OFFICE OF FAIR TRADING

Competition Legislation

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The application in the telecommunications sector

OFT 417

THE APPLICATION OF THE COMPETITION ACT IN THE TELECOMMUNICATIONS SECTOR

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This guideline is not a substitute for the Competition Act 1998 nor for the regulations and orders that are made under it. It should be read in conjunction with the legislation. It contains a discussion of relevant principles of Community law. It should not be seen as a substitute for or as a definitive interpretation of Community law. Anyone in doubt about how they may be affected by the legislation should seek legal advice.

1 INTRODUCTION

1.1 This guideline explains how the Competition Act 1998 (‘the Competition Act’) will be applied and enforced in the telecommunications sector. It also explains the relationship between the Competition Act and the Telecommunications Act 1984 (‘the Telecommunications Act’).

1.2 The guideline refers to other Competition Act guidelines where relevant and where appropriate avoids duplication. There is, however, a certain amount of duplication to ensure that the guideline is as self-contained as possible, making it a useful point of reference for the industry.

1.3 The Competition Act is based on Articles 81 and 82 of the EC Treaty. It contains two prohibitions:

- **of anti-competitive agreements**

  a prohibition of agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom *(‘the Chapter I prohibition’)*;

- **of abuses of dominance**

  a prohibition of conduct by one or more undertakings which amounts to the abuse of a dominant position, in a market in the United Kingdom (or a part thereof) which may affect trade within the United Kingdom *(‘the Chapter II prohibition’)*.

1.4 Articles 81 and 82 of the EC Treaty will continue to apply to:

- anti-competitive agreements, decisions or concerted practices; and

- abuses of a dominant position;

which may affect trade between Member States of the European Union.

1.5 In the telecommunications sector the Director General of Telecommunications (‘DGT’) and the Director General of Fair Trading (‘DGFT’) have concurrent jurisdiction to apply and enforce the Competition Act. References hereafter to ‘the Director General’ should therefore be read as meaning either the DGT or the DGFT.

2 THE MAJOR PROVISIONS OF THE COMPETITION ACT

The Chapter I Prohibition

2.1 The Chapter I prohibition prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom. Unless stated otherwise, any reference to an 'agreement' should be read as a reference to an 'agreement between undertakings, decision by an association of undertakings or concerted practice' and any reference to 'agreements' should be read as a reference to 'agreements between undertakings, decisions by associations of undertakings or concerted practices'.

2.2 An agreement may be anti-competitive even though it is not clearly expressed or overt. The Chapter I prohibition is subject to certain exclusions and exemptions. Further details can be found in the Competition Act guidelines ***The Major Provisions*** and ***The Chapter I Prohibition***.

The Chapter II Prohibition

2.3 The Chapter II prohibition prohibits conduct by one or more undertakings which amounts to the abuse of a dominant position in a market in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom.

2.4 The *holding* of a dominant position is not prohibited. It is the *abuse* of a dominant position that is prohibited.

2.5 The Chapter II prohibition is subject to certain limited exclusions. It is not possible to obtain an exemption from the Chapter II prohibition. Further details can be found in the Competition Act guidelines ***The Major Provisions*** and ***The Chapter II Prohibition***.

Concurrent Jurisdiction

2.6 The DGT is able to exercise, concurrently with the DGFT, almost all of the functions of the DGFT under the Competition Act[1], in so far as those functions relate to 'commercial activities connected with telecommunications'. References hereafter to 'Competition Act functions' should be read as meaning Competition Act functions exercisable concurrently by the DGT and the DGFT. 'Commercial activities connected with telecommunications' is defined in section 4(3) of the Telecommunications Act as:

> '…the provision of telecommunication services, the supply or export of telecommunications apparatus and the production or acquisition of such

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1 Only the DGFT is able to issue guidance on penalties and the DGFT's procedural rules.

apparatus and the production or acquisition of such apparatus for supply or export.'

2.7 Throughout this guideline the DGT and the DGFT are described as having concurrent jurisdiction in relation to 'the telecommunications sector', that is, commercial activities connected with telecommunications, as defined in paragraph 2.6 above. Agreements or conduct that relate to the telecommunications sector will normally be dealt with by the DGT. However, the DGT and the DGFT will always consult with each other before a decision is made as to who will deal with a case in respect of which there is concurrent jurisdiction. Further information on how concurrency will work in practice and the extent of the DGT's concurrent jurisdiction can be found in the Competition Act guideline ***Concurrent Application to Regulated Industries***.

Notifications

2.8 There is no statutory requirement to notify agreements or conduct. Undertakings are responsible for ensuring that their agreements and conduct are lawful and deciding whether notification is appropriate in any particular case.

2.9 Undertakings may make a notification for guidance or a decision, although the Director General will not provide guidance or decisions in respect of prospective agreements or conduct. In the telecommunications sector the DGFT and the DGT have concurrent jurisdiction to provide guidance or decisions. Notifications must be made to the DGFT by submitting Form N, plus an extra copy for the DGT, and enclosing the relevant fee. A further copy of Form N should also be sent directly to the DGT, but failure to send an additional copy of the form to or for the DGT will not render the notification incomplete. Notifications in respect of agreements or conduct relating to the telecommunications sector will normally be passed to the DGT. As soon as practicable, the DGFT will inform applicants who is dealing with the case, and applicants will also be informed if the case is subsequently transferred to another regulator or to the DGFT.

2.10 Guidance may indicate:

- whether or not the agreement or conduct would be likely to infringe the relevant prohibition; and

- in the case of agreements only, whether or not the agreement would be likely to be granted an exemption if an application for a decision were to be made.

2.11 The Director General is not able to reopen a case once guidance has been given unless:

- he has reasonable grounds for believing that there has been a material change of circumstances since the guidance was given; or

- he has a reasonable suspicion that materially incomplete, misleading or false information was given; or

- a complaint is received from a third party; or
- in respect of the Chapter I prohibition only, one of the parties to an agreement applies for a decision with respect to that agreement.

2.12 A decision may indicate that the agreement or conduct:

- is outside the relevant prohibition; or
- is prohibited; or
- in the case of agreements only, is exempt.

2.13 The Director General is not able to reopen a case once a decision has been given unless:

- he has reasonable grounds for believing that there has been a material change in circumstances; or
- he has a reasonable suspicion that materially incomplete, misleading or false information was given.

Complaints

2.14 In respect of agreements or conduct relating to the telecommunications sector, a complaint that there has been a breach of the Chapter I and/or the Chapter II prohibitions may be made to either the DGFT or the DGT. Complaints in respect of agreements or conduct relating to the telecommunications sector will normally be dealt with by the DGT.

Own-Initiative Investigations

2.15 The Director General may also carry out investigations on his own initiative.

Powers of Investigation

2.16 If the Director General has reasonable grounds for suspecting that an undertaking is infringing either of the prohibitions he (or authorised officials) can exercise his powers of investigation. This means that he can, among other things:

- require the production of any document or information that is specified or that falls within a specified category, which he considers relates to any matter relevant to the investigation, at a time and place, and in the manner or form specified;
- take copies of, or extracts from, any document produced;
- require an explanation of any such document; and

- if a document is not produced, require a statement as to where it can be found;

- enter premises without a warrant and, among other things, require the production of any document that he considers relates to any matter relevant to the investigation and require any relevant information held in a computer to be produced in a form in which it can be read and can be taken away;

- enter premises with a warrant and, amongst other things, search the premises and take copies of, or extracts from, any documents appearing to be the kind in respect of which the warrant was granted and require any relevant information held in a computer to be produced in a form in which it can be read and can be taken away.

2.17 The Competition Act creates a number of criminal offences. It would, for example, be an offence, subject to certain defences, not to produce a specified document. Further details of the powers of investigation and the offences created by the Act are given in the Competition Act guideline ***Powers of Investigation***.

Enforcement powers

2.18 Where the Director General proposes to make a decision that a breach of either prohibition has occurred ('an infringement decision') he will set out in a written statement the matters to which he has taken objection ('statement of objections'), the action he proposes to take and his reasons. Persons receiving the statement of objections will then have the opportunity to make representations.

2.19 Where the Director General then makes an infringement decision, he may give a direction to such persons as he considers appropriate, requiring them to bring the infringement to an end. This may include a direction to modify or terminate an agreement or to modify or cease the conduct in question.

