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Working Party No. 2 on Competition and Regulation

MARGIN SQUEEZE

-- Sweden --

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

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1. Summary

- In a request for a preliminary ruling, several questions have been referred to the European Court of Justice about the conditions that must be satisfied in order for a margin squeeze to infringe article 82 EC.
- The SCA has received complaints of margin squeeze mainly in the telecommunications sector. These allegations are sometimes supplemented by allegations of other forms of abuse. The SCA has found that competition law controls on refusal to deal, predatory pricing and prohibition on price discrimination cannot adequately control all of the anticompetitive concerns arising from margin squeezes, and has found it justified to identify margin squeeze as a standalone form of abuse.
- Margin squeeze cases will be more complex to analyse as bundling downstream becomes more common and new innovative pricing strategies are introduced.

2. Introduction

1. In this note, the Swedish Competition Authority (the SCA) briefly presents a case which it brought before the Stockholm District Court. The Court has asked the European Court of Justice for a preliminary ruling on what conditions must be fulfilled for a margin squeeze to infringe Article 82 of the EC Treaty. The note also addresses some of the SCA's experiences from investigations into suspected margin squeeze. Lastly, some questions are raised for further discussion.

3. Powers to take measures against margin squeeze

2. The Swedish Competition Act prohibits abuse of a dominant position on the Swedish market by one or more undertakings. The prohibition is based on Article 82 of the EC Treaty.¹

3. The SCA can order infringements of the prohibitions of the Act to be terminated with or without the attachment of a fine. A company in violation of any of the prohibitions of the Competition Act may be liable to pay an administrative fine. An administrative fine is determined by the Stockholm District Court subsequent to action brought by the Competition Authority.

4. No sector regulator in Sweden has the power to apply the Competition Act or Article 82 EC. Still, regulators deal with the issue of margin squeeze and its negative effects on competition. For example, a regulator may combine an access obligation with a non discrimination obligation to ensure that rivals of an integrated firm have equal opportunities to compete downstream. Also, so called retail minus pricing can be used in access regulation to avoid margin squeeze. Regulators and competition authorities may need to coordinate their efforts in order to find the most effective remedies for the anticompetitive effects of margin squeeze.

4. ADSL case (TeliaSonera)

5. In December 2004 the SCA sent a summons application to the Stockholm District Court requesting that the telecommunications company TeliaSonera should pay fines amounting to 144 MSEK (approx. 14 MEUR) for having abused its dominant position. The SCA's investigation showed that from

¹ The SCA – as well as national courts – is also required to apply Article 82 EC in accordance with EC Regulation 1/2003.

April 2000 to January 2003 the margin between the price charged by TeliaSonera for wholesale ADSL products and its retail price for ADSL services to consumers was insufficient to cover TeliaSonera's incremental downstream costs.

6. TeliaSonera is the incumbent telecommunications operator in Sweden and the company owns the nationwide copper based access network. The relevant downstream market was defined as the national market for broadband access to Internet to residential customers, including ADSL, cable and fibre networks. The relevant wholesale product is a reseller product, which includes both broadband access using ADSL technology and Internet connectivity. The reseller product was not subject to sector regulation, but was instead supplied voluntarily by TeliaSonera. TeliaSonera is required to give access to its fixed access network through local loop unbundling (LLUB). However, the opinion of the SCA is that access through local loop unbundling was not a viable alternative for rivals downstream during the time of the abuse.

7. The case is a "pure" margin squeeze case and the SCA has made no assertions about refusal to deal or predatory pricing. The SCA used the "as efficient competitor test" and made the margin squeeze test by comparing the margin between retail and wholesale prices with TeliaSonera's own long run incremental costs downstream.

8. The Stockholm District Court decided on 30 January 2009 to stay proceedings and to request a preliminary ruling from the European Court of Justice.² The ECJ has now the opportunity to make clear what conditions must be satisfied in order for a margin squeeze to infringe article 82 EC.

