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THE CONCURRENT APPLICATION OF COMPETITION LAW AND REGULATION: THE CASE OF MARGIN SQUEEZE ABUSES IN THE TELECOMMUNICATIONS SECTOR

by

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Introduction

Margin squeeze in the telecommunications sector has become a central concern among national regulatory authorities (hereafter, "NRAs"), national competition authorities (hereafter, "NCAs"), national courts, and the European Commission (hereafter, "Commission"). In recent months, competition law proceedings have been launched in several Member States, including Denmark, France, Italy, the Netherlands, and the United Kingdom. Most recently, on 16 November 2004, the Italian competition authority imposed a €152 million fine on Telecom Italia on the ground that it had engaged, *inter alia*, in a margin squeeze abuse. The need to prevent margin squeeze has also become a leitmotiv for NRAs in their capacity as regulators of wholesale and/or retail telecommunications prices. Thus, from an obscure issue that belonged to the realms of academic discussion, margin squeeze has become an intensely-debated practical issue in the area of telecommunications.

Margin squeeze cases are the product of increased competition in the post-liberalisation telecommunications sector. They also represent an important and necessary tool in the commercial strategies of new entrants that seek to compete with incumbent operators. While new entrants have made significant inroads in several telecommunications markets, many still claim that their growth is constrained by exclusionary practices carried out by the incumbents. Margin squeeze allegations feature prominently in this regard.

Simply expressed, a margin squeeze amounts to a reduction by a dominant operator of the margin between wholesale and retail prices so as to make entry difficult or to encourage exit. This can be done by raising wholesale prices, lowering retail prices, or doing both. While margin squeeze has been frequently alleged in recent years, findings of abuse have thus far been rare. This may be partly due to the difficulty of demonstrating a margin squeeze abuse, but doubtless also reflects the fact that incumbents have dramatically reduced wholesale and retail prices in recent years, for entirely legitimate reasons.

This paper looks at two instruments that can be used to prevent and/or sanction abuses of market power in telecommunications: sector-specific regulation, which is usually based on national regulatory frameworks transposing EC legislation, and national and/or EC competition law. While each instrument has advantages and disadvantages, their interaction often raises fundamental issues, which we seek to address in this paper.

This paper is divided into five parts. Part I lays out the conceptual framework on which the subsequent analysis in the paper is based. The basic concept of margin squeeze is first defined, followed by an identification of the essential conditions under which it can occur. The basic differences between regulatory and competition law powers in relation to margin squeeze are then summarised. The incentives for incumbent operators to engage in a margin squeeze are also examined, before exploring the relationship between excessive pricing, "pure" predation, cross-subsidies, and margin squeeze abuses under competition law.

Part II reviews how margin squeeze abuses can be addressed through the *ex ante* application of sector-specific regulation. The various regulatory strategies that can be used to address margin squeeze are first examined before concluding that such conduct has generally been prevented through the reliance on price control mechanisms. An evaluation of how wholesale and/or retail price controls can affect the ability and/or the incentives of vertically-integrated operators to engage in margin squeeze then follows. While there is no single, ideal wholesale price control methodology when it comes to stimulating competition in telecommunications, certain methodologies (*e.g.*, retail minus) are probably more effective than others if the objective is to prevent a margin squeeze.

Part III discusses the way in which margin squeeze abuses has been addressed under national and EC competition laws. Applicable EC and national precedent on margin squeeze is reviewed in detail before addressing several unresolved issues that emerge from the decisional practice and case law. The first relates to which test should be used to impute a margin squeeze under competition law. The second concerns the effect of a dominant firm's duty not to engage in a margin squeeze abuse against rivals on efficient forms of vertical integration. The third relates to the difficulty for NCAs, NRAs, and courts to identifying a margin squeeze abuse in the context of new products and new markets. The fourth issue is whether proof of actual or likely exclusionary effects is necessary in pricing abuse cases. Finally, whether downstream dominance is, or should be, a requirement in a margin squeeze case is discussed.

Part IV explores the interface between competition law and sector-specific regulation, and in particular the jurisdictional and substantive conflicts that it can lead to in the area of margin squeeze. An overview is first provided of the jurisdictional and substantive conflicts, which may occur when different authorities (NCAs, NRAs, etc) are competent in respect of the same matter. Several issues are then examined that are at the core of the interface between competition law and sector-specific regulation in respect of margin squeeze. First, we address whether *ex ante* intervention, taking the form of margin squeeze tests should be pursued at all or whether *ex post* intervention on the basis of competition rules is sufficient. Second, we examine whether when *ex ante* intervention has taken place, there should be any scope for *ex post* intervention on the basis of competition law. Finally, we explore how the issue of conflict between regulatory principles and competition policy should be resolved in cases brought under competition law.

A brief conclusion is contained in Part V.

I. Margin squeeze in telecommunications: An introduction to the issues

A. Definition

The basic definition of a margin squeeze is in theory straightforward. It refers to situations in which a vertically-integrated dominant firm uses its control over an input supplied to downstream rivals to prevent them from making a profit on a downstream market in which the dominant firm is also active. The dominant firm could in theory do this in a number of different ways. It could raise the input price to levels at which rivals could no longer sustain a profit downstream. Alternatively, it could engage in below-cost selling in the downstream market, while maintaining a profit overall through the sale of the upstream input. Finally, the dominant firm could raise the price of the upstream input and lower the price of the downstream retail product to create a margin between them at which a rival would not be profitable.

Unless the dominant firm is actually discriminating in the prices charged to downstream rivals and its own integrated business – which may in itself be contrary to the non-discrimination clause in Article 82(c) EC – the transfer charge that its downstream business pays to its upstream business appears to be the same as the input charge paid by downstream competitors. This is only superficially true, however, since vertical integration makes the dominant firm's charge to its downstream business a paper transfer price and not an actual cost faced by the downstream business (and even if the firm produces separate accounts). The objection therefore is that the *implicit* transfer charge imposed on downstream rivals is higher than the input charge that the dominant firm's downstream business faces.

The only official statement by the Commission on a margin squeeze abuse is contained in the telecommunications Access Notice.[1] At paragraphs 117-118, the Commission states as follows:

> "*A price squeeze could be demonstrated by showing that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company…. In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient).*"

B. Basic conditions under which a margin squeeze abuse may occur

A margin squeeze abuse requires several basic, cumulative conditions to be satisfied. These conditions are outlined in the present section and discussed in more detail in Part III below. The first condition is that a margin squeeze only arises in situations of vertical integration that is where a firm dominant on a market for an upstream input supplies that input to rivals

1 Notice on the application of the competition rules to access agreements in the telecommunications sector, OJ 1998 C 265/2 (hereafter "Access Notice").

operating on a downstream market where the dominant firm is also active. All margin squeeze cases involve two markets and downstream rivals which are both customers and competitors of the dominant firm.

Second, in addition to the firm being dominant upstream, the input it supplies to rivals must in some sense be "essential" for competition on the downstream market. Some downstream competitors, for example, may rely on alternative technologies and will not be dependent on the input price charged by the company. These competitors will be much less at risk from an attempted margin squeeze and their presence must be taken into account when considering the possible effect of a supposed margin squeeze. Thus, if the input is not essential (*e.g.*, if it is unnecessary or if there are substitutes available), it cannot be the subject of a squeeze,[2] because rivals do not need to buy it, at the dominant company's price or at all.[3] This condition is discussed in more detail in Part III below and in particular how it relates to the "essential facilities" doctrine under EC competition law.

Third, a margin squeeze assumes that the input supplied by the dominant firm constitutes a relatively high, fixed proportion of the downstream costs. If it represents a small proportion of overall costs, or is used in variable proportions by different downstream competitors, there would be severe practical problems in inferring that downstream rivals' apparent lack of profitability was caused by the dominant firm's input pricing.

The fourth, and arguably most important, condition concerns the identification (or imputation) of a margin squeeze abuse. Specifically, what legal test should be applied to determine whether the dominant firm's upstream price, downstream price, or the combination of both prices, causes the activities of a downstream rival to be uneconomic, *i.e.*, either loss-making or insufficient to provide a "reasonable profit." The most frequently-applied test is whether the dominant firm's downstream operations could trade profitably on the basis of the wholesale price charged to third parties for the relevant input. The Commission's telecommunications Access Notice also suggests a second test: a margin at which a "*reasonably efficient service provider*" can obtain a "*normal profit*."[4] Other commentators have suggested that an additional test should apply in addition to a test based on the dominant firm's costs: the downstream competitors' actual costs.[5] All of these tests seek to grapple with the standards of efficiency expected of competitors before intervention under competition law can be justified.

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2 See, e.g., *Price Squeezes In A Regulatory Environment*, J. Bouckaert & F. Verboven, Centre For Economic Policy Research, Discussion Paper Series, available at http://ssrn.com/abstract=405122 ("*[A price squeeze] assumes that the incumbent has an upstream monopoly over an essential input. In practice, the incumbent's upstream market power may not be that strong. While the incumbent operator typically owns the copper line, substitute networks in the form of cable, wireless etc… are available. In other words, the incumbent's essential facility is not absolute. The downstream competitors may therefore bypass the incumbent's network and consider purchasing access from alternative providers, or investing in an own network.*")

3 See, *e.g.*, Oftel, *Investigation by the Director General of Telecommunications into the BT Surf Together and BT Talk & Surf Together Pricing Packages*, 4 May 2001 (margin squeeze rejected since alternative technologies competed on the retail market).

4 Access Notice, *supra* note 1, at paragraph 118.

5 See P. Grout, "Defining a Price Squeeze in Competition Law", in *The Pros and Cons of Low Prices*, Swedish Competition Authority (2003), p.71, at 85.

Fifth, it needs to be assessed whether there is a justification or explanation for the dominant company's downstream losses other than an exclusionary intent or object. There are many legitimate reasons why a company may set prices below its own costs for a period of time. Market conditions may be temporarily bad but expected to improve; the company may be setting low prices as a temporary marketing device; it may have introduced a new product and currently have low volumes, but expects volumes to increase; a competitor may be charging unsustainable prices but will probably leave the market or revise its policies; the market may be in decline but some market participants are expected to exit; the company may have made a mistake and entered the market on too large a scale; it may be inefficient but believes it may be able to improve its performance or its products; and so on.

Finally, even if the above conditions are satisfied, and it is technically possible to identify a margin squeeze based on the appropriate imputation test, it would need to be considered whether the dominant firm's conduct has had, or is likely to have, a material impact on competition. This arguably requires consideration of several different issues. First, the margin squeeze should be persistent, in the sense that it lasts long enough for the dominant firm's pricing to have a non-transitory impact on downstream rivals. Second, it should be assessed whether the conduct at issue is likely to cause material harm to downstream rivals. As a final step, it should be assessed whether the harm to rivals also leads to harm to consumers in the form of higher prices or reduced choice. Whether and to what extent it is necessary to show material adverse effects on competition is an area of controversy in the decisional practice and case law.

C. <u>Basic differences between regulatory and competition law powers in relation to margin squeeze</u>

Controlling abuses of market power is of critical importance in liberalized industries, such as telecommunications, as in the years following liberalization the incumbent will generally retain large market shares.[6] In addition, it will also control essential inputs (*e.g.*, bottleneck infrastructures) and generally be reluctant to share them with new entrants, which, however, need them to compete with the incumbent in downstream markets.[7] This latter aspect is conducive to margin squeeze allegations since, even when the incumbent is forced to give access to essential inputs to the new entrants, it can engage into pricing strategies that will have an exclusionary effect on new entrants.

In these industries, two separate sets of rules can be used to prevent or sanction abuses of market power on the part of the incumbent.[8] First, abuses of market power can be controlled through competition rules and, in particular, Article 82 EC, which provides a non-exhaustive list of abuses by a dominant firm. Although margin squeeze is not specifically mentioned in Article 82 EC, the Court of First Instance has confirmed that dominant firms engaging in

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6 See D. Geradin, "The Opening of State Monopolies to Competition: Main Issues of the Liberalization Process", in D. Geradin, Ed., *The Liberalization of State Monopolies in the European Union and Beyond*, Kluwer Law International, 2000, at 181, 182.

7 Id.

8 See D. Geradin and M. Kerf, *Controlling Market Power in Telecommunications: Antitrust v. Sector-specific Regulation*, Oxford University Press, 2000.

such a conduct may be guilty of an abuse.[9] Sector-specific rules can also be used to prevent abuses of market power on the part of the incumbent. For instance, sector-specific rules may mandate incumbents to give access to their infrastructure,[10] or may impose price control regimes on wholesale and/or retail services.[11] While such regimes will not always prevent margin squeeze, they may affect the ability and incentives of incumbents to engage in such conduct.

At first sight, the objectives of regulation and competition law would seem to converge in regard to margin squeeze cases: both in essence seek to identify conditions in which effective downstream competition can function. On closer inspection, however, the treatment of margin squeeze cases under regulation and competition law not only diverges, but may in fact be flatly at odds with each other. The principal differences are noted below.

First, regulatory powers in respect of a margin squeeze are in principle more extensive. Under competition law, the margin squeeze principle prohibits only downstream gross profit margins which are so low (or negative) as to be exclusionary. Competition law does not give a competition authority any basis for ordering a vertically integrated dominant company to take a lower proportion of its overall profit, if any, upstream, so as to increase the profits of its downstream competitors, or its own downstream profits. By contrast, access price regimes can severely constrain the ability of the incumbent to make a margin on the upstream market(s). For instance, pricing methodologies based on forward-looking long-run incremental cost (LRIC) may have a serious impact on the ability of the incumbent to realize upstream profits as its compensation is based – at least in theory – not on its actual costs but on the costs of a benchmark efficient firm.[12] Moreover, under this pricing methodology, the incumbent receives no compensation for the profits it might lose if new entrants use its facilities to "steal" some of its customers on the downstream market, *i.e.*, the opportunity cost.[13] LRIC thus promotes downstream competition by new entrants at the expense of the incumbent's upstream margins.

A related point is that a dominant company is not required by competition law to compensate its competitors for disadvantages that they may be under (unless, of course, it has caused them). This is implicit in the *National Carbonising* case.[14] There, the Commission ultimately concluded that there was no margin squeeze, since for both companies, industrial coke was profitable and domestic coke was not (due to competition from gas and electricity). In periods of reduced industrial activity, neither company could shut down their coke plants

9 Case T-5/97 *Industrie des Poudres Sphériques SA v Commission* [2000] ECR II-3755.

10 See Article 12 of Directive 2002/19 on access to, and interconnection of, electronic communications networks and associated facilities, 2002 O.J., L 108/7.

11 Id. at Article 13.

12 See Geradin and Kerf, supra note 8, at 38.

13 Id.

14 Although the interim measures decision was favourable to the applicant, the final decision several months later came to the conclusions stated in the text. See J. Temple Lang, "Defining legitimate competition: companies' duties to supply competitors and access to essential facilities," in Hawk (ed.), 1994 *Fordham Corporate Law Institute*, 245, at p. 258.

(a coke plant cannot be shut down), but the dominant company sold a higher proportion of industrial coke than the complainant, because it had more long-term industrial-coke supply contracts. It was true that the dominant company, because of its position, was better placed than the complainant to make long term industrial contracts with bulk buyers, but this was not an advantage which could be complained of under competition law. The fact that this was a marketing advantage and not a cost advantage did not alter this conclusion. It was not suggested that the dominant company had a duty to compensate rivals for this advantage.

In contrast, under regulation, the incumbent firm may have affirmative duties that could not be imposed under competition law. For instance, as one of us as written elsewhere, the new regulatory framework on electronic communications seems to allow a NRA to mandate the incumbent to grant access to its network infrastructure in circumstances that would not be covered under the so-called "essential facilities" doctrine under Article 82.[15] Moreover, nothing in competition law would authorize an enforcement authority to mandate a firm to give access to essential inputs at a rate that does not cover its own costs whereas this possibility can arise when a NRA mandate access prices based on the LRIC methodology. Finally, a specific feature of most sector-specific regimes is that they apply "asymmetrically" in that the most demanding obligations will be imposed *ex ante* on one or a limited number of firms.[16] While Article 82 EC imposes a "special responsibility" on dominant firms, specific remedies will only be imposed when an abusive conduct has been established.[17]

Second, competition law is a set of principles which protects competition from anticompetitive conduct. It does not give a competition authority power to impose any *new* obligations (except as part of a remedy, based on existing competition law rules, for a breach of existing rules). Nor does it give a competition authority power to pursue any policy objectives, however legitimate, other than the protection of competition. In particular it does not empower a competition authority to offset or compensate rivals for any lawfully acquired competitive advantages of a dominant company. This is particularly important in margin squeeze and duty-to-contract cases in which the authority may need to fix the terms of contracts. If the authority is acting under competition law, it may fix the price or the terms of the contract only on the basis of competition law considerations.

Regulatory powers may impose new types of obligations on the addressees of the particular regulatory framework. For instance, sector-specific regimes contain universal service obligations that impose operators to serve certain categories of customers, which a normal profit-making firm would not necessarily serve.[18] Moreover, retail price controls may not only seek to prevent exploitative abuses on the part of the incumbent, but may also be based

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15 See D. Geradin and J.G. Sidak, "European and American Approaches to Antitrust Remedies and the Institutional Design of Telecommunications Regulation" in *Handbook of Telecommunications Economics*, Vol. 2, Elsevier, forthcoming 2005.

16 For instance, pursuant to the new EC regulatory framework on electronic communications, obligations of access, non-discrimination, etc., will only be imposed on operators that hold significant market power. See A. de Streel, "The Integration of Competition Law Principles in the New European Regulatory Framework for Electronic Communications", (2003) 26 *World Competition* 489.

17 R. Subiotto, "The Confines of the Special Responsibility of Dominant Undertakings not to Impair Genuine Undistorted Competition", (1995) 4 *World Competition*, p. 5.

18 See P. Larouche, "Telecommunications", in Geradin, Ed., supra note 6, at 42-44.

on social welfare considerations. This may force incumbents to price below cost on some market segments, a situation that could never occur through the application of competition rules. Finally, sector-specific regimes can in some cases take pro-active measures to effectively create competition on downstream markets. Incumbents may for instance be forced to divest their upstream operations, even in the absence of any abuse of dominance. In the case of margin squeeze, a NRA may also adopt wholesale rates that are favourable to the incumbent's competitors, in order to stimulate entry.

The final comment is that specific competition law duties should be imposed only if they lead to more competition overall than they discourage. A competition authority, or regulatory authority relying on competition law powers, when considering an alleged margin squeeze should therefore consider, for example, if the downstream market is easy to enter and so relatively unprofitable for objective and unavoidable reasons. If so, to impose a maximum upstream price on the dominant firm might discourage more competition than it promoted, because that it might discourage investment in the only profitable level, or the most profitable level, in the industry.

In contrast, regulatory authorities sometimes take action under regulatory powers that reduces the ability and incentives of the incumbent to compete. A regulator can, if authorised by legislation to do so, impose a duty on a dominant incumbent to give access on more favourable terms to competitors which are investing in their own networks (*e.g.*, if the regulatory framework favours network competition over service competition in the long-run). This may affect the ability and incentives of the incumbent to invest in its own infrastructure.

D. Incentives for dominant telecommunication operators to engage in a margin squeeze

One issue that has not received attention in the decisional practice and case law concerns a dominant firm's incentives to engage in a margin squeeze abuse. An unusual feature of a margin squeeze is that the downstream rival is at the same time a customer of the dominant firm upstream. Thus, by excluding a downstream rival, the dominant firm also reduces it upstream profits because it would also lose a customer. This dynamic can have substantial effects on the incentives for such conduct and may in fact amount to a disincentive to engage in a margin squeeze in the first place. While the reduced incentives for a dominant firm to engage in a margin squeeze do not mean that such abuses are always irrational, they should at least force competition authorities and courts to inquire whether a margin squeeze strategy is plausible in its proper market setting.

Whether the dominant firm has any rational incentive to engage in a margin squeeze is largely an empirical matter. The basic question is whether the reduction in demand for the dominant firm's products upstream is off-set by additional volumes downstream. The short answer is that, in general, the higher the upstream margin relative to downstream profits, the greater the disincentive to engage in a margin squeeze against downstream rivals. Much will depend therefore on the marginal profitability of the upstream and downstream markets (if the upstream market is more profitable relative to the downstream market, the incentives to exclude downstream rivals are less); the extent to which the dominant firm can pick up customers lost by the exiting firm (if rivals who remain in the downstream market can also capture them, there is less incentive to exclude); whether downstream rivals offer differentiated or homogenous products (if they offer differentiated products, the dominant firm's incentive to exclude them is even less (see Part III below)); whether rivals are more efficient downstream competitors than the dominant firm (if they are, it may be more efficient for the dominant firm to close its own downstream business and simply sell the upstream product to such firms), etc.

One additional question relevant to the issue of incentives to engage in a margin squeeze is the effect of the threat of regulation to actively promote effective competition on such incentives. Even if a dominant firm would have, solely from the perspective of the scope of application of the competition laws, an incentive to engage in a margin squeeze, the possibility for a regulatory authority, applying regulatory powers, to impose potentially wide-ranging new duties on the dominant firm vis-à-vis third parties may still act as a significant deterrent.

E. The relationship between excessive price, "pure" predation, cross-subsidies, and margin squeeze

As noted above, a margin squeeze applies where the dominant firm sets an "excessive" upstream price, a "predatory" downstream price, or a combination of both. Given that excessive pricing, predatory pricing, and cross-subsidies may constitute distinct violations of Article 82 EC and national law analogues, it is important to see to what extent, if any, these concepts can be usefully applied to help the analysis of a margin squeeze abuse. In brief, while we accept that there are certain parallels between these abuses and a margin squeeze, there are also sufficient differences to suggest that using these terms in the context of a margin squeeze is likely to lead to confusion.