2.20 If a person fails to comply with a direction, the Director General may seek a court order compelling him to do so. Non-compliance with such an order is a contempt of court punishable by fine and/or imprisonment.

2.21 Infringement of either of the prohibitions may result in a financial penalty of up to 10 per cent of an undertaking's turnover in the United Kingdom for each year that the infringement lasted, up to a maximum of 3 years.

2.22 Further details can be found in the Competition Act guideline ***Enforcement*** and in the DGFT's ***Guidance on Penalties***.

Appeals

2.23 Appeals against decisions of the Director General are heard by the Competition Commission. In addition to acting as an appeals tribunal, the Competition Commission has assumed the reporting role previously fulfilled by the Monopolies and Mergers Commission pursuant to the monopolies and mergers provisions of the Fair Trading Act 1973.

Transitional arrangements

2.24 Agreements made before the Chapter I prohibitions came into force on 1 March 2000 benefit, in general, from a further one year transitional period before the Chapter I prohibition can be applied. Certain types of agreements qualify for different transitional periods and details of these can be found in the Competition Act Guideline ***Transitional Arrangements***.

3 RELATIONSHIP BETWEEN THE COMPETITION ACT AND EC LAW

Consistency

3.1 Section 60 of the Competition Act sets out certain principles with a view to ensuring that the United Kingdom authorities handle cases in such a way as to ensure consistency with Community law.

3.2 The Competition Act places a dual obligation on the United Kingdom authorities in applying the Chapter I and II prohibitions. First, they must ensure that there is no inconsistency with either the principles laid down by the EC Treaty and the European Court or any relevant decision of the European Court. Secondly, the United Kingdom authorities must have regard to any relevant decision or statement of the European Commission. In the Director General's view this is limited to decisions or statements which have the authority of the European Commission as a whole, such as, for example, decisions on individual cases under Articles 81 and 82. It would also include clear statements about the Commission's policy approach which it has published in the Annual Report on Competition Policy and **{tc \l 2 ".
Relationship with Telecommunications Act licence conditions"}**the Commission's two notices on the application of EC competition law to the telecommunications sector:

- EC Notice on the application of the competition rules to access agreements in the telecommunications sector2 ('the EC Access Notice');

- Guidelines on the application of EEC competition rules in the telecommunications sector3.

3.3 The EC Access Notice is of particular relevance as it was published after the telecommunications markets in most member states had been liberalised.

3.4 The obligation to ensure consistency applies only to the extent that this is possible, having regard to any relevant differences between the provisions concerned. This means that there will be certain areas where the Community principles will not be relevant. For example, the Community single market objectives, which were designed to establish a European common market, would not be relevant to the domestic prohibition system.

3.5 The provisions of section 60 apply to all United Kingdom authorities which are involved with the application and enforcement of the Competition Act: the Director General, the Competition Commission and the domestic courts.

EC Telecommunications Legislation

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2 OJ 98/C 265/02
3 OJ 91/C 233/02

3.6 A number of EC Directives (including the Licensing Directive[4], the Interconnection Directive[5], the Revised Voice Telephony Directive[6], and the Amended Leased Lines Directive[7]) require Member States to impose obligations on telecommunications operators. The EC Access Notice, to which the Director General must have regard, states that such legislation may be relevant to the application of Articles 81 and 82 of the EC Treaty (and therefore to the application of the Chapter I and II prohibitions):

> ‘When appropriate, legislation such as the ONP [Open Network Provision] framework will be used as an aid in the interpretation of the competition rules. Given the duty resting on the National Regulatory Authority to ensure that effective competition is possible, application of the competition rules is likewise required for an appropriate interpretation of the ONP principles.’

3.7 The Access Notice provides a number of examples of how this might work in practice:

- accounting separation requirements may assist in investigating ‘price squeezing’ (see paragraph 7.26 below) by vertically integrated operators. They may also assist in the calculation of market shares;

- transparent cost-accounting systems may assist in the consideration of cases involving pricing issues, including, for example, an allegation of excessive pricing (see paragraphs 7.32 to 7.37 below).

3.8 Many of the obligations contained in the EC directives mentioned above are incorporated in the Telecommunications Act licences of operators. The relationship between the obligations contained in Telecommunications Act licences and the Chapter I and II prohibitions is explained below.

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4 EC Directive 97/13/EC
5 EC Directive 97/33/EC
6 EC Directive 98/10/EC
7 EC Directive 97/51/EC

4 RELATIONSHIP BETWEEN THE COMPETITION ACT AND OTHER RELEVANT STATUTES

a. The Competition Act and the Telecommunications Act

Relationship between the Chapter I and II prohibitions and conditions contained in Telecommunications Act licences

4.1 An agreement or conduct that is prohibited by the Competition Act may also be in breach of one or more of the conditions contained in the Telecommunications Act licence of a public telecommunications operator ('PTO'). The prohibitions therefore co-exist with the conditions contained in the licences of PTOs. This means that licensees must ensure that they do not breach the Chapter I and II prohibitions, as well as complying with specific licence conditions. For example, all licences granted to PTOs prohibit undue discrimination against any person, or any class of person, in relation to the supply of certain services. In supplying those services a PTO must therefore ensure that it does not breach:

- the condition in its licence that prohibits undue discrimination; and
- the Chapter I prohibition and/or the Chapter II prohibition.

Legal requirements

4.2 To the extent to which an agreement or conduct is required 'in order to comply with a legal requirement'[8] it is excluded from the Chapter I and the Chapter II prohibitions. A licence condition may impose a legal requirement and behaviour specifically required in order to comply with such a condition would not be prohibited by the Competition Act. For example, in certain circumstances a telecoms operator may be required to set prices between a floor and a ceiling. Choosing the precise price within that range does not, however, amount to compliance by the operator with a 'legal requirement'.

An agreement or conduct in breach of both the Competition Act and a licence condition

4.3 **{tc \l 3 "action under the Telecommunications Act or the Competition Act"}**As mentioned above, an agreement or conduct may be in breach of both the Competition Act and a licence condition. Price discrimination may, for example, breach the licence condition prohibiting undue discrimination and may also constitute an abuse of a dominant position contrary to the Chapter II prohibition as discussed in paragraphs 7.27 to 7.29 below. In such a case, the DGT may choose to take enforcement action under either the Competition Act or the Telecommunications Act.

4.4 Generally, the DGT has a duty to take enforcement action under the Telecommunications Act in response to a licence breach, but that duty does not apply

8 See schedule 3(5) of the Competition Act.

if he is satisfied that the more appropriate way of proceeding is under the Competition Act. He must then give notice to that effect in accordance with section 16(5) of the Telecommunications Act.

4.5 The DGT cannot fetter his discretion in advance. This means that where he has a choice, he must decide whether to proceed under the Telecommunications Act or the Competition Act on a case by case basis.

4.6 If it appears to the DGT that there is a breach of a licence condition and he has reasonable grounds to suspect that there is also a breach of the Competition Act, he will generally take enforcement action under the Competition Act rather than the Telecommunications Act.

4.7 Whether or not it would be possible for an agreement or conduct to be dealt with under either the Competition Act or the Telecommunications Act may, however, become apparent only after an investigation has commenced. When launching an investigation the DGT may therefore use his powers under both the Competition Act and the Telecommunications Act. He may also use information obtained under the Telecommunications Act in a case dealt with under the Competition Act, and vice versa.

Fair Trading Condition

4.8 The Fair Trading Condition ('FTC') is at present contained in the PTO licences of all major operators. The FTC, like the Competition Act, is based on Articles 81 and 82 of the EC Treaty and contains a clause stating that it shall cease to apply to any behaviour prohibited by new legislation that:

> '(i) contains a prohibition enforceable by the…[DGT]…of any behaviour prohibited [under the FTC];
>
> (ii) gives to third parties in respect of a breach of that prohibition at least the rights they have under section 18 of the [Telecommunications Act 1984] in respect of a breach of a provisional or final Order; and
>
> (iii) permits the imposition on the licensee of monetary penalties in respect of the breach of that prohibition.'

4.9 The DGT believes that the Competition Act meets these criteria and the FTC therefore ceases to apply to agreements and conduct that would otherwise be in breach of both the FTC and the Competition Act. The FTC ceases, in any event, to have effect on 31 July 2001.