² Case number C-52/09. The Stockholm District Court has asked the following questions (OJ C 90 of 18.04.2009, p.12).

Under what conditions does an infringement of Article 82 EC arise on the basis of a difference between the price charged by a vertically integrated dominant undertaking for the sale of input ADSL products to competitors on the wholesale market and the price which the same undertaking charges on the end-user market?

Is it only the prices of the dominant undertaking to end-users which are relevant or should the prices of competitors on the end-user market also be taken into account in the consideration of question 1?

Is the answer to question 1 affected by the fact that the dominant undertaking does not have any regulatory obligation to supply on the wholesale market but has, rather, chosen to do so on its own initiative?

Is an anti-competitive effect required in order for a practice of the kind described in question 1 to constitute abuse and, if so, how is that effect to be determined?

Is the answer to question 1 affected by the degree of market strength enjoyed by the dominant undertaking

Is the dominant position on both the wholesale market and the end-user market of the undertaking engaging in the practice required in order for a practice of the kind described in question 1 to constitute abuse?

For a practice such as that described in question 1 to constitute abuse, must the good or service supplied by the dominant undertaking on the wholesale market be indispensable to competitors?

Is the answer to question 1 affected by the question whether the supply is to a new customer?

Is an expectation that the dominant undertaking will be able to recoup the losses it has incurred required in order for a practice of the kind described in question 1 to constitute abuse?

Is the answer to question 1 affected by the question whether a change of technology is involved on a market with a high investment requirement, for example with regard to reasonable establishment costs and the possible need to sell at a loss during an establishment phase?

5. Some observations made by the SCA

9. This section summarises some observations the SCA has made during investigations into alleged margin squeeze. Complaints to the SCA with allegations of abuse of a dominant position in the form of margin squeeze have in most cases concerned the telecommunications sector. The products at the wholesale level have often been access to the incumbent's fixed network, but also call termination on fixed and mobile networks.

5.1 *Margin squeeze and other forms of abuse*

10. Complaints to the SCA with allegations of margin squeeze are often accompanied by allegations of other forms of abuses; notably price discrimination, predatory pricing and refusal to deal. It is certainly possible for a dominant firm to engage in several abusive practices at the same time. However, uncertainty regarding the legal standards to be applied to margin squeeze (reflected by the request for a preliminary ruling mentioned above) may partly explain why allegations of other forms of abuse are put forward by complainants in parallel with margin squeeze.

5.1.1 *Price discrimination*

11. The SCA has noted that complaints to the Authority with allegations of margin squeeze sometimes also include allegations of price discrimination between internal and external customers. The complainants' reasoning seems to be that if the dominant firm is able to offer lower prices to the end users, this implies that the dominant firm's downstream arm enjoys more favourable terms than its competitors. Although discrimination between internal and external customers has been found to amount to an abuse of a dominant position under EC competition rules, the SCA has so far found it more appropriate to analyse these allegations as margin squeeze cases. In the SCA's view, a duty on the dominant firm to charge its own downstream operations the same price for the relevant input as it charges its competitors would not necessarily eliminate the margin squeeze. Unless the dominant firm changes its retail and/or wholesale prices, the margin will still be squeezed and its competitors put at a disadvantage. Also, the dominant firm might not even use transfer pricing in the first place.

5.1.2 *Predatory pricing*

12. Margin squeeze complaints have also included allegations of predatory pricing, with the presumption that the wholesale price charged to competitors represents the dominant firm's costs for producing the input. In the SCA's opinion, the wholesale prices charged to competitors (or internally) may not always equal the costs relevant in a predatory pricing analysis. Consequently, the existence of a margin squeeze does not automatically imply existence of predatory pricing. Instead a more careful analysis of the dominant firm's production costs needs to be carried out on a case by case basis.

