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Margin Squeeze in the United States and in Europe: Stand Alone Abuse or Refusal to Deal?

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Margin Squeeze in the United States and in Europe: Stand Alone Abuse or Refusal to Deal?

Paolo Palmigiano*

I. INTRODUCTION

In December 2005, the European Commission published a "Staff Discussion Paper" on the application of Article 82 of the Treaty to exclusionary abuses by dominant undertakings. The document gave rise to heated discussions among academics, lawyers, economists, and competition authorities on the legal and economic principles to apply to abuses of dominance and monopolization. The debate on both side of the Atlantic has led to the publication by the European Commission of its Guidance on the application of Article 82 on 3 December 2008[1] and by the Department of Justice of a report on "Single-firm conduct under Section 2 of the Sherman Act" in September 2008.

Although officials from the Commission and from the DOJ are keen in public to downplay the differences between the two regimes, the debate, the published documents, and the court cases highlight that there are still substantial differences.[2]

A striking contrast between the two becomes obvious in relation to the so-called abuse of "margin squeeze." Recent court cases in the United States and Europe, dealing with very similar situations, show the differences of approach. In the United States, the Supreme Court decision in *linkLine*[3] in 2009 considers that there is no such thing as a

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[1] 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.

[2] It is also interesting to note that the DOJ report is the result of joint hearings by the Department of Justice and the Federal Trade Commission ("FTC"). The agencies were expected to issue a joint report. It has become clear that the two agencies held strikingly different views on enforcement policy for dominant firm conduct and the DOJ report was no longer issued as a joint document.

[3] Pacific Bell Telephone Co v linkLine Communications, INC no. 07-512 (Feb 25, 2009), The case was brought by internet service providers ("ISP") that bought digital subscriber lines ("DLS") from Pacific Bell (now owned by AT&T) and resold to retail customers in competition with Pacific Bell. Pacific Bell was required to sell wholesale DSL under regulation. The ISPs argued that Pacific Bell was creating a margin squeeze by intentionally charging them wholesale

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stand alone abuse called "price squeeze" but rather the abuse can be either a refusal to deal at the wholesale level or predation at the retail level. In Europe the Court of First Instance ("CFI"), in its recent *Deutsche Telekom*[4] case in April 2008, seems to confirm the Commission's view that margin squeeze can well be considered a stand-alone antitrust offence. Another margin squeeze case, *Telefonica* [5] is currently pending in front of the CFI and it might add further clarification.

These cases raise some very interesting questions, in particular on the nature of the abuse and on the correct approach to margin squeeze. My view, expressed in this short article, is that the differences have their origin in different policy objectives and, as such, they may both be appropriate if seen in their particular context.

II. MARGIN SQUEEZE: DEFINITION AND PRECEDENTS

A margin squeeze may arise when a dominant firm, which is vertically integrated, supplies a "necessary" input to its wholesale customers, which are also its competitors in the downstream market.[6] The dominant firm could in effect squeeze its downstream competitors in the retail market by charging a high wholesale price, a very low retail price or a combination of the two so that equally efficient competitors cannot compete profitably.

prices which were too high in relation to the prices Pacific Bell was charging its end users at the retail level, not giving them a "fair" or "adequate" margin to compete profitably.

[4] Commission Decision 2003/707/EC of 21 May 2003 and Judgement of the Court of First Instance of 10 April 2008 in case T-271/03. In 2003 the Commission investigated Deutsche Telekom which was found to be dominant in the upstream and downstream markets for access to local fixed networks. The Commission found a margin squeeze since Deutsche Telekom's wholesale charges were higher than retail charges so that competitors as efficient as Deutsche Telekom could never make a profit. A fine was imposed.

[5] Commission Decision of 4 July 2007, case COMP/38.784 – Wanadoo Espana v Telefonica. This case deals with the broadband market as well and the prices to competitors of wholesale access in relation to the prices Telefonica charges its retail end users. The Commission found Telefonica guilty of a margin squeeze and imposed a fine.

