MEMO/07/274

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Antitrust: Commission decision against Telefónica - frequently asked questions (see also IP/07/1011)

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 costs that an operator as efficient as Telefónica would have to incur to provide retail broadband access.

Wholesale access at national level allows alternative operators to offer retail broadband services throughout the Spanish territory without having to roll out any (or hardly any) network by connecting to a single, "national" access point. Wholesale access at the regional level requires that alternative operators roll out a costly network reaching up to 109 "regional" access points. Telefónica is dominant in the provision of both types of access.

The margin squeeze that Telefónica imposed on its competitors is a very serious infringement of Article 82 of the EC Treaty, which outlaws the abuse of a dominant position on a market. The impact of the abuse in the form of obstacles to the entry of competitors in this growing market of great importance for society as a whole, and the accompanying harm caused to domestic and business customers was considerable.

What is a margin squeeze?

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.

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 of importance in margin squeeze cases.

Faced with a margin squeeze, competing providers of retail broadband access, including those that were just as efficient as Telefónica, were faced with the choice of either exiting the market or, if they aligned their prices with those of Telefónica, incurring losses. Therefore, even though the margin squeeze stopped short of driving competitors out of the market, it restricted their sustainable presence and growth, limiting their ability to compete on the market.

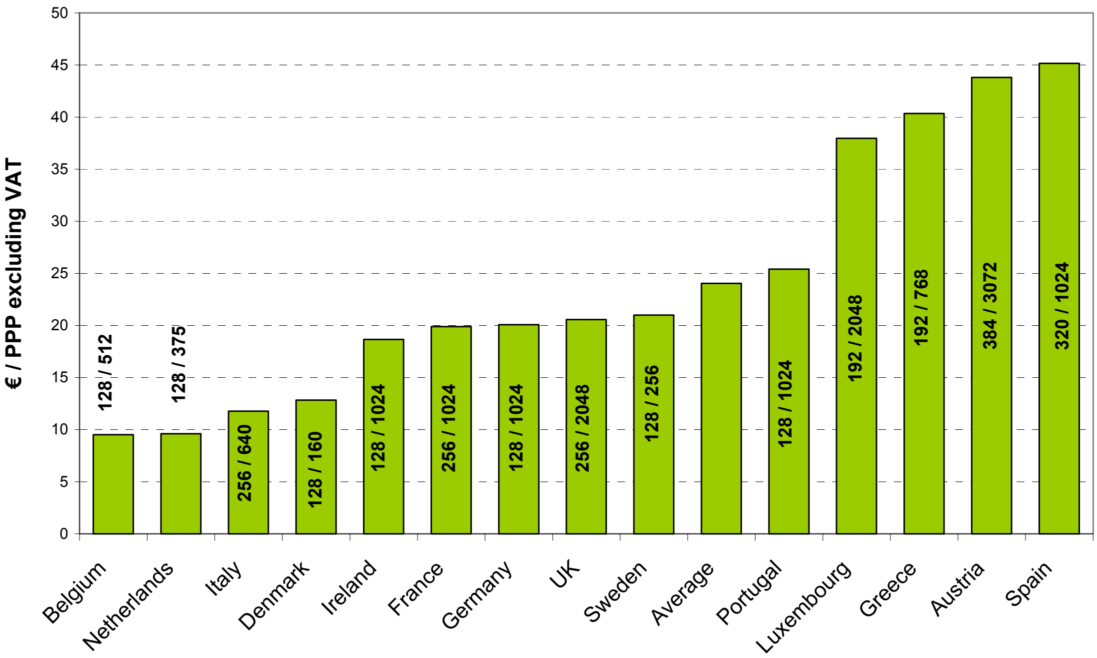
In normal conditions competition leads to lower prices for consumers and more innovation. In this case, by containing competitive pressure, Telefónica could cash in both high wholesale prices and supra-competitive retail prices to the detriment of consumers. Despite its levying of very high retail prices, its market share has increased lately (by 4% from June 2005 to June 2006).

What has been the impact of the margin squeeze on consumers?

By engaging in a margin squeeze, Telefónica has been able to sustain supra competitive retail prices which could not be matched by its competitors because the latter relied on Telefónica's wholesale products. Due to weakened retail competition on the broadband market, Spanish consumers pay about 20% more than the EU-15 average for broadband access. Also, the Spanish broadband penetration rate is 20% below the EU-15 average, and its growth is nearly 30% below that of the EU-15.

