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"Informative and Interesting": The CFI Rules in *Deutsche Telekom v. European Commission*

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"Informative and Interesting":[°]

The CFI Rules in *Deutsche Telekom v. European Commission*

Peter Alexiadis[*]

I. INTRODUCTION

On April 10, 2008, the European Court of First Instance ("CFI" or "the Court") delivered its long-awaited judgment in the *Deutsche Telekom AG v. European Commission* appeal ("CFI Judgment").[1] In doing so, the CFI upheld the Commission's 2003 decision ("Commission's Decision"),[2] where it had been found that the German fixed incumbent telecommunications operator, Deutsche Telekom ("DT"), had been abusing its dominant position on the market for access to its fixed network. It had acted

[°] The author is reminded of the alleged statement made by a gentleman in the audience at a public lecture. When asked what he thought of the speaker, the gentleman commented that he found the contents of the speaker's presentation "both informative and interesting." "Unfortunately," the gentleman went on to say, "the interesting bits were not informative and the informative bits were not interesting." The contents of the CFI's judgment bear no small resemblance to this maxim.

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[1] *See* Case T-271/03, Deutsche Telekom AG v. Commission (not yet reported) (judgment of Apr. 10, 2008) [hereinafter CFI Judgment].

[2] Commission Decision of 23 April 2003, COMP/C-1/37.451, 37.578, 37.579 — Deutsche Telekom AG, 2003 O.J. (L 263) 9 [hereinafter Commission's Decision].

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abusively by creating a margin squeeze between the prices charged to its competitors for wholesale access, on the one hand, and its own retail access charges, on the other.[3]

The case is notable insofar as it finally brings legal certainty to a complex area of practice where law and economics collide, and which is a strategically important precedent for the European Commission ("Commission") given the liberalization of ex-utility sectors that will no doubt give rise to many more margin squeeze cases in practice. That legal certainty has been won, however, at the expense of some much-needed analytical sophistication being developed on how to deal with complex pricing policies in the wake of disruptive technological change. It is, in short, a very blunt legal precedent.

II. THE CFI'S JUDGMENT

DT had argued before the CFI that the Commission had erred in finding that it had infringed Article 82 EC. The principal grounds on appeal were:

i. DT's pricing was not abusive, since it did not have sufficient margin of maneuver in order to be able to avoid the margin squeeze;
ii. the methodology adopted by the Commission to establish the margin squeeze was unlawful;
iii. the Commission's margin squeeze calculations contained errors; and
iv. it had not been proven that the margin squeeze identified had anticompetitive effects on the market.

In upholding the Commission's Decision on all grounds, the CFI addressed a major "constitutional" issue in terms of the relationship between sector-specific (ex ante) regulation and competition (ex post) rules. The consideration of this issue provides a

[3] DT supplied competitors *with* wholesale access to its so-called "local loop," which in turn can be used to serve retail customers with a range of narrowband and broadband service offerings (including Internet services).

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European response to the U.S. Supreme Court's 2004 judgment in *Trinko*,[4] where the relationship between sector-specific regulation and antitrust rules had been explored at some length. By contrast, the Court was also required to explore the technical elements of telecommunications sector costing policy with a view to establishing a workable legal standard for applying a margin squeeze test. More specifically, the CFI Judgment took very strong positions in relation to the following key issues:

- Dominant firms operating in regulated sectors must ensure that their pricing does not infringe Article 82 EC. Dominant undertakings that are subject to ex ante price approvals must ensure that they use any discretion permitted by the regulatory system to avoid abusive pricing. This discretion as to pricing is thus limited by the fact that the undertaking in question holds a "duty of special responsibility" to the marketplace.
- The "approval" of a dominant firm's pricing by a national regulatory authority ("NRA") will not necessarily protect it against a Commission finding that Article 82 EC has been infringed for the margin squeeze, particularly where the Authority in question has not expressly sought to apply Article 82 EC in approving the prices.
- A margin squeeze can exist where the retail prices are not in and of themselves abusive (in other words, where the retail prices are not predatory). The sole issue that needs to be determined is the fairness of the spread between wholesale and retail prices.
- The Commission is not required to produce evidence that a margin squeeze actually impairs competition, as the existence of such harm will be implicit from the existence of the margin squeeze itself.