Sectoral duties

4.10 Section 3 of the Telecommunications Act sets out the DGT's general ('sectoral') duties. The Competition Act has amended the Telecommunications Act so that when the DGT is exercising his Competition Act functions his sectoral duties do not apply. When exercising any function under the Competition Act, the DGT may nevertheless

have regard to any matter in respect of which a sectoral duty is imposed if it is a matter to which the DGFT could have regard when exercising that function.

b. The Competition Act and the Fair Trading Act 1973

4.11 As a general rule, agreements relating to mergers are excluded from the Chapter I prohibition. Specifically, paragraph 1(1) of Schedule 1 of the Competition Act provides that the Chapter I prohibition will not apply to an agreement to the extent to which the agreement would result in two companies ceasing to be distinct enterprises for the purposes of Part V of the Fair Trading Act 1973. Further details are given in the Competition Act guideline ***Exclusion of Mergers and Ancillary Restraints***.

4.12 The complex monopoly provisions of the Fair Trading Act continue to apply because there may be activities which are anti-competitive, but which are not caught by the prohibitions. Undertakings may engage in parallel behaviour, for example, which appears to be anti-competitive even though there is no evidence of collusion or agreement. The scale monopoly provisions are retained to deal with the situation where a prior infringement of the Competition Act prohibitions has already been proven, but where the Director General believes that there is a real prospect of further abuse by the same undertaking. The structural remedies available under the scale monopoly provisions may provide the only effective means of preventing those further abuses. Further information about the provisions of the Fair Trading Act that have been retained are given in the Competition Act guideline T***he Major Provisions***.

5 MARKET DEFINITION

5.1 In order to determine whether a particular agreement or form of conduct is in breach of the Chapter I and/or the Chapter II prohibitions the Director General will:

- first, seek to define the market to which the agreement or conduct in question relates;
- secondly, consider whether the undertaking or undertakings in question have market power, (although an agreement may breach the Chapter I prohibition where the parties do not have market power – see paragraph 6.4 below);
- thirdly, determine whether there is a breach of the Chapter I and/or the Chapter II prohibitions.

5.2 Defining the relevant market is therefore the first step in any investigation under the Competition Act. Until the market has been defined it is not possible to determine whether the undertaking or undertakings in question have market power. The way that the Director General approaches market definition is outlined below and further details are given in the Competition Act guideline ***Market Definition***.

The relevant market

5.3 In the context of a Competition Act investigation a market is defined by reference to:

- the products that are sold in the market ('the product market');
- the geographical area within which the products are sold ('the geographical market')9.

5.4 The product market consists of the product[G2LU1]10 (or group of products) to which the agreement or conduct relates *plus* any demand-side substitutes11 and/or supply-side substitutes12, the availability of which prevents the undertaking or undertakings from sustaining a small but significant increase in the price of the

9 In certain circumstances a market may also be defined by reference to time. It is possible, for example, that there could be separate markets for peak and off-peak telephone calls. It is also conceivable that a market could be defined by reference to a particular group of customers to which the product is supplied. This might be appropriate if, for example, an undertaking were able to discriminate between business and residential customers.

10 Any reference to a 'product' should be read as a reference to a product, service or property right.

11 A substitute product will not necessarily be identical or be sold at the same price or even be of the same quality as the product for which it is substituted.

12 It may be possible for other undertakings that supply related products to switch production capacity so as to begin supplying the product. In certain circumstances, however, supply-side substitution might be technically possible, but barriers to entry, such as the need to incur marketing costs to create brand awareness, would prevent supply-side substitution taking place within a reasonably short timescale.

product above the competitive level. Unless stated otherwise, any reference below to 'undertaking' should be read as a reference to 'undertaking or undertakings'.

5.5 The geographical market may be a part of the United Kingdom, the whole of the United Kingdom, or a larger geographical area. The boundaries of the geographical market will depend on the extent to which:

- customers are able to switch to substitutes supplied by undertakings in different areas; and
- undertakings in different areas are able to supply substitute products.

5.6 The Director General defines the relevant market by identifying the constraints on the freedom of the undertaking to raise the price of the product in question. One way to achieve this is to apply the 'hypothetical monopolist test'.

The hypothetical monopolist test

5.7 The Director General will generally start by taking a narrow view of the market. He will normally assume that there is a separate market for the product in question. He will also assume that there is only one supplier of that product ('the hypothetical monopolist'). He will then consider whether the monopolist supplier could sustain a 'small but significant non-transitory increase in the price' (see paragraphs 5.14 to 5.16 below) of the product above the 'competitive level' (see paragraphs 5.17 to 5.19 below).

5.8 To determine whether the price rise could be sustained the Director General will consider the extent to which customers would switch to demand-side substitutes[13] and whether suppliers that did not currently supply the product could start to supply the product within a relatively short time period, say, within a year. If the Director General decided that the price rise could be sustained, in that there was little scope for demand-side or supply-side substitution, he would assume that there was a separate market for the product in question.

5.9 If the price rise could not be sustained, due to the existence of demand-side and/or supply-side substitutes, the test would be applied again, including those substitutes in the potential market. The Director General would consider whether a monopolist supplier of all the products in the enlarged market could sustain a small but significant increase in the price of the products above the competitive level. Any demand-side and/or supply-side substitute products that would prevent the price rise being sustained would then be added to the market. The Director General would continue to apply the test until the hypothetical monopolist would be unable to sustain the price

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13 Not all customers, or even a majority of them, would necessarily need to switch to substitutes in order to prevent an undertaking from sustaining a small but significant price increase. Indeed, some of the customers may be captive in that they are unable to switch to other products. Provided, however, that there were a significant number of non-captive customers who could switch to substitute products and that the hypothetical monopolist could not price discriminate by charging the remaining captive customers a higher price, the hypothetical monopolist would not be able to sustain a price increase.

rise. In this way the Director General will be assisted in identifying the relevant product market.

5.10 Normally, the hypothetical monopolist test will also be used to define the scope of the geographical market. The Director General will generally start by defining the market as the area in which the undertaking or the agreement in question operates. He will then consider whether a hypothetical monopolist in that area would be prevented from sustaining a small but significant non-transitory increase in the price above the competitive level by the availability of demand-side and/or supply-side substitutes supplied by undertakings from other areas. The areas in which any such undertakings operate would then be added to the geographical market. The hypothetical monopolist test would then be applied to the enlarged geographical market. The Director General would continue to apply the test until the hypothetical monopolist would no longer be constrained by the availability of substitutes supplied by undertakings from other areas.

5.11 In defining the product market, the area within which the suppliers of substitute products operate will normally be apparent, making the application of the hypothetical monopolist test to the geographical market more straightforward. In the telecommunications sector, however, some product markets might have a narrow geographical scope. A customer that wished to lease a private circuit connecting city A to city B, for example, would not consider a private circuit linking city A to city C to be a substitute. On the supply side, it might not be feasible (at reasonable cost) for a supplier of circuits between cities A and C to extend its network also to supply city B. In such circumstances, the hypothetical monopolist supplier of circuits between cities A and B would not face any constraints on its price-setting behaviour and circuits on that route would constitute a distinct market.

5.12 In some telecommunications markets, however, there is a requirement for some operators (usually BT) to offer geographically averaged prices. This may act as an indirect constraint on the prices of operators, even where they do not compete directly in the same geographic area. A cable operator in one local franchise area, for example, may not compete directly with a cable operator in another local franchise area, suggesting that local franchise areas are distinct geographic markets. Cable operators also compete with BT, however, which offers geographically averaged prices. This means that if a cable operator in one local franchise area changed its price, any pricing response from BT would not be confined to that local area but would apply nation-wide. This would then have implications for cable operators in other local franchise areas who would have to change their prices. Consequently, markets that appear to be local may actually be wider.

5.13 Details of the types of evidence that the Director General will consider in defining a relevant market are given in the Competition Act guideline ***Market Definition***.

'A small but significant non-transitory increase in price'

5.14 The Director General will normally consider whether the hypothetical monopolist would be able to sustain a price increase of between 5 and 10 per cent

above the competitive level. However, what is a 'significant' price increase will vary from case to case.

5.15 Generally, if the hypothetical monopolist would be able to raise the price of a product a small but significant amount above the competitive level for more than a year the price rise will be regarded as non-transitory and sustainable. In other words, to prevent the hypothetical monopolist from sustaining a price rise the Director General would normally expect demand-side and/or supply-side substitution to take place within that time.

