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Working Party No. 2 on Competition and Regulation

MARGIN SQUEEZE

-- European Commission --

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The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 19 October 2009.

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1. Introduction¹

1. The European Commission has investigated margin squeeze allegations in a series of cases, four² of which have led to a formal decision, and three³ have resulted in court proceedings. In *Industrie des Poudres Sphériques* the Commission did not follow the complainant in its margin squeeze allegations and the Court upheld the Commission's findings. The European Court of First Instance (CFI) upheld the Commission's decision in *Deutsche Telekom*. As to *Telefónica*, the Courts have not ruled on it yet.

2. It follows that this submission is mainly based on the 2003 *Deutsche Telekom* decision of the Commission and the CFI judgment of 10 April 2004 on the same case. It should however be noted that this judgment has been appealed to the European Court of Justice (ECJ).

3. In *Deutsche Telekom*, the Commission took the view that there can be an abusive margin squeeze under Article 82 of the EC Treaty, which prohibits the abuse of a dominant position, if the difference between the retail prices charged by a dominant undertaking and the wholesale prices it charges its competitors for comparable services is negative, or insufficient to cover the product-specific costs of the dominant operator for providing its own retail services on the downstream market.

4. It indeed follows from the case law⁴ that the abusive nature of a margin squeeze is connected with the spread between the upstream prices and the downstream prices. In other words, there is no need for the Commission to demonstrate that either the wholesale or the retail prices are abusive in themselves. In this sense, margin squeeze is a stand-alone abuse under Article 82.

5. The anticompetitive effects associated with margin squeeze under the case law are the risks of foreclosure of equally efficient competitors whose access to the market is eliminated or hampered: in the presence of a margin squeeze the competitors of the dominant undertaking cannot trade profitably in the downstream market on a sustainable basis⁵. In *Telefónica* the Commission also established that by

¹ This paper owes to the contribution of Katja Viertiö, Unit A-2, Directorate-General for Competition of the European Commission.

² Commission Decision of 29 October 1975 adopting interim measures concerning the National Coal Board, national Smokeless Fuels Limited and the national Carbonising Company Limited, OJ L 35, 10.2.76 ("*National Carbonising*"), Commission Decision of 18 July 1988 relating to a proceeding under Article 86 of the Treaty of the EEC Treaty (Case No IV/30.178 Napier Brown – British Sugar), OJ L 284, 19.10.1988 ("*Napier Brown-British Sugar*"); Commission Decision of 21 May 2003 relating to a proceeding under Article 82 of the Treaty (Case COMP/C-1/37.451, 37.578, 37.579 – Deutsche Telekom AG), OJ L 263, 14.10.2003 ("*Deutsche Telekom*"), Commission Decision of 4 July 2007 relating to a proceeding under Article 82 of the EC Treaty (Case COMP/38.784 – Wanadoo España V. Telefónica), OJ C 83, 2.4.2008 ("*Telefónica*")

³ Judgment of the Tribunal of First Instance of 30 November 2000 in Case T-5/97 ("*Industrie des Poudres Sphériques*"), Judgment of the Court of First Instance of 10 April 2008 in Case T-271/03 ("*Deutsche Telekom*"), Action brought on 10 September 2007 – Telefónica and Telefónica de España v Commission), Case T-336/07, OJ C 269, 10.11.2007

⁴ Judgment of the Court of First Instance of 10 April 2008 in Case T-271/03 ("*Deutsche Telekom*"), paragraph 167.

⁵ In *National Carbonising* the Commission referred to a "margin sufficient to enable [a reasonably efficient competitor] to survive in the longer term". In *Napier Brown/British Sugar* the Commission considered that because of an insufficient margin, "if maintained in the longer run", any company equally efficient competitor would have been "obliged to leave" the retail market.

containing competitive pressure, the dominant firm could cash in both high wholesale prices and supra-competitive retail prices to the detriment of consumers.

6. One common feature in the margin squeeze cases handled by the Commission so far is that, on the facts, there do not appear to have been viable substitutes⁶ to the relevant input that would have enabled competitors to compete effectively on the downstream market. The input of the dominant undertaking was therefore objectively necessary for competing in the downstream market, and without it, there was a risk of elimination of effective competition on that market.