Each of these points is discussed in greater detail in sections III and IV.

[4] Verizon Comm'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004) [hereinafter *Trinko*].

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III. THE RESIDUAL ROLE OF ARTICLE 82 EC

Dealing with DT's major grounds of appeal in turn, the CFI reaffirmed the application of Articles 81 and 82 EC where national legislation leaves open the possibility of competition which may be prevented, restricted, or distorted by the autonomous conduct of undertakings. As the Court held: "[I]f national law merely encourages or makes it easier for undertakings to engage in autonomous anti-competitive conduct, those undertakings remain subject to Articles 81 and 82."[5]

In this context, it is worth recalling the scope of the German law regulating DT's pricing at the time. Between January 1, 1998 and December 31, 2001, DT's retail prices for access to analogue and ISDN lines had to be approved by the German communications sector regulator ("RegTP") within a price cap regime. Under the price cap, the aggregate prices for specified baskets of services had to be reduced by a specified percentage. Within that framework, DT could adjust its retail prices (with the prior authorization of the RegTP). The CFI found that, in the circumstances, DT had sufficient scope to fix its charges at a level that would have enabled it to end or reduce the margin squeeze. As a matter of fact, rather than exercising its discretion to reduce the margin squeeze, DT had actually lowered its ISDN line retail pricing (thereby exacerbating the margin squeeze).

However, DT argued that RegTP's obligation to examine whether charges conformed with "other legal provisions" meant that, in approving DT's charges, RegTP had at least implicitly concluded that they conformed with Article 82 EC. The Court

[5] CFI Judgment, *supra* note 1, at para. 89.

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noted that, at the requisite time, RegTP had regulatory powers, but these powers did not extend to the application of competition rules. Further, none of the RegTP decisions to which DT referred included any reference to Article 82 EC. In particular, while RegTP had found a negative spread between wholesale and retail prices, it had not objected to the charges, despite noting that DT's competitors would have to cross-subsidize their various services in order to be able to offer competitive retail prices. The CFI concluded that these decisions demonstrated that RegTP had either not considered the compatibility of the charges with Article 82 EC, or had not applied that provision correctly. The Court went on to note that (even assuming that RegTP was obliged to consider whether the retail charges were compatible with Article 82 EC), the Commission would not be precluded from finding that the charges infringed Article 82 EC, and that the Commission cannot in any event be bound by a decision taken by a national body pursuant to Article 82 EC.

The regulatory regime in force from 2002 capped DT's annual retail price increases for analogue and ISDN connections. Accordingly, the Commission had concluded that the adjustment of retail DSL charges was the only legal means available to DT to reduce the margin squeeze. DT's ability to increase its DSL retail charges was constrained only by the application of Article 82 EC. However, DT argued that changes to its retail DSL charges (services falling into a distinct retail market) could not have decreased the margin squeeze for analogue and ISDN services (services falling into a different retail market). Nevertheless, the Court noted that, since the relevant wholesale

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input could be used to provide services in a number of retail product markets, DT's ability to increase its DSL charges was capable of reducing the margin squeeze between the price of the wholesale input and the prices for all of the retail products. In the Court's view, an analysis combining the range of retail services was required not only because they amounted to "a single supply of services at wholesale level," but also because retail DSL cannot be offered of itself to end users because it will always involve the upgrading of narrowband connections.

IV. PRECONDITIONS FOR A MARGIN SQUEEZE

In relation to DT's arguments that the methodology used by the Commission to establish a margin squeeze was unlawful, the CFI reached a number of significant conclusions. First, the Court expressly stated that the Commission was not obliged to demonstrate that DT's retail prices were in fact abusive. The abusiveness of conduct (in the margin squeeze context) is determined *exclusively* by the fairness of the spread between the wholesale and retail price levels.

