When is a margin squeeze not an abuse?

On 20 June 2013 Ofcom closed its long-running investigation of BT's pricing of its Wholesale Calls product with a "no grounds for action" decision.[1] The investigation, which commenced in August 2008, focused on allegations of margin squeeze made by THUS plc and Gamma, two competitors to BT in the supply of wholesale calls that rely on BT for upstream inputs (call origination services in particular) provided over BT's copper access network.

The most important aspect of the decision from a policy perspective is that Ofcom carefully distinguished between a technical margin squeeze (i.e. a finding that downstream costs exceed the difference between upstream and downstream prices) and an abuse of a dominant position. Whilst finding a technical margin squeeze is a necessary condition for an abuse, it is not sufficient. Unless the technical squeeze leads to actual or likely consumer harm, there is no abuse. Ofcom should be applauded for its careful assessment of effects, which sets a standard for other authorities to follow when investigating matters under Article 102 or national equivalents.

Interestingly, Ofcom could have reached the same conclusion more directly had it prioritised an approach to the technical assessment of margins that more accurately reflected a number of realities facing competitors. This would have found positive margins for equally efficient competitors over the relevant arena of competition and saved Ofcom from needing to assess effects further.

What are wholesale calls?

In simple terms, a phone call consists of three components: call origination (CO), call termination (CT) and *core* network services in between. CO and CT are provided over *access* networks that link end-customers to local exchanges. In the UK, BT controls a near-ubiquitous fixed access network.

Phone calls are sold both to retail customers and at the wholesale level between communication providers (CPs). A CP that has its own core network may purchase CO and CT (from BT and other CPs) to complete calls at each end, and may sell these calls at the wholesale or retail level. A CP that does not have its own core network must buy wholesale calls from another CP and resell those calls. Wholesale calls thus allow a CP to sell calls without having a core network of its own.

Ofcom's investigation found that BT held a dominant position in the supply of upstream inputs (CO and CT) used to supply wholesale calls downstream, and that BT was also active downstream with its Wholesale Calls product. The margins between BT's upstream and downstream prices therefore fell for consideration under Chapter II of the UK Competition Act and Article 102.

A technical margin squeeze, but no anti-competitive effects

Applying an equally efficient operator (EEO) approach[2] (as is standard in Article 102 cases) Ofcom found that an EEO would have made negative margins over the ten month period from July 2008 to April 2009 (i.e. the margin between BT's upstream and downstream prices was insufficient to cover the downstream costs of an EEO over that period). Ofcom also found that, depending on how the arena of competition was defined (see below), an EEO might have earned negative margins over a longer 30 month period (from July 2008 to December 2010).

However, Ofcom did not find evidence of any reduction in the intensity of competition (despite more than four years passing since the complaint was made) or that BT's pricing conduct had led any competitors to exit the market. Indeed, Ofcom found that BT's competitors continued to compete successfully for new contracts with resellers. Ofcom also found that potential future anti-competitive effects were unlikely. Ofcom's decision highlights the value of a careful effects assessment: although Ofcom found negative margins, it did not find evidence of actual or likely future anti-competitive effects and concluded that there was no abuse. This is consistent with the case law (in particular the ECJ judgments in *Deutsche Telekom* and *TeliaSonera*) that holds that a pricing practice must have at least the potential for anti-competitive effects before it can be considered abusive.

The importance of the arena of competition

Ofcom asked itself why anti-competitive effects had not materialised despite the finding of negative margins.[3] One answer is that in a number of respects the negative margins calculated by Ofcom understated the actual margins available to equally efficient competitors.

In particular, a margin squeeze calculation will only provide useful information on whether margins are sufficient for competitors to be profitable if the scope of the

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[1] Ofcom, CW/988/06/08: Complaint from THUS plc and Gamma Telecom Limited against BT about alleged margin squeeze in Wholesale Calls pricing, Final Decision, 20 June 2013. The authors advised BT from an early stage in the investigation. The views expressed in this Competition Memo are those of the authors and do not necessarily represent the views of BT or other CRA staff.

[2] Ofcom actually applied what is called an "adjusted" EEO approach. However the adjustment that this refers to was minor and not controversial, so we do not discuss it further in this memo.