[6] Lengthy and complex discussions have arisen in Europe on whether the vertically integrated company needs only to be dominant upstream or whether the input it provides to itself and its retail competitors must in addition be "necessary," "indispensable." The question is still open but most commentators have expressed the view that, if the input is not indispensable and there are substitutes, there cannot be a margin squeeze as competitors can source the input from others and therefore avoid being "squeezed."

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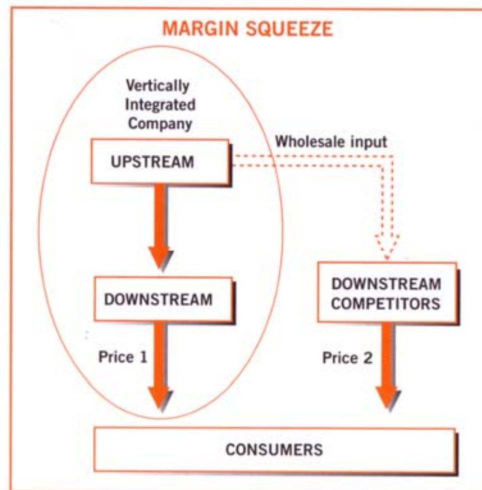

Several cases in Europe[7] and in the United States have dealt with the issue in the past. However, the two that best show the differences are *linkLine* and *Deutsche Telekom* (as well as *Telefonica*). They are also very useful to draw some comparisons. They all dealt with similar facts (access to an input in the telecoms sector where the obligation to supply had arisen from regulatory intervention) but they reach different conclusions. Both Europe and the United States have detailed ex ante telecoms rules. Access to the incumbent's network has been mandated under these rules and wholesale access prices are in most instances regulated.

III. DIFFERENT APPROACH IN THE UNITED STATES AND IN EUROPE

Looking at the recent cases, I intend to focus on the following aspects:

- The application of competition law in a regulated sector;
- Margin squeeze as a stand alone abuse or not;
- Need or not for an antitrust duty to supply; and
- Price / cost analysis by the courts.

A. The Application of Competition Law in a Regulated Sector

[7] Before Deutsche Telekom, some cases had dealt with margin squeeze such as National Carbonising (OJ 1976 L35/6), British Sugar / Napier Brown (Commission Decision of 18 July 1988, case no. IV/30.178, OJ L284 p41-59), Industrie des Poudres Spheriques (Judgement of the Court of First Instance of 30 November 2000, case T 597). All these cases involved mature industries where one product was essential to the downstream product that was a direct derivative of the raw material. In these cases, it was relatively easy to determine the relationship between the upstream and the downstream products (and their relative prices). The recent cases such as Deutsche Telekom and Telefonica, currently on appeal, involve telecommunications markets, new and emerging markets and multi-product industries where one or more inputs are used to produce a variety of different products downstream. The analysis is therefore much more complex.

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In *linkLine*, following a previous case, *Trinko*,[8] the Supreme Court shied away from applying competition rules in a regulated sector. As made clear by Justice Breyer in a concurring judgement in *linkLine*: "when a regulatory structure exists to deter and remedy anticompetitive harm, the costs of antitrust enforcement are likely to be greater than the benefits."

The same point was decided differently in *Deutsche Telekom*. Deutsche Telekom argued that the margin had been examined by the German national regulatory authority ("NRA") which did not find it illegal. The CFI concluded that the fact that telecoms regulation has been applied does not mean that competition law cannot apply. In the specific case the NRA did not apply competition law but regulation but, even if it had, the Commission couldn't be bound by a decision taken by a national body pursuant to Article 82. [9] As stated by the Commission in its press release on *Deutsche Telekom*[10] "The regulatory framework is not the only tool available. The conditions of [access], such as pricing, are subject to scrutiny under the EU competition rules."

B. Margin Squeeze as a Stand Alone Abuse or Not

In *linkLine,* the Supreme Court held that for a price squeeze a plaintiff must prove either a violation of the antitrust duty to deal upstream or predation downstream (under the standards arising out of *Brooke Group Ltd*[11]). The Supreme Court concluded that "if both the wholesale price and the retail price are independently lawful, there is no basis for imposing antitrust liability simply because a vertically integrated firm's wholesale price happens to be greater than or equal to its retail price." Margin squeeze is "nothing more than an amalgamation of a meritless claim at the retail level and a meritless claim at the wholesale level" to create a new form of antitrust liability.[12]

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[8] Verizon Communications Inc. v Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004).