Further, the Court addressed a number of key methodological issues in the determination of the appropriate margin between wholesale and retail levels, finding that:

- the abusive nature of a dominant firm's pricing practices is determined on the basis of its *own* charges and costs, rather than those of actual or potential competitors (i.e., the "equally efficient competitor" test);
- even if the relevant retail services in issue are provided as a "cluster" to end users, the Commission is entitled to consider only the revenues generated by the provision of the services potentially involved in the margin squeeze (e.g., it was appropriate for the Commission to consider revenues *only* from the provision of

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retail access services, and to exclude revenues from the provision of retail call services);

- it is appropriate to include "discontinuance" charges in the wholesale revenues taken into account, since these charges are part of the total cost of the wholesale service that must be reflected in competitors' retail prices; and
- the fact that the Commission's calculations contained some mathematical errors did not affect the lawfulness of its Decision, because the unfairness of the pricing stems from the existence of a margin squeeze, rather than its precise spread.

Finally, DT argued that the finding of the existence of a margin squeeze does not constitute an abuse per se, and that the Commission should have considered the *effects* of the conduct (i.e., it should have produced evidence that the margin squeeze had actually impaired competition). DT also submitted that, in order to establish a margin squeeze case, the retail price should be equivalent to what the CFI considers to be predatory, at least where wholesale prices have been fixed by an NRA.

Having taken into account the considerations outlined above, the CFI held that a margin squeeze between the indispensable input and the downstream service could be deemed to hinder competition in the relevant downstream market(s). Because the spread between the respective wholesale and retail charges was insufficient for an "equally efficient" potential competitor to cover its product-specific costs of supplying the retail service, such a market player would be unable to enter the retail market without suffering losses. While it may be the case that competitors can seek to counteract a price squeeze by cross-subsidizing those services that might be the subject of a margin squeeze, the effect of such cross-subsidy is to distort competition not only on the market affected by

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the margin squeeze, but also on the market used to finance the cross-subsidy. The Court went on to review the market structure, and also evidence of the relative lack of success of new entrants dependent on the indispensable wholesale input, before confirming its conclusion about the likely anticompetitive effects of the margin squeeze.

V. CONCLUSIONS

The CFI's Judgment raises a number of issues worthy of comment, both from a doctrinal point of view and from the viewpoint of the likely impact of the Judgment in practice.

1. The CFI clarified, in no uncertain terms, that ex post competition rules will continue to apply despite the existence of ex ante regulation, unless the system of sector-specific regulation confers upon the dominant firm no margin of freedom in which to pursue an independent pricing policy. This position differs quite materially from that taken by the U.S. Supreme Court in *Trinko*, where it ruled that sector-specific regulation trumps antitrust rules, and allows little or no scope for antitrust claims where that regulation "covers the field." The CFI's approach arguably reflects the institutional and policy balances that have been struck since the introduction of liberalization measures at Community level in the early 1990s. Not only does EU-level regulation not purport to "cover the field,"[6] but it is also adopted in a manner that envisages the existence of a symbiotic relationship between the two disciplines.[7] In striking the appropriate balance under the

[6] Community law usually seeks to create harmonized regulatory conditions in newly liberalized markets through the adoption of directives, which leave a degree of discretion in the hands of the implementing Member States about the level of detail and the form which the implementing laws and regulations will take.

[7] In the European Community, competition rules are said to operate alongside sector-specific rules. One of the three pre-conditions for the imposition of ex ante regulation in the telecommunications sector is said to be the lack of effectiveness of competition rules.

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Community legal order, it is inevitable that competition rules will have a residual role to play.[8]

Beyond the banality of such a conclusion, however, the more difficult issue is to identify where the boundaries of each of ex ante regulation and ex post competition rules should legitimately extend, and which public policy rationales should justify the drawing of such boundaries or resolve policy conflicts where there are overlapping competences. In the European context, doctrines such as subsidiarity, proportionality, legal certainty, legitimate expectations, and sound administration all have an important role to play. The balance between ex ante and ex post disciplines should surely reflect the interplay of such doctrines.[9] It is precisely because the relationship is so symbiotic that guidance from the CFI on such interplay should be welcomed. The Court will have the opportunity to explore such themes when the *Telefónica* margin squeeze appeal is heard.[10] Hopefully, it will not ignore them.[11]

2. The CFI confirms the view put forward by the Commission that, to the extent that the dominant firm has some flexibility to adapt its prices, it is under a positive obligation to adopt a pricing policy that avoids a margin squeeze.[12] This onerous obligation is based on the established principle of "special responsibility" which a

[8] Indeed, current thinking is that, to the greatest extent possible, sector specific regulation should be replaced altogether by ex post competition rules once the markets reach the point at which they can function properly without ex ante regulation.

