Price Squeezes with Positive Margins in EU Competition Law: Anatomy of an Economic and Legal Zombie

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Introduction

In European Union (“EU”) competition law, the supply policy of a dominant input provider can be deemed unlawful, if his wholesale and retail price-mix forces rival input purchasers to compete at a loss on the downstream market. This is known as an abusive “margin squeeze”.

Whilst this stands to reason, the TeliaSonera case-law adds that there can also be an “exclusionary” abuse when rivals’ margins are “positive”, by virtue, for instance of “reduced profitability”. In other words, there is an infringement of Article 102 TFEU even if rivals maintain the ability to competitively sell their products at prices above costs. We call this the positive margin squeeze theory.

After a quick overview of TeliaSonera and of its context (I), this paper shows that the positive margin squeeze theory is flawed on economic grounds (II). To this end, it resorts to a simple numerical example. Further, this paper explains that the positive margin squeeze theory is wrong on legal grounds, and that it has since been overruled by a subsequent judgment of the Court of Justice of the EU (“CJEU”) (III). Finally, we conclude that the positive margin squeeze theory can be disregarded in positive competition law.

I. TeliaSonera in Context

A margin squeeze arises where a vertically integrated dominant firm supplies an 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 competitors on the market for the processed product”. Understandably, margin squeeze situations are often seen in cases involving utilities (primarily telecommunications and, to a lesser extent, energy). There are, however, margin squeeze cases in other sectors of the economy (coal, sugar, calcium metal, pharmaceuticals, etc.), and virtually any economic sector characterized by vertical integration and strategic inputs is a potential antitrust target.

Altogether, those cases are the source of an extensive body of case-law, and of abundant scholarly commentary. Most discussions have so far focused on the same issues: can there be a margin squeeze if the input is not indispensable?; can there be abuse if the input supplier is not under an antitrust – or another type of (regulatory) – duty to deal; should abuse of dominance...
law step in ex post to decide on matters subject to ex ante sectoral regulation? should a margin squeeze allegation be assessed on the basis of the dominant firm’s costs or on the basis of the costs of a reasonably efficient rival? etc. The case-law has given clear, though sometimes surprising, answers to these questions (i.e. respectively, yes, yes, yes and both). It is not the purpose of this paper to discuss them yet again.

Instead, this paper focuses on a distinct issue, namely the margin squeeze levels necessary to establish an “exclusionary” abuse. An exclusionary abuse is conduct that forecloses as efficient rivals from the market. The leading EU precedent on this issue is TeliaSonera, a case dealing with conduct in electronic communications markets. Since TeliaSonera, an exclusionary margin squeeze can occur in two distinct situations. First, there can be an unlawful margin squeeze when the spread between the wholesale prices and retail prices is “negative”. In this case, inputs sell higher than outputs. The competitors of the dominant firm are thus “compelled to sell at a loss”, even if “they are as efficient, or more efficient”. Therefore, an effect which is at least potentially exclusionary is probable. We call this test the “negative” margin squeeze theory.

Second, the Court considers that there can be an exclusionary abuse even where the spread between the wholesale prices and retail prices is “positive”. It suffices that rival firms’ margins are “insufficient”, for instance because they must operate at “artificially reduced levels of profitability”. This, in the Court’s view, results in them being “competitively disadvantaged”, and prevents or restricts their access or growth on the market. The Court concedes, however, that exclusion cannot be presumed. Its likelihood (the Court says “likely”) must be established. This is what we call the “positive” margin squeeze theory.

It ought here to be noted that the positive margin squeeze theory already existed prior to TeliaSonera, and had been endorsed by a number of national jurisdictions, notably in France and in Belgium.

II. Numerical Invalidation of TeliaSonera

A simple numerical illustration helps understand that the positive margin squeeze theory of TeliaSonera is flawed, for it leads to the inevitable conclusion that the input provider has no other choice but to sell its inputs at 0.

Let us consider our illustration. We use here the bakery sector for its many, though non-obvious, analogies with utilities: consumer good, mature technology, homogeneous product, etc. In addition, the TeliaSonera judgment is not sector specific, and there is merit in assessing its consequences in an ordinary market context.

Firm A is the dominant bakery in a small village with 1,000 consumers. A produces 1,000 baguettes per week. Baguettes sell for €1.5 per unit. For each unit, A’s cost is €1. A has a large oven which can produce 1,500 baguettes per week, and which initially cost €10,000. The cost of the oven was written off years ago. B enters the market. Given that technology – essentially know-how – in this sector is mature, B has the same costs as A, i.e. €1. However, B has no oven and, as a new entrant, has insufficient capital to purchase a new one. A leases spare oven capacity to B.