[9] See paragraph 120 of the CFI's judgement. A different point that was examined by the CFI concerned when antitrust liability arises if only one of the prices is regulated. Deutsche Telekom argued that there could not be a margin squeeze in its case as this could only arise if the company could legally end the situation by varying either the wholesale or the retail price. It highlighted that the wholesale price had been fixed by the NRA. The CFI found that there can very well be a margin squeeze between regulated wholesale and retail prices, if there is a disproportion between the two charges such that competition is restricted and if the undertaking subject to price regulation has sufficient commercial discretion to avoid or end the margin squeeze on its own initiative: Deutsche Telekom had some discretion to vary its retail prices.

[10] Press release IP/03/717 of 21 May 2003, available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/03/717&format=HTML&aged=0&language=EN&guiLanguage=en

[11] Brooke Group Ltd. V Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993) where it is held that a claim of predatory pricing requires: 1) that the price is below some appropriate measure of cost; and 2) that there is a dangerous probability that the defendant will ultimately be able to recoup the losses after the competitor left the market.

[12] The judgement overrules a previous case that addressed margin squeeze (Alcoa) on the basis that 'given developments in economic theory and antitrust jurisprudence since Alcoa, we find our recent decision since Trinko and Brooke Group more pertinent to the question before us'. In Alcoa (Am. Tobacco Co v United States, 148 F.2d 416 (2nd Cir 1945)) a margin squeeze was deemed to exist where : 1) the defendant firm has a monopoly power over a particular

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Both the European Commission and the CFI concluded that margin squeeze is an abuse which exists "if the charges to be paid to [the applicant] for wholesale access… are so expensive that competitors are forced to charge their end-users prices higher than the prices [the applicant] charges its own end-users for similar services." An equally efficient rival would never be able to make a profit. The CFI also found that the Commission was not required to demonstrate that the applicant's retail prices were, as such, abusive.[13]

C. Need or Not For an Antitrust Duty to Supply

In *linkLine* the Supreme Court held that a price squeeze claim cannot be brought against a firm that is under no antitrust duty to deal. In this case the duty to deal arose from FCC regulation not from antitrust. Absent a duty to deal arising under the antitrust laws, it is not a violation of Section 2 of the Sherman Act if the dominant company sets its wholesale and retail prices so as to squeeze a competitor out of the market.[14]

The Commission dealt with a similar point in *Telefonica'*. It will be interesting to see the CFI's judgement in due course. Telefonica contended that it had provided access to its network as a result of a regulatory obligation imposed on it and would not have been obliged to do so under competition law. Its pricing policy should therefore not have been subject to Article 82. The Commission rejected the argument that a margin squeeze can only be found in a situation where there is a competition law duty to deal and made reference to the regulatory obligations to supply wholesale access that Telefonica was under. In other words, the Commission seems to say that once national regulation has imposed on Telefonica the obligation to supply under telecoms regulation, then the conduct and the pricing can be examined under competition law. Interestingly, the Commission argued that "Telefonica's duty to supply the relevant upstream products results from a balancing by the *public authorities*[15] of the incentives of Telefonica and its competitors to invest and innovate. The need to promote downstream competition in the long term by imposing access to Telefonica's upstream inputs exceeds the need to preserve Telefonica's ex ante incentives to invest in and to exploit the upstream infrastructure in question for its own benefit."[16]

D. Price / Cost Analysis by the Courts

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product; 2) its wholesale price for that product is "higher than a fair price;" 3) the product competes in a downstream market where the defendant itself competes; and 4) the defendant's price in the downstream market is so low that competitors cannot match it and still earn a "living profit."

[13] See paragraph 167 of the CFI's judgement.

[14] Based on Verizon Communications Inc. v Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004) which makes it clear that "if a firm has no antitrust duty to deal with its competitors at wholesale, it certainly has no duty to deal under terms that the rivals find advantageous."

[15] In this case the Spanish NRA.

[16] Paragraph 305 of the Commission's decision.