[9] The whole philosophy underpinning the current regulatory framework for electronic communications is seen through the prism of competition analysis. Subtle decisions need to be made about the scope and reach of that regulatory framework and the residual role of competition rules.

[10] Case T-336/07, Telefónica and Telefónica de España v. Commission, 2007 O.J. (C 269) 55 and Case T-398/07, Spain v. Commission, 2008 O.J. (C 8) 17; appeals from Commission Decision of 4 July 2007, Case COMP/38.784 — Wanadoo España v. Telefónica, 2008 O.J. (C 83) 5 [hereinafter *Telefónica*].

[11] On the other hand, there are policy arguments in favor of many and varied approaches as to how ex post and ex ante should interact with one another. Perhaps it should be the Commission or national governments of the relevant policymakers in each case that should not ignore them (e.g., the correct approach to media plurality issues).

[12] In the *Telefónica* appeal, a key line of defense for the appellant will surely be that the regulatory environment in Spain was more complex than that of Germany, thereby effectively denying it any real freedom to price independently.

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dominant firm owes to the marketplace, and which has played a prominent role in the thinking of the Court in recent cases decided under Article 82 EC.[13]

Between the traditional test of "cost-orientation" or benchmarked prices for the excessive pricing of wholesale products,[14] on the one hand, and the traditional "scientific" test for predatory pricing at the retail level,[15] on the other, dominant firms are left in the difficult position of having to ensure that the margin between their wholesale and retail prices is sufficiently large so as to allow a competitor which is as efficient as the dominant firm to be able to survive in the marketplace.[16] The Court does not, however, state a position regarding the rate of return it would expect of such a competitor, nor regarding the timeframe within which such a competitor should remain viable under current market conditions. In these circumstances, the clarity of the legal standard established by the Court is matched only by the virtual impossibility of dominant firms being able to predict that their pricing is not problematic. In these circumstances, the competition law response begins to look suspiciously like entry assistance for smaller market players, in the usual manner propounded by sectoral regulators which strive to "mimic" competition in newly liberalized markets, rather than a response to the negative effects on the competitive dynamic overall.[17] Accordingly, the Court seems be endorsing the introduction of a regulatory mindset to the application of competition law.

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[13] *See*, *e.g.*, Case T-340/03, France Télécom SA v. Commission, 2007 E.C.R. II-107; *cf* Case C-95/04P, British Airways v. Commission (not yet reported) (judgment of Mar. 15, 2007); and *cf* Case T-203/11, Michelin v. Commission (Michelin II), 2003 E.C.R. II-4071.

[14] *See* Case T-368/00, General Motors Nederland BV and Opel Nederland BV v. Commission, 2003 E.C.R. II-4491.

[15] *See* Case C-62/86, AKZO Chemie BV v. Commission, 1991 E.C.R. 1-3359.

[16] This is made difficult both because the "costs" are difficult to determine, especially when allocated across many services, and because the dominant firm and the relevant regulatory authority may take different views regarding the range of services to be taken into account in determining cost and margin. Moreover, there is often significant political pressure to keep retail prices low for end users.

[17] In other words, there is a tendency to protect competitors, rather than competition in the broader sense. Insofar as the Commission is applying a market access test, as opposed to a competition welfare test, there will be likely economic costs. Are these economic costs being offset by any overarching market integration goals? In the context of a price squeeze assessment, this does not appear to be the case.

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3. As a more general criticism, the CFI appears to migrate seamlessly between the application of competition law and regulatory standards when analyzing a problem, paying little heed to the application of consistent principles which characterize the distinct disciplines of ex post and ex ante. For example, the Court applies the "as efficient competitor" test as the benchmark for whether the costs incurred by an allegedly foreclosed competitor were reasonable in the assessment of a margin squeeze.[18] Although a less onerous standard (from a competitor's viewpoint) could arguably have been used by the Commission, this standard is both consistent with previous precedent[19] and also appears to be an inherently ex post standard.[20] Having said that, the Court then goes on to measure DT's costs by reference to a traditional ex ante standard—long-run incremental cost—which has nothing to do with the dominant firm's *actual costs* but which is designed to promote "efficiency" in an environment which should ideally be competitive.[21] The Court again seems to feel very comfortable about which services should (or should not) go into the retail "basket" of services against which the squeeze from the wholesale inputs is being exerted. In doing so, the Court seems to be adopting a regulatory mindset as to how to define "markets."[22] In addition, the Commission and the Court both avoided the thorny question of how one is to deal with retail