Margin squeeze and excessive pricing. Prices which are set significantly and persistently above the competitive level as a result of the exercise of market power may be regarded as "excessive" under Article 82 EC and equivalent national laws.[19] In practice, excessive pricing has proved a notoriously difficult abuse to prosecute, due to the problems in calculating a "fair" price and the Commission's publicly-stated reluctance to act as a price control authority.[20] No single test has been endorsed by the Community institutions to assess when a price is excessive,[21] but four possible tests have been suggested: (1) a price/cost comparison;[22] (2) a comparison of the dominant firm's price with prices in competitive

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[19] On excessive pricing, see D. Evans and J. Padilla, "Excessive Prices: Using Economics to Define Administrable Legal Rules", *CEPR Discussion Paper No 4626*, September 2004; M. Motta and A. de Streel, "Exploitative and Exclusionary Excessive Prices in EU Law", paper presented at the 8th Annual European Union Competition Workshop, June 2003, forthcoming in C.D. Ehlermann and I. Atanasiu, Eds., *What is Abuse of a Dominant Position*, Hart Publishing, 2005.

[20] See Vth Report on Competition Policy (1975), para. 76.

[21] EC Treaty Art. 82(a). See, e.g., Case 27/76, *United Brands v. Commission*, [1978] ECR 207; Case 26/75, *General Motors v. Commission*, [1975] ECR 1367. See also Commission decision *Deutsche Post AG* (2001 O.J. L331/40).

[22] Id.

markets;[23] (3) the "economic value" of the product service;[24] and (4) a price comparison in different geographic areas.[25]

Excessive pricing abuses differ from margin squeeze abuses in several respects:

- First, their legal basis and normative content are different. An excessive price is an "exploitative" abuse within the meaning of Article 82(a) EC, whereas a margin squeeze is an "exclusionary" abuse within the meaning of Article 82(b) EC.

- Second, the principal legal tests for identifying an excessive price under Article 82 EC are different to those for identifying a margin squeeze abuse. In assessing an exploitative excessive price, the usual benchmark is the firm's own costs of supplying the relevant product or service compared to similar products in the same market or other related markets. In a margin squeeze case, a price is not excessive in relation to the dominant firm's costs, but in relation to the relevant price and profit margin on a downstream market. In other words, an exploitative excessive price is abusive because of its relation to the relevant costs of supplying a single product, whereas an exclusionary margin squeeze is concerned with the excess of the price relative to prices on another related market.

- Finally, it is possible that an upstream price that is not excessive within the meaning of Article 82(a) EC could nonetheless give rise to a margin squeeze abuse under Article 82(b) EC. The converse is also true: an upstream price that is excessive within the meaning of Article 82(a) EC may not give rise to a margin squeeze abuse under Article 82(b) EC.

In short, if an upstream price is regarded as "unfair" and excessive, and so contrary to Article 82(a) EC, merely because of its exclusionary effect in the downstream market, including Article 82(a) EC in the analysis does not seem to add anything useful.[26] Indeed, calling an upstream price that gives rise to a margin squeeze abuse "excessive" is likely to cause unnecessary confusion between exploitative and exclusionary abuses. It should also be noted that, in any event, excessive input prices are unlikely in network industries as such prices are typically regulated.

Margin squeeze and "pure" predatory pricing. The basic conditions for a margin squeeze are in many respects very similar to a "pure" predation case, *i.e.*, predation in the context of a

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23 See Case 30/87, *Corinne Bodson v. Pompes funèbres des régions libérées*, [1988] ECR 2479.

24 See Case 26/75, *General Motors*, supra note 21.

25 See Case 110/88, *Lucazeau v. SACEM*, [1989] ECR 2811 and Case 395/87, *Ministère Public v. Jean-Louis Tournier*, [1989] ECR 2521.

26 The criteria under Article 82(a) concern the maximum legal price, and are entirely distinct from the possible criteria for the minimum non-exclusionary rate of profit under Article 82(b), which is relevant for this paper.

single product against horizontal competitors.[27] First, where the type of margin squeeze alleged is that the downstream price is unduly low relative to the upstream price, this is akin to predatory pricing. Of course, there are other types of margin squeeze – in particular where the upstream price is too high relative to the downstream price – which confirms that margin squeeze and predation are not necessarily the same. Second, both require that a firm has market power sufficient to engage in successful exclusion. Third, both require consideration of whether the conduct at issue is commercially rational or is only rational because of its ability to exclude rivals. Finally, both require that the conduct in question is likely to have an exclusionary effect on competitors; in particular whether the exit of rivals would allow profitable exploitation of market power in future.

At the same time, there are important differences between a margin squeeze and a "pure" predation case:

- First, in a predation case the competition authority looks at all the relevant costs of the dominant company. In a margin squeeze case, it looks only at the costs in the downstream market, including the upstream price (taking it as a given on the downstream market (unless there is actual discrimination)).

- Second, in a margin squeeze case the dominant company is not necessarily losing money overall (though it may be). It might be merely taking its profit upstream rather than downstream: the business engaged in a margin squeeze can be profitable on an "end-to-end" (*i.e.*, integrated) basis throughout the period of abuse. It follows that in a margin squeeze case the question of future recoupment does not necessarily arise as it often does in predation cases. More precisely, the fact that, in a margin squeeze case, the dominant firm remains profitable upstream can make recoupment more or less simultaneous. In a pure predation case, the loss-making and recoupment phases necessarily involve two different time periods.

- Third, the incentives to engage in exclusionary behaviour differ as between margin squeeze and predation cases. In predation cases there is usually no need to consider whether or not the alleged predator would benefit from successfully excluding rivals – it always will, to some extent. In contrast, as noted above, in a margin squeeze case, a vertically integrated company's incentives to exclude rivals from a downstream market are considerably reduced, since the competitor will also be an upstream customer. A vertically integrated dominant company might lose more by losing upstream customers than it could gain as a result of their withdrawal from the downstream market. One should therefore include, in analytical tests for a margin squeeze, an analysis of whether market conditions are such that a company has any incentive to exclude. Without such incentives,

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[27] See P. Areeda & D. Turner, "Predatory Pricing And Related Practices Under Section 2 Of The Sherman Act", (1975) 88 *Harvard L. Rev.* 697, later restated and modified in P. Areeda & D. Turner, Antitrust Law, vol. III, pp.148-193. Scherer, "Predatory Pricing and the Sherman Act: A Comment", (1976) 89 *Harvard L. Rev.* 369; P. Areeda & D. Turner, "Scherer on Predatory Prices: A Reply", 89 Harvard L. Rev. 891 (1976); F. Scherer, "Some Last Words on Predatory Pricing", (1976) 89 *Harvard L. Rev.* 901; R. Posner, *Antitrust Law: An Economic Perspective*, (1976). For a detailed treatment of the link between the economic literature and legal doctrine in the US, *see* J. Brodley and G. Hay, "Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards", (1981) 66 *Cornell L. Rev.* 738.

any failure to pass a price–cost test is more likely to be the result of a reasonable and temporary business strategy than a deliberate attempt to exclude.

- Fourth, a margin squeeze does not necessarily benefit consumers, whereas a predatory price does, at least in the short-term. In a pure predation case the dominant company is deliberately sacrificing short-term profits, for long-term exclusionary reasons. In a margin squeeze it is not necessarily sacrificing short-term profits, although, in practice, the prices which are most effective at excluding rivals will be downstream prices which do not maximise short run profits, in which case consumers do benefit.

- Finally, the scope of the available remedies may differ as between a margin squeeze and pure predation case. In a pure predation case, the remedy is usually to increase the (loss-making) price. In a margin squeeze case, the dominant firm could be required to lower the input price, increase the retail price, or slightly adjust, either upwards or downwards, the upstream and/or retail prices.

Margin squeeze and cross subsidies. A cross subsidy occurs where a company uses funds generated from one area of activity to fund activities in another area of its activity.[28] Multi-product companies cross-subsidise all the time. A number of regulatory issues are raised by cross-subsidies, particularly in the context of utilities and regulated markets, including the need for structural and accounting separation between reserved monopoly and competitive businesses.[29] Questions of how businesses finance particular activities are, however, generally irrelevant under competition law: the effects of an abusive practice are likely to be the same whether the resulting losses are sustained by cash flow from other activities within

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28 The seminal article on cross-subsidisation is G. Falhauber, "Cross-Subsidization: Pricing in Public Enterprises", (1975) 65 *American Economic Review*, p. 966. See also E. Bailey and A. Friedlaender, "Market Structure and Multiproduct Industries," (1992) XX *Journal of Economic Literature*, p. 1024; T. Brennan, "Cross-Subsidization and Cost Misallocation by Regulated Monopolists", (1990) 2 *Journal of Regulatory Economics*, p. 37. For a discussion of cross-subsidies under Community law, see L. Hancher and J.L. Buendia Sierra, "Cross-Subsidization and EC Law," (1998) 35 *Common Market Law Review*, pp. 901, 944.

29 EC competition law imposes a number of important additional constraints on reserved (State) monopolies that may be relevant to the scope for cross-subsidies. First, in order to avoid classification as unlawful State aid, government subsidies for public service obligations must satisfy several cumulative conditions: (1) the public service obligation must be clearly defined; (2) the subsidy recipient must actually be required to discharge public service obligations; the parameters on the basis of which the compensation is calculated have been established beforehand in an objective and transparent manner; and (3) the compensation does not exceed what is necessary to cover all or part of the costs incurred in discharging the public service obligations, taking into account the relevant receipts and a reasonable profit for discharging those obligations. See Case C-280/00 *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht* [2003] ECR I-7747 and Case T-613/97 *Ufex v. Commission*, [2000] ECR II-4055 (on appeal Case C-94/01, *La Poste and others v Ufex, DHL International, Federal Express International (France) and CRIE*)). Second, a State monopoly cannot use funds derived from abusive behaviour in connection with the reserved monopoly to fund the acquisition of an undertaking active in a neighbouring market open to competition. *See* Case T-175/99, *UPS Europe v Commission*, [2002] ECR II-1915, para. 55. Finally, the scope of a State monopoly may be open to challenge under Article 86, although, in practice, much of this area of law has been superseded by legislation under liberalisation reforms: See, *e.g.*, Case C-320/92 *Corbeau* [1993] ECR I-2533.

the same company – which may lie in completely unrelated markets – or from some other source such as capital markets or financial reserves.[30] Moreover, in most cases, there will not be a transfer of "funds," but cross-subsidization through a strategic allocation of costs. The only exception concerns predatory pricing. Where it can be shown that there is a *causal link* between losses on one market and profits on another, it may be appropriate to find an abuse of predatory pricing. The abuse remains predatory pricing, but the source of funding for the losses is the cross-subsidy from the profitable market. This was the situation in the *Deutsche Post* case.[31]

It is difficult to see, however, what a cross-subsidy analysis would add to the substantive inquiry for a margin squeeze abuse. Clearly, there are situations in which the *source* of funding for downstream losses is a profitable upstream (dominant) market, but the competition-law effects of conduct are likely to be the same whether the funds concerned come from the upstream market, another totally unrelated market, or from capital market sources. Applying a cross-subsidy analysis would therefore simply have the effect of requiring a competition authority or plaintiff to show that the source of the funds to support the downstream losses is the profitable upstream market (*i.e.*, a causal connection), in addition to having to satisfy all the other conditions for a margin squeeze. Such an analysis would, however, have the benefit of requiring precision in the identification of the method by which a margin squeeze could be carried out, which would be desirable.

II. Margin squeeze under sector-specific regulation

A. The effect of *ex ante* sector-specific regulation on the scope for margin squeeze abuses *ex post*

Sector-specific regulation can be used to prevent or redress margin squeezes. Indeed, margin squeeze is a manifestation of the issues that can arise in the context of vertical integration – a situation creating market failures that regulation has long sought to address.[32] The core

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30 This appears to have been the conclusion reached in *Tetra Pak II* (1992 OJ L 72/1, on appeal Case T-83/91 *Tetra Pak v. Commission II* [1994] ECR II-755). Tetra Pak was found to have committed a range of pricing and other abuses in two different but related markets; aseptic and non-aseptic machinery and cartons. Tetra Pak's market shares in the aseptic and non-aseptic markets were approximately 90% and 50%, respectively. There were also important associative links between these two markets. The Commission's case was that Tetra Pak had engaged in predatory pricing in relation to its Tetra Rex non-aseptic carton by pricing below average total cost. This finding assumed that Tetra Pak was able to incur losses in the non-aseptic sector by substantial profits made in the monopoly aseptic sector. Tetra Pak argued before the Community Courts that it had not engaged in cross-financing from the aseptic to the non-aseptic sector. The Court of First Instance did not rule on this point, but simply noted that the "application of Article 8[2] of the Treaty does not depend on proof that there was cross-financing between the two sectors" (para 186). In other words, the source of the funding for the losses was not relevant if the conditions for predatory pricing under Article 82 EC were satisfied.

31 Case COMP/35.141, *Deutsche Post AG*, 2001 O.J. (L 125) 27. For an analysis of the decision, see D. Sappington & J.G. Sidak, "Competition Law for State-Owned Enterprises", (2003) 71 *Antitrust Law Journal* 479, 485.

32 See Geradin and Kerf, supra note 8, at 57-60.

problem with vertical integration when downstream markets have been opened to competition is that it creates incentives for incumbents to discriminate against downstream competitors. Such discrimination can take the form of refusal to grant access to essential inputs, excessive prices for such inputs, or a margin squeeze.

Regulators have employed various strategies to address problems associated with vertical integration. One such strategy consists in requiring a degree of separation between the uncompetitive (upstream) and competitive (downstream) activities of the incumbent. In the telecommunications sector, such a separation has been typically limited to accounting separation, combined with cost allocation rules.[33] In theory, only a full separation of the wholesale and retail activities (*i.e.*, through the creation of two distinct companies with separate ownership) could fully eliminate the incumbent's incentives to discriminate against downstream rivals.[34] In practice, however, this solution only makes sense when the costs of the inputs provided by the incumbent represent a significant part of downstream operators' overall costs.[35] Moreover, vertical separation may have significant drawbacks, such as the loss of economies of scope, increased transaction costs,[36] and the risk of "double marginalisation."[37] In addition, users may also have a preference for a vertically-integrated one-stop-shop meeting all their needs. Because of the uncertain benefits of vertical separation, regulators have generally eschewed such policies, relying instead on price control mechanisms designed to prevent exclusionary pricing.

Following the entry into force of the liberalisation directives adopted by the Community institutions, NRAs have devoted considerable energy and resources to the definition of interconnection regimes, as well as pricing regimes for unbundled network elements. The elaboration of such regimes has been difficult and contentious as NRAs seek to balance competing interests: stimulating entry of new competitors, while maintaining the incumbent's incentives to invest. Initially, NRAs showed little interest in margin squeeze issues, leaving this problem to be addressed by competition authorities, with the exception of NRAs with parallel jurisdiction to apply competition rules (*e.g.*, Ofcom).

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33 See Article 11 of Directive 2002/19, supra note 10.

34 See Geradin and Kerf, supra note 8, at 59.

35 Id.

36 For example, agreements that could easily be concluded within a single entity might become more difficult – and therefore more costly – between vertically separated entities. On the impact of transaction costs on the optimal size of the firm, see the seminal article by R. Coase, "The Nature of the Firm", (1937) *Economica*, 386-405.

37 When the vertically separated entity operating in the potentially competitive segment retains substantial market power, vertical separation might lead to "double marginalisation" whereby monopolistic profits are extracted in both segments of the market, thus resulting in prices in the downstream market which are further from the social optimum than would be the case if a single vertically integrated monopolistic firm operated on both segments. See J. Vickers and M. Waterson, "Vertical Relationship: An Integration", (1991) 39 *Journal of Industrial Economics*, 445, 446.

Recently, however, margin squeeze has become a major regulatory issue. At EC level,[38] the importance of preventing incumbents from engaging in margin squeeze strategies was outlined by the Commission in the 8th recital of its proposal for a European Parliament and Council Regulation on unbundled access to the local loop adopted in 2000, which provided:

> "*Costing and pricing rules for local loops and associated facilities (such as collocation and leased transmission capacity) should be transparent, non-discriminatory and be objective to ensure fairness. Pricing rules should ensure that the local loop provider is able to cover its appropriate costs in this regard plus a reasonable return. Pricing rules for local loops should foster fair and sustainable competition and ensure that there is no distortion of competition, in particular no margin squeeze between prices of wholesale and retail services of the notified operator. In this regard it is considered important that competition authorities are consulted.*"[39]

This passage, which can now be found in the 10th recital of Regulation No 2887/2000 on unbundled access to the local loop, seems to urge NRAs to ensure that margin squeezes are avoided when they set the prices of unbundled network elements. Similarly, Directive 2002/19 on access to, and interconnection of, electronic communications networks and associated facilities (the so-called "Access Directive") directly refers to the necessity to prevent margin squeeze through ex ante intervention.[40] Specifically, Recital 20 provides:

> *"Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition".*

Moreover, Article 13, which deals with price controls and cost accounting obligations provides:

> "*A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, or apply a price squeeze, to the detriment of end-users.*"

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38 This is also a major issue at Member State level. In the UK, see, for instance, Ofcom's Review of the Wholesale Broadband Access Markets, document available at http://www.ofcom.org.uk/codes_guidelines/telecoms/netw_intercon_index/wholesalebroadbandreview/

39 COM(2000) 394.

40 See *supra* note 10.

Price controls on wholesale services can thus be imposed, *inter alia*, when the NRA fears that, due to the lack of effective competition on such services, the incumbent might be in a position to apply a margin squeeze. The directive, however, leaves the NRAs free to select the pricing mechanisms to be used to prevent margin squeezes from occurring.

B Impact of price control mechanisms on margin squeeze

In the telecommunications sector, wholesale and/or retail markets may be subject to price regulation. While wholesale price controls essentially seek to prevent exclusionary abuses by the incumbent, retail price controls seek to prevent exploitative abuses or, in some cases, to ensure wide availability to the service in question. The following sections evaluate how the various price control mechanisms can affect the ability and/or the incentives of vertically-integrated operators to engage in margin squeeze. In this regard, an important distinction should be made depending on the scope of regulation of the incumbent's prices.

Wholesale and retail markets regulated. In this situation, a margin squeeze should in theory never occur, since prices are no longer set by the incumbent, but by the regulator. This does not mean, however, that the risks/incentives of margin squeeze or, more generally, of exclusionary abuses are completely absent:

- First, there may still be a "regulatory" margin squeeze, which would arise "when access prices are cost-oriented, and retail prices are either cost-oriented or below-cost (unbalanced tariffs)".[41] When retail prices are set below cost (*e.g.*, to ensure access to low-income households or customers located in high-cost areas), no entry is therefore possible. This type of margin squeeze would not, however, arise from the pricing practices of the incumbent, but would be artificially created by the regulator.[42]

- Second, the incumbent may decide to set its retail price below the level set by the regulator (assuming it is allowed to do so, see below). There might be good reason for this (*e.g.*, to respond to aggressive price cuts by a new entrants). Below-cost pricing may also be carried out with a predatory intent. The later strategy would be risky, of course, as the regulator will by definition have substantial information on the incumbent's cost structure.

- Third, as will be seen below, a margin squeeze could also occur when retail prices are controlled through a price-cap that covers a basket of services. In such cases, the incumbent could price aggressively one service (thus reducing or even eliminating the margin of its competitors for the provision of that service), but still remain in compliance with the overall price cap.

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41 Bouckaert and Verboven, *supra* note 2, at 14.

42 The risk of regulatory price squeeze is particularly significant when retail tariffs have not yet been re-balanced (*i.e.*, cost-oriented). For certain areas or categories of customers, retail tariffs may thus be higher than the wholesale tariffs. This was essentially the case in *Deutsche Telekom* where the margin squeeze was due in large part to the failure by the NRA to rebalance tariffs.

- Fourth, margin squeeze could also occur when the wholesale and retail markets are regulated through a global price cap, *i.e.*, a global cap on a basket of prices comprising both the price of interconnection and the prices of end-users services in the downstream market.[43] With this price control strategy, the incumbent could, for example, decide to set very high interconnection rates and very low end-user prices (in a manner that would nonetheless remain consistent with the global cap) in an effort to drive its competitors out of the market. Such a price structure would also be unfavourable to the incumbent, but it might still adopt this strategy if it believes that its superior financial resources would enable it to outlive its competitors and that the losses it is likely to make under this price structure will convince the regulator to relax the cap at the next price review.

- Finally, even when incumbents can no longer adopt exclusionary prices, they can still rely on non-price instruments to drive competitors out of the market.[44] The incumbent may seek to raise rivals' costs by degrading the quality of interconnection, increasing the processing times of orders, etc.[45]

Wholesale market regulated and retail markets unregulated. In this situation, the incumbent can margin squeeze its competitors on downstream markets by lowering its retail prices. This pricing strategy could be facilitated by cross-subsidization between the wholesale and retail markets, either through transfer of funds or through misallocation of common costs. This later strategy may, however, be constrained by accounting separation and cost-allocation rules. Alternatively, the incumbent could offer its retail subsidiary lower interconnection prices than its competitors. This would, however, violate the non-discrimination obligation that is generally imposed on the incumbent by sector-specific regulation,[46] or, absent such an obligation, Article 82(c) EC.[47] Of course, there may be legitimate reasons why an incumbent can offer lower prices to its downstream operations. Vertical integration may allow the incumbent to realise economies of scale and scope, which may translate in lower delivery costs to its integrated downstream operations.

Wholesale market unregulated and retail markets regulated. This situation is unlikely to occur. Indeed, the absence of price control on the wholesale market suggests that this market is competitive due to the presence of several access providers. Competition at the upstream level should normally trigger competition at the downstream level, if only because new entrants will no longer be handicapped by the lack of competition, and the risks of anti-competitive strategies this lack of competition entails, at the upstream level. The incumbent

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43 See J-J. Laffont and J. Tirole, "Creating Competition through Interconnection: Theory and Practice", (1996) *Journal of Regulatory Economics*, 227 and J.-J. Laffont and J. Tirole, "Access Pricing and Competition", (1994) *European Economic Review*, 1673.

44 See Bouckaert and Verboven, *supra* note 2, at p. 14.

45 Id. (citing Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist", (1998) 16 *International Journal of Industrial Organization*, 271-284).