Let us assume again that despite the entry of B, A does not lower the retail price of bread which stays at €1.5. This is because customers do not shop around for minute price changes. Moreover, A keeps the same production mix so that costs stay at €1.5. It is not sector specific, and there is merit in assessing its consequences in an ordinary market context.

A must set a lease price for its oven. A lease price > €0.5 per baguette is surely a “probable” margin squeeze for it forces B to incur a negative margin, and sell at a loss. In contrast, however, any lease price ≤ €0.5 should be fine, because B can compete with A at a price of €1.5 per unit and make a profit on each unit. As long as B makes profits, he will not be excluded from the market. B’s upper possible profit will

14. See European Commission, Guidance on the Commission’s enforcement priorities in applying Article 102 TFEU to abusive exclusionary conduct by dominant undertakings, Communication (2009/C 45/02), OJ (2009) C 45/7, §19, where exclusionary abuse is defined as conduct which gives rise to “anticompetitive foreclosures”. This refers to “a situation where effective access of actual or potential competitors to supplies or markets is hampered or eliminated as a result of the conduct of the dominant undertaking whereby the dominant undertaking is likely to be in a position to profitably increase prices.”
16. Ibid §32.
17. Ibid §73.
18. Ibid §74.
19. Ibid §73.
20. Ibid §32.
21. Ibid §32.
22. Ibid §32.
23. Ibid §32.
24. Ibid §74.
25. See Décision du Conseil de la Concurrence du 26 mai 2009, Base/BMII, §200: “il peut y avoir abus lorsque la différence entre les prix de détail d’une entreprise qui domine le marché et le tarif des prestations intermédiaires pour des services comparables à ses concurrents est soit négative, soit insuffisante pour couvrir les coûts spécifiques des produits de l’opérateur dominé pour la prestation de ses propres services aux abonnés sur le marché en aval.”

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be €0.49, if the lease price is €0.01; B’s lowest possible profit will be €0.01, if the lease price is €0.49.

Yet lease prices are not calculated by unit, but on a monthly basis. And A has no idea how many baguettes B will sell in the market in a month. A can nevertheless attempt to structure a reasonable monthly lease price that keeps B economically viable. First, A can speculate that B will be a big seller, and quickly supply 50% of demand, i.e. 500 baguettes per week. We use 50%, because beyond this point, A is no longer dominant, and his duty to grant oven access ceases. In this situation, the maximum monthly lease price is 500*4*€0.5 = €1,000 and the minimum lease price is 500*4*€0.1 = €200. Second, A can speculate that B will be a small seller, and only supply 15% of demand, i.e. 150 baguettes per week. We use 15% because below this point, A can refuse to supply access for 15% vertical foreclosure is deemed to have de minimis effects on consumer welfare. In this situation, the maximum lease price is 150*4*€0.5 = €300, and the minimum lease price is 150*4*€0.1 = €60. With this backdrop, and considering a 0.5 probability that B will be a large or a small seller, A can safely offer a monthly lease price between €200 and €300 without risking that this would harm B.

However, this is not what the teachings of TeliaSonera command. The case-law says that even if B’s margin remains positive, there can be a “potential” exclusionary squeeze. In practice, any lease price [€0; €0.5] can potentially be caught by antitrust agencies and courts as abusive, as long as it makes it “at least more difficult” to trade on the market, for instance, because of “reduced profitability”. Regrettably, the case-law gives no benchmark of how much profitability has to be reduced to warrant antitrust intervention.

Moreover, the case-law fails to understand the self-correcting dynamic effects of “positive margins”. For any lease price between €0 and €0.5, B achieves profits. B can therefore save them, and in turn achieve the purchase of an oven to avoid paying the lease to A. At the median lease price of €0.25, B needs to sell 40,000 units to purchase an oven. This represents a market share of 24% in 4 years, or a yearly progression in market share of 6%. And the purchase of its own oven by B in turn has a range of welfare enhancing effects. B can decrease prices to all the way down to €1. In addition, A and B are no longer in commercial dealings, which reduces the risks of collusion (e.g. A and B agreeing to raise retail prices at €2.0).

Like it or not, any lease price that maintains a positive profit margin to B cannot yield exclusionary effects. B may well be less profitable than A because he has to lease (and A not), but he will not be excluded.