[3] Paragraph 7.233.

calculation is limited to the arena over which competition occurs. If firms compete to supply a number of contracts or products, then what matters is whether an EEO can be profitable over that range of contracts/products, not whether each individual contract/product is profitable, or whether a larger group of contracts/products is profitable. Ofcom recognised this principle in its decision: "[t]he role of margin squeeze rules is to protect efficient competition from being distorted and restricted. Central to the decision over the relevant output increment for cost testing is therefore the output increment for which firms compete."[4]

This was an important issue in the Wholesale Calls case. BT's negative margins over the entire product were largely driven by one large contract *that was not open to competition*. Ofcom accepted that the customer in question would not have bought wholesale calls from another CP if it had not reached an agreement with BT; it would instead have self-supplied. Therefore, this was not a contract that was open to BT's competitors to compete for and should not have been included in the margin squeeze calculations. Ofcom accepted that, ignoring this contract, an EEO would have been able to compete profitably with BT over the 30 month period.

This finding is consistent with Ofcom's finding of no exclusion. Since efficient competitors could compete profitably over the relevant competitive increment it is not surprising that competitors were not excluded.

Two further conceptual issues raised by Ofcom's technical margin squeeze assessment

The case also raised a number of other interesting conceptual issues with respect to how the technical margin squeeze assessment should be performed. In each respect Ofcom's modelling choices tended to further understate margins available to equally efficient competitors. We mention two of these here.

First, Ofcom applied a long-run incremental cost (LRIC) standard to estimate the EEO's downstream costs. An alternative cost standard is avoidable costs (AC). The essential difference between LRIC and AC is that the latter ignores sunk costs. When the concern is with new entry, a cost standard that includes the sunk costs of entry is reasonable. However, when the concern is whether existing competitors will be excluded, an AC standard makes more sense (and hence is typically used in predation cases). In the case of wholesale calls, new entry and sunk costs were irrelevant. As Ofcom acknowledged, BT faced competition in wholesale calls from a number of well-established players with substantial existing core networks with excess capacity. The investments in these networks were largely sunk and irrelevant to the pricing decisions of those competitors. In these circumstances, Ofcom should not have been concerned to force BT to maintain sufficient margins for new entrants that would need to take into account the sunk costs of core networks.

4 Paragraph 6.37.

Ofcom accepted that where costs were genuinely sunk "there may be a valid argument for excluding them from the assessment", but declined to assess the extent of sunk costs given that it was in any event issuing a "no grounds for action" decision.[5]

Second, Ofcom modelled margins on the basis of a competing CP entirely reliant on BT for upstream inputs. It was reluctant to model on the basis of the upstream inputs that would be used by competing CPs that bypass BT's upstream infrastructure with access networks of their own (at least with respect to some end-customers). Many wholesale calls providers avoid paying CO charges to BT with respect to at least some end-customers as they serve them using unbundled local loops (LLU) or their own fibre networks. Where end-customers buy broadband in a bundle with calls, the incremental cost of originating calls over LLU or fibre is considerably less than using BT CO. As a consequence, CPs that supply wholesale calls using LLU or fibre have a cost advantage over those that rely on BT CO. By requiring BT to price wholesale calls in a way that preserves sufficient margins for CPs entirely reliant on BT CO, Ofcom constrains BT from competing with CPs that partly or wholly use their own access networks to originate calls. The justification for insisting on such "headroom" for inefficient operators is the "ladder of investment" argument introduced in the *Telefonica* case: inefficient operators should be given some headroom to allow them to climb the ladder of investment and become efficient. As discussed in an earlier Competition Memo,[6] we have reservations regarding the use of such a justification for finding an abuse of dominance under competition law.

Conclusions

Ofcom's decision is to be welcomed for its acknowledgement that what ultimately matters in a margin squeeze case are effects: are competitors likely to be excluded and consumers potentially harmed? Even if there is a technical margin squeeze, it is always necessary to carry out a careful effects analysis, as Ofcom did in this case. Ofcom might have reached the same conclusion on the basis of a technical assessment of margins that more accurately reflected market realities. This would have revealed that an equally efficient operator would have realised positive margins over the relevant arena of competition. However, there is more than one way to skin a cat, and Ofcom commendably did not allow its finding of negative margins to colour its subsequent assessment of effects: the matters that were underplayed in Ofcom's margin modelling were accounted for in its effects assessment, and the right conclusion of "no grounds for action" was ultimately reached.

5 Paragraphs 6.271-6.272.

6 http://www.crai.co.uk/ecp/assets/margin_squeezes.pdf Republished as Geoff Edwards (2011), "Margin Squeezes and the Inefficient 'Equally Efficient' Operator", *European Competition Law Review*, 32(8): 402.