46 Article 10 of the Access Directive.

47 On Article 82(c), see J. Temple Lang and R. O'Donoghue, "Defining Legitimate Competition: How to Clarify Pricing under Article 82 EC", (2002) 26, *Fordham International Law Journal*, 83, at 119-120.

may seek to exclude competitors on the retail market by lowering its prices, but, as long as it remains dominant, these prices should in principle remain above cost in order to avoid a violation of Article 82 EC.

Wholesale and retail markets unregulated. Margin squeeze strategies are most likely to arise in this situation. Absent regulation, such strategies fall to be dealt with under the competition rules.

The above discussion makes clear that scope of price regulation can substantially affect the ability of incumbents to engage in a margin squeeze. In general, the greater the pricing flexibility afforded to the incumbent, the more likely a margin squeeze will occur. In addition to determining the scope of regulation (*i.e.*, regulation of upstream and/or downstream prices), regulators must also choose a specific pricing methodology. These methodologies can also have substantial effects on the ability and incentives of incumbents to engage in a margin squeeze.

As far as the wholesale access is concerned, telecommunications regulators have generally relied on two principal methodologies: LRIC and retail-minus:

- *LRIC*. The LRIC model considers the incremental costs incurred in the long run, which are causally related to the provision of access, and which would be incurred by an incumbent using the most efficient current technology to provide such access.[48] On the one hand, LRIC promotes competition by new entrants in the downstream market since it does not compensate the incumbent for the profits it might forgo in providing interconnection. Moreover, the incumbent is not compensated for the costs it actually incurs, but for the costs supported by an efficient operator. On the other hand, as, under LRIC, the incumbent receives no compensation for the profits which it might lose if new entrants use its facilities to take away some of its customers and, in some cases, may be mandated to provide access below its costs, it will have high incentives to engage in exclusionary conduct to drive downstream competitors out of the market. Hence, the risk of margin squeeze abuses are potentially significant under LRIC.

- *Retail minus*. Under the "retail-minus" approach, the access price equals the price at which the incumbent would sell a service to a given end-user in the downstream market minus the costs which it avoids when the new entrant shoulders some of the costs of providing this service to an end-user.[49] One advantage of retail-minus is that since the wholesale price is linked to the retail price, the incumbent should in theory lose the ability to impose wholesale prices that are lower or equivalent to retail prices.[50] Another

48 See Geradin and Kerf, supra note 8, at pp. 36-39.

49 Id.

50 See ERG Common Position on the approach to appropriate remedies in the new regulatory framework (hereafter, the ERG Common Position"), p. 85 (A retail-minus access price usually also prevents the dominant undertaking from exposing its competitors to a margin squeeze, as it links wholesale and retail prices such that an independent retail undertaking as efficient as the incumbent is able to compete).

advantage is that it only allows efficient entry since, in order to be profitable, the incumbent's competitors will need to have lower costs than the incumbent's avoided costs (*e.g.*, billing, etc.). A final advantage of this approach is that it generally allows the incumbent to maintain all, or a substantial, part of its downstream profits, which will reduce the incentives for exclusionary strategies. The problem with this approach is that, without retail price regulation, it does not bring down excessive wholesale prices to a cost-oriented level. Since the wholesale price is calculated as the retail price minus the costs of the incumbent, an excessive retail price will automatically translate into an excessive wholesale price.[51]

In the light of the foregoing, it is apparent that there is no single "ideal" pricing methodology for stimulating downstream competition: each has advantages and disadvantages.[52] On the one hand, LRIC has strong pro-competitive features, since it is generally unfavourable to incumbents. However, this may also give incumbents incentives to engage in exclusionary strategies, such as margin squeeze. On the other hand, retail-minus has limited pro-competitive features, since it makes it difficult for new entrants to seriously challenge the incumbent. But it has the advantage that it considerably reduces the incumbent's incentives to engage in exclusionary strategies. From the simple objective of preventing margin squeeze, retail-minus is thus the preferable pricing methodology. This has recently been confirmed in the ERG common position on remedies,[53] and in the approach taken by certain NRAs.[54]

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51 See ERG Common Position, id. The Commission, however, notes that this pricing strategy might be applied "in cases where excessive prices are not a major concern of the regulator. If circumstances are such that, for example, the market power at the wholesale level is likely to erode within a reasonable period of time, the distortions which result from excessive prices might be negligible"

52 See E. Noam, *Interconnecting the Network of Networks*, MIT Press, 2001, at pp. 113-16.

53 See *supra* note 50.

54 In its Review of the Wholesale Broadband Access Markets, supra note 38, pt. 4.71, Ofcom defended the view that retail minus was the most appropriate methodology to prevent margin squeeze from occurring: "[T]he main concern is that, since BT is vertically-integrated, it could squeeze the margin between the wholesale products, in whose provision it has market power, and the downstream ones, thus preventing other operators from competing in downstream markets. Hence Ofcom believes that retail minus is the most appropriate pricing approach since it addresses the primary concern about the margins between the relevant products rather than absolute level of charges. In addition, retail minus avoids the risk of adversely affecting investment in wholesale broadband access market"). Interestingly, Ofcom, however, recognised that the retail minus methodology may not be sufficiently tight to allow entry in several markets and, in particular, in on the market for wholesale products that are used as input by Internet service providers (ISPs) to offer broadband Internet access service to consumers and services. Ofcom thus considered that, for some markets, the retail minus methodology has two shortcomings. See, Ofcom, Direction setting the margin between IPStream and ATM interconnection prices, 26 August 2004. First, although retail minus prevents the incumbent from imposing a negative margin on its downstream competitors, at the time they are willing to enter the market these competitors have no guarantee that their future margins will be sufficient to justify entry. Indeed, as wholesale prices are based on retail price minus avoided costs and as such costs may vary in the future (if the incumbent becomes more efficient and is able to cut its downstream-related costs), the new entrant may find itself soon after its entry in the market unable to realise a sufficient profit. Second, because the incumbent will initially have a much larger customer base than new entrants, its avoided costs will probably lower than the costs of new entrants due to the capacity of amortizing such costs on higher volumes. This may again contribute to preventing entry. On the basis of this analysis, Ofcom thus considered it is necessary to specify the level of the margin between ATM interconnection

Retail price control methodologies may also affect the ability/incentives of incumbents to engage in margin squeeze. This applies not least because a margin squeeze occurs not only when the incumbent increases its wholesale prices, but also when it lowers its retail prices (or both). Regulators have generally the choice between two methodologies to set retail prices: rate-of-return regulation and price caps. (We assume for present purposes that regulated retail prices represent a ceiling, but not a floor, *i.e.*, the incumbent is not allowed to set a price that is above the regulated price, but it is allowed to set a price that is below the regulated price.)

- *Rate-of-return regulation*. One way to calculate retail price is to rely on rate-of-return regulation.[55] Rate-of-return regulation enables the regulated firm to charge prices which cover its operating costs and provide a pre-determined return on the capital committed to its operations. Rate-of-return pricing is thus a cost-based method of setting prices. In practice, costs that can unambiguously be allocated to a given service are included in the price of that service and costs that are common to several services are allocated according to some accounting principles to those services. When costs are no longer covered by the regulated prices, the firm can ask for a review to determine a new set of prices.[56] Rate-of-return seriously constrains the ability, and reduces the incentives, of the incumbent to adopt prices below the regulated price as part of a margin squeeze strategy. In order to adopt a price below the regulated price, the incumbent would have to either to reduce its costs or to price below costs. The first option would be unappealing as it would lead to the setting of a lower regulated price by the regulator in its subsequent pricing review. The second option would be risky as regulators relying on rate-of-return regulation typically have detailed information on the incumbent's retail cost structure. Predatory pricing could thus be easily detected.

- *Price caps.* Instead of regulating the return that the regulated firm is allowed to make on its investment, regulators might impose a cap on the incumbent's prices.[57] Price cap regulation has progressively become the preferred methodology of regulators as it provides the incumbent with strong incentives

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(the intermediary service bought by BT's competitors to be able to provide wholesale products to ISPs) and IPStream (the retail products sold by BT to ISPs) to ensure that this margin is not subject to "adverse unpredictable changes, thereby fundamentally altering the basis of competition in the Wholesale Broadband Access market". Compared with the traditional retail minus approach where the minus is not specified and can thus fluctuate, the approach described here set the minus at a specific level to be reviewed if there is a material change in circumstances. Although the main goal of this approach is to provide greater certainty to BT competitors, Ofcom also argued that it should also "provide BT with greater certainty in how it can change its IPStream prices while remaining compliant with the margin squeeze test". See Ofcom, *Direction setting the margin between IPStream and ATM interconnection prices*, 26 August 2004.

55 See generally, D. Newbery, *Privatization, Restructuring and Regulation of Network Utilities*, MIT Press 2000, at p. 38 and R. Baldwin and M. Cave, *Understanding Regulation: Theory, Strategy, and Practice*, Oxford University Press, 1999, at p. 224.

56 See J.-J. Laffont and J. Tirole, *Competition in Telecommunications*, MIT Press, 2000, at pp. 84-85.

57 See generally, M. Amstrong et al., *Regulatory Reform: Economic Analysis and British Experience*, MIT Press, 1994, at p. 165 and Baldwin and Cave, supra note 55, at p. 226.

to reduce costs during the period in which prices are fixed. An important feature of price caps when it comes to assessing the impact of this strategy on the ability/incentives of the incumbent to engage in margin squeeze is that these caps are usually imposed upon baskets of prices, *i.e.*, it is a weighted average of these prices which cannot exceed the cap. The flexibility introduced by the reliance on baskets of prices allows the incumbent to price aggressively on some retail markets (where it faces competition), by imposing for instance higher prices on others (where it does not face competition). An incumbent facing tough competition on long-distance services, but no competition on local services, could thus be tempted to reduce its prices on the former market and to increase them on the later market, assuming of course that long-distance and local services belong to the same basket of prices.

In conclusion, it seems that price caps offer greater scope for incumbents to engage in margin squeeze strategies, at least when price caps are imposed on baskets of services. By contrast, rate-of-return regulation does not allow the incumbent to lower its prices below the regulated rate as part of a margin squeeze strategy.

III. Margin squeeze abuse under EC and national competition law

Prior to the widespread liberalisation of telecommunications and other utilities, margin squeeze allegations did not feature prominently in the decisional practice and case law. The advent of liberalisation, however, has seen a dramatic increase in the number of margin squeeze cases before the Commission, NCAs, NRAs with concurrency powers to apply competition law, and, doubtless, arbitral award bodies.[58] It bears emphasis from the outset, however, that a very small number of cases have resulted in a finding of infringement. The following sections summarise the principal cases under Article 82 EC (Section A) and national laws (Section B). A discussion of the principal points of interest and controversy to emerge from the decisional practice and case law follows thereafter (Section C).

A. EC decisional practice and case law

[58] Margin squeeze allegations have also featured prominently in other non-EU jurisdictions. In 2004, the Australian Competition and Consumer Commission (ACCC) conducted an imputation analysis to see whether there is a sufficient margin between Telstra's retail prices and the prices it charges other service providers to use the core telecommunications services (plus related costs) to allow efficient firms to compete at the retail level. Although preliminary inquiries showed that insufficient margins were available for local call services (line rental and local calls combined), the ACCC does not at this stage regard the insufficient margins for local call services to be a competition concern (primarily due to the common bundling of local call services with other telephony services). The ACCC is also investigating similar claims for wholesale ADSL services: see ACCC press release of October 18, 2004, available at http://www.accc.gov.au/content/index.phtml/itemId/544190/fromItemId/2332. The United States also has a long history of reviewing margin squeeze allegations, both in regulated and unregulated markets. See *United States v Aluminium Co of America* 148 F.2d, 437-438 (2.d Cir. 1945); *Bonjorno v Kaiser Aluminium & Chem Corp*., 752 F.2d 802, 808-809 (3d Cir 1984)); *Ray v Indiana & Mich Elec. Co*., 606 F Supp. 757, 776 (N.D. Ind. 1984)); *City of Batavia v. FERC*, 672 F.2d 64,90 (D.C Cir. 1982)) for unregulated markets. For regulated markets, see *Town of Concord v. Boston Edison Co.* 915 F.2d 17 (1st circuit 1990) and *Town of Norwood v. New England Power Co.* 499 U.S 931 (1991). The interface between antitrust law and regulation under the US Telecommunications Act 1996 is discussed in more detail below in the context of *Law Offices of Curtis v. Trinko, L.L.P v AT&T.*

National Carbonising. Margin squeeze allegations have arisen in a small number of cases before the Community institutions. The earliest was *National Carbonising*.[59] National Carbonising Company (NCC) purchased all the coal it needed for coke production from the National Coal Board (NCB), whose subsidiary, National Smokeless Fuels Limited ("NSF"), produced industrial and domestic hard coke in competition with NCB. NCB held a virtual monopoly in coal production and, through NSF, almost 90% of the downstream coke market. The Commission found that NSF was also the price leader on the downstream market and there was no possibility for NCC to increase its prices above NSF's. As a result of successive increases in the cost of NCC's raw materials sourced from NCB, NCC's costs of production rose by £10.39 per ton, whereas the maximum price increase downstream for the finished product was only £6.70. NCC would therefore have been unable to operate economically on the basis of these pricing structures and sought interim relief.

Because it was only an interim decision, the Commission's decision does not enter into detail on the relevant legal principles to be applied to a margin squeeze. It merely states that an upstream dominant firm supplying an essential input to rivals may "have an obligation to arrange its prices so as to allow a reasonably efficient manufacturer of the derivative a margin sufficient to enable it to survive in the long-term."[60]

British Sugar/Napier Brown. The next case was *British Sugar/Napier Brown*,[61] where a margin squeeze was one of a number of abuses levelled against the dominant sugar manufacturer in the United Kingdom. British Sugar plc (BS) was found dominant in the UK markets for the supply of raw and granulated sugar to retail and industrial clients (60% share in each market). Its pricing policy towards Napier-Brown (NB) – which acted as a buyer and re-seller of sugar in competition with BS – was found to result in "insufficient margin for a packager and seller of retail sugar, as efficient as BS itself in its packaging and selling operations, to survive in the long-term."[62] The Commission found that BS was dominant in both the market for the raw material (sale of bulk sugar) and the derived product (retail sugar) and that "maintaining … a margin between the price which it charges for a raw material to the companies which compete with the dominant company in the production of the derived product and the price which it charges for the derived product, which is insufficient to reflect that dominant company's own costs of transformation (in this case the margin maintained by BS between its industrial and retail sugar prices compared to its own repackaging costs) with the result that competition in the derived product is restricted, is an abuse of dominant position."[63]

Industrie des Poudres Sphériques. The most comprehensive treatment of a margin squeeze abuse by the Community Courts is the *Industrie des Poudres Sphériques* case.[64] Industries des Poudres Sphériques (IPS) applied for the annulment of a 1996 Commission decision

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59 OJ 1976 L 35/6.

60 Id. at L 35/7.

61 OJ 1988 L 284/41.

62 Id., para. 65.

63 Id., para. 66.

64 See Case T-5/97 *Industrie des Poudres Sphériques SA v Commission* [2000] ECR II-3755.

which rejected its request for a finding that an infringement of Article 82 EC had been committed by Pechiney Electrometallugie (PEM). PEM was the sole Community producer of primary calcium metal and also marketed broken calcium metal (a derivative of primary calcium metal). IPS competed with PEM in the derivative market for broken calcium metal. IPS alleged that PEM set the price of primary calcium metal abnormally high, which in combination with the very low price for broken calcium metal, forced its competitors to sell at a loss if they were to remain in the market. IPS claimed that that PEM's primary calcium metal offer of 21 June 1995 gave rise to a margin squeeze.

The Court defined a margin squeeze as arising where a vertically-integrated dominant firm supplies input to rivals at prices "at such a level that those who purchase it do not have a sufficient profit margin on the processing to remain competitive on the market for the processed product."[65] The Court suggested that this might occur in two ways: (1) where the prices for the upstream product were abusive; or (2) the prices for the derived product were predatory.[66] However, in practice, the Court applied a single test for abuse, since it held that the upstream price would be abusive or the downstream price predatory if "an efficient competitor" could not compete on the basis of the dominant firm's pricing.[67] The Court expressly excluded from this definition a company with higher processing costs than the dominant firm.[68]

The Court also added some important statements about the application of competition law to margin squeezes: (1) in the absence of an exclusionary margin squeeze, the way in which a dominant vertically-integrated undertaking decides its profit margin "is of no relevance to its effects on its competitors;"[69] (2) it is relevant to ask whether the dominant firm is a price leader on the downstream market or whether prices are influenced by other factors and would allow competitors to charge higher prices.[70] At the same time, however, the Court's conclusions on the nature and scope of the margin squeeze abuse under Article 82 EC are limited, since the case involved an appeal against a decision to reject a complaint.

Deutsche Telekom. The *Deutsche Telekom* case represents the first occasion that the Commission has applied competition law principles to a margin squeeze in the telecommunications sector.[71] DT was found guilty of a margin squeeze in circumstances where it charged competitors more for unbundled broadband access at the wholesale level than it charged its subscribers for access at the retail level. From 2002, prices for wholesale access were lower than retail subscription prices but the difference was still not sufficient to cover DT's own downstream product-specific costs for the supply of end-user services.

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65 Id., para 178.

66 Id., para 179.

67 Id., para 180.

68 Id., para 179.

69 Id., para 183.

70 Id., para 185.

71 OJ 2003 L 263/9.

The Commission stated that a margin squeeze would occur where the competing services were comparable and "the spread between DT's retail and wholesale prices is either negative or at least insufficient to cover DT's own downstream costs."[72] This would mean that DT would have been unable to offer its own retail services without incurring a loss if it had had to pay the wholesale access price as an internal transfer price for its own retail operations. As a consequence the profit margins of competitors would be squeezed, even if they were just as efficient as DT.[73] In other words, a "margin squeeze imposes on competitors additional efficiency constraints which the incumbent does not have to support in providing its own retail services."[74]

B. National decisions and cases

Margin squeeze cases have featured prominently in the decisional practice of NCAs, NRAs, and national courts in recent years. Virtually all cases have arisen in the telecommunications sector. The United Kingdom has the greatest number of cases, which is most likely a function of the fact that its telecommunications markets are among the most advanced in the EU. Cases have also arisen in other Member States, including Denmark, France, Italy, and the Netherlands. The principal cases are discussed in more detail below.

1. United Kingdom

Several margin squeeze decisions have been taken by in the United Kingdom by the NCA (the Office of Fair Trading (OFT)), NRA (Office of Communications (Ofcom)), and the specialist competition appeals tribunal (the Competition Appeal Tribunal (CAT)) since the introduction of the 1998 Competition Act (which mirrors the wording of Articles 81 and 82 EC). In addition, a number of official and semi-official documents set out the UK authorities' current thinking on margin squeeze abuses.

Official and semi-official statements. The OFT and Ofcom (and its predecessor Oftel) have made a number of public statements on the issue of margin squeeze, both generally and in the specific context of the telecommunications sector. Guidance was first set out in the Guidelines on the application of the Competition Act 1998 to the telecommunications sector:[75]

> "*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 to a price or margin squeeze by raising the cost of the key input (see paragraphs 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*

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72 Id., para 140.

73 Id., para 102.

74 Id., para 141.

75 *The Application of the Competition Act 1998 in the Telecommunications Sector*, OFT 417. The same definition appears in the OFT's guideline *Assessment of Individual Agreements and Conduct*, OFT 414, para. 7.26.

the gross margin available to its competitors, which might well make them unprofitable."

In a subsequent (and on-going) investigation into an alleged margin squeeze by British Telecom in the supply of wholesale and retail broadband services, Oftel took the unusual step of publishing a detailed analytical framework setting out its current thinking on margin squeeze abuses and how they relate to other forms of exclusionary pricing.[76] The Analytical Framework states that a margin squeeze generally arises where a firm:[77]

- "*is vertically integrated, i.e., operates in both upstream and downstream markets;*
- *is dominant in the upstream market, so that downstream competitors have a degree of reliance upon the firm's upstream input;*
- *sets a margin between its downstream retail price and upstream wholesale charge (paid by downstream competitors) that is insufficient to cover its downstream costs;*
- *on an 'end-to-end' basis, i.e., aggregating across the firm's upstream and downstream activities, the firm may be profitable;*
- *but an equally (or more) efficient downstream competitor could be unable to compete, because, in effect, it is being charged a higher price for the upstream input than its competitor, the vertically integrated firm's own downstream arm.*"

Decisional practice and case law. The first major margin squeeze decision adopted by the UK authorities was *BSkyB*,[78] where the OFT rejected a margin squeeze allegation in the pay-TV sector. Several distributors of pay-TV channels (ITV Digital, NTL and Telewest) alleged that BSkyB's wholesale pricing of its premium pay-TV channels allowed an insufficient margin for its competitors at the distribution level to compete on resale. (ITV Digital, NTL and Telewest compete with BSkyB on various downstream retail markets.) The Director found that BSkyB was dominant in both the wholesale and retail levels of these markets, but that it did not abuse its dominant position.

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76 See *Analytical Framework for New Freeserve Case*, ("Oftel Analytical Framework"), 14 August 2003.

77 Id. para. 22.

78 Case CA 98/20/2002 *BSkyB Investigation*, decision of 1 January 2003. Price squeeze allegations have also been rejected in several decisions by the UK competition authorities. See, *e.g.*, CA98/19/2002 *The Association of British Travel Agents and British Airways plc* (2002) (reduction in travel agents' booking payments found not to give rise to a margin squeeze vis-à-vis British Airways' own on-line booking services); Case CP/1139-01 *Companies House* (2002) (no evidence of Companies House cross subsidising its competing activities so as to allow it to engage in predatory pricing, or impose a margin squeeze on its competitors); *British Telecom UK SPN*, Oftel decision of May 23, 2003 (margin squeeze rejected for loss-making new telecommunications service on grounds, inter alia, that BT's predictions of future profits were not implausible); Case CA98/01/2004 *Albion Water/Dwr Cymru*, Ofwat decision of May 26, 2004 (Dwr Cymru prices for water access found not to give rise to a margin squeeze); and Case CA 98/07/2004 *TM Property Services Limited/Transaction Online*, OFT decision of August 18, 2004 (allegation of margin squeeze by Transaction Online in the market for property searches rejected).