5.16 This will not always be the case, however, as the Director General will also take into account the ease with which substitutes can be obtained or provided. If customers could switch to a substitute product within a year, for example, but in order to do so they would have to incur significant switching costs, the availability of the substitute product might not be regarded as sufficient to prevent the hypothetical monopolist from sustaining a price rise. The Director General would not normally take into account supply-side substitutes that could be supplied only as a result of significant investment in fixed assets.

The 'competitive level'

5.17 Prices are at the competitive level when no supernormal profits are being made in the long run. Although OFTEL has used price controls to reduce the prices of products in respect of which there was not the prospect of effective competition, it may still be the case that some prices are above competitive levels.

5.18 An undertaking with market power may already have sought to maximise profits by raising the price of the product above the competitive level. If this is the case the application of the hypothetical monopolist test might produce a different market definition from that which would be produced if the price were at the competitive level. The hypothetical monopolist might be prevented from sustaining a price increase by the availability of substitutes that would not form part of the relevant market if the price were raised from a competitive level.

5.19 The Director General will normally proceed on the basis that the current price is at a competitive level *unless* there is evidence to the contrary. Evidence that prices are above competitive levels might include excess profits or past price movements. Further details are contained in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***.

Previous cases

5.20 Although a market definition used in a previous case may provide a useful reference point, it will not necessarily be the correct market definition to use subsequently. This is particularly true in the telecommunications sector, which is characterised by rapid technological change. The Director General will not therefore be bound by previous market definitions when carrying out Competition Act investigations, although they will usually provide a useful starting point.

5.21 Further details are given in the Competition Act guideline ***Market Definition***.

6 ASSESSMENT OF MARKET POWER

6.1 In order to determine whether there is a breach of either prohibition the Director General will first, define the relevant market and secondly, assess whether the undertaking or undertakings in question have market power. An agreement may, however, breach the Chapter I prohibition where the parties do not have market power as explained in paragraph 6.4 below. The approach to the assessment of market power that the Director General will take is outlined below, and further details are given in the Competition Act guideline ***Assessment of Market Power***.

6.2 An undertaking has market power if it is not constrained effectively by competition. In practice, an undertaking with market power will be able to raise prices consistently and profitably above the competitive level. It may also be able consistently to supply goods of a lower quality than it would be able to supply in a competitive market. As is explained below, in determining whether an undertaking has market power the Director General will take into account a range of factors, including:

- the undertaking's market share and changes in that share over time;
- whether there are constraints that would prevent the undertaking from acting anti-competitively, even where it does have a high market share.

The Chapter I prohibition

6.3 While the Chapter I prohibition prohibits agreements that have the object or effect of preventing, restricting or distorting competition in the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom, an agreement will infringe the Chapter I prohibition only if it has an 'appreciable' effect on competition. In practice, if the parties to an agreement do not already have market power – either individually or collectively – and could not acquire such power as a result of the agreement, it is unlikely that the agreement would have an appreciable effect on competition.

6.4 However, the following types of agreement may have an appreciable effect on competition even though the parties to the agreement do not have market power, namely an agreement that:

a. has the object or effect of:

i. directly or indirectly fixing prices or sharing markets; or

ii. imposing minimum resale prices;

or b. is one of a network of similar agreements that cumulatively have an appreciable effect on competition.

6.5 Subject to the preceding paragraph, if the parties to an agreement have a combined share of the relevant market that does not exceed 25 per cent it is unlikely that they will have market power - individually or collectively - and consequently, it is unlikely that the agreement would have an appreciable effect on competition. Further information on how the Director General will calculate market shares is given at paragraphs 6.13 to 6.16 below.

6.6 Even where the parties' combined market share does exceed 25 per cent, the Director General may find that the agreement would not have an appreciable effect on competition. The other factors that the Director General will take into account are set out at paragraphs 6.17 to 6.32 below.

The Chapter II prohibition

6.7 The Chapter II prohibition prohibits conduct by one or more undertakings which amounts to the abuse of a dominant position in a market in the United Kingdom (or a part thereof), which may affect trade within the United Kingdom. The European Court has defined a dominant position as:

> 'a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers.'[14]

6.8 A dominant undertaking will possess a substantial degree of market power that is in excess of any market power held by any of its competitors. It is not, however, necessarily the case that a firm with market power, or even the firm with the greatest degree of market power in any particular market, will be dominant.

6.9 The European Court has stated that if an undertaking's market share has persistently exceeded 50 per cent, it will, unless there is evidence to the contrary, be presumed to be dominant[15]. In the absence of other factors, however, the Director General considers it unlikely that an undertaking will be dominant individually if its market share is below 40 per cent. Even where an undertaking has a market share in excess of 40 per cent it may not have a dominant position as there may be other factors that would prevent the undertaking acting anti-competitively. Further information on how the Director General will calculate market shares is given at paragraphs 6.13 to 6.16 below and the other factors he will take into account in assessing market power are set out at paragraphs 6.17 to 6.32 below.

Collective dominance

6.10 Conduct on the part of *one or more* undertakings that amounts to the abuse of a dominant position is prohibited. Undertakings may therefore be dominant collectively.

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14 Case C27/76 *United Brands v. Commission*, [1978] ECR 207, [1978] 1 CMLR 429

15 Case C62/86 AKZO *Chemie BV v. Commission*, [1993] 5 CMLR 215

6.11 Undertakings in the same corporate group may have collective dominance. Collective dominance may also exist when two or more undertakings are linked in such a way that they adopt the same conduct in the market. The Court of First Instance has stated that:

> 'There is nothing in principle, to prevent two or more independent economic entities from being, on a specific market, united by such economic links that, by virtue of that fact, together they hold a dominant position vis-à-vis the other operators on the market.'16

6.12 A recent decision of the Court of First Instance17 under the EC Merger Regulation suggests that collective dominance (at least for the purpose of that Regulation) may also exist where there are no such links between the undertakings in question, but where they are acting in the same way on the market. This is likely, however, to be the case only in oligopolistic markets characterised by homogeneous products and high entry barriers. It is not yet clear whether this broader definition of collective dominance under the Merger Regulation will also be applied to Article 82 of the EC Treaty (on which the Chapter II prohibition is based).

Calculating market shares

6.13 In determining whether an undertaking has market power the Director General will take into account the undertaking's market share, although even where an undertaking has a high market share there may be constraints that would prevent the undertaking acting anti-competitively.

6.14 Market share will normally be measured in terms of either value or volume of sales. The Director General will use whichever measure of market share is more appropriate, although it will generally be useful to obtain information in respect of both the value and volume of sales.

6.15 When calculating an undertaking's share of the relevant market the Director General will also take into account the market share of any undertakings in the same group:

- over which it exercises control directly or indirectly;

- which exercise control over it directly or indirectly.

6.16 In calculating an undertaking's market share the Director General will take into account not just its market share at a given point in time. As mentioned above, an undertaking will be presumed to be dominant if its market share has been *persistently* above 50 per cent. The Director General will therefore look at how the market shares of all undertakings in the relevant market have changed over time. In order to

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16 Case T-68/69 etc *Societa Italiano Vetro SpA v. Commission* [1992] 2 ECR 1403, [1992] 5 CMLR 302.
17 CaseT-102/96 *Gencor v. Commission* [1999] 4 CMLR 971

calculate market shares the Director General will normally consider information from a variety of sources, including:

- information from the undertaking or undertakings that he is investigating;
- information from competitors, customers, suppliers and trade associations;
- market research reports.

Other factors

6.17 An undertaking with a persistently high market share may not necessarily have market power. First, there may be constraints that prevent the undertaking from acting anti-competitively:

- existing and potential competitors;
- barriers to entry or exit;
- buyer power;
- the undertaking's conduct/performance.

Secondly, in a market where undertakings regularly improve the quality of their products, a persistently high market share may be the consequence of persistently successful innovation.

Short-run constraints: existing competitors and supply-side substitution

6.18 Existing competitors may be able to prevent an undertaking from behaving anti-competitively, for example, by undercutting an undertaking that increases the price of its product above the competitive level.

6.19 An undertaking may also be constrained in the short run by the prospect of supply-side substitution. As mentioned in part 5 above, other undertakings may be able to increase production or switch capacity quickly and easily. As a rule of thumb, supply-side substitution should take place within a year and ought not to require significant investment in fixed assets.

Barriers to entry

6.20 An entry barrier is a cost borne by an undertaking entering a market that is not borne by an undertaking already operating in the market. The lower the barriers to entry, the more likely it is that the threat of competition will prevent an undertaking from acting anti-competitively. There are three types of barrier to entry:

- absolute advantages;

- strategic advantages;
- exclusionary behaviour.