13. A vertically integrated firm could indeed engage in margin squeeze and predatory pricing at the same time. However, an integrated firm has the possibility to set its retail and wholesale prices in a proportion that does not allow as efficient rivals to be profitable, while at the same time being profitable on an end-to-end basis.

5.1.3 *Refusal to deal*

14. One prerequisite for a margin squeeze is that the vertically integrated firm offers a product at the wholesale level and that there is a wholesale price to be used as a starting point. The offer can be made either voluntarily or as a result of regulation or an anti-trust duty to deal. Intuitively, it seems that a margin squeeze case cannot at the same time be characterised as a "pure" refusal to deal, where in the latter case

there is no offer at all from the dominant firm. If there is no offer, there is no wholesale price and it will not be possible to calculate a margin between retail and wholesale prices.

15. Still, complaints to the SCA have included allegations of both margin squeeze and “pure” refusal to deal. First, the vertically integrated firm may offer a wholesale product to its downstream competitors at a price that does not leave a sufficient margin, indicating a margin squeeze. At the same time, the input provided by the integrated firm to the downstream rivals may be different from the input that it provides to itself, and the dominant firm may refuse to supply this latter input to its rivals.

16. In such a case the question arises if the dominant firm is engaged in a refusal to supply an “appropriate” wholesale product to its rivals. Measures against a refusal to deal may be taken based on competition law. In addition, if the wholesale product is the result of sector regulation, as is often the case in the telecommunications sector, it could also be argued that the obligations imposed on the dominant firm under the regulation are not properly designed. These cases call for co-operation between competition authorities and regulators to identify the most efficient way to remedy the anticompetitive conduct.

5.2 Complicating factors

17. In the ADSL-case described above, the wholesale input and the downstream product were easily comparable and the calculation of the margin quite straightforward. However, in other cases it can be more complex. Below are some examples of how recent developments in the telecommunications markets will affect the analysis.

5.2.1 Different pricing structures upstream and downstream

18. Telephony services to end-users have traditionally been priced on a per minute basis, but lately fixed price offers have become more common. Fixed price offers are available both for fixed and mobile telephony.

19. Interconnection with other operators is a necessary input to telephony services. All operators buy call termination from other operators. Operators which do not own an access network also need to buy call origination from the operator controlling the local loop. Just as with the end-user services, call termination and call origination have traditionally (at least in Sweden) had variable prices, either on a per minute or a per call basis.

20. When revenues are based on fixed fees and the costs are variable (and depending on the actual call pattern of the users), this may have some implications on the margin squeeze test.

21. First, the question is which call pattern should be used to calculate the margin between end-user revenues and wholesale costs; the dominant firm’s customers’ or its rivals’ customers’? In order to ensure legal certainty, it seems in the SCA’s opinion reasonable that it is the call pattern of the dominant firm that should be used.

22. Second, smaller operators and operators without own networks may face a bigger risk since they rely more heavily on buying interconnection at variable prices from other operators than incumbents do. A question here is whether calculation of a margin squeeze should include a “risk premium” that takes account of this asymmetry? Or does the “as efficient competitor test” imply that no such considerations should be made?

23. Obviously, one way to reduce the risk of margin squeeze would be to move away from minute based interconnection fees towards a pricing structure that better reflects the pricing at the retail level. The

so called bill and keep³ model could possibly totally eliminate the risk for margin squeeze in these cases. This is another area that calls for co-operation between competition authorities and regulators.

5.2.2 *Bundles*

24. Another development that has been observed in the Swedish telecommunications market is increased bundling at the retail level. In the consumer market, broadband, telephony and television services are bundled in different combinations. In the business market, data communications services are bundled with IT services.

25. When end users buy several services from the same supplier, a margin squeeze can have effects on other, adjoining, markets. For example, a downstream rival exposed to margin squeeze in the broadband market, may be forced to compensate its losses with cross subsidies from other services. This will cause distortions not only on the squeezed market, but also on the neighbouring markets.