The high level of the Spanish broadband prices is confirmed by all available studies. For example, the consultant Teligen (which regularly benchmarks prices for the OECD) has compared the cheapest retail ADSL offer of each country and concluded that Spain ranks last among the EU-15 countries.

Lowest Monthly Rental ADSL among Member States – November 2006[1]



Telefónica claimed that the high level of prices is the result of some country-specific circumstances in Spain and submitted an econometric study to support its allegations. The Commission concluded that this study was flawed and that none of the factors presented by Telefónica can adequately explain the difference between the prices in Spain and in the rest of Europe.

[1] Prices are expressed in Purchasing Power Parities ("PPPs") excluding VAT, i.e. at currency conversion rates that both convert to a common currency and equalise the purchasing power of different currencies. Teligen's benchmarking model assumes an average usage profile of 25 hours per month, with each session being 1 hour long in each country. It further assumes a download usage of 10 Gigabytes every month for each service. Figures in columns indicate upload and download speeds in kilobits per seconds. Source: Comreg, Quarterly Key – Explanatory Memorandum, December 2006 (page 15).

Why can competitors not simply buy unbundled local loops from Telefónica?

Besides wholesale access at national and regional level, Telefónica provides alternative operators with unbundled access to its local loops. In view of its investment intensity, this product is however not a substitute for the other two wholesale products. In addition, there have been significant problems with the effective availability of unbundled access to the local loop, which have been sanctioned by the Spanish telecommunications regulator (CMT), and the Spanish competition authorities have also been looking at this market.

Why are the cable operators not sufficient to provide competition to Telefónica?

The Spanish cable operators are not dependent on Telefónica for wholesale inputs for retail broadband access. However, they have not exerted sufficient competitive pressure on Telefónica as to mitigate or neutralise the effect that the margin squeeze has had on consumers in terms of high retail prices. Cable operators' networks in Spain have limited coverage compared to Telefónica's. Cable operators have continuously lost market share since 2001.

To what extent is Telefónica responsible for the abuse when the Spanish telecommunications regulator CMT has found no margin squeeze?

Telefónica is fully responsible for the abuse. The CMT only regulated part of the prices for wholesale broadband access (i.e. the **regional** wholesale prices). This accounted for approximately 30% of the wholesale prices covered in this decision in 2006. The CMT never analysed the margin squeeze between Telefónica's **national** wholesale prices and retail prices (which represented approximately 70% of the wholesale prices covered in this Decision in 2006) . Moreover, when analysing the existence of a margin squeeze between the regional wholesale and the retail prices, the CMT used different data than the Commission, since it was working in a forward-looking context, it used **estimates** made on the basis of market and cost forecasts provided by Telefónica in 2001 (whereas the Commission used *ex post* data). Therefore although the CMT used the same methodology as the Commission, it was working with different data, which explains why it came to a different conclusion.

Telefónica would have known that the estimates made by the CMT were not matched by its own business plan and its actual costs. Telefónica's internal documents show that the company was aware that it was engaging in a margin squeeze. Moreover, Telefónica was at all times free to end this margin squeeze by lowering its wholesale prices, given that its national wholesale prices were not regulated and its regional wholesale prices were only subject to **maximum** prices – it was free to set prices below the maximum. However, it never took this initiative until it was obliged to by the Spanish regulator in December 2006. Therefore Telefónica is entirely responsible for the abuse.

Is the Commission not undermining the authority of the Spanish regulator?

Not at all. This Decision is against Telefónica, not against the Spanish regulator. There is nothing extraordinary or exceptional in the fact that the Commission and the CMT found different results: in the telecommunications sector regulators put in place *ex ante* regulatory mechanisms allowing competition to develop, but can only do this on the basis of market and cost **forecasts**. In so doing regulators lessen, but cannot entirely eliminate the risk of anti-competitive behaviour. Competition authorities act *ex post*, using historical data on effectively incurred costs. Accordingly, in many Member States, competition authorities have investigated and sanctioned *ex post* anti-competitive conducts in the regulated telecommunications markets, including broadband access.

So there is no question that the CMT, or other European regulators for that matter, have not done their job. It is precisely the CMT that put an end to the margin squeeze through its efficient intervention in December 2006 to set new wholesale prices.

Does the finding of a margin squeeze depend on the methodology used for its assessment?

In the decision, the Commission used two different methodologies, including that proposed by Telefónica in its reply to the Commission' statement of objections. The Commission assessed whether Telefónica was incurring downstream losses every year but also assessed whether its initial losses would be covered by future profits over a reasonably long period (more than five years) and under competitive conditions. Both methodologies lead to the same result – the finding that there was a margin squeeze.