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The Supreme Court was concerned about acting as a central planner and policing both the wholesale and retail prices to ensure that rival firms are not squeezed. In its view, courts would be aiming at a moving target since it is the interaction between these two prices that may result in a "squeeze" and courts would find it nearly impossible without conducting complex proceedings to determine what the fair or adequate margin should be.[17]

In *Deutsche Telekom* there was a long discussion of what costs and revenues to take into account to determine a margin squeeze. The wholesale input was used for a variety of products at the retail level and so allocation of costs and revenue was crucial and extremely complex. Neither the Commission nor the CFI shied away from looking at this in detail.

III. CONCLUSION

As has been shown, the U.S. and EU cases have reached different conclusions. Can they be reconciled? Clearly not. So what is the correct approach? Both approaches could be justified in light of different policy choices and different objectives pursued. The cases show that the policy approach to competition law on both sides of the Atlantic is very different.

The approach by the Supreme Court indicates that, where there is sector specific regulation, antitrust enforcement becomes less relevant, as stated by Justice Breyer mentioned above. This view and the concerns raised by the Supreme Court can be understood if one considers that U.S. approach to antitrust is mostly based on private action. For the Supreme Court, accepting margin squeeze as a separate abuse would have lead courts to have to determine complex issues such as what is an efficient competitor, whether the competitor is less or more efficient than the incumbent, to calculate and allocate cost and revenues etc. as well as constantly having to monitor the spread.

Such concerns are less material in Europe where competition law is mostly applied by public bodies such as the European Commission or national competition authorities. And in *Deutsche Telekom* both the Commission and CFI go at length in discussing which revenues and costs to take into account, precisely the type of analysis the Supreme Court was concerned about.

[17] As stated in Town of Concord v Boston Edison Co, 915 F.2d 17 (1st Circ 1990): "How is a judge or jury to determine a 'fair price'? Is it the price charged by other suppliers of the primary product? None exist. Is it the price that competition 'would have set' were the primary level not monopolized? How can the court determine this price without examining costs and demands, indeed without acting like a rate-setting regulatory agency, the rate setting proceedings of which often last for several years? Further how is the court to decide the proper size of the price 'gap'? Must it be large enough for all independent competing firms to make a 'living profit', no matter how inefficient they may be? And how should the court respond when costs or demands change over time, as they inevitably will?"

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But the key difference in the approach is to be found in what has always been one of the European Commission's key objectives; that is, the liberalisation of those sectors that were controlled by former state monopolies. It is interesting that margin squeeze cases are mostly found in telecoms, water, and electricity. Sector specific regulation has been used to liberalise those markets and to allow competition and new entry. In *Deutsche Telekom* and in *Telefonica,* notwithstanding the intervention and regulation by the NRA, progress had not been as fast as the European Commission would have wished. In both cases, the Commission seems to have lost patience with the speed of liberalisation and with the NRA and decided to intervene with a very powerful weapon at its disposal, competition law. That such was the main drive seems evident by reading the Commission's press release[18] for *Deutsche Telekom.* This mentions that although since 1998 Deutsche Telekom was obliged to provide competitors with access to its local loop,[19] Deutsche Telekom still had a market share of 95 percent and after 5 years new entrants could still not compete, mostly because Deutsche Telekom charged competitors higher fees for local loop access than it charged its end users.

Competition law has become a liberalisation tool in European telecommunications and energy sector; for example, competition law (or rather the threat to use it) has been instrumental in reducing mobile termination rates across Member States and it is currently being used to address issues in the energy sector.

A few years ago, some commentators were arguing on whether there was an abuse of margin squeeze or not and if so what principles to apply. It seems now that we have more clarity. But the discussions are not over yet, especially in Europe. There are still many unresolved issues on key elements of a margin squeeze that need to be clarified.

It will be interesting to observe the type of cases the European Commission and NCAs will take and how the theory of margin squeeze will evolve.

[18] Press release IP/03/717 of 21 May 2003, available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/03/717&format=HTML&aged=0&language=EN&guiLanguage=en

[19] The local loop is the physical circuit between the customer's premises and the telecommunications operator's local switch, New entrants need access to the local loops ('local loop unbundling') to be able to offer retail services to end customers, as it would be impossible to replicate such a network built over a century.

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