Absolute advantages

6.21 An undertaking has an absolute advantage if it has access to important assets and/or resources that are not accessible to a potential entrant or are accessible only at a substantially higher cost. Until December 1996, for example, BT and Cable & Wireless had an absolute advantage in the handling of international telecoms traffic in that only they were licensed to own and operate international facilities, the infrastructure for handling international traffic. Also, the fact that there is a finite amount of radio spectrum means that only four undertakings are currently licensed to operate mobile networks. Those operators therefore have an absolute advantage.

Strategic advantages

6.22 A strategic advantage typically results from being the first to enter a market. An undertaking may have a strategic advantage over potential entrants, for example, as a result of its reputation for engaging in predatory pricing (see paragraphs 7.13 to 7.19 below) so as to drive competitors out of the market – something which would also fall within the category of exclusionary behaviour (see paragraph 6.26 below).

6.23 An undertaking may also have a strategic advantage over potential entrants if, in order to enter the market, undertakings would have to incur a high level of sunk costs, costs that would not be recoverable if it proved necessary to exit the market. Given that most telecommunications' services are based on or around networks that require substantial investment, a number of telecommunications markets are characterised by a high degree of sunk costs. The level of sunk costs is likely to be higher where there are significant economies of scale and/or scope[18], because in order to compete undertakings would need to enter the market on a scale large enough for them to obtain the same economies of scale and/or scope as incumbents.

6.24 New entrants will also have to incur sunk costs in an effort to influence demand for their products – they may need to incur marketing costs in order to create brand awareness and to overcome customer inertia towards switching from a long-established incumbent operator. Incumbents may also be able to influence the level of sunk costs faced by the entrant.

6.25 An undertaking may also have a strategic advantage over potential entrants as a result of having more information on the existing costs of production. Potential entrants may not have the same access to finance as an undertaking that is already operating in the market and may therefore have a strategic disadvantage.

Exclusionary behaviour

18 Economies of scale exist where average costs fall as output increases; economies of scope exist where average costs fall as more types of product are produced.

6.26 Entry barriers may be created by exclusionary behaviour on the part of an undertaking that is already operating in the market. Competing telecommunications operators, for example, need to be able to interconnect with other networks in order to provide a full service to their customers. In particular, a small network with only a few subscribers that is competing with a large dominant network operator will need to be able to terminate calls on the latter's network. This is because the small network is unlikely to be able to attract customers if they are unable to make calls to the large number of subscribers remaining with the dominant operator. By contrast, there is little cost to the dominant operator if its subscribers are unable to call the relatively small number of customers of the small competing network. A dominant operator can exploit this asymmetry in order to exclude rivals by refusing to allow other network operators to interconnect with its network or allowing interconnection only on unfavourable terms.

Assessing barriers to entry

6.27 The Director General will generally seek information regarding the costs of entering the market from undertakings already operating in the market and from potential entrants. He might, for example, ask for an estimate of the cost of obtaining a 5 per cent share of the market. He might also ask for an estimate of the cost of operating at the 'minimum efficient scale' – the size of plant that an entrant would need in order to obtain the same economies of scale as undertakings already operating in the market.

6.28 The Director General will also look at the history of entry to, and exit from, the market (or closely related markets). The level of profits that have been earned will also be relevant. If an undertaking has consistently earned excess profits this might suggest that there are high barriers to entry, but they may also be a reward for persistently successful innovation, and might therefore encourage market entry.

6.29 The level of growth or prospective growth in the market will also be relevant. Entry will be more likely in a growing market than in a static or declining market because it will be easier for new entrants to gain market share. The rate of innovation is important too. In markets where high rates of innovation occur, or are expected to occur, innovation may enable barriers to entry to be overcome relatively quickly. Indeed, profit that results from a barrier to entry created by successful innovation may create an incentive to innovate.

Buyer power

6.30 An undertaking's ability to behave anti-competitively may also be affected by the power of a buyer (or group of buyers) to exert a substantial influence on the price, quality or terms of supply of a product. In order to have such power a buyer is likely to account for a large proportion of the producer's total output, be well-informed about alternative sources of supply, be able to switch to other suppliers readily at little cost to itself, and may even be able to begin producing the relevant product itself. The existence of countervailing buyer power does not, however, guarantee a more beneficial outcome in terms of, for example, lower prices to end consumers. If the buyer itself has market power in the downstream markets, it may not be sufficiently

constrained by competition to pass on any benefits it obtains from its suppliers to its end customers.

Conduct and performance

6.31 An undertaking's conduct or financial performance may in itself provide evidence of market power. The Director General will examine whether the undertaking has been able consistently to charge a price that is in excess of costs. In analysing the extent of price competition the Director General will take into account the impact of any price controls. It is feasible, however, that a price control which is averaged across several markets may still leave room for an undertaking to raise prices persistently above competitive levels in one or more of the markets in question.

6.32 As well as being relevant to the issue of whether barriers to entry exist, the fact that an undertaking has been able consistently to earn excess profits may also indicate that there is a lack of price competition.

Significant Market Power and Market Influence

6.33 The concepts of Significant Market Power ('SMP') and Market Influence are regulatory concepts. Telecommunications operators that are designated as having SMP and/or Market Influence must fulfil certain regulatory obligations. Further details are given in OFTEL's *Draft guidelines on Market Influence Determinations* (April 1999)19

6.34 In the context of an investigation under the Competition Act, the fact that an operator has been determined as having SMP and/or Market Influence status in a particular market does not imply that it will have market power in all markets in which it operates. In particular, it does not imply that it will have market power in the market that is the subject of the Competition Act investigation. This will have to be considered fully as part of the investigation, with the Director General first defining the relevant market and then assessing whether the operator has market power, using the approach outlined above.

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19 These guidelines are not guidelines within the meaning of section 52 of the Competition Act.

7 ASSESSMENT OF AGREEMENTS AND CONDUCT

7.1 If having defined the relevant market the Director General determines that the undertaking or undertakings in question have market power, he will then consider whether there is a breach of the Chapter I prohibition, which prohibits anti-competitive agreements, and/or the Chapter II prohibition, which prohibits abuses of a dominant position. This is subject to the proviso that certain types of agreement may have an appreciable effect on competition and be in breach of the Chapter I prohibition even though the parties to the agreement do not have market power individually or collectively as referred to in paragraph 6.4 above. Further details are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***.

7.2 This part provides guidance on how the Director General will assess whether certain types of agreement and conduct are in breach of either prohibition. It concentrates on the types of agreement and conduct that are likely to be of concern in the telecommunications sector. Emphasis is placed on types of conduct rather than types of agreement, but there may be a breach of the Chapter I prohibition where conduct of the type mentioned below forms the subject matter of an agreement. It is also possible that by entering into an agreement that is in breach of the Chapter I prohibition an undertaking may also be in breach of the Chapter II prohibition.

Leveraging dominance into upstream or downstream markets

7.3 In assessing whether agreements and conduct are in breach of either prohibition, it is important to bear in mind that if an undertaking is dominant in one market and is vertically integrated into markets upstream or downstream of that market, it may have the ability adversely to affect competition in the upstream or downstream markets. The EC Access Notice, to which, in accordance with section 60 of the Competition Act, the Director General must have regard, states that the European Court of Justice's analysis in *Tetra Pak II*[20], which concerned the leverage of dominance into closely related horizontal markets, is 'equally applicable…to closely related vertical markets'. The EC Access Notice goes on to state that where an operator has:

> 'a very high degree of market power on at least one of those [closely related markets]…it may be appropriate…to find that the particular operator was in a situation comparable to that of holding a dominant position on the markets in question as a whole.'

7.4 Telecommunications operators and/or independent service providers may rely on an operator for the provision of network inputs ('the upstream market'), while at the same time competing with that operator in downstream markets. If the vertically integrated operator were dominant in the upstream market there could be scope for it to leverage its position of dominance into the downstream market (see, for example, the discussion on price squeezing in paragraph 7.26 below).

20 Case C-333/94P *Tetra Pak II* [1996] 1 ECR 595, [1997] 4 CMLR 662.

Measuring the cost of providing telecommunications services

Background

7.5 Before dealing with specific types of pricing behaviour that may be anti-competitive it is necessary to explain how the Director General will measure the cost of providing telecommunications services.