Is broadband not an emerging market, and is it not normal that Telefónica should have incurred some initial losses?

Already on the starting date of the infringement, the retail broadband market could not be considered as an emerging one, and it did not show signs of marked instability during the period at issue. On the contrary, stable market shares were already established in September 2001, with Telefónica having the largest share.

The important question is whether all market players have been in a position to enter and to expand in the fast growing retail market on an equal footing without being financially exhausted by the strategy of the dominant undertaking.

Telefónica's downstream losses were not inevitable because Telefónica has been profitable on an end to end basis but has been incurring downstream losses. Therefore the margin squeeze cannot be explained by the fact that the market was not fully mature.

s there not a risk that the Commission's intervention will reduce Telefónica's incentives to invest and innovate?

Firstly, Telefónica's infrastructure is to a large extent the fruit of investments that were undertaken for the provision of traditional fixed telephony services well before liberalisation and the advent of broadband in Spain The investments aimed at enabling this infrastructure to carry broadband have been made in a context where Telefónica knew that it was obliged under Spanish regulation to provide its competitors with access to this enabled infrastructure. When obliging Telefónica to provide wholesale access to its competitors, the Spanish regulator made a balanced analysis between the need to stimulate competition to the benefit of consumers and the need to stimulate investment and innovation.

Secondly, prices have to be allowed to find the competitive level for the right signals for investment and innovation to be sent to the market. Prices which have the effect of excluding competitors, even those that are just as efficient as Telefónica, and which impose a long-lasting consumer harm send the wrong investment signals

Finally, it is important to preserve the incentives to invest and innovate for all companies on the market and not only Telefónica.

Is the Commission decision consistent with the latest developments regarding the application of Article 82 to exclusionary abuses?

This decision sanctions an abusive behaviour that has significantly harmed consumers. It is fully in line with the case law and the Commission's past decisions on margin squeeze and also with the line taken in the Article 82 Discussion Paper.

Does the Commission's decision prevent Telefónica from providing attractive retail prices?

There is plenty of scope for reducing the retail charges in Spain. However, this pre-supposes fair wholesale prices.

Lower and fairer wholesale prices putting an end to the margin squeeze were introduced at the end of December 2006 when, following a market analysis, the Spanish regulator reduced Telefónica's wholesale prices by between 22% and 61%. This intervention opened the way to lower retail prices for the benefit of the Spanish consumers.

Why is the fine significantly higher than the ones imposed to Wanadoo and Deutsche Telekom?

Deutsche Telekom and Wanadoo were the first precedents for price abuses (respectively margin squeeze and predatory pricing) under Article 82 of the EC Treaty in the broadband markets (see IP/03/717 and IP/03/1025). These decisions should have clarified the consequences of levying unfair prices to Telefónica. Telefónica's behaviour shows that the fines imposed in those cases did not have a sufficient deterrent effect.

A higher fine is also justified in this case because the Spanish broadband market is significantly larger than the French and German broadband markets at the time of the respective infringements. Moreover, Telefónica's abuse has harmed consumers in the form of high prices more significantly than in the other cases. The combination of Telefónica's retail and wholesale prices resulted in losses for its competitors and significant profits for the company.

Also, the room for manoeuvre left by regulation to Telefónica is much wider than in the Deutsche Telekom case. Contrary to Deutsche Telekom, Telefónica never adjusted its retail or wholesale tariffs with a view to reducing (or eliminating) the margin squeeze.

Why does the Commission intervene against Telefónica and not against other incumbents?

The Commission's investigation was prompted by a complaint lodged by France Telecom España on 11 July 2003 alleging that Telefónica was engaging in a margin squeeze in the Spanish broadband markets.

Given the high level of retail prices (see above), an intervention in the Spanish broadband market was more necessary compared with other Member States.

It should be recalled that the Commission has already intervened in other national broadband markets. For example:

- In May 2003, the Commission fined Deutsch Telekom for a margin squeeze in the German narrowband and broadband markets (see IP/03/717).
- In July 2003, the Commission fined the subsidiary of France Telecom for predatory prices in the French retail market (see IP/03/1025).
- The Commission has also been working in close cooperation with some competition and regulatory authorities of other Member States.

Also, competition law is not the only means for the Commission to intervene in national broadband markets that are not functioning. For example, the Commission recently launched an infringement procedure against Germany in order to prevent Deutsche Telekom from benefiting from regulatory holidays in the broadband sector (see IP/07/889). The Commission is closely monitoring that market in order to ensure that the latter remains competitive to the benefit of consumers.