[18] In theory, it could have had recourse to one of three benchmark tests, namely: (1) the "as efficient competitor" test; (2) the "reasonably efficient operator" test (notional or hypothetical); or (3) a combination of tests (1) and (2), taking into account the manner in which the dominant firm's operations would perform on the basis of the wholesale prices charged to competitors upstream.

[19] In doing so, the CFI is taking an approach which is consistent with the precedent in Case T-5/97, Industrie des Poudres Sphériques SA v. Commission, 2000 E.C.R. II-3755; *see also* Commission Decision in Napier Brown – British Sugar, 1988 O.J. (L 284) 41. But, *see also* National Coal Board Case, 1976 O.J. (L 35) 6.

[20] It is also the only standard capable of producing quantifiable results, while not penalizing the dominant firm for efficiencies derived from various economies of scale and scope. See also, most recently, the guidance provided by the Court of Justice on the cost-orientation obligation: Case C-55/06, Arcer AG & Co, v. Germany (not yet reported) (judgment of Apr. 24, 2008).

[21] In doing so, it puts forward a classic regulatory model for costs which is predicated on the existence of mandated access relationships, by developing a cost model for a notional efficient operator in the dominant firm's shoes.

[22] The results would arguably have been different had ISDN and analogue access not been included in the retail "basket."

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services that can be provided using different wholesale inputs when calculating the margin when any one of those wholesale inputs is considered on a stand-alone basis.[23] Consequently, the Judgment, by fully endorsing the Commission's approach, has inadvertently trumpeted the supremacy of competition law while fundamentally applying sector-specific tools to underpin its substantive analysis. The blurring of regulatory standards in this way may ultimately lead us inadvertently down the *Trinko* path—if competition law becomes so imbued with regulatory principles, its role alongside ex ante regulation might ultimately be called into question.

4. The Commission, as a competition law enforcement agency, is no doubt delighted with the CFI's unequivocal endorsement of its margin squeeze practice. It will no doubt imbue the Commission with every confidence to pursue margin squeeze case in other liberalized sectors; the energy sector will no doubt figure prominently in this regard. But, based on the old adage "be careful you don't get what you wished for," the *Deutsche Telekom* precedent might open up a Pandora's box of margin squeeze cases across the European Union, whether in Member State courts or before national competition authorities. Given the open-ended legal test set forth by the Court, it will be difficult to resist margin squeeze being used as a veritable Trojan Horse to challenge many forms of market behavior that might otherwise need to be addressed by more complex analytical tools and might need a more delicate balancing of consumer welfare interests, investment incentives, and competitive dynamics.[24] The fact that the CFI has clearly ruled that no "effects-based" analysis[25] of a margin squeeze case is necessary in order to

[23] In the *Telefónica* appeal, *supra* note 10, the Commission has identified three separate wholesale markets against which to measure a squeeze, while the appellant is arguing before the CFI that the Commission should at least have included national and regional access within the same relevant market.

[24] One cannot help by feel that the case is based on a flawed assessment of wholesale costs by an NRA, which is the true origin of the "squeeze" in question. In such a case, is not the better legal option to proceed with an infringement action against a Member State?