The basic legal test applied to determine a margin squeeze was whether an undertaking as efficient in distribution as BSkyB could earn a normal profit when paying the wholesale prices charged by BSkyB to its distributors. This was tested by reference to BSkyB's own costs of transformation. The OFT relied in this regard on an historic model of costs/revenues, which matched costs and revenues by amortising investment expenditures. This approach was preferred to the net present value ("NPV") approach advocated by BSkyB,[79] on the grounds that the latter ignores the possibility that a period of margin squeeze could successfully restrict competition and subsequently boost BSkyB's (monopoly) profits. It was also considered to involve significant uncertainty as it requires knowledge of the cash flows during the whole life of the project.[80]

In determining the appropriate accounting methodology for the margin squeeze test, the OFT concluded that the return on investment is the best measure of the distribution arm's profitability and, for the purposes of the investigation, required the distribution arm to achieve a return of at least 1.5% (with costs and revenues allocated between the broadcasting and distribution arms on the basis of causation). The OFT admitted that this test was necessarily *ex post*.[81] Applying this analysis, the historic model employed by the OFT showed that the distribution arm of BSkyB would have incurred certain losses in distribution during the period investigated, but would also have been profitable during certain periods. Having regard, however, to the limited and intermittent nature of the losses, the OFT did not consider that there were sufficient grounds to find that BSkyB had exercised a margin squeeze.

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79 NPV involves evaluating the cost/benefit of tying up capital in a project – the opportunity cost of capital. Two stages are involved. First, future cash flows (i.e., revenues and costs) are forecast. Second, future net cash flows are discounted at the appropriately adjusted discount rate and added up to yield a single NPV figure. The appropriate adjustment (i.e., the risk premium added to the pure time-value-of-money component incorporated in the discount rate) becomes necessary whenever future cash flows are subject to uncertainty. This reflects the fact that most investors are averse to risk and therefore need to be compensated for taking on this risk in the first place. If the NPV of a project is positive, then it is better to do the project than not to do it. If it is negative then it is better to do nothing than to undertake the project and stick with it to the end.

80 BSkyB argued that the historic test inappropriately required its distribution arm to be profitable even when its subscriber numbers were growing and it was not in a steady state. It was submitted that the margin squeeze should recognise the burden of fixed costs, increasing retail prices, duplication of transmission costs and the inflated payments for third party channels. The OFT however, considered that these temporal items were unexceptional in nature, and could not be considered investment costs. The Director did accept, however, that such factors should be considered in interpreting the results of the test.

81 Although favourable to the defendant, the OFT's decision has been criticised for this reason: see S. Hornsby, "Abuse of Dominance – Margin squeezes by dominant firms after BSkyB: should there be a law against them in new markets," *Competition Law Insight*, June 2003. The principal criticism is that the application of the methodology used by the OFT is, by its very nature, not predictable in advance. The OFT allocated functions, and hence costs and revenues, to each of the distribution and broadcasting arms of BSkyB. The OFT noted that alternative assumptions or decisions could have been analysed and considered, but noted that he considered that those he used were the best possible on a fair and objective basis. The crucial problem is that BSkyB could never have known how the OFT would make his allocation in the particular market. The test proposed by OFT is therefore considered by the author to fail the fundamental legal criterion of predictability.

The next decision was rendered on 20 November 2003, in connection with allegations of a margin squeeze by British Telecom in the broadband sector.[82] Downstream retail broadband competitors complained that BT's wholesale input and retail prices prevented them from earning a positive margin. The original complaint was filed in March 2002 and was rejected by Oftel in May 2002. The applicant appealed the decision rejecting the complaint to the CAT, which remitted the matter to Oftel on the grounds that further reasoning was required on the distinction between a margin squeeze and a pure predation case. Oftel then rejected the complaint for a second time in November 2003. However, following the adoption of a new BT business plan for broadband in 2004, Oftel's successor, Ofcom, continues to pursue certain aspects of the case, which culminated in the issuance of a statement of objections against BT in August 2004.

Both the 2003 Oftel decision and the on-going Ofcom investigation are unusual in that they involve the assessment of a margin squeeze abuse in a market where all firms are presently losing money and are competing to acquire additional customer volumes that will allow them to reduce costs over time and enter into profitability in the near future. In its 2003 decision, Oftel accepted that it would not be an abuse for a firm to lose money in the short-term if it had in place a legitimate plan to recover present losses, *i.e.*, a plan that does not depend or assume that rivals will exit due to exclusionary conduct. The difficult task faced by Oftel was to devise a legal test that would allow it to verify whether the assumptions of future profitability contained in the dominant firm's business plan were based on legitimate, reasonable considerations or exclusionary motives.

In its 2003 decision, Oftel essentially applied a two-stage test in order to determine whether BT's losses were based on legitimate start-up losses or exclusionary motives. First, it assessed whether BT's business case was NPV positive over a core period of five years. Following certain adjustments made by Oftel to BT's business plan, Oftel found that BT's downstream business would have been profitable over this period. As a second stage, Oftel tried to correct the optical flaw in a NPV analysis – that positive NPVs may also be the result of anti-competitive behaviour – by testing the robustness of the positive NPV results against assumptions about what it would have been reasonable for BT to expect in a competitive market. Although Oftel disagreed to some extent with the assumptions in BT's business plan about future margins, its analysis showed a majority of positive NPVs overall. In this circumstance, and given that BT's retail prices were in any event higher than its competitors, Oftel found that the margin squeeze allegation was not sufficiently proven. Ofcom's current investigation is focusing on much the same issues in the light of certain revisions to BT's business plan in 2004.

Genzyme[83] represents the first detailed opportunity that the CAT has had to review the issue of margin squeeze. The case involved the drug Cerezyme, the only effective treatment for the rare (but fatal) Gaucher's disease and its manufacturer, Genzyme. Genzyme was found to be a virtual monopolist in the supply of drugs for the treatment of Gaucher's disease. Two abuses were alleged: (1) the bundling by Genzyme of the sale of Cerezyme with the supply of homecare services for the administration of Cerezyme to patients; (2) a margin squeeze.

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82 Investigation by the Director General of Telecommunications into alleged anticompetitive practices by British Telecommunications plc in relation to BTOpenworld's consumer broadband products, 20 November 2003.

83 *Genzyme* [2004] CAT 4, judgment of 11 March 2004.

Genzyme sold the dominant Cerezyme drug to the NHS at £2.975 per unit, a price that included the provision of the separate service for the homecare administration of the drug. Genzyme's price to its own subsidiary was lower, at £2.50 per unit, giving it a margin of £0.475 on each sale. In contrast, Genzyme charged downstream rivals who needed access to Cerezyme to provide homecare services the same retail price as it charged the NHS. Because rivals had to supply the additional homecare services at their own expense, they would have made a loss on their sales to the NHS. As NHS got both the drug and the service for £2.975, and rivals would have to charge more if they supplied both, the NHS never bought from rivals.

Both the OFT and CAT upheld the margin squeeze complaint. The rationale was that Genzyme was discriminating in two ways: its price to its subsidiary was lower than its price to competitors, and its price to NHS included a service which it did not provide to or for its competitors. It was discriminating against downstream rivals by charging a price for one product that was the same as its retail price for that product plus a service. This was considered by the UK authorities to be exclusionary and discriminatory.

The most recent UK decision on margin squeeze is a decision rendered by Ofcom on 12 July 2004, in which it rejected an allegation that BT was engaged in a margin squeeze.[84] The allegation concerned three new packages of line rental and domestic and international calls offered by BT with effect from 1 April 2004 (the so-called BT Together Options 1, 2 and 3 residential retail services). Competing Carrier Pre-Selection (CPS) providers claimed that, by raising the minimum monthly rental charge to £10.50 (from £9.50 on standard line rental package) and reducing call prices, BT's revised pricing gave rise to a margin squeeze between the wholesale input price CPS providers were required to pay to BT's wholesale division and the retail prices charged by BT in the downstream calls markets, such that CPS Providers would no longer be able to compete profitably.

Ofcom's analysis is interesting because it applied different tests to assess the margin squeeze allegation. First, Ofcom applied an "equally efficient operator" test based on BT's downstream costs. Ofcom conducted this test on the basis of different, variants: (1) local and national calls based on BT's fully allocated cost; (2) national calls based on LRIC; and (3) local and national calls based on a combinatorial test, i.e., whether relevant common costs were recovered in aggregate across local and national calls combined. Second, Ofcom applied a test based on BT's costs, but adjusted those costs to allow for a local calls cost advantage that BT's retail had over CPS providers, i.e., a mixture of BT's costs and rivals' costs. Finally, Ofcom applied a "reasonably efficient operator test" that included CPS provider customer acquisition costs, i.e., only rivals' costs. The application of these tests showed a positive margin overall and Ofcom therefore rejected the complaint.[85]

2. Denmark

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84 Case CW/00760/03/04, *Investigation against BT about potential anti-competitive exclusionary behaviour*, Ofcom decision of 12 July 2004.

85 See also Case CW/00615/05/03, *Suspected margin squeeze by Vodafone, O2, Orange and T-Mobile*, Ofcom decision of 21 May 2004 (allegation that mobile operators were pricing the delivery of certain fixed-to-mobile calls to business customers at levels that constituted a margin squeeze vis-à-vis the wholesale charges that fixed operators pay for mobile call termination rejected).

On 27 April 2004, the Danish Competition Authority adopted its first margin squeeze decision. Song Networks A/S (Song), a provider of fixed line telephony for business customers in Denmark, filed a complaint before the Danish Competition Authority against TDC and SONOFON, the leading providers of mobile telephony and fixed line telephony to business users in Denmark. Song argued that TDC and SONOFON infringed the Danish Competition Act by practicing excessive prices for mobile termination, collusive behaviour in connection with the mobile termination charges, and cross-subsidisation and margin squeeze between wholesale and retail divisions.

The Competition Authority upheld the margin squeeze allegation, which concerned TDC's PlusNet Mobile product – a bundle of mobile and fixed telecommunications services. On certain individual call directions included in the PlusNet Mobile service, the Competition Authority found that TDC was creating an illegal margin squeeze by selling below cost to end consumers, making it difficult for TDC's wholesale customers to compete for the end users of products similar to PlusNet Mobile. Having determined that TDC was dominant on the relevant markets, the Authority then analysed the cost structure. The Competition Authority found that TDC had been selling below cost on some individual call directions. The Competition Authority found that TDC's profit on the overall PlusNet Mobile product was not sufficient to cover the commercial risk that call volumes would rise on some of the individual loss making call directions which, if it happened, could lead to a loss on the overall product.

3. France

On 14 October 2004, the *Conseil de la concurrence* fined two French telephone operators €20 million for a margin squeeze abuse in the national fixed line and mobile phone markets.[86] France Télécom (FT) was fined €18 million and Cegetel was fined €2 million. Both companies were found to have a dominant position for call termination on their respective mobile phone networks.

FT, Cegetel and Bouygues were alleged to have infringed Article 82 EC and the equivalent provision in Art. L.420-2 of the French Commercial Code. In particular, since April 1999, FT's retail prices for calls from fixed-mobile lines by large and medium-sized corporate clients did not cover the variable cost that would be incurred by an equally efficient fixed-line operator. This delayed entry on the market for fixed-to-mobile calls for corporate clients, since a new fixed-line operator would not be able to provide fixed to mobile calls services without incurring a loss. Cegetel was criticised for substantially the same reasons for the same period concerning retail prices for fixed line to SFR mobile line calls for corporate clients. The complaint against Bouygues was not, however, upheld.

The test applied to assess whether FT's tariffs gave rise to a margin squeeze involved a comparison between: (1) the average (net) revenue per minute for calls from fixed lines to the FT's mobile arm (Orange France); and (2) the average cost for the providing this service, for an operator as efficient as FT, *i.e.*, an operator interconnected to FT's mobile network. "Average cost" was defined as LRIC. Applying this test, the Conseil found that the margin was negative on the market for medium-size corporate accounts from 1 January 1999, to 1

86 See http://www.conseil-concurrence.fr/pdf/avis/04d48.pdf.

October 2000 and on the market for large corporate accounts between 1 January 1999, and 1 January 2001.

The Conseil also applied different variants of the basic margin squeeze test in order to take into account the different technical means of access used by downstream operators. Fixed-line operators wishing to route calls to a corporate client's mobile could do so either by having FT interconnect the calls or by connecting the client directly to a local loop installed by the operator for corporate clients ("LLU"). Where corporate clients were not connected to a LLU, Cegetel's costs included in its incremental cost included (1) the termination charge fixed by the national regulator; (2) a contribution to the "universal service" (3) FT's interconnection costs as invoiced to Télécom Développement (*i.e.*, FT's interconnection charge to subscriber's receiver); and (4) the transit cost invoiced by Télécom Développement to Cegetel (*i.e.*, connection charge from the receiver to the SFR site). Where the customer was connected to the LLU, the costs were the same, less the FT interconnection costs. Applying these two variants, the margin was found to be zero on the market for medium-size corporate accounts during the first six months of 1999 and then negative until to March 2000. On the market for large corporate accounts, the margin was found to be negative from 1 January 1999 to 30 April 2001.

A major contributory factor in the margin squeeze finding was the termination charge set by the French telecoms regulator for calls to mobiles in the FT network. FT claimed that this should not be factored into the margin squeeze analysis since it was a cost-based charge imposed by the national telecoms regulator, *i.e.*, the charge set by the regulator was not, by definition, excessive or discriminatory. The Conseil rejected this argument. It first noted that the termination charge was not in fact cost-based – citing a previous decision by the national telecoms regulator to this effect – and that the charge was high as compared to the actual termination costs incurred. The Conseil then cited the Commission's *Deutsche Telekom* decision for the proposition that the existence of regulatory-imposed charge did not immunise conduct from the application of competition law.

The Conseil also rejected Cegetel's argument that regard should be had not only to the costs of the dominant firm, but also to the actual costs incurred by downstream rivals to the extent that they were lower than the dominant firm's, *i.e.*, where downstream operators are more efficient.[87] In particular, Cegetel claimed that international re-routing and other technical options allowed downstream fixed operators to route traffic towards mobile telephones more efficiently than FT itself. The Conseil rejected this on the basis that the prohibition on abuse of dominance cannot be limited to the case of undertakings that are more efficient than the dominant firm: undertakings at least as efficient also required protection to compete on the merits. The termination charge imposed by the national regulator prevented an undertaking as efficient as FT from making an adequate profit downstream. The Conseil also took into account third-party observations to the effect that international re-routing and other technical options did not result in materially lower costs, suffered from quality issues, and were in any event not widely used in France.

4. Netherlands

[87] Id., paras. 222-224.

Official statements. In 2001, the Dutch Competition Authority and the Dutch Postal and Telecommunications Authority issued joint guidelines for the appraisal of unfairly low end user prices charged by telecommunications companies that have significant power within the meaning of the Dutch Telecommunications Act or that have a dominant position within the meaning of the Dutch Competition Act (the "Guidelines").[88] The Guidelines develop a margin squeeze test that both sets of authorities indicate that they will apply when dealing with complaints from competitors concerning unfair prices charged by the incumbent dominant network operator, KPN, in circumstances in which it also acts as a downstream service provider.

Although detailed in scope, the Guidelines in essence adopt a margin squeeze test based on an assessment of end-user prices in light of: (1) the costs the dominant company would incur if it were to buy its own network services on the market and (2) the retail margin that an efficient service provider would need to achieve a reasonable profit. Based on the assumption that an alternative service provider should be able to operate at least as efficient as KPN, the retail margin is calculated as a percentage of the actual retail costs of KPN.

On the basis of these principles, the Guidelines then elaborate detailed margin squeeze tests for a number of telecommunications services (e.g., fixed intra-regional calls, fixed extra-regional call, internet access calls, calls from fixed to mobile). For each of these services, the Dutch authorities set out in detail how the end user prices, the network services costs and the retail margin have to be determined and how the margin squeeze test has to be applied. The Guidelines set out different margin squeeze tests for Biba (speech) traffic, Buba (data) traffic, inbound internet traffic and fixed-mobile traffic. In summary:

- For Biba and Buba traffic, the margin squeeze test is end user rate adjusted to take account of discount > = interconnection rate adjusted to take account of retail charges;

- For inbound Internet traffic, the test is KPN revenue > = interconnection rate adjusted to take into account retail charges; and

- For fixed-to-mobile traffic, the test is end user rate adjusted to take account of discount > = interconnection rate adjusted to take account of retail charges.

Decisional practice. The Dutch Competition Authority has rejected margin squeeze allegations in at least one complaint against the incumbent operator, KPN.[89] The case concerned a complaint filed by a mobile service provider Talkline Benelux B.V. ("Talkline") against the mobile network operator KPN Telecom B.V. ("KPN"). Talkline alleged that KPN has abused its dominant position (1) by granting more favourable conditions to its own service provider ("SPM") and (2) by having an unfair price structure. With regard to the unfair price structure, Talkline argued in particular that the prices applied by KPN make it impossible for an independent service provider to operate in a profitable manner.

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88 A non-binding English translation of the guidelines is available at http://www.nmanet.nl/en/Images/14_10517.pdf.

89 Case 1657 *Talkline v. KPN*, decision of available at http://www.nmanet.nl/nl/Images/11_24381.pdf.

The Dutch competition authority rejected Talkline's complaint. In essence, its reasoning was that: (1) the rebates and other conditions granted by KPN to independent services providers were very similar and substantially higher than the rebates and other conditions granted by KPN to SPM; and (2) there was evidence that several independent services providers who relied on access to KPN's network, including Talkline, were able to operate on the market profitably.

5. Italy

On 16 November, 2004, the Italian Antitrust Authority ("IAA") imposed a fine of €152 million on Telecom Italia ("TI") for having abused its dominant position on the fixed network telecommunications services for business customers, including a margin squeeze abuse.[90] The complaint was made in the context of a bid submitted in tender proceedings called by the entity charged with purchasing communications services for public bodies in Italy (Consip). Consip asked various telecoms operators to submit bids with respect to a bundle of services. Part of the inputs that TI's rivals required to offer the bundle of services had to be made available by TI at charges set by the national telecommunications regulator.

The case was not treated as an orthodox margin squeeze, however, but as a discrimination issue. In essence, the IAA concluded that TI abused its dominant position by making a bid that could not be matched by its competitors. This was not, according to the IAA, due to TI's superior technology or efficiency, but because TI charged its internal divisions less than it did to its competitors for the relevant inputs. The reason was that the price paid by rivals to TI was regulated, whereas TI's internal transfer price was not. The IAA reasoned that rivals trying to match TI's prices in a bidding process had to factor in the regulated charges paid to TI in any final bid. Accordingly, the IAA used regulated charges as the benchmark to assess whether competitors could place equivalent bid. To the extent that regulated charges exceeded TI's actual costs for the input in question, it was not allowed to price this component of the bundled price below the regulated price level. Otherwise, rivals would not be able to compete. The IAA dismissed the argument that, in order to be on a par with competitors, it is enough that a dominant undertaking ensures that competitors can make a competitive offer on the bundle overall. Rather, the IAA stated that, when making an offer that encompasses regulated services, competition law requires a dominant firm not to price below the regulated price for any individual item of the bundled offer. The case is interesting in that the national telecoms regulator disagreed with the IAA's findings in certain respects.

The investigation also attached importance to the fact that TI's conduct formed part of a single strategy, clearly laid down in the central level, in order to explicitly exclude its competitors from the business end-users market for telecommunications services and thereby to maintain its historically dominant position both on the end-users market and the market for intermediate services for its competitors.

C. <u>Unresolved issues regarding margin squeeze abuses under competition law</u>

Despite a burgeoning decisional practice and case law on margin squeeze abuses, the nature and scope of this abuse remains unclear in material respects. In addition, the decisions and

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[90] See also *Tiscali-Albacom/Telecom Italia*, No. 8482 (A280), 13 July 2000, where the IAA fined Telecom Italia for a price squeeze against other fixed telecom operators.

cases often take divergent approaches on the core legal conditions for a margin squeeze. A final general problem concerns the failure to consider how a margin squeeze abuse fits with the notion that firms generally have no duty under competition law to deal with rivals (and *a fortiori* no duty to deal on specific terms).

1. The correct imputation test

Which test is, or should be, used to impute a margin squeeze under competition law is not clear from the decisional practice and policy guidance. The telecommunications Access Notice suggests two different tests for a margin squeeze: (1) "*that the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the operating arm of the dominant company*;"[91] (2) "*the margin…is insufficient to allow a reasonably efficient service provider to obtain a normal profit*."[92] In a later Open Network Provision document,[93] however, the Commission stated that the first and second tests amount to the same thing, since it confirmed that it uses the dominant firm's costs as the benchmark for a "*reasonably efficient service provider*:"[94]

> "*The suspicion of a "margin squeeze" arises when the spread between access and retail prices of the incumbent's corresponding access services is not wide enough to reflect <u>the incumbent's own downstream costs</u>. In such a situation, alternative carriers normally complain that their margins are being squeezed because this spread is too narrow for them to compete with the incumbent. […] Provided access and retail services are strictly comparable, <u>a situation of a margin squeeze occurs where the incumbent's price of access combined with its downstream costs are higher than its corresponding retail price</u>*."

