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# Ex ante margin squeeze tests in the telecommunications industry: What is a reasonably efficient operator?

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ABSTRACT

This paper studies the implementation of Reasonably Efficient Operator margin squeeze tests by National Regulatory Authorities in European telecommunications markets. It provides a theoretical framework which shows how regulatory authorities deal with the asymmetries between entrants and incumbents by adjusting the Equally Efficient Operator margin squeeze test used in competition policy. Using this framework, this paper presents a benchmark of implementation choices by inspecting authorities' guidelines, market analyses, and decisions. Whereas some implementation choices are very similar across authorities' decisions, some others display a strong heterogeneity.



## 1. Introduction

In recent years, competition authorities have dealt with high-profile margin squeeze (or price squeeze) cases in the telecommunications industry. For instance, the European Commission intervened in margin squeeze cases such as *Deutsche Telekom* in 2003, or *Telefónica* in 2007.[1] These cases have established the nature of a margin squeeze in competition policy and have characterized it as a stand-alone anticompetitive conduct: a margin squeeze occurs when a vertically integrated firm, providing an essential input to downstream competitors, sets retail and input prices that do not leave an economic space for efficient downstream firms to make positive profits.

Margin squeeze analyses are also popular among European National Regulatory Authorities (NRAs) of the telecommunications industry. According to a 2009 survey by the European Regulators Group (ERG), twelve NRAs declared having a procedure to conduct ex ante margin squeeze analyses in at least one retail market.[2] As stated by the ERG, the purpose of ex ante margin squeeze testing in a regulatory framework is different than in competition policy, because "while competition law is intended to prevent margin squeeze as an exclusionary abuse, ex ante regulation seeks the more ambitious goal of promoting competition."

NRAs might conduct margin squeeze tests for three different reasons. Some NRAs employ ex ante margin squeeze tests as a regulatory tool to set downstream price floors whenever the vertically integrated incumbent is dominant in both the downstream and upstream markets.[3] Alternatively, some NRAs use margin squeeze tests in a competitive downstream

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[1] Case COMP/C-1/37.451, 37.578, 37.579 – Deutsche Telekom AG, later confirmed by Case T-271/03 before the European Court of First Instance and Case C-280/08 P before the European Court of Justice; and Case COMP/38.784 – Wanadoo España vs. Telefónica, confirmed by Case T-398/07 before the General Court.

[2] See ERG (2009). The European Regulators Group has been replaced by the Body of European Regulators for Electronic Communications (BERECs) in 2009.

[3] When the test is implemented between two wholesale markets, a margin squeeze test is also called a "noneviction test."

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market as a regulatory tool for the upstream market as in a retail-minus mechanism. Finally, the tests are in some cases implemented to analyze the replicability of the unregulated retail offers of the incumbent on top of another access price control remedy.

Ex ante margin squeeze tests will be a key tool in the regulation of next generation access (NGA) networks. Indeed, the 2010 European Commission's Recommendation on regulated access to NGA networks highlights that margin squeeze tests are appropriate when mandated access is not cost-oriented. Furthermore, when Neelie Kroes, the Vice President of the European Commission responsible for the Digital Agenda, announced in July 2012 the forthcoming Recommendation on non-discrimination, she stated that NRAs would have to analyze the economic replicability of dominant firms' offers through “a properly-specified ex ante ‘margin squeeze’ test.”[4]

Whereas competition authorities base the implementation of their margin squeeze tests on case law, NRAs have relied on general guidelines rather than on an explicit methodology. Only in 2010, the Commission's NGA Recommendation explicitly described a margin squeeze test based on a reasonably efficient operator (REO) as an alternative to the equally efficient operator (EEO) test established by competition case law. The Commission's Recommendation states that in order to maintain effective competition, NRAs may consider margin squeeze tests according to costs and characteristics of a *reasonably efficient* operator that does not exhibit the same economic conditions as the incumbent. The Commission however does not define what “reasonably efficient” means; it only states that NRAs should properly specify in advance the methodology that they will follow to implement such a test.[5] Therefore, NRAs' appreciation in conducting ex ante REO margin squeeze tests is large.