[25] The application of an effects-based economic analysis to cases including foreclosure was the cornerstone of the Commission's (now apparently abandoned) *Article 82 Discussion Paper* (EUROPEAN

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substantiate an action under Article 82 EC means that the allegation that a dominant firm has engaged in a margin squeeze might be perceived to be a relatively straightforward claim to make. In the telecommunications sector, traditional copper-based transmission networks are being replaced by fiber-based ("next-generation") networks. While firms are experimenting with their retail pricing packages in order to drive demand for these new services on next-generation networks, one can imagine that they will be very susceptible to margin squeeze allegations. Similarly, in mobile voice markets, the widespread practice of maintaining low on-net tariffs might be the subject of challenge under the Court's margin squeeze test.[26] The over-zealous prosecution of margin squeeze cases, based on the clear precedent established by the CFI, may create more harm to innovative pricing schemes than good to the structure of competition. In these circumstances, policymakers at Community level may have very little choice other than to encourage the use of ex ante regulation in retail markets that are related to wholesale regulated markets to address margin squeeze issues. This is because it is only ex ante regulation which is able to take into account the complex welfare, innovation, and technology tradeoffs that come into play in relation to these markets.[27]

COMMISSION, DG COMPETITION DISCUSSION PAPER ON THE APPLICATION OF ARTICLE 82 OF THE TREATY TO EXCLUSIONARY ABUSES (Dec. 2005) [hereinafter Discussion Paper], *available at* http://ec.europa.eu/comm/competition/antitrust/art82/discpaper2005.pdf).

[26] Mobile operators often adopt on-net retail tariffs (cable originated *and* terminated on their networks) that either offer free calls or calls at prices which are lower than the wholesale termination rate charged to other operators. It could be argued that mobile operators, who are monopolists over termination on their own networks, are creating a margin squeeze for their competitors.

Having said this, where retail charges are at, or close to, zero, predation challenges have always been a possibility.

[27] As a counterweight to this, however, sector-specific regulators are more inclined to regulate only at the wholesale level, whereas the prevention of a margin squeeze requires them to apply remedies which go beyond wholesale relevant markets.

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5. Finally, one needs to take into account the current thinking in the United States on the treatment of margin squeezes. In a recent article,[28] Gregory Sidak criticizes the generation of price squeeze cases brought in the wake of the precedent established in *Alcoa*, where Justice Learned Hand expressed the view that a vertically integrated monopolist must charge downstream competitors not more than a "fair price" for its bottleneck input, and it must charge end users a retail price for its own downstream product that is high enough to ensure that its competitors can match that price and still make a "living profit."[29] According to Sidak, price squeeze theory is incompatible with the contemporary antitrust jurisprudence established by *Trinko*[30] and by the *Brooke Group* case,[31] as well as economic principles. Moreover, according to Sidak, "price squeeze liability also discourages investment, retail price competition, and the voluntary provision of inputs on negotiated terms by vertically integrated monopolists to current and potential rivals otherwise unable to obtain or self provide them." Finally, explains Sidak, a price squeeze is a "regulatory issue, which makes sense only as a rule of price regulation in an industry already subject to duties to deal and to control by institutionally competent regulators."[32]

While this author does not agree that there is no role for margin squeeze actions under competition rules,[33] there is much merit to the view that these are situations best

[28] J. Gregory Sidak, Abolishing the Price Squeeze as a Theory of Antitrust Liability (mimeo, Criterion Economics) (Apr. 11, 2008), *available at* http://ssrn.com/abstract=1119308.

[29] United States v. Aluminum Co. of America, 148 F.2d 416 (2nd Cir 1945) [hereinafter *Alcoa*].

[30] *Trinko*, *supra* note 4.

[31] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 US 209 (1993) [hereinafter *Brooke Group*]. Whereas *Trinko* established a rule that a monopolist's refusal to deal with a competitor does not amount to an antitrust violation "where there has been no prior course of voluntary dealings between the parties," the *Brooke Group* precedent instructs courts not to discourage a "price cut" that "forces firms to maintain supracompetitive prices, thus depriving customers of lower prices."

[32] In Sidak's view (*see* Sidak (2008), *supra* note 28), the appropriate competition law response to unfair pricing is to take action against either excessive or predatory pricing (as appropriate).

[33] For example, European regulators have a right to be skeptical that ex-monopolists are not inclined to enter into contractual wholesale access relations unless coerced by regulation to do so. Moreover, unlike

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addressed by sector-specific regulation. It is ironic that a CFI judgment, whose overall effect is to reinforce the ascendancy of competition rules and to establish a strong precedent, has raised more questions than it has provided answers about the suitability of ex post competition rules to deal with margin squeezes.

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the United States, a price squeeze action will *only* be brought where the impugned practice is committed by a firm with market power.

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