The above clarification is also consistent with the Commission's approach in *Deutsche Telekom*, where it relied upon the costs of the dominant firm in imputing a margin squeeze abuse. Nonetheless, it is clear that a number of decisions by NCAs or NRAs applying competition law have focused, at least in part, on whether the margin between the dominant firm's wholesale and retail prices would be insufficient based on downstream customers' costs or those of a "*reasonably efficient service provider*." For example, in rejecting a margin squeeze allegation under competition law, Ofcom has relied in part on the fact that the margin was positive overall taking into account a cost disadvantage faced by downstream rivals that the incumbent did not suffer from.[95] Margin squeeze precedents in France, Italy, and the Netherlands have also taken account of the fact that, for various reasons, downstream rivals have higher costs than the vertically-integrated dominant firm and that some account should be taken of this in the analysis.[96]

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[91] *Supra* note 1, para. 117.

[92] Id. para. 118.

[93] See ONP Committee document 01-17 (2001).

[94] Id., p. 5, (emphasis added).

[95] Case CW/00760/03/04, *Investigation against BT about potential anti-competitive exclusionary behaviour*, Ofcom decision of 12 July 2004.

[96] *Supra*, Section III.B.

There are a number of compelling reasons why reliance on a "*reasonably efficient service provider*" test as the sole test for a margin squeeze under competition law would be wrong (and *mutatis mutandis* for any different test based on rivals' costs):

- First, the only margin squeeze test endorsed by the Community Courts is the dominant firm's costs. As the Court of First Instance held in *Poudres Sphériques*, if the dominant firm's downstream business could trade profitably based on the wholesale prices charged to rivals, "*the fact that the [rival] cannot, seemingly because of its higher processing costs, remain competitive in the sale of the derived product cannot justify characterising [the dominant firm']s pricing policy as abusive*."[97] Thus, under competition law, the important question is whether the rival is as efficient as the dominant company's downstream operations. If it is, and if the dominant company's operations are profitable, the rival should be able to be so. The fact, if it is a fact, that they are both unusually efficient, or that neither is efficient, is irrelevant for this purpose.

- Second, a "*reasonably efficient service provider*" test is not capable of *ex ante* application by a dominant firm. The lawfulness of its prices should not depend on its rivals' costs, which it cannot know, or on a hypothetical entrant. This would be contrary to the general principles of legal certainty and the rule of law: the law must provide a precise test or tests which a dominant company can use without the need for confidential information about its downstream competitors' costs, and before it adopts the pricing policy the lawfulness of which is under consideration.

- Third, a test based on the dominant firm's costs takes into account any relevant advantages or disadvantages arising from its vertical integration. Using the dominant company's downstream profits automatically takes into account its competitive advantages, including any advantages due to vertical integration, and any disadvantages which its rivals may be under. Any other advantages or disadvantages suffered by either the dominant firm or its rivals are irrelevant under competition law.

- Finally, a reasonably efficient competitor test would encourage dominant firms to try to obtain information on their rivals' costs or profits – which would often be illegal.

A "*reasonably efficient service provider*" test might be valid in a regulatory framework. Regulators might find it justified to promote the entry of relatively inefficient operators in the short-term, in the expectation that they will become more efficient in the long run. However, this test makes little sense, on its own, from a competition policy perspective. Under competition law, a dominant firm is not required to price its products to maximize social welfare in the long run. Nor is it required to price artificially high in order to encourage (inefficient) entry into its market so as to increase the competitiveness of that market in the long run. The responsibility of the dominant firm is limited to competing on the merits. Competition on the merits is consistent with the exclusion of less efficient competitors, but is

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97 Id., para. 179.

not compatible with the exclusion of equally efficient rivals. Using the dominant firm's costs as the basis for a margin squeeze test, while imperfect in some respects, is a test of competition on the merits and, therefore, the most relevant test from a competition policy perspective.

At the same time, however, a good case can be made for saying that a competition authority or court should, in order to find a margin squeeze, look at both the dominant firm's costs and those of rivals. In other words, a margin squeeze could only be shown if both tests were satisfied.[98] The reason for insisting on a second test based on downstream rivals' costs is that the mechanical application of a test based only on the dominant firm's costs can lead to incorrect outcomes in practice.

One obvious reason would be where downstream rivals offer products that are differentiated in terms of quality or characteristics to the dominant firm's. In this circumstance, their margins may in fact be very different to the dominant firm's. Where third parties' products are differentiated, they may make adequate profits even in circumstances where the dominant firm's downstream business would notionally make a loss if it had to pay the same wholesale prices as it charges to third parties. Thus, the intuition behind the imputation test based on the dominant firm's cost – that they are a reliable proxy for those of rivals – is likely to be incorrect in many cases. It only tests whether a firm supplying an identical product would be profitable or not.[99]

Another reason why it may make sense to look also at downstream rivals' actual costs is that the basic theory of margin squeeze relies on a simple, linear vertical chain of production, *i.e.*, a single, clearly-identifiable upstream product and a single, clearly-defined downstream product in which the upstream product is a high, fixed proportion of total costs. In many instances, there may not be a simple linear pass through of this kind. For example, downstream rivals may have the option of using a range of different wholesale or intermediate inputs in combination in order to give them a lower overall cost than the dominant firm (who may suffer from technical, regulatory, or legacy constraints that prevent it from using some or all of the same inputs). This applies in particular in the telecommunications sector where options such as local-loop unbundling, cable, and mobile technologies (*e.g.*, WiFi and WiMax) increasingly give non-incumbents a range of lower-cost technical solutions. In markets where there is no simple, linear chain of production a margin squeeze test based only on the cost structure of the dominant firm may therefore give a misleading picture of rivals' costs and competitive constraints.

In conclusion, the mechanical application of a margin squeeze test based only on the dominant firm's costs may result in wrongly imputing a margin squeeze in several cases. This applies in particular where rivals face less elastic demand, have different cost structures, or have additional revenue streams than the vertically integrated firm dominant firm does not.

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98 See Grout, *supra* note 5, at 85.

99 The two-fold test outlined above is more likely to be effective in the context of administrative action than litigation, since details of rivals' costs may be treated as "business secrets" that should not be disclosed to the dominant firm. In the context of litigation, the same safeguards do not generally apply. Disclosing detailed cost information to a dominant upstream input supplier will usually be unattractive for a plaintiff, although it could be argued that a similar problem arises for a dominant defendant accused of a margin squeeze. Certain jurisdictions provide for the deletion of business secrets in public versions of judgments.

In such cases, a margin squeeze could be wrongly found in circumstances where the dominant firm's conduct had no exclusionary motive or effect. An important cross-check therefore in many cases would be to assess whether the notional losses that the dominant firm would incur under an imputation test based on its costs would also lead rivals to make a loss based on their *actual* costs.

2. The effect of a duty not to margin squeeze on efficient vertical integration

A more fundamental issue raised by a dominant firm's duty not to engage in a margin squeeze abuse against downstream rivals concerns the effect of such a duty on efficient forms of vertical integration. At its most basic, a margin squeeze requires a vertically-integrated firm to set input and final product prices at a level at which a non-integrated rival can make an adequate profit. Unless the dominant firm is actually discriminating between the prices charged to its downstream business and rivals, the duty not to margin squeeze effectively requires the dominant firm to create a unique set of prices at which non-integrated downstream rivals can survive. And this duty applies even if the dominant firm is not actually losing money overall.

In many cases, the dominant firm may be required to offer third parties a combination of prices that are not efficient in the context of its own vertical integration. A simple numerical illustration by Professor Grout has shown how a strict margin squeeze test can have the perverse effect of raising prices for consumers on the downstream market.[100] He summarises the qualitative reasons for this perverse result of a margin squeeze test as follows:[101]

> "*The presence of fixed costs in the upstream market and different consumer preferences (i.e., elasticities) over the final products can lead to different (yet efficient) prices in the retail market for products even though they have similar end to end costs. However, a requirement that competitors should be able to purchase the input at a price that allows them to compete in the retail market (i.e., a price squeeze test) in conjunction with similar retail costs does not allow the products to have different prices. This raises the price for the cheaper product and hence reduces its demand. As a result this product contributes less to the common cost, which implies that the other product has to contribute more, raising prices even further. That is, the application of a price squeeze test has had pernicious effects on the market.*"

Applying a margin squeeze test in a manner that produces inefficient outcomes on a downstream market (*i.e.*, higher prices, lower output, and sub-optimal common fixed-cost recovery) would violate a cardinal principle of competition law – that competitors should only be protected to the extent that it enhances consumer welfare.[102] While subsidising inefficient entry in the short-term on the basis that the entrant would become more efficient

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100 Grout, *supra* note 5 at p. 81.

101 Id.

102 In *Bronner*, Advocate General Jacobs confirmed this when he stated that "*the primary purpose of Article 8[2] is to prevent distortion of competition - and in particular to safeguard the interests of consumers - rather than to protect the position of particular competitors*." See Case C-7/97 *Oscar Bronner GmbH & Co. KG v. Mediaprint Zeitungs-und Zeitschriftenverlag GmbH & Co. KG and others* (hereafter "*Bronner*") [1998] ECR I-7791, Opinion, para. 58

over time may be a legitimate objective under regulatory policy, no such mandate exists under competition law.

That a margin squeeze test can lead to inefficient outcomes on retail markets also raises another fundamental issue regarding the legal test. Because the failure to pass a margin squeeze test may just as easily reflect non-exclusionary reasons, proof of a margin squeeze abuse should also require evidence that the dominant firm has a rational, credible strategy to unlawfully exclude downstream rivals. Absent such evidence, the failure to pass an imputation test may simply be the result of an efficient combination of prices by a vertically-integrated dominant firm, *i.e.*, non-exclusionary reasons. An exclusionary object test would therefore serve as a useful screen to help ensure that competitively-benign practices were not wrongly found to be abusive.

The potential adverse effects of a strict margin squeeze rule on efficiency is closely related to the issue of whether, for a margin squeeze to be illegal, it is also necessary to prove that there was a legal duty to contract in the first place, *i.e.*, the "essential facilities" doctrine and analogous issues.[103] Specifically, there is a reasonable argument that a margin squeeze can be illegal only if exclusionary behaviour monopolising the downstream activities would be contrary to Article 82 EC (or equivalent provisions of national law). In simple terms, if there is no duty to deal at all under competition law, a dominant firm cannot be criticised for dealing on terms that would render non-integrated rivals unprofitable on a downstream market.

The relationship between essential facilities principles and a margin squeeze abuse raises complex issues that go to the heart of the efficiency objectives of competition law and policy. The issue is rendered more difficult by the fact that the status of the essential facilities doctrine is not clear, either under US antitrust law[104] – where the doctrine was first developed – or EC competition law.[105] Margin squeeze case law that has considered the issue is also unsatisfactory in many respects. In *BSkyB* the OFT appeared to suggest that there could be a

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103 Copious amounts have been written on this topic. Among the better articles are R. Subiotto "The Right to Deal with Whom One Pleases under EEC Competition Law: A Small Contribution to a Necessary Debate," (1992) 6 *European Competition Law Review* 234; K. L. Glazer and A. B. Lipsky, Jr., "Unilateral Refusals to Deal Under Section 2 of the Sherman Act," (1995) 63 *Antitrust Law Journal* 749; J. Temple Lang, "The Principle of Essential Facilities in European Community Competition Law – The Position Since Bronner," (2000) 1 *J. of Network Industries* 375; J. Temple Lang, "Defining Legitimate Competition: Companies' Duties to Supply Competitors, and Access to Essential Facilities," 1994 *Fordham Corporate Law Institute* 245; and J. Venit and J. Kallaugher, "Essential Facilities: A Comparative Law Approach," 1994 *Fordham Corporate Law Institute* 315.

104 In *Trinko*, the US Supreme Court cast serious doubt on future reliance on the "essential facilities" doctrine by stating that it had only been applied by lower courts and had never been recognised by the Supreme Court itself. The Court also cited, with approval, a seminal article strongly criticising the general application of the doctrine (P. Areeda, "Essential Facilities: An Epithet in Need of Limiting Principles", (1989) 58, *Antitrust Law Journal*, 841). See *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, LLP 540 U.S., 2, 682, (2004).

105 The recent Court of Justice judgment in Case C-418/01 *IMS Health GmbH & Co. OHG v. NDC Health GmbH & Co. KG* (judgment of April 29, 2004, not yet reported), while recognising the existence of an exceptional duty to deal, left open a number of important interpretative issues regarding its application (e.g., the degree to which the requesting party's product needs to be new in order to justify such a duty, the nature of vertical integration in essential facilities cases, and whether customer preferences are relevant to assessing the "indispensability" of an input).

margin squeeze even if there was no duty to contract,[106] but still concluded that there were not sufficient grounds for a finding of abuse. This conclusion appears to have been based on a distinction made in the case law between the duties to deal with new customers (*i.e.*, essential facilities) and existing customers (*i.e.*, voluntary dealing).[107] Case law suggests that a dominant firm's duties in respect of third parties with whom it is already dealing are stricter than those in situations in which it has never previously supplied a third party. To the extent that such a distinction can be made on the basis of the case law, however, it is intellectually unsatisfactory. A prior course of dealings may offer a useful indication that an obligation to deal is reasonable and workable, but this does not answer the fundamental question of why there can be a duty, under a margin squeeze abuse, to deal on specific terms unless there is also a basic obligation to deal in the first place. The fact that the dominant firm is already dealing with a third party is more likely to reflect happenstance and does not provide a satisfactory basis for saying that stricter legal duties apply.

The relationship between the duty to deal under competition law and margin squeeze also arose in *Genzyme*, but the CAT largely avoided dealing with the issue by finding that Genzyme had not in fact refused to deal.[108] This was true, though largely irrelevant. The issue in the case was said to be unlawful bundling and a margin squeeze. Genzyme was found to have committed an abuse by supplying a package comprising its near-monopoly medicine (Cerezyme) and a service for home administration of that drug at the same price as it charged stand-alone providers of home administration services for the drug.

In reality, however, the case should have been characterised as a refusal to deal issue (which the OFT had done in its interim decision in the case). Genzyme had developed Cerezyme at considerable expense as an "orphan drug," *i.e.*, a medicine that treats rare, but generally fatal, diseases affecting a tiny proportion of the population. Orphan drugs benefit from a unique set of extended patent protection laws under Community legislation since, otherwise, no rational firm would invest in research and development of medicines with such a small consumer base. The extent to which there was a meaningful relevant downstream market for the home delivery of Cerezyme seemed very questionable. The key input was clearly the Cerezyme product and this accounted for the vast proportion of the packaged price to the National Health Service. The value-added aspect of the home delivery service seemed minimal in the overall context: home delivery of Cerezyme was a "market" that was effectively created by Genzyme's discovery of Cerezyme.

It is also difficult to see how forcing Genzyme to reduce the price at which it supplied Cerezyme to third parties active only in Cerezyme home delivery services would have created more competition than it discouraged. Genzyme's incentives to produce Cerezyme were already weak, since they required extended patent protection under Community orphan drug legislation. Requiring Genzyme to effectively subsidise companies who chose only to

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106 *BSkyB*, id., paras. 352-353.

107 See R. Subiotto and R. O'Donoghue, "Defining the scope of dominant firms to deal with existing customers under Article 82 EC," [2003] *European Competition Law Review*, 683-694. While agreeing that such a distinction could be made on one reading of the case law, the authors go on to argue that the distinction is unwarranted and that the case law should be assimilated under a single doctrine of essential facilities.

108 *Genzyme*, id., para. 567.

offer home delivery services for Cerezyme risked adversely affecting those incentives, with little real gain for consumers in the form of lower prices. One obvious strategy for Genzyme would have been to withdraw from the downstream market and simply charge a higher, but non-exploitative, price for Cerezyme. Genzyme could also have withdrawn from the downstream market and continued to charge different prices to the National Health Service and home delivery service providers, *i.e*, a two-part tariff. (The non-discrimination clause in Article 82(c) EC would arguably not have applied in this instance, since the National Health Service and home providers were not in competition with one another.)

To justify imposing a legal duty to contract, there must be pro-competitive benefits for consumers in the downstream market that outweigh the costs and risks involved for the dominant firm in developing the essential input.[109] This is not merely because of the transaction costs of imposing such a duty, although these may be considerable.[110] It is also because, as explained by Advocate General Jacobs in *Bronner*, it is normally pro-competitive to allow a dominant company to keep for its own use assets which it has legitimately acquired or developed.[111]

There are a number of counterarguments against limiting the margin squeeze doctrine to cases in which the upstream input is also an essential facility. A pragmatic, but unsatisfactory, argument is that a dominant firm cannot have it both ways. Either it decides to deal or it does not: if it does, it is subject to all rules of Article 82 EC concerning exploitative and exclusionary pricing; if it does not, only the rules of Article 82 EC on a duty to deal are relevant. A more satisfactory explanation is that the rule that a dominant company may not discriminate in favour of its own downstream operations (Article 82(c) EC) is clearly not limited to essential facility cases; the price might still be excessive under Article 82(a) EC, and a vertically integrated dominant company should not be allowed to foreclose

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109 See J. Temple Lang, supra note 103 at 379-380. See also P. Areeda, supra note 104, at 852 ("[N]o one should be forced to deal unless doing so is likely substantially to improve competition in the marketplace by reducing price or by increasing output or innovation. Such an improvement is unlikely…when the plaintiff merely substitutes itself for the monopolist or shares the monopolist's gains."). The need to balance *ex ante* effects on investment incentives and *ex post* benefits to competition of forced sharing was made clear recently in *Microsoft* (Case COMP/C-3/37.792, decision of March 21, 2004)**,** para 783 ("*A detailed examination of the scope of the disclosure at stake leads to the conclusion that, on balance, the possible negative impact of an order to supply on Microsoft's incentives to innovate its outweighed by its positive impact on the level of innovation of the whole industry (including Microsoft). As such the need to protect Microsoft's incentives to innovate cannot constitute an objective justification that would offset the exceptional circumstances identified.*").

110 See G. Werder, "The Law and Economics of the Essential Facility Doctrine," 32 *Saint Louis University L. Journal*, 433, at 462-463.

111 *Bronner*, Advocate General Jacob's Opinion, para. 58 ("*[The]…justification in terms of competition policy for interfering with a dominant undertaking's freedom to contract often requires a careful balancing of conflicting considerations. In the long term it is generally pro-competitive and in the interest of consumers to allow a company to retain for its own use facilities which it has developed for the purpose of its business. For example, if access to a production, purchasing or distribution facility were allowed too easily there would be no incentive for a competitor to develop competing facilities. Thus while competition was increased in the short term it would be reduced in the long term. Moreover, the incentive for a dominant undertaking to invest in efficient facilities would be reduced if its competitors were, upon request, able to share the benefits. Thus the mere fact that by retaining a facility for its own use a dominant undertaking retains an advantage over a competitor cannot justify requiring access to it.*").

its downstream competitors (contrary to Article 82(b) EC) and to overcharge them at the same time.

At a minimum, consideration of a margin squeeze abuse under competition law must take account of some of the well-known pitfalls of applying a duty to deal in the first place. The key considerations are that: (1) adding more competitors does not necessarily improve competition, in particular if two or more firms simply share the monopoly profits; (2) there must be scope for meaningful added-value competition on the downstream market before a duty to deal (or to deal on specific terms) can be imposed; and (3) any duty to deal should encourage more competition than it discourages, *i.e.*, the *ex post* benefits of a duty to deal to consumers must outweigh any harm to firms' *ex ante* incentives to develop products. In view of the complexity of margin squeeze cases, there is also some pragmatic appeal to limiting them to situations akin to essential facilities, *i.e.*, where the dominant firm has a "*genuine stranglehold*" on the market.[112] Otherwise, the risk of falsely imputing a margin squeeze where there is none, or where it would be inefficient to do so, are relatively high.

3. Margin squeezes abuses in the case of new products and emerging markets

Margin squeeze issues in the telecommunications sector frequently arise in the context of new products and markets where retail operators rely on access to the incumbent's upstream infrastructure. Identifying abusive conduct in such markets presents great difficulties for NCAs, NRAs, and courts. Several difficulties arise:

- First, as noted above, the practical application of a margin squeeze test is already complex in the context of mature, stable markets. Put simply, the stylised, simplistic assumptions applied under the margin squeeze test frequently do not work in practice (product differentiation, efficient vertical integration *etc*.) These practical complexities are much greater in markets that are not in a steady state in their early stages and exhibit dynamic changes over time.[113] The pace of technological change also makes it perilous for NCAs, NRAs, and courts to adopt decisions based on a static snapshot of the market at any given stage.

- Second, start-up losses are common in the case of markets in which dynamic linkages (or efficiencies) can be achieved over time. Markets with these characteristics usually require large, up-front risky investments and involve start-up losses in order to increase consumer uptake and thereby acquire the scale or experience needed to reduce costs over time. These markets are not only more likely than other markets to exhibit below-cost pricing for a period, but are also more likely to have a non-exclusionary reason for doing so.[114] Dynamic linkages can lead to recovery of initial losses by creating cost

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112 *Bronner*, Advocate General Jacob's Opinion, id., para. 64.

113 The OFT noted this problem in *BSkyB*, id., para. 344 ("*The practical application of a test for margin squeeze may be complex. Precedents have not related to multi-product, high technology, expanding distribution businesses with different revenues and costs that are not in a steady state*.").

114 See *Wanadoo*, Case COMP/38.233, Commission decision of July 13, 2003 (not yet published), paras. 260-261 (Commission made allowance for features of launching a new product) and para. 264 (recognition that a more "nuanced" approach to prices below average variable in growing markets).

savings over time as a company achieves more efficient scale, greater learning experience, or some other efficiency capable of reducing costs. Examples of legitimate means of reducing costs over time include economies of scale,[115] market education,[116] and learning by doing.[117]

- Third, assessing whether in fact the dominant firm is pricing below cost in the case of inevitable start-up losses requires certain adjustments for cost amortisation over the lifetime of the relevant business plan and asset and use depreciation. If costs were only assessed at the initial stage, they could suggest loss-making whereas, over time, the product may in fact be profitable, or less loss-making than originally thought.[118]

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115 Scale economies exist when the average total cost declines as output increases over a range of output. If average total cost declines as output increases, so must the marginal cost. The reason is usually that average total cost initially declines because fixed costs are being spread over increasing output and then eventually increase as variable costs increase. The minimum efficient scale is the minimum level on the average cost curve. It may therefore be rational to have low initial prices in order to gain volume and reach minimum efficient scale more quickly.