7. This is reflected in the Communication adopted by the Commission in December 2008 in order to provide guidance on its enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings⁷. This Guidance includes a chapter called "Refusal to supply and margin squeeze". It covers situations in which the dominant undertaking competes on the "downstream" market with a buyer that needs the dominant firm's input in order to manufacture a product or provide a service on that market. Three conditions are established in that chapter for such cases to be considered as an enforcement priority under Article 82: the (upstream) product or service concerned should be objectively necessary⁸ for competitors to be able to compete effectively on the downstream market, there should be a risk of elimination of effective competition on the downstream market, and there should be likely consumer harm. This approach allows for a careful balancing of the incentives to invest and innovate of both the dominant undertaking and its competitors and therefore preserves consumer welfare.

8. In certain very specific circumstances it is however clear that the Commission does not need to test the above three conditions, because the input owner's and/or other operators' incentives to invest and innovate upstream, whether *ex ante* or *ex post*, are manifestly not affected⁹. The Commission considers that this is particularly likely to be the case where regulation compatible with Community law already imposes an obligation to supply on the dominant undertaking and it is clear, from the considerations underlying such regulation, that the necessary balancing of incentives has already been made by the public authority when imposing such an obligation to supply. This could also be the case where the upstream market position of the dominant undertaking has been developed under the protection of special or exclusive rights or has been financed by state resources.

⁶ See for example *Napier Brown/British Sugar*, paragraph 66: "It is clear from the facts as set out above that should British Sugar have maintained this margin in the long term, Napier Brown, or any company equally efficient in repackaging as British Sugar without a self-produced source of industrial sugar, would have been obliged to leave the United Kingdom retail sugar market".

⁷ Communication from the Commission – Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, OJ C 45/7, 24.2.2009 ("Article 82 Guidance"). The Article 82 Guidance outlines the analytical framework that the Commission applies in determining whether to intervene against exclusionary conduct under Article 82 as a matter of priority. This will be the case if the conduct of a dominant undertaking is likely to restrict competition in such a way as to have harmful effects on consumers, whether in the short or longer term.

⁸ This relates to the absence of viable actual or potential substitutes, and to whether competitors could effectively duplicate the input produced by the dominant undertaking in the foreseeable future. In the assessment of the existence of viable substitutes, account should be taken of any relationship-specific investments made by the competitors to use the relevant input and all other relevant switching costs.

⁹ Article 82 Guidance, paragraph 82.

2. Margin squeeze and predatory pricing

9. As mentioned above, and in accordance with the CFI Judgment in *Deutsche Telekom*, the abusive nature of a margin squeeze is connected with spread between the upstream prices and the downstream prices. In other words, there is no need to demonstrate that the wholesale prices are excessive or that the retail prices are predatory.

10. There are substantive differences between conduct in the form of a margin squeeze, on the one hand, and predatory pricing, on the other hand. In a predatory pricing case, the dominant company first incurs losses because it charges prices below cost. After this has led to foreclosure, the dominant company may recoup such losses in the longer term as it exploits its strengthened market power.

11. On the contrary, margin squeeze does not require such a trade-off or *ex ante* sacrifice as the dominant company may not incur losses on an end-to-end basis, and a margin squeeze may involve a high retail price (relative to end-to-end costs) in the short-run as well as the long run. Indeed, by restricting entry and/or growth of competitors on the market and ultimately reducing competitive pressure, the margin squeeze allows the dominant firm to sustain a high level of retail prices. A margin squeeze can be a profitable strategy for the dominant firm already during the period in which it engages in the margin squeeze: the profits extracted from a high level of retail prices may surpass by far the forsaken profits related to the forsaken wholesale sales as a result of the high wholesale prices relative to the retail prices¹⁰.

3. Margin squeeze and duty to deal

12. The margin squeeze cases mentioned in the Introduction involve both situations in which there was no pre-existing obligation to supply (whether under Article 82 or sector specific regulation), and in which such an obligation had been established. In both *Deutsche Telekom* and *Telefónica*, the dominant firms were obliged to provide access to the relevant upstream input under sector specific regulation.

