling effects on innovation and investments
- Need for certainty and clarity
- The role of the European Courts