116 Economies of scale are not limited to manufacturing, but can arise in marketing and other functions. When offering a new product, a company often has a difficult task convincing potential customers to buy it and must achieve awareness, in particular for technology products with new uses. Once the product has achieved a certain level of awareness, marketing expenditure can be reduced because company eventually benefits from "cost-free" advertising due to the impact of "word of mouth." Early adopters play a critical role in enhancing the awareness for a product, which is why companies are particularly keen on attracting this type of subscriber through promotional efforts. Winning early adopters is often costly, since a company has to spend on marketing in order to get an estimate of customers' characteristics. For these reasons, the business might not be profitable at the early phase of the adoption process. *See* E.M. Rogers, *Diffusion Of Innovations* (5th edition), New York: The Free Press (2003).

117 It is well-established that suppliers become better and more cost-efficient as the installed base increases. At the heart of the learning by doing theory lies the observation that an individuals' performance at a task improves with experience. At the beginning, the optimal processes have yet to be found and the tasks to fulfill need to be learned. The effectiveness increases as the cumulated output increases. At an early stage of the life cycle of a product, the supplier may not be able to effectively compete on the product market or serve the whole market at a price that covers costs. Therefore, it might be profitable and efficient to set low prices and forego profits in the short run in order to "run down" the learning curve faster, ultimately being able to offer services more cost-efficient and at better quality from an earlier point of time on. *See*, e.g., T. Wright, "Factors Affecting the Cost of Airplanes", (1936) 4 *Journal of Aeronautical Science*, 122; K. Arrow, "The Economic Implications of Learning by Doing", (1962) 29 *Review of Economic Studies*, 155.

118 The technical calculation of loss-making in the context of inevitable start-up losses raises complex issues that fall outside the scope of this paper. Briefly, however, three basic approaches may be applied, often in parallel. *First*, it may be possible to exclude part of the start-up period from the calculation of costs. In *Wanadoo*, the Commission excluded from the assessment of losses a period of fourteen months in which residential broadband internet services has been made available by the dominant firm in France on the basis that "the high-speed internet market ha[d] not developed sufficiently for a test of predation to be significant" (*Wanadoo*, supra note 112, para. 71). *Second*, it may be appropriate to adjust the relevant measure of cost by spreading costs over a period of time in line with the principle of the depreciation of assets. This is "*based on the consideration that it is not the firm's objective to produce an instantaneous profit*" and that, instead the firm will seek to achieve "*return on its investment within a reasonable time*." (*Wanadoo*, supra note 112, para. 76). This suggests that there may be a legitimate, non-exclusionary explanation for low initial prices, since "*it may be that prices will not cover its costs in the first few years of business, without driving off the*

- Finally, even if the dominant firm could be said to be selling at a loss for a certain period, or pricing at a level at which equally-efficient rivals would not be profitable, NCAs, NRAs, and courts must still devise useful legal tests for distinguishing between legitimate start-up losses from those based on exclusionary considerations.

The final issue above raises some of the most complex issues in margin squeeze cases. The Commission, NCAs, and NRAs accept in principle that there may be a legitimate (*i.e.*, non-exclusionary) justification for initial low prices, including by a dominant firm, but have struggled to devise useful legal rules that distinguish situations of legitimate pricing from those involving unlawful pricing. The first practical difficulty is that there may be an evidential problem in that, often, the only evidence of the rationale for start-up losses is the company's business plan. Unless the business plan contains express evidence of anti-competitive purpose, there would be severe practical problems in inferring such purpose from an assessment of the reasonableness or plausibility of the plan. In growing dynamic markets, it is very difficult to say with confidence whether assumptions about the level of competition reflect exclusionary behaviour or merely depend on reasonable assumptions about the evolution of the market.[119]

Another problem is that theories of anti-competitive harm (or lack thereof) based on future market conditions are by nature speculative. There is significant scope for divergence between business plans and actual market outcomes. Businesses may fail or may apply overly-conservative or optimistic assessments or may simply get it wrong. The more risky the investment, the greater the scope for failure and, therefore, for assumptions in business plans that, *ex post*, turn out to be wrong. The decision to enter a particular market or to introduce a new pricing strategy is itself based on *ex ante* forecasts and takes place in a world of uncertainty. A business plan therefore represents, at best, a reasonable assessment by the company concerned of its options at a given time based on the information available to it. In any given scenario, companies may choose a range of different options *ex ante*, without any one of these options being unreasonable or implausible. Companies would often have chosen a different option *ex post*.

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market competitors with less financial stamina who are likewise investing with a view to reasonable profitability" (*Wanadoo*, supra note 112). The appropriate period will depend on the "economic equilibrium" of the product in question; in other words, the period in which it is usual in the industry in question to recover non-recurrent entry costs. In *Wanadoo* the Commission used a period of four years over which to spread the costs of acquiring broadband internet customers, despite the fact that customer subscriptions tied the customer to the service for a period of only one year. *Finally*, standard techniques used to measure cash flow over time in the context of investment-making decisions can be applied. This involves evaluating the cost/benefit of tying up capital in a project – the opportunity cost of capital. The most commonly-used method is discounted cash flow (DCF), which may be forward-looking or historical: See *BSkyB*, supra note 78. The DCF approach suffers from an optical flaw: it may show positive returns over time, but it does not distinguish between situations in which positive margins are due to legitimate pricing and situations in which the only reason for the profits is the exclusion of competitors.

119 As Professor Baumol notes, there is "no generally effective way" of determining whether a pricing decision is a legitimate business practice or an unlawful one. This is effectively impossible if the issue is said to turn on the probabilities of forecasts of future profits in a developing market. *See* W. Baumol, "Principles Relevant to Predatory Pricing", in *The Pros and Cons of Low Prices*, Swedish Competition Authority (2003), at p.25.

The need to allow for the possibility that some businesses fail has been recognised by NCAs and NRAs. For example, in *British Telecom/UK-SPN*,[120] Oftel rejected margin squeeze allegations despite evidence of losses by BT for a new service on the basis that: (1) on BT's original forecast volumes the UK-SPN service would have been a profitable service in aggregate and those call-types forecast to be below cost would be insignificantly so relative to price; (2) on actual and revised forecast volumes carried by the UK-SPN network, prices were unlikely to cover the relevant cost floor for any call-type; (3) however, BT's original business case was not implausible and, after several months, BT took the decision to close the business; (4) there was no evidence to demonstrate that the UK-SPN service had a material adverse effect on competition; and (5) there was also insufficient evidence that BT intended to pursue an anti-competitive strategy: the available evidence suggested a new business that was unsuccessful in meeting forecast demand rather than a deliberate or negligent anti-competitive strategy.

Allied to the above problems is the fact that there are no clear economic or financial tests to distinguish cases of legitimate start-up losses from those of illegality. In developing a useful legal principle for assessing start-up losses in industries with dynamic linkages, one cardinal principle should be borne in mind: start-up losses should only be condemned where there is convincing evidence of an exclusionary strategy. This results from two considerations. In the first place, there is a high social cost of (wrongly) hampering or preventing product launches that involve legitimate start-up losses. A second consideration is that assumptions as to future recovery of start-up losses are by definition matters of forward-looking assessment rather than fact. A firm should therefore be afforded some margin of appreciation in making such assessments, in much the same way as competition authorities have discretion in making complex future economic assessments in mergers and other cases.

Only two types of evidence arguably constitute an appropriate legal test in the case of start-up losses in dynamic markets. In the first place, there may be evidence of express exclusionary intent on the part of the dominant firm. This was the interpretation applied by the Commission in *Wanadoo*, where there were not merely start-up losses necessary to enter the market, but an express plan of incurring whatever losses were necessary as part of a richly-documented "plan to pre-empt the market."[121] The Commission's strong reliance in *Wanadoo* on extensive documentary evidence of exclusionary intent, probable recoupment, and actual or likely exclusionary effects suggests that a high evidentiary threshold applies before start-up losses can be found predatory.

Alternatively, in the absence of express evidence of intent, evidence of anti-competitive object could be inferred from a number of "convergent factors" that, taken together, clearly demonstrate anti-competitive purpose rather than legitimate start-up losses.[122] Thus, there must be convincing evidence that no reasonable company in possession of the information

120 See *British Telecom UK SPN,* Oftel decision of 23 May 2003, para. 54.

121 See *Wanadoo Decision*, supra note 112, heading preceding para. 256. *See also Deutsche Telekom* (*supra* note 71), where the Commission interpreted the application of the *AKZO* rules to a margin squeeze test in a new market (broadband internet access) as requiring both below-cost selling and evidence that prices "are set as part of a plan aimed at eliminating a competitor" (para 179).

122 See Case C-62/86 *AKZO Chemie v Commission* [1991] ECR I-3359, para. 80; *Wanadoo*, supra note 112, para. 271. *See also* Philip Lowe, "EU Competition Practice on Predatory Pricing", at the seminar Pros and Cons of Low Prices, Stockholm, 5 December 2003.

available to the dominant firm at the time it formulated its business plan would have adopted the same course of action. This evidence would need to be similar in quality to express evidence of anti-competitive intent, since, otherwise, the latter would be treated comparatively more leniently than the former, which would not make sense. In other words, there must be evidence that the business plan or projections are "unjustified or implausible;"[123] in effect, a sham. In such cases, any future recovery of losses envisaged in the business plan is premised on the additional market power that the low exclusionary prices would confer rather than legitimate efficiencies.

4. The need for anti-competitive effects in a margin squeeze case

Whether proof of actual or likely exclusionary effects is necessary as a matter of law in pricing abuse cases is unclear. The decisional practice and case law is something of a mess. On the one hand, several cases indicate that there must be a concrete assessment of the effects of a practice on the market before a finding of material adverse effect can be made.[124] This is consistent with the fact that there are no *per* se Article 82 EC violations; practices that are abusive in some circumstances may be efficient and pro-competitive in others. It is also consistent with the notion that the hallmark of abusive conduct is that it has the effect of foreclosing competitors to the detriment of consumers (*i.e.*, of restricting competition), which means that it is necessary to examine the effects of the challenged practices.

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123 See OFT Guideline 417 (February 2000), para. 7.23 ("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.").

124 For example, in *BPB Industries*, the Court of First Instance held that promotional payments made by a dominant supplier to a customer in return for an exclusive purchasing commitment are "*a standard practice forming part of commercial cooperation between a supplier and its distributors*" that "*cannot, as a matter of principle, be prohibited*," but rather must be assessed in the light of their effects on the market in the specific circumstances. See *BPB Industries and British Gypsum v. Commission*, Case T-65/89, 1993 ECR II-389, paras. 65 and 66. More recently, in *Van den Bergh Foods Ltd*, the Court of First Instance examined the effects of exclusive contracts on the market in detail before concluding that they gave rise to material foreclosure under Article 82 EC. The Court held that contracts by which a dominant ice-cream firm insists that the refrigerators it provides to customers should be used exclusively for the dominant firm's products were abusive. This conclusion was based on a detailed examination of several facts as evidence that the exclusivity clauses had a foreclosure effect. See Case T-65/98, *Van den Bergh Foods Ltd v Commission*, [2003] ECR II-0000. The Commission has also routinely examined actual market effects in other abuse cases. *See ECS/AKZO* [1985] O.J. L374/1 at para. 86 (concluding after analysis of potential reaction from other competitors "*that the elimination of ECS from the organic peroxides market would have had a substantial effect upon competition notwithstanding its still minor market share and the existence of other suppliers*"); *Deutsche Post A.G.* [2001] O.J. L125/27 at paras. 36-37 (finding that below cost pricing where there is no prospect of price rise inhibited growth of more efficient rivals (para. 36) with identifiable welfare loss (para. 37). *See also* Case T-83/91 *Tetra Pak International SA v Commission* [1994] ECR II-755, where the Court of First Instance noted that the Commission's analysis that Tetra Pak's prices were below cost was "*corroborated by the eliminatory effect of the competition engendered by Tetra Pak's pricing policy*," including "*the increase of sales of Tetra Rex cartons in Italy and the corresponding reduction in the growth of sales of Elopak cartons, during a period of market expansion, followed by their decline as from 1981*" (para. 151).

On the other hand, in *Michelin II*, the Court of First Instance indicated that anti-competitive object or potential restrictive effects are sufficient to prove an abuse.[125] The Court rejected Michelin's argument that, as its market share and general price levels had fallen during the period of the practices in question, the Commission had failed to prove that the alleged abuses had in fact reinforced its dominant position or restricted competition. According to the Court, in order to fall under Article 82 EC, it is sufficient that a dominant undertaking's behaviour is liable to restrict competition or by its very nature did so.[126] Thus, where it is established that a dominant undertaking's behaviour has the object of restricting competition, such behaviour potentially has a restrictive effect: it is unnecessary to prove that there was an actual or concrete effect.[127] In support of this proposition, the Court cited the principles established in the *AKZO* case, where prices below average variable cost were presumed unlawful without the need to examine their market effect.[128]

The contradictions in the decisional practice and case law on the issue of effects have also spilled over into the area of margin squeeze. In *Deutsche Telekom*, the Commission stated that, once a margin squeeze was shown, it was not necessary to assess any effects on competition: such effects were presumed from the mere existence of a margin squeeze.[129] However, the Commission nonetheless undertook a detailed analysis of likely exclusionary effects.[130] The Commission noted Deutsche Telekom's 90% share of the affected market and competitors' falling share of analogue connections.[131] The same approach was adopted in *France Télécom/SFR Cegetel/Bouygues Télécom*. The Conseil de la Concurrence stated that, under *Deutsche Telekom*, once margin squeeze is established, it is not necessary to evaluate its actual impact on competition.[132] However, it still examined the actual scope of the margin squeeze's anticompetitive effects, particularly with respect to Cegetel. Finally, a number of

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125 Case T-203/01, *Michelin* v. *Commission* (hereinafter "*Michelin II judgment*") [2003], not yet reported.

126 *Michelin II judgment,* id., para. 239.

127 *Michelin II judgment,* id., para. 241.

128 *ECS/AKZO*, (1983 OJ L 252/20); Case C-62/86 *AKZO v Commission*, [1991] ECR I-3359. In *BA/Virgin*, the Court of First Instance adopted essentially the same reasoning as in *Michelin II*. The Court held that that it is sufficient for an abuse that the conduct "tends to restrict competition" or "*in other words… is capable of having, or likely to have, such an effect*." (Case T-219/99 *British Airways plc v Commission*, (hereinafter "*BA/Virgin judgment*") [2003] ECR II-0000, para. 293) The Court added that "*where an undertaking in a dominant position actually puts into operation a practice generating the effect of ousting its competitors, the fact that the hoped-for result is not achieved is not sufficient to prevent a finding of abuse*" (*BA/Virgin judgment*, para. 295). As in *Michelin II*, the Court disregarded the decline in BA's share of sales and a corresponding increase in competitors' sales in favour of an assumption that competitors would have done better in the absence of BA's unlawful practices. The case is currently on appeal to the Court of Justice on this and other issues.

129 *Deutsche Telekom*, *supra* note 71, paras. 179-180.

130 *Deutsche Telekom*, id., paras. 181-183.

131 Id.

132 *France Télécom/SFR Cegetel/Bouygues Télécom*, *supra* note 86, para 242.

national decisions have rejected margin squeeze allegations based, *inter alia*, on the lack of actual or probable anti-competitive effects.[133]

The current state of the law on this issue is highly unsatisfactory. The following comments are offered by way of clarification. In the first place, ignoring the issue of actual or likely effect adverse effects in favour of presumptions of law is out of kilter with the Commission's current emphasis on an economics-based approach. Recent major Commission decisions on abuse of dominance have undertaken a detailed analysis of the effects of the conduct at issue. Most notably, in *Wanadoo*, the Commission undertook an extremely detailed recoupment and effects analysis,[134] despite the fact that Wanadoo's prices were found to be below average variable cost – which had been considered as presumptively unlawful under the *AKZO* case law – and there was a range of evidence of an express exclusionary plan. The Commission relied on the fact that: (1) Wanadoo's market share rose by nearly 30% during the period of the infringement; (2) Wanadoo's main competitor at the time had seen its market share tumble; and (3) one competitor (Mangoosta) even went out of business. If such an analysis is undertaken for the practice under Article 82 EC that is generally considered to be closest to a *per se* abuse (pricing below average variable cost), the same *a fortiori* applies for other (less serious) forms of pricing practices.[135]

Second, it should be recalled that abuse of dominance cases involve situations in which the defendant is already in a dominant position, *i.e.*, the conduct at issue will generally have lasted for a period of time. In this circumstance, it should be possible to consider whether the market is consistent with a case of possible exclusion or exhibits characteristics more consistent with a competitive environment. While difficulties of observational equivalence and comparing counterfactual situations may arise, evidence of new entry, lack of market exit, stable or growing market shares among rivals, and falling prices during the period of the alleged abusive conduct must carry some weight.

One interesting contrast in this regard was the different conclusions reached by the US courts and EU authorities in respect of Virgin Airways' complaint against British Airways' incentive schemes. The Commission assumed that competitors were harmed by BA's loyalty rebates despite evidence that their market share had *increased* during the relevant period and BA's had decreased by 10% during the period of the infringement.[136] Similar facts were presented to the US courts in Virgin's lawsuit against BA and the Second Circuit concluded

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[133] See *e.g.*, Case CW/00615/05/03, *Suspected margin squeeze by Vodafone, O2, Orange and T-Mobile*, Ofcom decision of May 21, 2004; and *Investigation by the Director General of Telecommunications into alleged anticompetitive practices by British Telecommunications plc in relation to BTOpenworld's consumer broadband products*, Oftel decision of November 20, 2003.

[134] See *Wanadoo Decision*, supra note 112, paras. 332 et seq. (recoupment) and paras. 369 et seq. (effects on competition).

[135] See also *Microsoft*, *supra* note 107, paras. 693 et seq. (effect of Microsoft's refusal to deal on technical development and consumers analysed in detail) and paras. 879 et seq. (detailed analysis of likely adverse effects of Microsoft's conduct on content providers and software developers).

[136] ("*Despite the exclusionary commission schemes, competitors of BA have been able to gain market share from BA since the liberalisation of the United Kingdom air transport markets. This cannot indicate that these schemes have had no effect. <u>It can only be assumed that competitors would have had more success in the absence of these abusive commission schemes</u>.*" *BA/Virgin judgment*, *supra* note 128, paras. 105-106 (Emphasis added)).

that no adverse competitive effect was made out. The Second Circuit held that business practices presumptively should not be viewed as anti-competitive when "*the practices have been on-going for several years and rivals have managed to profit, new entry has occurred, and their aggregate market shares are stable*."[137]

Third, statements by the Commission and Court of First Instance in *BA/Virgin* and *Michelin II* that *prima facie* evidence of *lack of adverse effect* can be ignored in favour of a presumption of law are unhelpful. There is no effective counter thesis to this assumption: it can *always* be assumed that practices had an adverse effect on competitors if evidence of lack of effect is disregarded in favour of such an assumption. This reasoning is also circular and inconclusive. It is circular because the conduct is said to be unlawful <u>only</u> because it ousts competitors, but if that is the reason, it cannot then be said that one does not need to look to see if it had that effect. It is inconclusive because legitimate competition can also result in competitors' exit (*i.e.*, the observational equivalence problem). If a practice would be illegal because it caused foreclosure and so had anti-competitive effects, it cannot be shown to have those effects by merely stating that it is illegal. Even in a case where the practices in question had no effect on competition, an abuse could be found by relying on a presumption of law.

Finally, in addition to the general arguments outlined above, there are compelling reasons why, in a margin squeeze case, an analysis of actual or likely anti-competitive effects is necessary. As noted above, the legal test for a margin squeeze is based on stylised assumptions that are often inapplicable, or require significant modification, in practice. In particular, the legal test only works well where downstream rivals supply homogenous goods or services, the upstream input represents a high, fixed proportion of downstream rivals' costs, and there is a simple, linear pass through of costs from the upstream level to the downstream market. Testing for actual or likely anti-competitive effects therefore helps minimise the welfare costs of wrongly finding an abuse due to the mere failure of a price to pass an imputation test.

5. The need for downstream dominance in margin squeeze cases

A final vexed issue in margin squeeze cases is whether downstream dominance is a requirement for an abuse. Certainly, a number of compelling arguments suggest that it is, or should be. First, a margin squeeze abuse is in effect a form of predatory pricing that arises in the context of vertical integration. Given that dominance in the market in which foreclosure effects are alleged is a requirement in a pure predatory pricing case, proof of a margin squeeze abuse would also seem to require downstream dominance. Indeed, it would be curious and anomalous if a margin squeeze abuse was in practice much easier to prove than pure predation. Second, downstream dominance also seems inherent in the basic notion of a margin squeeze – that a firm controls the prices on two vertically-related markets and can therefore squeeze the margin between those two prices. If a firm only has market power in relation to prices on one of the markets concerned, it is difficult to see how a margin squeeze could arise. Finally, it is notable that cases in which a margin squeeze abuse has been found have generally involved dominance on both the upstream and downstream markets (*e.g.*, *National Carbonising*, *Deutsche Telekom*). By the same token, cases in which margin squeeze allegations have been rejected have generally involved dominance on the upstream market only (*e.g.*, *BT Broadband* (Oftel 2003)).

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137 *Virgin Atlantic Airways v. British Airways*, 257 F.3d 256 (2d Cir. 2001), citing IIIA Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 807f (1996)).

On the other hand, it is well established under Article 82 EC that dominance and abuse may occur on different markets, in particular where there are "associative links" between the two markets that allow a firm to unlawfully extend its power from one market to the other, *i.e.*, leveraging.[138] Case law has also reasoned that a dominant supplier of an essential input for rivals on a downstream market has a credible threat to exclude such competitors on the downstream market, without it being necessary to formally find that the firm is also dominant on the downstream market.[139] In other words, a margin squeeze abuse does not involve the use of power on the downstream market to exclude rivals, but implies the use of control over an essential upstream input to *gain* market power on the downstream market by excluding competitors.