In practice, such tests have been implemented by European NRAs according to different methodologies. NRAs can build a bottom-up hypothetical efficient operator using parameters tuned from quantitative measures; they can use alternative operators' actual costs and data; they can adjust the costs and economic conditions of the incumbent to account for new entrants' disadvantages;[6] or they can combine these three approaches.

This paper analyzes the third approach, whereby NRAs make adjustments to margin squeeze tests based on the incumbents' data in order to model a reasonably efficient operator. This paper identifies the ex ante specific issues related to market asymmetries considered by NRAs, and provides a theoretical framework that allows to translate these issues into practical test adjustments.

As a result, this paper concludes that REO margin squeeze test is different from EEO tests in three categories. The first category, usually considered as the main differentiating factor between REO and EEO tests relates to downstream cost asymmetries between firms. Per unit downstream costs may be modified to take into account possible economies of scale, economies of scope, as well as entrants' specific costs. The other two categories are not formally associated with REO tests but they also follow the same rationale: they take into account the disadvantages of entrants in order to create a level playing field. The second category deals with access charge adjustments. When several wholesale products are available to entrants, several margin squeeze tests may be conducted according to the notion of efficient entry as determined by the regulator. Finally, the third category explores possible price adjustments. Specifically, it covers adjustments related to bundling practices that could compromise the competing capacity of entrants.

Using this theoretical framework, this paper reviews the implementation of margin squeeze tests by European NRAs. Along with documents from the European Commission (EC) and the European Regulators Group (ERG), it also reviews decisions and guidelines from the following NRAs: RTR (Austria), BIPT (Belgium), ARCEP (France), BNetzA (Germany), ComReg (Ireland), AGCOM (Italy), OPTA (the Netherlands), UKE (Poland), Anacom (Portugal), CMT (Spain), and Ofcom (United Kingdom).

While this paper focuses on European regulatory authorities, the U.S. Federal Communications Commission (FCC) also refers to an hypothetical “reasonably efficient competitor” regarding the current regulation in place for the narrowband mass market and the business market.[7] The FCC explains that a reasonably efficient competitor should aim at providing all services to all consumers, as long as this is supported by the market;[8] but it also states that it would take into account entrants' disadvantages in providing multiple services, such as diseconomies of scope.[9] Nevertheless, because of the existing inter-platform competition in place between telecommunications incumbents and cable operators, there is no access regulation in the U.S. since the D.C. Court decision in *United States Telecom Association vs. FCC* and the regulatory authority's Triennal Review Order released in 2003.[10] Therefore, the FCC does not use margin squeeze tests as an ex ante regulatory tool in the U.S.

[4] “Enhancing the broadband investment environment,” policy statement by Vice-President Kroes, Brussels, 12 July 2012.

[5] The forthcoming Recommendation on non-discrimination is expected to specify the relevant parameters for the test. The parameters of the so-called “economic replicability test” as proposed in the draft Recommendation are being vigorously debated given the particular context of NGA networks and their uncertain profitability. In particular, the BEREC insists on the introduction of a test based on REO parameters.

[6] This last approach has the practical benefit that NRAs can use incumbent's data provided in the framework of accounting separation and cost accounting remedies. Some NRAs call this approach an “adjusted equally efficient operator” test or “similarly efficient operator” test.

[7] More precisely, in the current framework one of the standards needed to require the unbundling of a network element is that the lack of access to this element raises barriers to entry “that are likely to make entry into a market by a reasonably efficient competitor uneconomic,” when taking into consideration alternative suppliers, access types, or bypass opportunities. See FCC (2005), §51.317.

[8] FCC (2005, §25).

[9] FCC (2005, §24).

[10] See Bauer (2005) for an history of unbundling policy in the U.S.