7.6 The supply of telecommunications services is characterised by economies of scale[21] in the provision of networks, (which stem partly from the fact that there are some large elements of cost that do not vary with the number of customers or calls, even in the long run), and economies of scope[22] in the provision of services (stemming from common costs[23]). This means that telecommunications companies tend to be multi-product firms and that their pricing policies have to take into account the need to recover both the fixed costs of supplying a service and the common costs. In particular, the incidence of low marginal costs[24] and the existence of substantial common costs mean that an undertaking that is involved in a range of markets has, subject to regulatory constraints, a great deal of freedom to offer a range of prices and to choose the markets from which to recover its costs. This can put such an undertaking at a significant advantage over competitors that do not have the same degree of freedom because of their size and/or because they supply a more limited range of services. There is nothing wrong with a dominant undertaking having such advantages provided that it does not abuse its dominant position.

The use of long run incremental cost

7.7 In considering the appropriate cost base against which prices should be assessed, it is first of all necessary to distinguish between the short run and the long run. In the short run some costs, in particular capital costs, are fixed. In the long run, however, all costs, including capital costs, are variable.

7.8 The long run incremental cost[25] ('LRIC') measure takes into account the total long run costs (that is, both capital and operating costs) of supplying a specified additional unit of output ('the increment'). The increment could be, for example, the provision of a new service. If the price of a service covers all its LRIC, including the costs of capital (and with any common costs being recovered through charges for the undertaking's other services), it will be profitable for the undertaking to offer the service. As the provision of telecommunications services is characterised by high levels of capital costs it will generally be appropriate to use LRIC as the cost base.

7.9 In contrast, short run marginal cost, which includes only the short run cost of producing an additional unit of output, excludes capital costs. The use of short run marginal cost as a cost base tends, therefore, to result in prices that are very low.

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21 Economies of scale exist where average costs fall as output increases

22 Economies of scope exist where average costs fall as more types of products are produced.

23 Common costs are costs of production that are shared between two or more products.

24 The marginal cost is the cost of producing an additional unit of output.

25 Incremental costs should be calculated on the basis of 'forward-looking costs', taking into account the current valuation of assets.

Where the costs of production include a large proportion of costs that do not vary with output, as is the case in telecommunications, the short run marginal cost of an additional unit of output could even be as low as zero. Setting prices in relation to short run marginal cost would therefore tend to underestimate the costs of supplying telecommunications services, whereas prices that are derived from incremental costs reflect the actual costs of supply. Prices that are derived from LRIC should also enable potential new entrants to make informed pricing and investment decisions.

7.10 The use of LRIC as the cost base for the supply of telecommunications services is also consistent with the view that in network industries it is generally inappropriate to measure the cost of supplying a service by reference to average variable costs[26]. The EC Access Notice states that:

> ‘a price which equates to the variable cost of a service may be substantially lower than the price the operator needs in order to cover the cost of providing the service…the costs considered should include the total costs which are incremental to the provision of the service…[Therefore,] the Commission will often need to consider the average incremental costs of providing a service, and may need to examine average incremental costs over a longer period than one year.’

Common costs

7.11 When examining pricing issues in the telecommunications sector, LRIC is generally therefore a more satisfactory cost base than marginal or average variable cost. However, the existence of economies of scope means that if the prices of each of an undertaking’s services are all equal to each service’s LRIC, the undertaking will not recover its common costs. To ensure that such a situation could not have an anti-competitive effect, the undertaking would need to be able to demonstrate two things, first, that its individual prices are set at or above LRIC and secondly, that the combined prices of services in groups that share common costs cover both LRIC and the common costs of supplying those services. OFTEL usually refers to this as a ‘combinatorial’ test.

The use of LRIC in practice
{tc \l 3 "use of LRAIC in practice"}
7.12 Under the Network Charge Control arrangements, BT’s charges for interconnection services are derived from the LRIC of conveyance, with an appropriate mark up to cover common costs. In relation to retail services, BT has, in consultation with OFTEL, recently developed a methodology to produce cost information based on LRIC. When dealing with cases concerning the supply of telecommunications services the Director General proposes to request that BT provides cost information produced in accordance with this methodology. The Director General will also ask other operators to provide cost information based on

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26 Average variable costs are calculated by dividing an undertaking’s total variable costs by its output. Average variable costs are normally used as a proxy for short run marginal costs, which can be difficult to estimate.

LRIC when dealing with cases that are concerned with the supply of telecommunications services.

Pricing behaviour that may be anti-competitive

Predatory pricing

7.13 Predatory pricing is a strategy whereby an undertaking deliberately incurs short term losses so as to eliminate a competitor and be able to charge excessive prices in the future. Customers and/or consumers may benefit in the short term from lower prices, but in the longer term weakened competition will lead to higher prices, reduced quality and reduced choice. Predatory pricing is therefore likely to be in breach of the Chapter II prohibition.

7.14 In assessing whether an undertaking is engaging in predatory pricing the Director General will consider whether:

- in the short run the undertaking will make an incremental profit[27], which will enable it to cover its costs[28];

- it is the undertaking's intention to eliminate a competitor;

- it would be feasible for the undertaking to recover its losses.

Further details are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***.

7.15 For the Director General to examine whether an undertaking is covering its LRIC is consistent with the approach set out in the EC Access Notice, which recognises that cost structures in network industries tend to be different from most other industries and that a straightforward application of the test established by the European Court of Justice in the *AKZO* case[29] (using average variable cost as the cost floor) is inappropriate. Further details of the *AKZO* case and the costs tests the Court established are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***. If a dominant undertaking is pricing below LRIC the Director General will therefore presume that it is intending to engage in predatory pricing. It will be for the undertaking in question to rebut this presumption, which, the Director General recognises, will be possible in certain circumstances. It may, for example, be rational to price below LRIC where an operator has excess capacity and this has not been reflected in existing prices.

7.16 If an undertaking's individual prices are above LRIC but revenue overall fails to cover total costs, it will be regarded as intending to engage in predatory pricing if it

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27 An incremental profit is the change in profit that results from a particular decision such as a price reduction.
28 It should be noted that an undertaking could respond to competition by reducing its prices and running at a lower level of profitability. In such circumstances, the undertaking would make an incremental loss, but might still be covering its costs.
29 Case C62/86 AKZO *Chemie BV v. Commission*, [1993] 5 CMLR 215

can be established that the purpose of the conduct is to eliminate a competitor. The existence of common costs will also mean that it will be appropriate to undertake the tests outlined in paragraph 7.11 above, to establish whether total revenue covers total costs.

7.17 An undertaking may seek to justify its pricing strategy by arguing that it will result in an incremental profit that will enable it to cover its costs. As stated in the EC Access Notice, however, pricing below average total costs would not be justifiable if a dominant operator would benefit only if one or more of its competitors were weakened.

7.18 In assessing whether an undertaking's pricing strategy would result in an incremental profit that would enable it to cover its costs, it will often be appropriate to use a net revenue test, which compares the profitability of a particular decision (for example, to adopt a lower price) with the alternative 'benchmark' strategy (for example, to maintain prices at their existing level). If profitability were not adversely affected by the reduction in price because the demand increased sufficiently to offset the price reduction and at the same time, the price remained sufficiently high to cover the incremental costs of the increase in output, the price reduction might be viewed as legitimate competitive behaviour. If, however, an undertaking had no realistic expectation that a profit would be made or had made no attempt to assess the impact on profitability that the pricing strategy would have, the price reduction is likely to be taken as evidence of an intention to eliminate a competitor.

7.19 An additional factor that will need to be taken into account is the extent to which there is strong complementarity between two or more services in respect of which there are different supply and demand conditions. Where there is strong complementarity, in applying the relevant tests it may be more appropriate to take into account the costs and revenues of all the complementary services rather than require each individual service to cover its costs. For example, access (that is, line rentals and connections) and calls are likely to be strong complements in that customers would probably have a demand only for access services, primarily because they wished to make and receive calls. In general, however, the Director General would expect each individual service to be priced above LRIC because although a consumer may require two or more services, they need not be obtained from the same supplier.

Cross-subsidies

7.20 A cross subsidy occurs where an undertaking uses revenues from one market to subsidise losses in another market. Where the undertaking uses revenues from a market where it is dominant there may be a breach of the Chapter II prohibition.