Whatever the merits of the respective arguments, it is important that a plaintiff or competition authority should be required to substantiate a credible case of foreclosure in circumstances where the firm is not dominant on the downstream market. Foreclosure concerns can only arise on the downstream market and these concerns are necessarily less pronounced where the market is competitive and no single firm, or group of firms, is dominant. This foreclosure analysis should be similar in scope to the recoupment inquiry under predatory pricing. Thus, it should be analysed whether: (1) there are technological changes at the upstream or downstream level that would allow rivals to base their offerings on alternative inputs; (2) rivals are likely to exit the market if a margin squeeze persists; (3) there will entry by more competitive or more determined rivals in future, and that when the dominant company increases its price, it will not attract new entry; and (4) absent new entry, the price elasticity of the product was such that, although buyers were accustomed to low prices today, they would be willing to pay significantly higher ones in the future. In other words, these must be some credible basis for saying that foreclosure concerns are likely to arise on a market in which no firm is dominant and that these concerns are likely to lead to higher prices over time. This applies not least because of the significant uncertainty surrounding the conditions for a margin squeeze abuse and the effect of a broad margin squeeze principle on efficient market outcomes.

IV. The interface between competition law and sector-specific regulation

Jurisdictional and substantive conflicts are likely to arise more frequently in the telecommunications sector than other areas. The first problem is that two different types of rules – competition law and sector-specific regulation – can be applied to the same matter. A second issue is that different authorities can simultaneously be competent in respect of the same case (*i.e.*, Commission, NRAs, NCAs, and national courts).[140] A third complicating

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[138] See Case T-83/91 *Tetra Pak v. Commission II* [1994] ECR II-755, confirmed on appeal in Case C-333/94 *Tetra Pak II* [1996] ECR I-5951.

[139] See *Genzyme*, *supra* note 83, at para. 364.

[140] For instance, a firm could: (1) initiate proceedings in a national court on the basis of national competition rules and Article 82 of the EC Treaty when the practice in question has an effect on intra-Community trade (Article 3.1 of Regulation 1/2003); (2) lodge a complaint to the NRA when the practice in question violates a regulatory obligation (Article 20 of the Framework Directive). The complaint could also be based on national or EC competition rules when, as in the United Kingdom, the NRA is entitled to apply such rules (See Section 371 of the Communications Act 2003); (3) lodge a

factor in the telecommunications sector is that the competencies of the different authorities can vary: certain authorities are competent to apply competition rules only; others apply only sector-specific rules; and, in some Member States (e.g., the UK), an authority (e.g., Ofcom) may be entitled to apply both. These factors create an environment in which jurisdictional and substantive conflicts are likely to occur.

The following sections identify a number of such potential conflicts. The purpose is not to provide a detailed discussion of the various forms of conflicts that may arise in the context of disputes between telecommunications operators, nor to explore the various solutions to prevent or solve these conflicts that have been provided by EC or national law. Instead, we explore a number of practical and legal questions that are at the core of margin squeeze cases. Before doing so, a brief overview is provided of the types of jurisdictional and substantive conflicts that may arise.

A. Overview of jurisdictional and substantive conflicts

Jurisdictional conflicts may occur when different authorities are in principle competent in respect of the same matter. Parallel actions before different authorities are not uncommon given complainants' understandable desire to maximise the prospects of a favourable outcome. Parallel proceedings risk, however, the duplication of work, as well the possibility of contradictory decisions. This risk is more acute in the case of margin squeeze, since, as noted above, the NCAs and NRAs do not necessarily apply the same imputation and other tests such cases.

Although, in theory, plaintiffs can initiate proceedings before national courts on the basis of national and/or EC competition rules, the margin squeeze proceedings described in Part III above have, almost without exception, taken place before NRAs, NCAs, or the Commission. Complainants thus seem to prefer bringing margin squeeze cases before specialized bodies than courts. This preference is most likely justified in the case of margin squeeze abuses, since they are by nature very technical matters that are not suitable for non-specialised courts. Thus, the main risks of overlap reside in parallel proceedings before NRAs and NCAs or parallel proceedings before the Commission and NRAs. It is on these risks that we focus in the following paragraphs, leaving aside for now proceedings before national courts.

In terms of potential jurisdictional conflicts, a useful distinction can be made between "vertical overlaps", *i.e.* overlaps between proceedings taking place at the EC level and proceedings taking place at the national level, and "horizontal overlaps", *i.e.*, overlaps between proceedings taking place at the national level. Vertical overlaps may occur in two situations. First, a complainant in a margin squeeze case could lodge a complaint before both the Commission and an NCA. Second, an overlap may occur when, in the same matter, the Commission engages an action on the basis of EC competition rules and an NRA initiate proceedings on the basis of sector-specific regulation.[141] Horizontal overlaps may occur

complaint to the NCA on the basis of national competition rules or Article 82 of the EC Treaty when the practice in question has an effect on intra-Community trade; and (4) file a complaint to the European Commission on the basis of Article 82.

141 Article 7 of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive) authorizes the Commission to block certain NRA decisions relating to market definition or

when a NCA and an NRA are both seized of the same matter. In the case of a margin squeeze problem, plaintiffs could lodge a complaint before the NCA on the basis of competition rules (*e.g.*, claiming that the incumbent has committed an abuse of dominance) and before the NRA (*e.g.*, asking that the price regime be modified in order to prevent the margin squeeze to occur).

Vertical overlaps between actions started before the Commission, on the one hand, and one or several NCAs, on the other, will not be further discussed here, since Council Regulation 1/2003 and the accompanying Commission guidelines are likely to prevent such overlaps occurring in the vast majority of situations.[142] Instead, greater attention will be paid to overlaps that may occur between competition authorities (*i.e.*, the Commission or NCAs) and NRAs. Jurisdictional overlaps between competition authorities and NRAs often trigger substantive conflicts, since both sets of authorities apply different rules.[143] These overlaps

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to the designation of an operator as having significant market power. NRA Decisions adopted in the context of margin squeeze proceedings are not covered by this provision.

142 Mechanisms exist to prevent parallel proceedings before the Commission and NCA. First, as recently confirmed in the Commission Notice on cooperation within the network of competition authorities, the Commission considers itself well placed to deal with agreements or practices that have effects on competition in more than three Member States (See § 14. O.J. 2004, C 101/43). In addition, it also considers that is well placed to "deal with a case if it is closely linked to other Community provisions which may be exclusively or more effectively applied by the Commission, if the Community interest requires the adoption of a Commission decision to develop Community competition policy when a new competition issue arises to ensure effective enforcement" (Id. at § 15). Following the same logic, the Commission Notice on the handling of complaints by the Commission under Articles 81 and 82 of the EC Treaty provides that the Commission may reject a complaint "when it considers that the case does not display a sufficient Community interest to justify further investigation" (See § 28. O.J. 2004, C 101/65). In that case, the firm seeking relief will have to redirect its complaint to the NCA. Conversely, pursuant to Article 11(6) of Regulation 1/2003, when the Commission decides to prosecute a given conduct because it has a Community interest, the NCAs that would have been seized of the matter will be automatically relieved of their power to apply Article 81 and 82. The risk of parallel proceedings before the Commission and an NCA is thus eliminated.

143 Measures have been adopted at both EC and national levels to prevent or at least reduce the risks of such overlaps to occur. First, with respect to conflicts between the Commission and the NRAs, the 1998 Commission notice on the application of the competition rules to access agreements in the telecommunications sector, the Commission states that "[m]ultiple proceedings might lead to unnecessary duplication of investigative efforts by the Commission and the national authorities". (See § 28. O.J. 1998, C 265/2). To avoid such multiple proceedings, the Commission states it will not act on a complaint if parallel procedures are running before the NRA unless (i) the matter is not solved within a reasonable period of time (6 months); (ii) it feels that in a particular case, there is a substantial Community interest affecting, or likely to affect, competition in a number of Member States; and (iii) adequate interim relief is not available to the complainant in national proceedings. Id. at §§ 29-33. Second, with respect to conflicts between NCAs and NRAs, the Framework Directive provides that Member States shall ensure, where appropriate, consultation and cooperation between these authorities on matters of common interest. Article 3.4. The Framework Directive also states that the NCAs and the NRAs should provide each other with the information necessary for the application of its provisions and the specific directives that are part of the new framework on electronic communications. Article 3.5. Nothing in EC law seems, however, to specifically prevent NCA/NRA parallel proceedings from taking place. In several Member States, mechanisms have also been developed to ensure cooperation and avoid unnecessary overlaps between NCAs and NRAs. These mechanisms are generally contained in a Memorandum of Understanding (MoU) between the two institutions. For instance, in the Netherlands, the NMa and OPTA have signed a Protocol on the method of cooperation in matters of mutual interest. See http://www.globalcompetitionforum.org/regions/europe/Netherlands/OPTA.PDF. This Protocol is intended to help *inter alia* the two parties to coordinate the exercise of concurrent powers when taking decisions in order to prevent forum shopping. In order to achieve this aim, it

raise fundamental questions concerning the interface between competition law and sector-specific regulation, which forms the core of this paper. The following sections discuss a number of specific questions that have been raised in margin squeeze cases to date or are likely to arise in forthcoming cases.

B. The desirability of NRAs applying *ex ante* margin squeeze tests

Before examining potential conflicts between competition law and sector-specific rules, it is legitimate to ask whether *ex ante* regulatory intervention, taking the form of margin squeeze tests, should be pursued at all or whether *ex post* intervention on the basis of competition rules is sufficient. This question cannot be addressed in the abstract, but depends on a number of factors discussed below.

Added-value of regulation compared with ex post competition law intervention. The new framework on electronic communications makes clear that *ex ante* regulation is only justified when the application of competition rules is insufficient to address market failures.[144] Arguably, the main advantage of *ex ante* intervention is that it provides a greater degree of certainty to the incumbent's competitors, since they will know in advance the price at which they can buy wholesale products to the incumbent. Thus, in order to prevent margin squeezes, the regulator can impose a wholesale price mechanism based on the retail minus methodology. The level of certainty given to new entrants can be set at an even higher level by deciding the specific margin (*i.e.*, the "minus") between the wholesale and the retail

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contains a system of case referral whereby a matter notified to one authority can be better dealt with by the other authority. In the UK, rules of coordination of the enforcement activities of the NCA and the NRAs are also in place. These rules, however, do not try to identify the cases that will be examined by the NCA on the basis of competition rules and those that will be dealt with by the telecommunications regulator on the basis of sector-specific regulation, but rather try to establish which of these authorities will implement competition rules to a given conduct involving telecommunications operator. The Competition Act indeed authorizes not only the OFT, but also the sectoral regulators to enforce competition rules. These coordination rules, as set out in the Competition Act 1998 (Concurrency) Regulations 2000, are primarily designed to ensure that only one competent authority may launch a formal CA98 investigation into the same conduct. SI 2000/260. Thus, any authority proposing to open such an investigation has to inform other authorities that may also have concurrent jurisdiction of its intention to do so and to obtain their agreement to this. Another document, the OFT's Concurrency Guidelines, also specifies that cases will generally be investigated by the authority which is best placed to undertake the investigation. The working assumption is generally that the competent sectoral regulator is better placed than the OFT to investigate agreements or conduct relating to its sector. In some cases, however, the OFT may be better placed to undertake an investigation. The Concurrency Guidelines suggest that, when establishing which of the OFT or the relevant regulators is best placed, one needs to consider factors such as the sectoral knowledge of the regulator, whether the case affects more than one regulated sector, the extent of previous contacts with the parties or complainant and recent experience of dealing with the same undertakings or similar issues.

144. In its recommendation on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation, Commission identifies three criteria that have to be taken into account for a market to be susceptible to regulation: (1) the presence of high and non-transitory whether of structural, legal or regulatory nature; (2) the presence of a market structure such that the market does not tend towards effective competition within the relevant time frame horizon; and (3) the application of competition law alone would not adequately address the market failure(s) concerned. See § 9 of the Commission Recommendation of 11 February 2003 on relevant product and service markets within the electronic communications sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC of the European Parliament and of the Council on a common regulatory framework for electronic communications networks and services, O.J. 2003, L 114/45.

prices. This approach was followed by Ofcom when it set the margin between BT's IPStream and its ATM interconnection prices in order to stimulate competition in the market for the provision of access services to IPS.[145] If certainty is a major concern, then *ex ante* regulation can generally bring some added-value compared with *ex post* intervention on the basis of competition rules, unless it can be shown that the deterrent effect of competition rules is such that the incumbent would never engage in margin squeeze (which seems highly unlikely given the number of decisions and cases to date).

Added-value of regulation compared with less intrusive form of regulation. Sector-specific regulation typically provides for less intrusive forms of regulation than the type of *ex ante* price controls described above. Before turning to such price controls, it thus needs to be demonstrated that regulatory obligations (*e.g.*, transparency, non-discrimination, etc.) are insufficient to prevent a margin squeeze from occurring. As is made clear in the EC regulatory framework on electronic communications, remedies adopted by the NRAs must be proportionate to the objectives pursued.[146] As the source of the margin squeeze problem originates from the ability for a vertically-integrated incumbent to discriminate between its own retail operations and the retail services provided by downstream competitors, a strict non-discrimination obligation might be sufficient to address the problem.

Cost of regulatory intervention. The advantages of *ex ante* regulation must be balanced against its costs. Regulatory intervention will typically impose implementation costs on the NRA and compliance costs on the incumbent. Devising a proper margin squeeze test will involve substantial costs for the regulator in terms of collecting the relevant information, developing a pricing methodology, consulting with stakeholders, and ensuring compliance with its chosen policy. *Ex ante* price regulation will also involve costs for the incumbent, since it will not only have to provide periodic information to the regulator, but also will be imposed reduced flexibility in its pricing decisions. A tension thus exists between the certainty needed by new entrants and the flexibility required by the incumbent to conduct its business in an optimal fashion.

Risks of regulatory mistakes. One of the problems of *ex ante* regulation is that it needs to rely on a set of assumptions that may not necessarily hold true in the long run. Regulation takes time and can often lag behind market developments. The welfare costs of regulatory lag in the telecommunications sector may be enormous, given the extreme sensitivity of this sector to regulation. From that standpoint, the advantage of *ex post* intervention is that it intervenes after the facts. Thus, the risks of mistaken intervention are probably lower than under *ex ante* regulation. An obvious counterargument to this is that, in some circumstances, *ex post* intervention will come too late. Thus, a balance must be struck between the risk of mistakes that is inherent to *ex ante* intervention and the risk of complete elimination of competition.

Respective abilities of the NRA and the NCA to define and enforce effective remedies. It is often argued that NRAs are better equipped than NCAs to define and enforce price-related remedies in sectors as complex as telecommunications. It is true that the definition of such

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145 See *supra* note 54.

146 See § 118 of the Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services, O.J. 2002, C 165/6.

remedies typically require detailed information about the costs of providing certain services, etc., which NRAs are better able to collect and process than NCAs.[147] This disadvantage is, however, compensated by the fact that NCAs will intervene on an *ex post* basis and thus have more information on the practical impact of the incumbent's pricing strategy. A more serious disadvantage for the NCAs is that they are not typically equipped to engage in the monitoring tasks that are required to properly enforce price-related remedies once they have been adopted. This should not, however, lead to the conclusion that *ex ante* intervention is always warranted. Indeed, as suggested below, competition authorities intervening *ex post* can share the work with NRAs, for instance by allowing them to define remedies and to enforce them. This cooperative strategy is frequently pursued by the Commission in its application of EC competition rules to the telecommunications sector.

Impact on consumer welfare. The overarching goal of both *ex ante* and *ex post* intervention is to optimise consumer welfare. Yet, it is not clear that assisting entry through favourable price regulation will necessarily favour of the consumer. In fact, allowing inefficient operators to enter the market can often lead to price increases at the expense of the consumers. The assumption that a short-term inefficient entrant will move down the cost curve over time and provide a long-term benefit to consumers may be heroic. Arguably, consumer welfare is generally better protected by *ex post* competition law enforcement as competition authorities have to be guided by a consumer welfare standard in the assessments.[148]

In sum, before engaging into *ex ante* intervention, the burden ought to rest with the NRA to demonstrate the benefit of imposing *ex ante* margin squeeze test compared with the application of *ex post* competition rules, the absence of less restrictive regulatory alternatives, as well as to compare its benefits to its costs, before engaging into this form of intervention. This conclusion has particular resonance in the telecommunications sector where new, dynamic markets are at issue and the welfare cost of mistaken intervention at an early stage are potentially very large.

C. The scope for application of competition law where sector-specific remedies exist

Assuming that *ex ante* regulatory intervention has taken place (*e.g.*, through the adoption of a pricing regime for wholesale products), the question arises whether there remains any residual scope for the application of competition law *ex post*. This raises difficult issues about the nature and extent of regulatory objectives and to what extent the consumer welfare concerns underpinning regulation and competition law converge or diverge.

An illustration of this problem is provided by the *Deutsche Telekom* case. As noted, the case concerned the prices DT charged its competitors for unbundled access to local loops in Germany. The Commission had received complaints from DT's competitors, who claimed that DT's access charges were incompatible with Article 82 EC. In its defence, DT argued that its local access tariffs had been approved by the NRA, the RegTP. DT contended that if there was an infringement of Community law, the Commission should not be acting against the addressee of the regulatory framework, but against the Member State under Article 226

147 See Geradin, *supra* note 6.

148 S. Bishop and M. Walker, *The Economics of EC Competition Law – Concepts, Application and Measurement*, 2nd Ed., Sweet & Maxwell, 2002, at p. 24.

EC.[149] The Commission, however, rejected this argument on the ground that "*competition rules may apply where the sector-specific legislation does not preclude the undertakings it governs from engaging in autonomous conduct that prevents, restricts or distorts competition*."[150] The Commission considered that, despite the intervention of the RegTP, DT retained a commercial discretion, which would have allowed it to restructure its tariffs further so as to reduce or indeed to put an end to the margin squeeze.[151] The Commission therefore considered the margin squeeze constituted the imposition of unfair selling prices within the meaning of Article 82(a) EC and imposed a fine of € 12,6 million on DT. Similar reasoning was adopted in the recent *France Télécom/SFR Cegetel/Bouygues Télécom* decision by the Conseil de la concurrence in France.[152]

This decision suggests that, even when an NRA has adopted a decision on the basis of sector-specific regulation, the Commission (or a NCA) remains entitled to intervene when the outcome of this decision fails to prevent competition-law violations from occurring. This approach has very significant consequences for dominant operators since it implies that, when an NRA adopts a price control regime that fails to sufficiently protect the conditions of competition, a dominant operator could also itself be held responsible for violating competition rules if it nonetheless had the commercial freedom to adapt its tariff structure in such a way as to prevent a margin squeeze from occurring. Thus, incumbents would have to ensure that, to the extent possible, their pricing schemes are compatible with competition rules even in circumstances where they have been expressly approved by the competent regulator.

Interestingly, in its recent judgment in *Trinko*, the Supreme Court adopted a different approach to the Commission in *Deutsche Telekom*.[153] Verizon Communications Inc. (hereafter, "Verizon") was the exclusive local exchange carrier ("LEC") for the State of New York until the 1996 Telecommunications Act (hereafter, the "1996 Act") sought to introduce competition in the local telecommunications market.[154] The 1996 Act compelled Verizon and the other LECs to share some of their local networks with new entrants (known as the competitive local exchange carriers or "CLECs"), including provision of access to individual elements of the network on an "unbundled basis" (known as unbundled network elements or "UNEs"). Part of Verizon's UNE obligation related to the provision of access to operation support systems (hereafter, "OSS"), which allow CLECs to fill their customers' orders.

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149 *Deutsche Telekom*, *supra* note 71, at para. 53.

150 Id. at para. 54.

151 Id. at para. 57.

152 Id.

153 *Verizon Communications Inc. v. Law Offices of Curtis v. Trinko*, LLP 540 U.S. 682, (2004). For a discussion of this case and its relevance to EC law, see D. Geradin, "Limiting the Scope of Article 82 of the EC Treaty: What can the EU learn from the U.S. Supreme Court's Judgment in *Trinko* in the wake of *Microsoft, IMS*, and *Deutsche Telekom*?", *Common Market Law Review*, forthcoming, December 2004.

154 Telecommunications Act of 1996, Pub L No 104-104, 110 Stat 56. For a discussion of this statute, see Thomas G. Krattenmaker, "The Telecommunications Act of 1996", (1996) 29, *Connecticut Law Review*, 123.

In late 1999, CLECs complained to regulators that many orders where going unfulfilled in violation of Verizon's obligation to provide access to OSS functions. The Public Service Commission (PSC) of the State of New York and the Federal Communications Commission (FCC) opened parallel investigations, which led to a series of orders by the PSC and a consent decree by the FCC. The day after Verizon entered its consent decree with the FCC, the Law Offices of Curtis Trinko, a law firm that bought services from one of the new entrants, filed an antitrust complaint, alleging that Verizon had violated Section 2 of the Sherman Act by filling rivals' orders in a discriminatory manner to discourage customers from becoming customers of the new entrants.

The Supreme Court held that Trinko did not state a claim under Section 2 of the Sherman Act as a matter of law. This was based on the Court's view that, absent exceptional circumstances that were not present in the case at hand, incumbents should not be required to give their competitors access to essential inputs. However, the Court's refusal to apply Section 2 of the Sherman Act to the matter at hand was also strongly influenced by its view that, once a sector-specific regulatory structure "designed to deter and remedy anticompetitive harm" exists, there should be no further scope for antitrust intervention. The reasoning of the Court runs as follows: First, it states that "[a]ntitrust must always be attuned to the particular structure and circumstances of the industry at issue". It then claims that "[o]ne factor of particular importance is the existence of a regulatory structure designed to deter and remedy competition harm. Where such a structure exists, the additional benefits to competition provided by antitrust enforcement will tend to be small and it will be less plausible that the antitrust laws contemplate such additional scrutiny". (The other reasons are more specific to the US legal system where antitrust cases are argued before federal courts.[155])

Whether the approach chosen by the Supreme Court in *Trinko* is preferable to that followed by the European Commission in *Deutsche Telekom* raises complex issues. This question is obviously of critical importance in the telecommunications area given the growing overlap between sector-specific regulatory regimes and competition law. As noted above, the interface between sector-specific rules and EC competition law is at the core of the margin squeeze debate.

