Legal Alert: the CFI backs the Commission’s approach to margin squeeze in the Deutsche Telekom case

On 10 April 2008, the Court of First Instance (“CFI”) confirmed the European Commission’s (“Commission”) decision that Deutsche Telekom (“DT”) abused its dominant position on the markets for direct access to its fixed telephone network by engaging in a margin squeeze.

A margin squeeze relates to a situation where a vertically integrated company provides an important input into a downstream market in which it also competes, and prices this input at such a level that the competitors it supplies cannot make a margin for profit. The CFI has confirmed this conduct can amount to an infringement of Article 82 EC Treaty under certain conditions.

In summary, the CFI clarified the following points:

- the fact that a dominant company's tariffs are subject to price caps approved by a national regulatory authority is not an exemption from competition law;
- the vertically integrated company's own costs are the correct benchmark to assess whether a reasonable margin is possible for competitors; and
- a comparison of (i) the prices of the upstream input with (ii) a weighted average of the prices of the bundle of downstream services for which the upstream input is needed can provide evidence of a margin squeeze.

This judgment is binding on the Commission and the national courts of the EU Member States in their assessment of alleged margin squeezes. In practice, national competition and regulatory authorities will also likely follow it in their application of Article 82 EC to this type of practice in the future. This note summarises the background of the case, and then discusses the main findings of the CFI in relation to some of the key issues concerning the practical assessment of an alleged margin squeeze.
Background

In 2003, the Commission found DT held a dominant position on the wholesale local loop access market (upstream), and the corresponding retail access market (downstream). According to the Commission, “even after five years of competition”, DT still held around 95 per cent market share while the remaining 5 per cent was divided amongst a large number of DT’s competitors. The Commission concluded that DT charged new entrants higher fees for wholesale access to the local loop than DT’s own subscribers were paying for their connections at retail level. By doing so, DT abused its dominant position. As a result, the Commission imposed a fine on DT, but limited it to €12.6 million by accepting “mitigating circumstances due to the fact that under the German sector-specific regulation there was some degree of legal uncertainty about the tariffs under scrutiny”. In particular, under German telecommunications law, DT was required to comply with price caps both at wholesale and retail levels and its tariffs had been approved by the national regulator, RegTP. DT appealed the Commission’s decision before the CFI, which rejected the appeal on all grounds. In doing so, the CFI clarified the following practical issues of law.

“State action” defence

DT rejected the charges moved against it by the Commission, arguing that it simply complied with national telecommunications law. The jurisprudence of the Court of Justice clarifies that where State regulation requires a company to take a particular course of action which is anti-competitive, there is no liability on the part of the company for the infringement of EC competition law (see Case C-198/01, CIF v AGCM, 2003). However, the case law also makes clear that EC competition law may apply if it is found that the national legislation leaves open the possibility for the regulated company to act independently, even if only to a limited extent. In this case, the CFI held that DT could adjust its retail prices after obtaining the prior authorisation of RegTP and should have done so. By not doing so, DT infringed EC competition law and no “State action” defence was available to it.

Margin squeeze and “imputation” test

According to the Commission’s own practice in the telecommunications sector, there are two “imputation” tests to determine whether a margin squeeze has occurred: (i) the dominant company’s downstream division cannot trade profitably (using its own downstream costs) on the basis of the price charged to competitors upstream; or (ii) the difference between upstream and downstream prices is not sufficient for a reasonably efficient competitor to make a normal profit (using its own downstream costs). In this case, the Commission applied the first test, despite DT’s arguments that the right test to be applied was to demonstrate the abusive nature of the retail prices – given that DT had no control over its wholesale access prices, which were set by RegTP. The CFI approved the Commission’s approach and, in doing so, it stated that the appropriate “imputation” test is the vertically integrated company’s own charges and costs, rather than those of actual or potential competitors.

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Relevant market definition and “indispensability” of upstream input

Key to an analysis of the alleged margin squeeze is the definition of the relevant markets, both upstream and downstream. Indeed, access to the upstream input must arguably be necessary for downstream competitors to provide the downstream product, as well as for ensuring downstream competition in the downstream market. Often these markets will be the same as those defined in the Commission’s recommendation on the relevant markets for the purpose of sector specific regulation in the telecommunications sector. However, narrower or wider markets may be defined depending on the period of time taken into account for the assessment (e.g., peak or off-peak times) or the type of customer groups (e.g., residential or business). During the course of proceedings, DT sought to distinguish two separate wholesale markets relating to narrowband services and broadband services respectively, but that argument was declared inadmissible because, in its application, DT had not challenged the definition of the relevant markets.

Accounting issues – costs and profitability

In assessing a margin squeeze, the Commission is called upon essentially to assess costs, revenues and profitability. This is difficult in practice for various reasons: for example, there are various methods (i) to calculate costs (e.g., short run or long run; historic or forward looking; fully allocated or average incremental); (ii) to allocate “common costs” to different services; and (iii) to measure profitability (e.g., return on capital employed or return on turnover). In the DT case, the upstream local loop access service was “common” to a bundle of retail access services (namely, analogue, ISDN and ADSL connections). The Commission took a rather simplistic approach: it excluded revenues from other services, such as call services, and then compared, on the one hand, the weighted average of prices of this bundle of retail access services with, on the other hand, the price charged to competitors for upstream access to the local loops. It concluded that due to the insufficient spread between the two sets of prices, new entrants did not have the scope to compete with DT for end consumers. The CFI found that the Commission had been correct to take this approach.

Effect on competition on the downstream market

DT argued that margin squeeze is not an abuse per se and that the Commission should have considered the actual effects on the downstream market. The Commission maintained that it was not necessary to demonstrate an anti-competitive effect, although, in practice, it did examine that effect in the recitals of its Decision. The CFI found that in this case – where DT had a monopoly position on both the wholesale and retail markets – all the Commission was required to identify were the possible barriers to entry resulting from DT’s pricing practices. Because wholesale access to DT’s network was indispensable to enabling a competitor to enter the downstream retail market, the margin squeeze between the wholesale and retail charges was considered to raise entry barriers.

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3 Commission Recommendation 2007/879/EC.
Relationship with sector-specific regulation

In the EU, companies are subject to both competition law and sector specific regulation. Accordingly, competition authorities may carry out their own market analysis and impose appropriate remedies alongside any sector-specific measures applied by the national regulators. In this case, the CFI confirmed that such simultaneous application of remedies by different regulators would address different problems in such markets, and are therefore not mutually exclusive.

Unresolved issues

A number of issues were not relevant to the facts of the case and accordingly remain open questions as a matter of law. To name but a few: it has been argued that, for a dominant company to commit a margin squeeze it must be “super dominant”, that is to have a market share of over 80%\(^4\). The DT case met this requirement, but it is not obvious that this always needs to be the case. It has also been suggested that the margin squeeze must be demonstrated to have occurred over a sufficiently long period of time\(^5\). The DT case met this requirement too. But little guidance is available for the assessment of an alleged margin squeeze in emerging markets, where the retail offers would often be loss making for a start-up period of time.

Concluding remarks

In its judgment, the CFI rejected all pleas advanced by DT and provided further backing to the Commission’s approach to assessing margin squeeze cases. A case on similar grounds concerning an alleged margin squeeze by incumbent operator Telefónica is currently pending before the CFI and it remains to be seen what will be the final outcome.

If you have any questions please contact Frances Murphy or Gillian Sproul at Mayer Brown International LLP.

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\(^5\) In Napier Brown/British Sugar, cited at footnote 2 above, the Commission found that if British Sugar had maintained its pricing policy in the long-term rivals would have been forced to exit the downstream market.