The sole undergirding rationale for the positive margin squeeze theory is thus that the impugned input pricing level, despite positive margins, makes it “more difficult [...] to trade on the market concerned” for the rival input purchaser. But this cannot be a relevant reason for taking issue with the supplier’s pricing policy: any price level makes the life of the input purchaser comparatively more difficult than the life of the input supplier, because he has to lease. In other words, the price level charged by the input supplier is causally irrelevant, for any price can be deemed to make rivals’ life more difficult.

Interestingly, one remedy to restore a balance could be to request the dominant input supplier to reduce his own profitability by decreasing revenues. Assuming that B pays €0.1 for the lease, A could be requested to reduce his prices by €0.1, as a sort of compensating penalty. But this would lead A to sell at €1.4, outcompeting B on the market who sells at €1.5. Surely, B could reduce prices to €1.4, but would again end up with a lower profitability (€0.3), than A (€0.4).

In reality, the only effective remedy to avert this conundrum would be to request the supplier to sell free inputs. But this radical policy is only acceptable if the supplier no longer incurs input costs, for instance, in industries with government-sponsored inputs. Network industries used to be a prime candidate for this, for infrastructures in those sectors have often been financed by public investments or under special or exclusive rights, but this is no longer the case with the obsolescence of legacy-infrastructures, and their progressive replacement by next generation networks (“NGN”). In contrast, the abovementioned remedy is unacceptable if the input is a running cost or if dealing with an input purchaser generates opportunity and transaction costs. In this variant, it is the life of the input supplier which risks being more difficult in the short term, and his incentives to invest which risk being chilled in the long term.

All in all, it is inevitable that the life of an input purchaser (B) is “less easy” (the case-law says “more dif-
ficult”) than that of a dominant input supplier (A). But is this sufficient to justify antitrust interest? In other words, should the fact that life could be marginally better for him – he already enjoys a mandatory access remedy and the protective umbrella of a cap on negative squeezes – warrant heavy handed antitrust intervention, with fines and intrusive remedies?

III. Legal Invalidation of TeliaSonera

The positive margin squeeze theory is a legal zombie. It has been supplanted by the 2013 PostDanmark judgment which defines a zone of antitrust immunity for above cost pricing conduct under Article 102 TFEU (1). In reality, the positive margin squeeze theory can only survive if framed as a theory of discriminatory abuse liable to inflict “competitive disadvantage” under Article 102 c) TFEU. This latter option is however a logical impossibility, if one follows the Court’s own reasoning in TeliaSonera (2).

1. PostDanmark

Most commentators of TeliaSonera have criticized its inconsistency with previous case-law, especially with the case-law on refusals to supply under Bronner. The Court’s view that a dominant firm can squeeze as efficient rivals even if its input is not “indispensable” by Bronner standards remains disputed. Coates stood in support of the judgment on the basis of “estoppel” based arguments. Whichever view may be right, we believe that TeliaSonera is inconsistent with subsequent case-law. In particular, the positive margin squeeze theory of TeliaSonera is irreconcilable with the judgment of the CJEU handed down approximately a year later in Post Danmark. In this case, the Court had to determine whether a dominant firm’s strategy of above-costs selective price cuts could be held abusive.

In essence, PostDanmark says that above cost pricing abuses have no place in modern EU competition law. As the Court holds at §38:

“to the extent that a dominant undertaking sets its prices at a level covering the great bulk of the costs attributable to the supply of the goods or services in question, it will, as a general rule, be possible for a competitor as efficient as that undertaking to compete with those prices without suffering losses that are unsustainable in the long term”.

In other words, pricing above costs is presumptively lawful for a dominant firm, because equally efficient rivals can profitably stay in the market. Or, put yet another way, if as efficient rivals keep positive margins, there cannot be an exclusionary abuse.

This, clearly, stands in blatant contradiction with the positive margin squeeze theory. In PostDanmark, the CJEU affirms that there should be, as a “general rule”, no such thing as a pricing abuse as long as equally efficient rivals do not incur loss. A fortiori, this “general rule” applies to all pricing practices by dominant firms. And it means that there cannot be abusive margin squeezes when as efficient input purchasers make no losses. This invalidates the positive margin squeeze theory of TeliaSonera, which left a possibility to apply Article 102 TFEU despite proof that rivals achieved profits.