7.21 A cross-subsidy will normally be judged to occur where an undertaking's revenues from an activity (for example, a new service) may be expected to fail to cover the costs associated with that activity over its *economic lifetime*. The Director General will consider whether the revenue over the lifetime of a service would exceed the LRIC, including the cost of capital. If the revenue would exceed the LRIC, the service would be sustainable in the long term, that is, providing the service would not require a cross-subsidy.

7.22 A group of services may share common costs which, although the services are individually priced above LRIC, are not covered. A combinatorial test would establish whether the prices of services in groups that share common costs cover both the incremental and common costs of supplying those services. If they did not, this would indicate that the group of services is being cross-subsidised.

7.23 In assessing whether the revenue from providing a service would exceed the LRIC it may be useful to perform a Discounted Cash Flow ('DCF') analysis[30]. This is a forward-looking analysis of the incremental cash flows (in terms of both costs and revenues) that are expected to arise from a service. It may be particularly useful to perform a DCF analysis in relation to new services or for a service in its start-up phase, when it is often reasonable to expect initial losses to be incurred. A DCF analysis is one of the standard methods of investment appraisal. It should be based on assumptions that are consistent with those made in an undertaking's business plan in relation to, for example, the competitive conditions to be expected in the market. It will not always be possible for an undertaking to meet all the targets set out in its business plan. Evidence of an abuse of dominance may be provided, however, where a business case is based on unjustified and implausible assumptions or where there has been a failure by the undertaking to take remedial action once it became apparent that it would not meet the targets.

7.24 For mature services there will be circumstances where a profitability analysis based on accounting data (with an allowance for the return on capital) may be used to assess whether there is a cross-subsidy. An undertaking would be expected to be able to justify the cost of capital figure that it has chosen to use in relation to the product in question and will be expected to earn at least that cost of capital. If there is a high level of risk it might be appropriate to allow the undertaking to earn a higher rate of return than would normally be assumed for products of average risk.

7.25 Further details are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***.

Price squeezing

7.26 Where a vertically integrated undertaking is dominant in an upstream market and supplies a key input to undertakings that compete with it in a downstream market, there is scope for it to abuse its dominance in the upstream market. The vertically integrated undertaking could subject its competitors in the downstream market to a price or a margin squeeze by raising the cost of the key input (see paragraph 7.32 to 7.37 below on excessive pricing) and/or by lowering its prices in the downstream market. The integrated undertaking's *total* revenue may remain unchanged. The effect would be to reduce the gross margin available to its competitors, which might well make them unprofitable. In considering whether an undertaking is engaging in price squeezing in breach of the Competition Act, the Director General will consider whether the dominant undertaking would be profitable in the relevant downstream

30 The detailed information required to perform such an analysis will usually be available in the telecommunications sector, but may not be available in other sectors.

market if it had to pay the same input prices as its competitors. A dominant undertaking may try to conceal a price squeeze by allocating to its upstream activities costs that are actually incurred as a result of its downstream activities. The Director General will give close consideration to the method of cost allocation where he believes that it may be being used to aid anti-competitive behaviour.

Price discrimination

7.27 An undertaking can be said to be discriminating when it applies dissimilar conditions to equivalent transactions. There may, however, be objective reasons for an undertaking charging different prices to different customers, where, for instance, there are different transport costs. The Director General recognises that where the demand for a service is different among different customers or groups of customers, price discrimination may be an efficient method of recovering substantial fixed costs.

7.28 Price discrimination, and discrimination more generally, may be an abuse of the Chapter II prohibition, where, for example:

- its effect is to exclude competitors from the market in question;

- an undertaking (or group of undertakings) exploits its market power by charging excessively high prices to certain customers.

7.29 Further details are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***.

Discounts

7.30 Discounts are a form of price competition. They can sometimes reflect the lower costs of supplying certain customers or groups of customers and, in general, such discounts would not normally be in breach of the Competition Act. Where discounts are offered to certain customers that do not reflect underlying cost differences they represent a form of price discrimination. There may be legitimate reasons for offering such discounts, even when they do not reflect underlying cost differences. They may, for example, represent an efficient way of recovering fixed or common costs.

7.31 There are some types of discounts, however, that, when offered by a dominant undertaking, would be likely to cause concern in the telecommunications sector:

- loyalty rebates, where the discount (or its level) is dependent on the customer not taking (or restricting) supplies from competitors, whether this is *de facto* (for example, the customer must meet certain expenditure targets) or by agreement;

- discounts which are calculated across, and applied to products offered in, a range of markets including those where the undertaking is dominant;

- volume rebates that are calculated on the basis of total telecommunications expenditure across a range of competitive and regulated markets even though the discounts are applied to spending only in competitive markets;

- discounts which are targeted at a narrow group of customers, particularly where the group consists of only those customers who have the ability to switch to alternative suppliers.

Excessive pricing

7.32 The charging of excessive selling prices (or, conversely, the extraction of unfair or excessively low buying prices) by a dominant undertaking may be an infringement of the Chapter II prohibition31. The European Court of Justice has held that:

> '…charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied…is an abuse.'32

7.33 The Court stated that a detailed analysis of costs would be required before any judgement could be reached and said that the question to be asked was:

> '…whether the difference between the costs actually incurred and the price actually charged is excessive, and if the answer to this question is in the affirmative to consider whether a price has been charged which is either unfair in itself or when compared to other competing products.'

7.34 Excessive prices charged by a dominant undertaking for the supply of network inputs required by competitors in a downstream market would be of particular concern (see also paragraph 7.26 above in relation to price squeezing). In addition to having no relation to the economic value of the product supplied, such excessive prices might make it more difficult for undertakings to compete and could deter market entry at the downstream level. This may be less of a concern, however, if the excessive prices attract new entry at the network level, although whether this can happen and how quickly will depend on the extent to which there are entry barriers at the network level.

7.35 An undertaking's prices in a particular market can be regarded as excessive if they allow the undertaking to sustain profits higher than it would expect to earn in a competitive market ('supra-normal profits'). Essentially, excessive prices will be abusive only if they have persisted in the absence of continuing successful innovation and/or without stimulating successful new entry or significant loss of market share. Excessive prices will not always, however, result in supra-normal profits as an undertaking protected from competition might be able to sustain higher costs.

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31 The European Commission's decision to initiate proceedings against Deutsche Telecom (see *XXVIIth Report on Competition Policy: 1997*, European Commission, point 77) suggests that the Commission would be willing to take action under Article 82 of the EC Treaty if it found that prices in the telecoms sector were excessive. Deutsche Telecom subsequently agreed to reduce certain tariffs.
32 CaseC 27/76 *United Brands v. Commission*, [1978] ECR 207, [1978] 1 CMLR 429.

7.36 An agreement between two or more undertakings to set excessive prices might be in breach of the Chapter I prohibition if it has an appreciable effect on competition. Undertakings might also engage in tacit collusion by, for example, deciding to follow each others' prices ('parallel pricing') or following the pricing policy of a market leader ('price leadership'). Such behaviour might also be in breach of the Chapter I prohibition if it has an appreciable effect on competition. It might also amount to an abuse of dominance or joint dominance under the Chapter II prohibition. In determining whether tacit collusion had occurred the Director General would consider whether price changes were related to costs. In particular, he would look at whether the prices of undertakings had risen when costs had not and whether cost reductions had been passed on to customers in the form of lower prices.

7.37 Further details are given in the Competition Act guideline ***Assessment of Individual Agreements and Conduct***. The guideline also explains how the Director General will determine whether an undertaking is making supra-normal profits.

Other types of conduct and agreements

Refusal to supply

7.38 A dominant undertaking's refusal to supply may be in breach of the Chapter II prohibition if it cannot be justified objectively, for example, for safety reasons, to protect network integrity, because of the lack of creditworthiness of the operator seeking access or because of a lack of capacity. Various types of refusal to supply are dealt with below. As mentioned above, where a refusal to supply is the subject of an agreement, there may be a breach of the Chapter II and/or the Chapter I prohibitions.

Refusal to grant access to facilities

7.39 A refusal to grant access to certain facilities may be a breach of either prohibition. The EC Access Notice sets out three types of refusal to supply:

> 'a. a refusal to grant access for the purposes of a service where another operator has been given access by the access provider to operate on that services market;
>
> b. a refusal to grant access for the purposes of a service where no other operator has been given access by the access provider to operate on that services market;
>
> c. a withdrawal of access from an existing customer.'