13. In *Deutsche Telekom* the CFI held that competition rules apply where sector-specific legislation leaves open the possibility of competition which may be prevented, restricted or distorted by the autonomous conduct of undertakings¹¹. In this case, the dominant firm was found to infringe Article 82, because the sector-specific legislation left it with sufficient scope for autonomous conduct as to eliminate the margin squeeze, but it did not do so.

14. In *Telefónica*, only the prices of one of the two upstream products in relation to which the Commission established a margin squeeze (which accounted for approximately 30% of the wholesale prices covered in the Decision in 2006) were regulated: they were subject to maximum prices, which means that the dominant firm was free to set prices below the maximum. The prices of the other upstream product (accounting for the remaining 70%) were not regulated. In other words, the dominant firm had all the necessary room of manoeuvre to put an end to the margin squeeze(s). However, it did not take this initiative on its own free will, and this in spite of the fact that its internal documents showed that the company was aware that it was engaging in a margin squeeze contrary to Article 82. The margin squeeze eventually ended when the national telecommunications regulator lowered the prices of the relevant upstream inputs.

15. In *Telefónica*, the question whether there needs to be an obligation to supply under Article 82 (rather than any sector-specific regulation) before a margin squeeze is found to be abusive was at the centre of the dominant firm's argumentation. It argued that it had no antitrust duty to supply the relevant input.

¹⁰ *Telefónica*, paragraph 611.

¹¹ See paragraphs 88 and 89 of the CFI Judgment.

However, its obligation to provide access to that input (and also the express obligation not to engage in a margin squeeze) had been imposed by the national telecommunications regulator after a market and dominance analysis based on competition law principles, as required by the relevant EC Directives, including in particular a careful balancing of the respective incentives to invest and innovate of the dominant firm and its competitors, which was in all material aspects the same as one that the Commission would do in application of Article 82.

16. This issue has not been expressly addressed by the Community judicature yet. The ECJ will nonetheless be called to pronounce on it, also because of a reference for a preliminary ruling from the Tingsrätt Stockholm (Sweden) lodged on 6 February 2009 - Konkurrensverket v TeliaSonera Sverige AB (Case C-52/09).

4. Relationship between competition law obligations and regulatory obligations

17. In their appeals against the two above-mentioned Commission decisions, both dominant firms have argued that the existence of price regulation at the national level should, as it were, have shielded them from an intervention by the Commission under Article 82 of the EC Treaty.

18. However, as mentioned above, in *Deutsche Telekom* the CFI held that competition rules apply where sector-specific legislation leaves open the possibility of competition which may be prevented, restricted or distorted by the autonomous conduct of undertakings. In other words, competition rules apply where sector specific legislation leaves scope for competition in the regulated sector but the dominant firm prevents, restricts or distorts that competition.

19. In the Commission's view¹², ex ante regulation and ex post antitrust intervention go hand in hand, and complement each other. Regulators set access regimes and prices on the basis of market and cost projections (in other words, estimates) to reduce the risk of market failures, but cannot entirely eliminate them. Therefore, antitrust authorities that work with historical data and actually incurred costs must be able to sanction infringements of Article 82. What matters is that there is scope for autonomous conduct and that the dominant firm could not have ignored that it was engaging in a margin squeeze contrary to Article 82.

5. The margin squeeze test as applied by the Commission in its decisional practice

5.1 Equally efficient competitor test

20. The CFI in *Deutsche Telekom* established that it follows clearly from the case-law that the abusive nature of a dominant undertaking's pricing practices is to be determined in principle on the basis of its own situation, and therefore on the basis of its own charges and costs, rather than on the basis of the situation of actual or potential competitors¹³. This is because any other approach could be contrary to the general principle of legal certainty. If the lawfulness of the pricing practices of a dominant undertaking depended on the particular situation of competing undertakings, particularly their cost structure – information which is generally not known to the dominant undertaking – the latter would not be in a position to assess the lawfulness of its own activities¹⁴.

¹² See press release from the Commission - IP/O7/1011 and MEMO/07/274 of 4 July 2007.

¹³ CFI Judgment in *Deutsche Telekom*, paragraph 188.

¹⁴ CFI Judgment in *Deutsche Telekom*, paragraph 192.