It may be tempting, of course, to distinguish the two cases, and confine PostDanmark to the narrow area of selective price cuts and predatory pricing. But this is not the dominant view in the competition scholarship, which has interpreted PostDanmark as a seminal judgment in the Article 102 TFEU case-law. Moreover, this would disregard a number of important contextual features of PostDanmark. First, PostDanmark is also a judgment rendered under the Article 267 TFEU preliminary reference procedure. In this setting, it is important to understand that the Court does not seek to pass judgment on facts, but rather seeks to make principled statements on the substance of Article 102 TFEU law. Second, PostDanmark is not the run of the mill preliminary reference judgment. The CJEU heard the case in “Grand Chamber”, a judicial arena reserved to strategic cases where the Court intends to issue a strong message. Given that the Court does not act haphazardly, one can reasonably explain recourse to this formal procedural configuration by the desire to formulate Article 102 TFEU judicial policy, in a context of considerable doctrinal uncertainty (in particular, as regards the validity of the Commission’s more economic approach under Article 102 TFEU, as set out in several decisions and in the Commission’s Guidance Paper of 2009).

2. TeliaSonera (bis)

The sole possible intellectual manner to salvage the positive margin squeeze theory concocted in TeliaSonera is to frame it as a form of abusive discrimination under Article 102 c) TFEU, which provides that it is unlawful to apply “dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage”.

In this variant, the theory of harm is no longer that the prices of the vertically integrated input supplier yield “exclusionary” effects. It is that a positive margin squeeze arguably “competitive[ly] disadvantage[s]” rival input purchasers, who must purchase something that the dominant firm’s downstream operations (e.g. a subsidiary) receive for free. In short, the dominant firm and its rival purchasers do not face equal profit opportunities.

This hypothesis is, at least in theory, well worth discussing. After all, in antitrust history, most abusive discrimination cases under Article 102 c) TFEU concern vertically integrated firms in network industries, where margin squeezes are often said to be pervasive. 38

Nevertheless, one should not lose sight of the fact that in contemporary competition enforcement, cases of abusive discrimination are now marginal. In 2009, they were even explicitly excluded from the enforcement priorities of the EU Commission in 2009. 39

But the real problem with this hypothesis lies elsewhere. In TeliaSonera, it is the Court itself that “suicided” any possibility to frame the positive margin squeeze theory as abusive discrimination. Firstly, the TeliaSonera Court insisted at §56 – this is actually one of the most commented on angles of the judgment – that margin squeezes are a novel, “independent” form of abuse, “distinct” from the conventional abuses known in EU competition law, and in particular of refusals to supply. The Court refused to consider margin squeezes under a refusal to supply theory of harm because “before any conduct of a dominant undertaking in relation to its terms of trade could be regarded as abusive the conditions to be met to establish that there was a refusal to supply would in every case have to be satisfied, and that would unduly reduce the effectiveness of Article 102 TFEU”. 40 By parity of reasoning, margin squeezes should thus be deemed “independent” and “distinct” from abusive price discrimination under Article 102 c) TFEU, which too is a type of infringement subject to demanding substantive conditions. Using the Court’s own words, envisioning squeezes as abusive discrimination would also “unduly reduce the effectiveness of Article 102 TFEU”, for this would require establishing those strict conditions.

Secondly, at §31, the TeliaSonera Court categorized a margin squeeze as a form of “exclusionary” abuse, hinting that one cannot do away with the application of anticompetitive exclusion tests in discrimination cases. In 2013, the CJEU in Post Danmark in fact confirmed this, stressing that “the fact that a practice of a dominant undertaking may [...] be described as ‘price discrimination’, [...] cannot of itself suggest that there exists an exclusionary abuse”. 41

Conclusion

As hinted above, the positive margin squeeze theory can be called a legal “zombie”. It is a theory of harm which is dead – it was overruled – but which does not know that it is dead – it is still often presented as currently applicable law.

Moreover, it shares another analogy with zombies: the positive margin squeeze is brain-defective for it stands to reason that no dominant firm pricing policy that keeps rival profitable can yield “exclusionary” effects on equally (or more) efficient rivals. In reality, a firm that makes profits can only be excluded by a more efficient competitor... or by an act of god (i.e. governmental expropriation, war, etc.). 43

Fortunately, however, in TeliaSonera, the Court did not get everything wrong. As noted by several authors, the TeliaSonera Court submitted price squeezes with positive margins to a higher standard of proof than price squeezes with negative margins. 44 At §73, it held that when the dominant firm’s pricing conduct led to a negative margin (wholesale price > retail price), ex-
clusion could be presumed as “probable”. In contrast, at §74, it held that in the presence of a positive margin (wholesale price < retail price), “likely” problematic effects had to be “demonstrated”. Real, though limited, relief...