Type (a) refusal to grant access - discriminatory refusal

7.40 The EC Access Notice states that:

> 'a refusal to supply…where a dominant facilities owner is already supplying one or more customers operating in the same downstream market would constitute discriminatory treatment which, if it would restrict competition on

> the downstream market, would be an abuse…The dominant company's duty is to provide access in such a way that the goods and services offered to downstream companies are available on terms no less favourable than those given to other parties including its own corresponding downstream operations.'

7.41 Thus, where a discriminatory refusal by a dominant operator to grant the access required by a competing operator restricts competition in a downstream market it is likely to be an abuse of dominance in breach of the Chapter II prohibition. A discriminatory refusal to supply by a dominant operator might not be an abuse, however, if an objective justification for the refusal can be demonstrated.

Type (b) refusal to grant access - access required to supply new services

7.42 The EC Access Notice recognises that there is considerable scope for a refusal to supply to have serious anti-competitive consequences where, 'if there were no commercially feasible alternatives to the access being requested, then unless access is granted, the party requesting access would not be able to operate on the service market.' The Notice recognises that a refusal to grant access in such circumstances would limit the development of new services or impede the development of competition and would be likely to have abusive effects.

7.43 In accordance with the decision of the ECJ in *Oscar Bronner*[33], a refusal to grant access required to supply new services will be prohibited under the Competition Act only if:

- it is likely to eliminate all competition on the part of the undertaking that is seeking access in the relevant downstream market;
- the refusal is incapable of objective justification.

7.44 Whether a refusal to grant access to a facility is in breach of the Competition Act will need to be assessed on a case by case basis. In respect of the launch of one service, a refusal to grant access to a facility may be prohibited, but the refusal to grant access for the launch of another service may not be. The Director General considers that a refusal by a dominant undertaking to grant access might be an abuse of dominance where, for example, the refusal prevents the supply of a new service that has one or more of the following characteristics:

- the service requires end to end capability across the dominant undertaking's network;
- the service requires interconnection in order to be economically viable;
- the service requires that equipment on customers' premises be capable of interacting with the network.

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33 Case C 7/79 *Oscar Bronner v.Mediaprint and others* [1999] 4 CMLR 112

Type (c) refusal to grant access - withdrawal of access from an existing customer

7.45 The unilateral termination of access agreements raises similar issues to type (a) and type (b) refusals to grant access. The Director General will follow the approach of the European Commission as set out in the EC Access Notice:

> 'withdrawal of access from an existing customer will usually be abusive…objective reasons may be provided to justify the termination. Any such reasons must be proportionate to the effects on competition of the withdrawal.'

Refusal to supply information

7.46 A refusal by a dominant undertaking to supply information generated by its network, for example, calling line identification information, might be an abuse of a dominant position if the refusal means that services based on the availability of the information could be provided only by the dominant operator.

7.47 The refusal by a dominant operator to supply technical information may also be an abuse of dominance. The refusal by a dominant operator to inform a new operator where it can interconnect with its network, for example, would be likely to be prohibited.

7.48 Intellectual property rights ('IPRs') may exist in relation to technical information, and there are circumstances in which an IPR might be exercised in a manner that would constitute an abuse of a dominant position. A refusal by a dominant operator to supply interface information, for example, may have an effect on competition in the market for the supply of customer equipment designed to take advantage of the new interface. The Director General recognises, however, that the ability to obtain IPRs encourages innovation and therefore the circumstances in which the exercise of an IPR would constitute an abuse are likely to be limited.

Behaviour short of refusal to supply

7.49 In the absence of an objective justification, behaviour that falls short of a refusal to supply might be an abuse of dominance. A dominant undertaking might in principle be prepared to grant access to one of its facilities, for example, but might seek to impose unreasonable terms and conditions, delay access or refuse to allow testing. Guidance on what the Director General will regard as reasonable time scales for resolving interconnection disputes is contained in OFTEL's ***Guidelines on Interconnection and Interoperability*** (July 1999)34 and ***Guidelines on the Operation of the Network Charge Controls*** (October 1997)35.

Bundling

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34 These guidelines are not guidelines within the meaning of section 52 of the Competition Act.

35 These guidelines are not guidelines within the meaning of section 52 of the Competition Act.

7.50 Bundling generally involves the tying of the supply of one product to the supply of other products. Bundling does not raise competition concerns when it is carried out by undertakings without any market power. It can also benefit consumers where, for example, it allows two or more products to be offered at a lower, combined price than if they had been supplied separately or where products are produced which otherwise would not be. In such cases, consumers may benefit from being able to consume products that would otherwise not be available to them. Bundling by a dominant undertaking can, however, affect competition in both retail and wholesale markets. The assessment of whether bundling has anti-competitive effects can raise complex issues, although the main concern will be to determine whether the bundling has any exclusionary effects on competition. The Director General will balance any exclusionary effects against any countervailing benefits, such as lower prices resulting from the exploitation of economies of scope. He will also take into account the possibility that unbundling the products in question may not be feasible for economic or technical reasons.

7.51 There are a number of forms of bundling that are likely to be prohibited under the Competition Act:

- where a dominant telecommunications operator ties the supply of products in a market in which it is dominant to the supply of products that are (at least potentially) supplied competitively, for example, where a dominant operator ties the supply of access to its network to the supply of its own telephone equipment. This could be enforced through contractual means by, for example, making it a condition of the sale of the non-competitive product that the competitive product is purchased as well. Alternatively, it could be enforced through non-contractual means by, for example, offering more favourable terms for the non-competitive product if the competitive product is purchased as well. Such a practice could have the effect of foreclosing the market to other suppliers of the competitive product, even where the dominant undertaking also offered to supply the different elements of the bundle separately. There could still be an anti-competitive effect if the (implicit) price of the competitive product as part of the bundle were below cost. This would mean that other suppliers of the competitive product would not be able to compete;

- where a dominant operator bundles together physically services that could be supplied separately, for example, where a switch is supplied to a customer with the software already installed, when it is technically possible for it to be supplied separately and competitively. This could have the same foreclosure effects on other suppliers of the competitive service as mentioned above.

Vertical restraints

7.52 In general, a vertical restraint is a provision in an agreement made between undertakings operating at different stages in the supply chain that restricts the commercial freedom of one or more of the parties. A vertical restraint might, for example, be contained in an agreement between a network operator and a telecommunications service provider which, for the purposes of the agreement, operate at different stages in the supply chain. The restraint could take the form of an

exclusive purchasing agreement whereby the service provider agreed only to purchase the network services of one operator. Vertical agreements are excluded from the scope of the Chapter I prohibition, although the Director General has the power to claw back agreements so that the Chapter I prohibition will apply. The Chapter II prohibition will apply to vertical agreements. Certain agreements in the telecommunications sector are likely to be classified as vertical, for example, non-reciprocal access agreements and agreements between mobile operators and service providers.

7.53 Further information on types of vertical restraints and how the Director General will assess whether they are prohibited is contained in the Competition Act guideline ***Assessment of Individual Agreements and Conduct*** and ***Vertical Agreements and Restraints***.

Interconnection agreements

7.54 Interconnection agreements are an essential pre-requisite of network and services competition. It is possible, however, that an interconnection agreement may be in breach of the Chapter I and/or Chapter II prohibitions. The EC Access Notice recognises that an interconnection agreement may be anti-competitive where:

- it restricts competition between the parties to the agreement by, for example, price fixing or market sharing;
- it restricts competition from those not party to the agreement where, for example, it provides for interconnection on an exclusive basis;
- commercially sensitive information is used for other purposes36.

7.55 Operators with Significant Market Power ('SMP') (see paragraph 6.33 above) are required by the Interconnection Directive to:

- publish a standard 'interconnection agreement' containing standard prices for access to and use of its network; and
- offer interconnection on the same terms and conditions as are offered to their own downstream operations.

7.56 The Director General therefore considers it unlikely that standard interconnection agreements will be caught by the Chapter I prohibition.

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36 The Interconnection Directive (see paragraph 3.7) requires that information received by a network operator from an undertaking seeking interconnection be used only for the purposes for which it is supplied. Operators should therefore introduce safeguards to ensure that confidential information is only disclosed to those staff who are involved in making the interconnection agreements and that the information is not used for anti-competitive purposes.

7.57 Notification of interconnection agreements to OFTEL to meet the requirements of the Interconnection Directive does not amount to a notification for guidance or a decision under the Competition Act.