Several remarks can be made. In the first place, the scope for residual application of competition law in circumstances where there is also *ex ante* regulation of course depends on the level of detail of the regulatory regime. An important factor in *Trinko* was that the US regulatory regime applicable to telecommunications (the 1996 Act and its numerous implementing orders) is much more intrusive than the EC regulatory framework on electronic

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155 The Court also pointed to the importance of evaluating the costs of antitrust intervention. Citing the decision of the Court of Appeals (DC Circuit) in *Microsoft*, the Court states that "[u]nder the best circumstances, applying the requirements of §2 'can be difficult' because 'the means of illicit exclusion, like the means of legitimate competition are myriad'" (See *United States v Microsoft*, 253 F.3d. 34, 58 (DC Cir. 2001)). The Court also pointed to the risks of "mistaken inferences and the resulting false condemnations", which are associated with antitrust proceedings. Recalling its *Brooke Group* decision, the Court further stated that, even in the absence of the problem of false positives, the conduct consisting of violations of the regulatory framework (*i.e.*, Section 251 of the 1996 Act) would be "beyond the practical ability of a judicial tribunal" since "[e]ffective remediation of violations of regulatory sharing requirements will ordinarily require continuing supervision of a highly detailed decree."

communications.[156] The 1996 Act is a 600-page piece of legislation, which regulates in enormous detail the various aspects of the US telecommunications industry.[157] By contrast, the new EC regulatory framework on electronic communications is composed of a small number of directives imposing a limited number of obligations on operators holding significant market power.[158] There is thus arguably greater scope (and need) for intervention on the basis of competition rules in the EC than in the US.

A second, significant difference between *Trinko* and *Deutsche Telekom* is that, while, in the former case, the US regulators (*i.e.*, FCC and PSC) had taken an appropriate remedy to put an end to the abusive practices of Verizon, in the latter case the RegTP had failed to deal with the margin squeeze problem that was faced by DT's competitors.

Finally, while in the US both telecommunications and antitrust rules are embodied in legislation (*i.e.*, the 1996 Telecommunications Act and the Sherman Act), the hierarchy of norms is different in the EC as, while the new regulatory framework on electronic communications is contained in a set of directives, EC competition rules are based on primary legislation in the EC Treaty. The Community Courts might therefore take the view that secondary legislation cannot deprive primary legislation of its effectiveness, in particular where no regulatory remedy has been adopted to address the stated concerns. It should also be recalled, however, that the Commission is entitled to establish priorities when it comes to enforcing EC competition rules. Thus, even, if it had the option of intervening, the Commission could decide not to intervene in cases where a sector-specific regime provided appropriate solutions to competition-related problems.

That said, the question remains whether the Commission *should* intervene when a sector-specific remedy is available. Two situations should be distinguished. The first is whether the Commission should intervene when there is a sector-specific remedy that protects a competitive market structure in a given industry, which has been correctly enforced by a national regulator and which does not violate EC competition rules (*i.e.*, there is an "effective" regulatory remedy). In that case, the Commission should not intervene for the following reasons:[159]

- First, sector-specific regulators will be generally better placed than the Commission to address the relevant issues, such as the pricing of wholesale inputs or retail products, etc. These issues require technical expertise, as well as a range of information, which the Commission does not generally

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156 See Geradin and Sidak, *supra* note 15.

157 Id., at 70-76.

158 The most demanding obligations will be limited to operators, which hold "significant market power". See Article 16(4) of the framework directive, *supra* note 139.

159 Some recent cases suggest that the Commission might be willing to follow this approach. For instance, in its *02/T-Mobile* decision, which concerned a notified agreement on infrastructure sharing by mobile telecommunications operator in Germany, the Commission voiced no concern over the fact such agreement may create risk of foreclosure of sites as a sector-specific remedy was provided for by Article 12 of the Framework Directive and could be used by NRAs if a restriction of competition was observed. See Commission Decision No 2003/570/EC of 30 April 2003, *O2 UK Ltd./T-Mobile UK Ltd.*, O.J. 2003, L 59.

possess.[160] Moreover, as noted above, pricing decisions require constant monitoring (*e.g.*, as costs evolve), which is not compatible with competition authorities' publicly-stated reluctance to act as price control agencies.[161]

- Second, having two sets of rules and two distinct authorities involved on a similar issue raises the risk of contradictory decisions or the imposition of inconsistent remedies.[162] There are already numerous examples in the decisional practice where NRAs on the one hand and NCAs and the Commission on the other have diverged.

The second issue is whether the Commission should intervene when there is a sector-specific regime designed to protect a competitive market structure, but that regime has not been applied by the regulator (*i.e.*, the presence of a "lazy" and/or "captured" regulator). In that case, competition authorities should be left free to launch proceedings on the basis of Article 82 EC. The Commission should also be entitled to act when the decision adopted by the NRA is not compatible with EC competition law.[163] However, as the Commission has done in the majority of cases in the telecommunications sector to date, the case should be transferred to

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160 See OECD, Relationship between Regulators and Competition Authorities, DAFFE/CLP(99)8, at 8, available at http://www.oecd.org/dataoecd/35/37/1920556.pdf

161 See, *inter alia*, Xth Report on Competition Policy, 1975, point 76.

162 See Nicolas Petit, "The Proliferation of National Regulatory Authorities Alongside Competition Authorities: a Source of Jurisdictional Confusion", *GCLC Working Paper Series*, 02/04.

163 In such cases, the Commission could not only start proceedings against the incumbent as it did in *Deutsche Telekom*, but it could also launch proceedings against the NRAs themselves. NRAs fall under a general duty of observance of EC competition rules when dealing with matters within their jurisdiction. In *GB-Inno-BM*, the ECJ held that pursuant to Article 10 of the Treaty: "While it is true that Article 86 (now 82) of the Treaty is directed at undertakings, nonetheless it is also true that the Treaty imposes a duty on Member States not to adopt or maintain in force any measure which should deprive that provision of its effectiveness". See Case 13/77, *SA GB – Inno – BM v. Association des détaillants en tabac (ATAB)*, [1977] E.C.R. 2115, at para. 31. In addition, the ECJ considered that Article 86 implied that: "In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary inter alia to the rules provided for in Articles 85 (now 81) to 94 (now 90). Likewise Member States may not enact measures enabling private undertakings to escape from the constraints imposed by Articles 85 (now 81) to 94 (now 90)". Id. at paras. 32-33. Thus, a price control decision of an NRA that would be incompatible with EC competition rules could be challenged by the Commission. Two different legal bases could be used by the Commission to challenge such an NRA decision. First, the Commission could launch Article 226 infringement proceedings against the Member State to which the NRA belongs for the failure of the latter to comply with the EC Treaty (on the basis of Article 10 and 82 of the EC Treaty). Alternatively, the Commission could adopt an Article 86 decision (in combination with Article 82 of the EC Treaty). See, for instance, Commission Decision No 95/489/EC of 4 October 1995 concerning the conditions imposed on the second operator of GSM radiotelephony services in Italy, O.J. 1995, L 280/49 and Commission Decision 97/181/EC of 18 December 1996 concerning the conditions imposed on the second operator of GSM radiotelephony services in Spain, O.J. 1997, L 76/19. This implies that, when setting a price control regime, NRAs have not only to comply with the sector-specific rules they are responsible to implement, but they also have to make sure that this regime complies with EC competition rules on pain of having it challenged by the Commission. Alternatively, this regime could be challenged by an operator before the jurisdictional body that is competent to hear appeals against decisions adopted by the NRA in question.

the NRA(s) to allow them take a decision on the basis of the sector-specific legislation.[164] Such a transfer should, however, only take place when the Commission is confident that the matter will be sufficiently addressed by the NRA(s) on the basis of sector-specific rules. This apparently was not the case in *Deutsche Telekom* where the Commission investigated the case, adopted remedies, and imposed a penalty.

D. <u>Conflicts between regulatory duties and competition law principles</u>

The scope for residual application of competition law in circumstances where *ex ante* regulation applies was discussed in the previous section. As noted, the Commission, NCAs, and NRAs have generally adopted the position that, if the regulatory framework affords the dominant firm sufficient freedom to arrange its prices in a manner that avoids a margin squeeze under competition law, the dominant firm must do so, *i.e.*, competition law still applies. This does not fully answer, however, the question of how conflicts between regulatory objectives and competition law should be resolved. Specifically, there may be instances where the existence of regulation upstream could lead to conflicts with the objectives of competition law downstream. Several different situations might be envisaged.

The first situation of potential conflict is where the dominant firm's *actual* costs are lower than the regulated access charges set for competitors. In this circumstance, all things equal, the dominant firm could offer lower prices to consumers without pricing below its own costs, whereas rivals, unless they were more efficient, would have comparatively higher prices, since the regulated wholesale price would represent an unavoidable cost to them. This issue arose to some extent in the recent *Telecom Italia* case.[165] The NCA concluded that TI's bundled prices on a public bid gave rise to a margin squeeze because TI's allocation of costs for a portion of the services covered by the tender offer was below the regulated cost at which TI's rivals purchased the same essential inputs from TI. It seems that TI's *actual* cost of providing the input in question was lower than the regulated price at which it was made available to rivals. But the NRA said, in effect, that TI could not price below the regulated cost that rivals paid for the inputs concerned even if its actual costs were lower.

This seems a questionable outcome under competition law principles. The most widely-used imputation test for a margin squeeze is based on the dominant firm's costs. To the extent these are lower than rivals' costs, the dominant firm's prices represent competition on the merits. The issue, then, is whether a different rule should apply under competition law where the incumbent has a comparative cost advantage over rivals due to the fact that the pricing methodology chosen by the NRA results in access charges higher than the dominant firm's actual costs. It is difficult to see a reason under competition law for doing this. Article 82(b) EC permits competition on the merits unless rivals' opportunities are "*limited*" <u>and</u> there is "*prejudice of consumers*." Requiring a dominant firm to refrain from lowering its prices to consumers in line with its actual costs on the basis that, in so doing, the dominant firm would price below a benchmark set for access by a NRA pursuant to powers under secondary

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164 See, for instance, the approach taken by the Commission sector with regards to the pricing of leased lines inquiry and the mobile termination charges inquiry. See Commission Press Release IP/02/1852 of 11 December 2002, "Prices decrease of up to 40% lead Commission to close telecom leased lines inquiry". See also Commission Press Release IP/98/707 of 27 July 1998, "Commission concentrates on nine cases of mobile telephony prices".

165 See Section III.B.5 *supra*.

Community legislation seems to subjugate the protection of consumers to the protection of rivals.

Of course, in this case, the NCA might, as occurred in *Telecom Italia*, conclude that the dominant firm was discriminating, contrary to Article 82(c), against third parties by charging them a higher price than its own retail business. Although the decision does not discuss this specific legal issue in detail, the NCA seems to have concluded, in line with the principle established in *Deutsche Telekom*, that the dominant firm had a duty under competition law to off-set any disadvantages caused by regulation if inaction on its part would lead to a competition-law violation. It could certainly be argued that transactions between the dominant firm and third parties and the dominant firm and its integrated business would be "*equivalent transactions*" subject to a non-discrimination duty under Article 82(c).

This should not, however, be the end of the enquiry. Although Article 82(c) does not include the same phrase "*prejudice to consumers*" contained in Article 82(b), consumer welfare cannot be ignored where, as in a margin squeeze case, Articles 82(b) (foreclosure) and 82(c) (discrimination) are applied in parallel.[166] Thus, Article 82(c) should not be applied in a manner that would cause "*prejudice to consumers*." This would arguably be the case where a dominant firm was prevented from pricing at a level above its own costs, but below the costs of rivals (which are partly influenced by regulatory decisions).

A second situation is where the incumbent has to make available a certain technical means of access on non-discriminatory terms under regulation, but the incumbent still retains a cost advantage over rivals due to the fact that it has *different*, more efficient technical means of routing. For example, the functional and technical specifications decided by NRAs for carrier pre-selection operators (CPSOs) sometimes have inherent cost disadvantages for CPSOs, as compared to the incumbent. Frequently, CPSOs interconnect with the incumbent at the highest level in the network hierarchy, whereas the incumbent's own downstream business interconnects at the lower hierarchy levels of the network. In effect, therefore, rivals have to purchase an additional network element that incumbent does not need for its service. The same issue arises in any situation in which an incumbent can transport voice or data by a more direct, cheaper means, while rivals use different, less direct and more expensive routing. These differences of course impact on the wholesale end-to-end costs of rivals and, in certain instances, on their ability to compete downstream with the incumbent.

Certain national decisions have touched on cost disadvantages suffered by rivals as a consequence of regulatory choices.[167] These cases are inconclusive, however, on the principles to be applied, since no margin squeeze was found even taking into account <u>only</u> rivals' cost disadvantage as a result of regulatory choices. It is difficult to see, however, why, as a matter of competition law, a margin squeeze abuse could be found in these circumstances.

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166 See J. Temple Lang, "Anticompetitive Non-Pricing Abuses Under European and National Antitrust Law" in Hawk (ed.), 2004 *Fordham Corporate Law Institute*, pp. 235-340.

167 See, *e.g.*, Case CW/00760/03/04, *Investigation against BT about potential anti-competitive exclusionary behaviour*, Ofcom decision of 12 July 2004.

There is no case law under Article 82 EC to the effect that a dominant firm must, in order to avoid an exclusionary conduct, compensate rivals for higher costs that are the result of a technical means of access under regulatory principles that is less efficient that a different means of access used by the dominant firm. Indeed, *Industrie des Poudres Sphériques*[168] and *Bronner*[169] arguably suggest that no such duty arises. One of the reasons for Industries des Poudres Sphériques' apparent lack of downstream profitability was that it had higher processing costs than the dominant firm. The Court of First Instance held that, unless rivals' higher processing costs were caused by an exclusionary margin squeeze, the way in which a dominant vertically-integrated undertaking decides its profit margin "is of no relevance to its effects on its competitors." Similarly, the fact that the dominant firm has lower costs than a rival is of no incidence unless the prices it charges competitors give rise to a margin squeeze.

In *Bronner*, Advocate General Jacobs concluded that, unless there is an abuse, "*the mere fact that by retaining a facility for its own use a dominant undertaking retains an advantage over a competitor cannot justify requiring access to it*." The mere fact that a dominant firm has cost advantages over a rival cannot require the dominant firm to compensate rivals for them. If the dominant company has cost advantages in comparison with its competitor, they are legitimate, and the dominant company need do nothing to lessen the impact of the cost advantage. It is only if the dominant company charges its competitor more for some essential input *which both the downstream operations must use* (*i.e.*, discrimination), or if the dominant company's downstream operations are below its costs on the basis of that price (*i.e.*, a margin squeeze), that an abuse occurs.[170] A dominant company has no obligation to subsidise a competitor or to compensate it for any cost disadvantages. In sum, a rival cannot claim under competition law to be entitled to the same efficiencies and cost basis as a dominant firm.

An example may be useful. Suppose a vertically-integrated dominant firm supplies two different inputs that can both be used in similar quantities to make a final product, but the first input reduces overall production costs by 50% more than the second input. Now suppose that a competitor can only use the higher cost input to produce its products because it has an older plant that is not tooled to use the other input and it would be uneconomic to build a new plant capable of using the lower-cost input. In contrast, the dominant firm has a newer plant that allows it to use the lower cost input, which would give it a cost advantage over the rival in the downstream market. Provided that the dominant firm has done nothing to make it more difficult for the competitor to use the cheaper input, it could not be suggested that the cost advantage created by using the cheaper input is something that the dominant firm should compensate the rival for, or that it would be abusive for the dominant firm to take advantage of it. The fact that the dominant firm also supplies the rival with the higher cost input and the rival has no effective opportunities to switch to the lower cost input for technical or other reasons does not change the analysis. Using the cheaper input is simply a legitimate advantage available to the dominant firm, but not the rival.

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168 *Supra* note 64.

169 *Supra* note 109.

170 The non-discrimination obligation in Article 82(c) EC is not relevant in this situation because the dominant firm's technical means of access and rival's are not "equivalent transactions".

A final, more difficult case is where the effect of regulation is that the dominant firm's own costs are higher than some or all of its downstream rivals. This situation can arise where an incumbent has a duty to make available a range of different technical access solutions that third parties can use alone or in combination. Suppose that, over time, rivals limit themselves to using a range of intermediate inputs whereas, for legacy or regulatory reasons, the dominant firm's own business is required to continue to use more expensive inputs. In effect, therefore, regulation creates a situation in which some or all of the dominant firm's rivals have lower costs relative to the dominant firm.

Can the dominant firm price below the regulated price for the more expensive inputs? Certainly, in so doing, the dominant firm would technically commit a margin squeeze. This was the approach applied in *France Télécom/SFR Cegetel/Bouygues Télécom*. We have argued above that, in general, a margin squeeze should not be found unless revenues are less than the dominant firm's and rival's costs. If this were accepted, the dominant firm would not be committing an abuse by pricing at a level below the regulated cost of the input that its downstream business relies on, but would only do so by pricing below rivals' actual costs. But it is also arguable that, even if this were not accepted, the dominant firm should have a defence of "meeting competition" under competition law in the situation outlined above,[171] at least to the extent that it remained profitable on an end-to-end basis.

All of the above scenarios raise essentially the same point: the concurrent application of regulation and competition can frequently create situations in which conflicts arise between the consumer welfare standards that underpin competition law and the need to maintain equality of opportunity for firms who depend on incumbents for essential inputs under regulation. Most of these conflicts can be resolved by bearing in mind several basic principles. First, Article 82 EC, as primary legislation, takes precedence over regulation, which is a creature of secondary legislation. Second, to the extent that trade-offs must be made under competition law between protecting consumer welfare in the form of lower, non-predatory prices and protecting competitors, consumer welfare should prevail. If, rightly or wrongly, regulators believe that consumer welfare can be enhanced in the long run by promoting less efficient entry, this must be done using regulation, not competition law. Third, there is no general duty on a dominant firm under competition law to compensate rivals for a disadvantage that they may be under, unless of course it has caused it. A disadvantage that results from choices made by a NRA is not caused by the dominant firm and the dominant firm should not be obliged to compensate rivals for it under the non-discrimination clause in Article 82(c). Fourth, it should be remembered that disadvantages caused by regulation are not immutable: regulators can change their decisions and can

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171 The Commission has applied a "meeting competition" defence in several cases. See *ECS/AKZO*, (1983 OJ L 252/20, Article 4) (providing for interim measures against AKZO, but allowing AKZO "to offer or supply below the minimum prices determined as above ... if it is necessary to do so in good faith to meet (but not to undercut) a lower price shown to be offered by a supplier ready and able to supply to that customer.") (confirmed in Case C-62/86 *AKZO v. Commission* [1991] ECR I 3359 para. 156); *Eurofix-Bauco v. Hilti* (1987 OJ L 65/19) (Hilti obliged to cease all price discrimination by ensuring that any differences in its prices were justified by differences in costs, except where it was necessary to meet a competitive offer, in making promotions, or where to do so would generate sales that Hilti would not otherwise make); *Tetra Pak II*, (1992 OJ L 72/1) at para. 148 (argument that Tetra Pak was merely meeting competition recognized but rejected on factual grounds); *British Sugar/Napier Brown* (OJ [1988] L 284/41, para. 31) (while undercutting a competitor's prices would be abusive, matching them would not); *Wanadoo*, *supra* note 112, para. 316 (meeting competition defence accepted in principle but rejected on facts).

generally do so more quickly and more effectively than competition authorities. Finally, a NRA cannot impose pricing or other requirements that conflict with the fundamental aims of the EC Treaty, including Article 82 EC.[172]

V. Conclusion

Margin squeeze is a complex issue in practice. Despite the considerable attention it has received in recent years from NCAs, NRAs, and the Commission, several issues remain unresolved. There is divergence, for example, on the type of imputation test that should be relied upon when analysing margin squeeze abuses and the calculation of the underlying costs to be included in that test. Similarly, identifying margin squeeze abuses in new and emerging markets creates a range of analytical issues that have not been satisfactorily addressed to date. Another layer of complexity is created by the concurrent application of competition rules and sector-specific application, which increases the risk of jurisdictional and substantive conflicts. While mechanisms have been developed to reduce such risks, there are still many instances in which conduct is subject to the simultaneous application of sector-specific regulation and competition law. This concurrent application of different sets of rules creates significant risks for incumbents, in particular given the divergence in rules and standards between NRAs and NCAs.

The greatest risk, however, arises not from procedural or substantive disputes, but from conflicts between competition law principles and regulatory objectives. Competition law seeks to promote economic efficiency by protecting a competitive market structure. Regulation is different in that it seeks to smooth out market imperfections over time, including, where appropriate by creating (new) precise duties that could not be imposed under competition law. Competition law cannot and should not be used to achieve regulatory objectives, such as assisting the entry of additional operators on the market through favourable pricing mechanisms, even if the competition authorities of NRAs believe that, in so doing, competition would be enhanced in the long-run. The risk of regulation through competition law is particularly acute when sector-specific regulators have concurrent powers to apply competition rules to the sector that they are charged with regulating. But competition authorities acting in newly-liberalised markets also ignore from time to time that their duty is to protect competition and not competitors. Incumbents can only be required under competition to assist their competitors in wholly exceptional circumstances and they have no duty to compensate rivals for any advantages that they might be under (unless of course they have caused them). To hold otherwise risks promoting the uncertain gains of short-term inefficient entry over the present certainty that consumers are best served by competition policies that only protect competition on the merits.

[172] Case 66/86 *Ahmed Saeed* [1989] ECR 803. See J. Temple Lang, "Community Antitrust and National Regulatory Procedures", 1997 *Fordham Corporate Law Institute*, 297-334.