5.2 *The cost standard*

21. The Commission's preferred measure of cost is long run average incremental cost (LRAIC), when the latter is available or can be constructed¹⁵. This is in accordance with economic theory and the Commission's decisional practice where the ability of competitors to operate profitably in the long term was assessed. In order to assess whether the prices that the dominant firm applies over time are such that they can foreclose equally efficient competitors the costs considered must include the total costs which are incremental to the provision of the product/service. These are also the prices which form the basis of the firm's decision to invest.

5.3 *The level of aggregation of the test*

22. In *Deutsche Telekom*, there was a (regulated) single charge for the upstream input which had to be compared with the prices of a range of retail services. The Commission thus carried out a quantitative weighing exercise in respect of the applicant's various retail charges. Also in *Telefónica*, the margin squeeze test was conducted on the basis of an aggregated approach, i.e. on the basis of the mix of services marketed by the dominant firm at the retail level. This approach is based on the principle that equally efficient competitors must at least be able to profitably replicate the dominant firm's product pattern.

23. In *Telefónica*, the Commission conducted the margin squeeze test in respect of three upstream inputs, one of which was not substitutable with the two others and thus belonged to a distinct upstream product market. The two other upstream inputs were substitutable among themselves. The Commission took the view that the dominant firm's retail prices had to be replicable by an equally efficient competitor on the basis of at least one product of the dominant firm in each relevant upstream market. The result of the margin squeeze test was that they were not replicable on the basis of any of the three upstream inputs.

5.4 *Allocation of costs*

24. With the LRAIC standard, the allocation of common costs is often a thorny issue. The issue is so case-specific that reference is made here to the relevant Commission Decisions. As an example of the issues discussed, the Commission noted in *Telefónica* that the mere fact that a cost is common to different services does not necessarily imply that the LRAIC is zero. Indeed the LRAIC also includes any increase in the common costs that are due to the provision of the relevant product/service in the downstream market. This may in particular be the case for common assets whose capacity is progressively adapted to the short and medium term demand of all the services that share the common asset. If the traffic generated by the product in question represents a significant proportion of the traffic generated by the totality of the services that share the common asset, it is highly probable that a significant proportion of the corresponding common cost is an avoidable cost and hence incremental¹⁶.

5.5 *Profitability analysis*

25. A margin squeeze test entails assessing whether the vertically integrated dominant firm's own downstream operations could operate profitably on the basis of the upstream price charged to its competitors by its upstream operating arm. In *Telefónica* the Commission applied two methods for assessing this, namely the "period by period" approach and the discounted cash flow ("DCF") approach.

¹⁵ See also the Article 82 Guidance mentioned in footnote 7.

¹⁶ *Telefónica*, paragraph 431.

26. The former; which has been applied by the Commission in Decisions involving price abuses (which have subsequently been upheld by the Courts)¹⁷, compares for every year (or for shorter periods) the observed revenues and costs extracted from the dominant firm's accounts in which investment expenditure have been amortised over appropriate periods.

27. The DCF approach consists in assessing the overall profitability over an adequate period (in general several years) in order to take account not only of current revenues but also of future revenues flowing from current investments. The firm's future growth is taken into account in the profitability analysis by aggregating the expected future cash flows over time in order to arrive at a single measure, namely the net present value ("NPV"). What constitutes an "adequate period" and the cost of capital to the company are two important parameters in this analysis. In *Telefónica* the Commission calculated the NPV over a little bit more than five years (by reference to the economic lifetime of the assets employed in the business in question), using a weighted average cost of capital of 15.72%, which was used by the regulator and proposed by the dominant firm itself, but subsequently contested by the latter

28. The DCF approach displays a number of shortcomings in that it can be biased because it can include the rewards from an anticompetitive behaviour, which preclude it from being the main or only method of assessing the profitability of business. It was used by the Commission in *Telefónica* in support of the "period by period" approach in order to avoid a situation where the latter would point to a margin squeeze due to accounting distortions resulting from the fact that the market was growing.

¹⁷ See for example Commission Decision of 16 July 2003 relating to a proceeding under Article 82 of the Treaty (COMP/38.233 - Wanadoo Interactive) ("*Wanadoo*"), upheld by the ECJ in its Judgment of 2 April 2009 (Case C-202/07P).