26. This development raises the question at what level of aggregation the margin squeeze test should be applied. So far, the SCA has taken a case by case approach, taking into account the demand for separate products and for bundles in the downstream market.

5.2.3 *The dominant firm uses other inputs than it offers its competitors*

27. As mentioned above, the input provided by an integrated firm to its downstream rivals may be different from the input that it provides to itself. Such a case can have implications for the margin squeeze test. Incremental costs in the downstream operations can differ depending on what input is used, and the integrated firm may be more efficient downstream because of the different input it provides to itself. Consequently, the “as efficient competitor test” that uses the integrated firm's downstream costs may not be appropriate.

28. One alternative could be to use the “reasonably efficient competitor test” instead. In the SCA’s opinion, this test might be justified in specific cases, for instance when competitors cannot achieve sufficient economies of scale due to the existence or the behaviour of the dominant firm. However, care must be taken since the “reasonably efficient competitor test” may not ensure the same legal certainty as the “as efficient competitor test”.

29. If the integrated firm provides different input to rivals than it provides to itself, this raises suspicions of other forms of abuses, such as refusal to deal or discrimination. As mentioned above, if the wholesale input offered to rivals is a result of sector specific regulation, a change in the regulatory obligations may have to be considered.

6. **Questions for discussion**

6.1 *Indispensability of the input*

30. In the ADSL case described above, the SCA has not considered it necessary to prove that the wholesale input was indispensable in the sense of an essential facility. The wholesale product was provided voluntarily, and the practices under investigation differed from those in a refusal to deal case. In examining whether the vertically integrated firm had a dominant position, account was taken of the existence of possible substitutes. A dominant position was found, and it could be ruled out that the input was

³ Bill and keep is a pricing scheme under which the reciprocal call termination charge is zero - that is, each network agrees to terminate calls from the other network at no charge.

unnecessary to downstream competitors. On the contrary, if alternative sources of supply could have been accessed by the downstream rivals, it is unlikely that the margin squeeze could have harmed competition. Hence, the issue of the indispensability of the input was part of the dominance test.⁴

31. A relevant question is whether the issue of indispensability can always be “taken care of” in the dominance test, or if there is a need for a separate criterion? If a separate criterion is justified, is the degree of indispensability required in a margin squeeze case equal to the concept of essential facility?

32. As noted above, there is a trend towards increased bundling in the telecommunications sector. To be able to offer bundles, several different inputs may be necessary. A necessary (and indispensable) input might then become “diluted” by other components in the bundle. It will still be possible to make a calculation to determine if the integrated firm can recover its downstream costs, but it may be less obvious that the integrated firm’s pricing is crucial to the rivals’ possibilities to compete. A question here is if this development will call for a separate criterion of indispensability in addition to what is included in the assessment of dominance?

6.2 *Effects on incentives to invest*

33. The question of indispensability is related to the concerns expressed by commentators that imposing liability for a margin squeeze might have negative effects on incentives to invest.

34. The high legal standard under EC competition law as to when a duty to deal may be imposed aims at protecting incentives for investments and innovation. A balance must in each case be struck between the interest of competition in a market and the interest of not deterring investments.

35. As noted above, there is a difference between margin squeeze and “pure” refusal to deal. In case of a margin squeeze, the vertically integrated firm does offer a product at the wholesale level. If the integrated firm has chosen to offer a wholesale product, it indicates that the firm has identified benefits from this. At the same time, the dominant firm may be tempted to expose downstream rivals to margin squeeze. Intervening against margin squeeze will prevent the dominant firm from controlling and limiting the competition on the downstream market.

36. A relevant question is then if an intervention against a margin squeeze risks having the same negative effects on investments and innovation as an introduction of a duty to deal in the first place?

⁴ Note that question number seven in the request for a preliminary ruling referred to above addresses the issue of indispensability. Further details about the SCA’s position on the referred questions are given in the Authority’s written observations submitted to the ECJ.