

# MARGIN SQUEEZE IN THE U.S. AND THE EU: WHY THEY DIFFER?

*Professor Demetrius Yannelis*

Department of Economics, University of Piraeus

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## Abstract

Margin squeeze has recently emerged as an important issue in the electronic communications markets in the EU, as many incumbent operators have exercised this strategy in order to foreclose competitive new entrants. The experience in all European cases considered in the literature so far shows the difficulty and complexity faced by the competition enforcement authorities in implementing the appropriate imputation test for the purpose of substantiating an abuse of the dominant position. In the US, some Courts have followed a different approach and some authors do not consider margin squeeze as a stand-alone form of anti-competitive conduct. Recent Court decisions have validated these claims and there is a renewed interest on the question of the usefulness of margin squeeze tests in protecting competition and consumers. In the economic literature, there are two imputation tests that can be applied to demonstrate an abusive margin squeeze. The first test known as the Equally Efficient Operator (EEO) test is based on the costs of the incumbent. The second test known as the Reasonably Efficient Operator (REO) test is based on the costs of the entrant. The aim of the present paper is to analyze these tests and stress their weaknesses as policy tools. In doing so we will compare the different approaches on the issue of margin squeeze by the EU and the US antitrust authorities. Furthermore, we will offer some thoughts on how the margin squeeze problem can be tackled from a dynamic point of view.

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**Keywords:** Margin squeeze, regulation, abuse of dominance, antitrust

## Introduction

Margin or price squeeze and its conformity with Article 102 TFEU has recently emerged as an important issue in the electronic communications markets in the EU, as many incumbent operators have exercised this strategy in order to foreclose competitive new entrants. The experience in all European cases considered in the literature so far shows the difficulty and complexity faced by the competition enforcement authorities in

implementing the imputation test for the purpose of substantiating an abuse of the dominant position. In the US, some Courts have followed a different approach and some authors do not consider margin squeeze as a stand-alone form of anti-competitive conduct. This approach will be examined later in the paper.

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The aim of the present paper is to analyze these tests and stress their weaknesses as policy tools. In doing so we will compare the different approaches on the issue of margin squeeze by the EU and the US antitrust authorities. Furthermore, we will offer some thoughts on how the margin squeeze problem can be tackled from a dynamic point of view.

### **What is a margin squeeze?**

In general, a margin squeeze exists when a dominant vertically integrated operator sets its wholesale and/or retail prices at levels that do not give a reasonable margin to its downstream competitors (see Crocioni and Veljanovski (2003). According to the

European Commission “Notice”: “A price squeeze exists if “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”(see European Commission (2002b). The crucial factor is the margin between the wholesale and retail price and not the absolute value of each one price.

Below are some definitions of margin squeeze that the European Commission has applied in recent cases.

According to the European Commission Decision (2003b) in the Deutsche Telecom case: “a margin squeeze exists if the charges to be paid to DT for wholesale access... are so expensive that competitors are forced to charge their end users prices higher than the prices DT charges its own end users for similar services. If wholesale charges are higher than retail charges, DT’s competitors, even if they are at least as efficient as DT, can never make a profit...”. Also according to the CFI (2008) in the same case: “If the applicant’s retail prices are lower than its wholesale charges, or if the spread between the applicant’s wholesale and retail charges is insufficient to enable an equally efficient operator to cover its product-specific costs of supplying retail access services, a potential competitor who is just as efficient as the applicant would not be able to enter the retail access services market without suffering losses”.

A similar approach has been taken by the Commission in the Telefonica case: "... a margin squeeze is an insufficient margin between the price of an upstream product A and a price of a downstream product A+B of which A is a component...It is this difference and not the specific level of the retail and/or wholesale prices which is of importance in margin squeeze cases"(see Commission Decision (2007).

Here arises the crucial question. What insufficient means? If we adopt the definition provided by Carlton (2008) then an entrant will exit the downstream market as it will be not be able to compete profitably: "A price squeeze occurs when a vertically integrated firm supplies an input to its downstream competitors at a price that generates a profit margin so low that the competitors exit the downstream market."

However, there remains the issue of timing. Given a margin squeeze, will the entrant continue operating with a loss and for how long? Or will the entrant exit the market once margin squeeze is applied by the incumbent? These questions are important since they are related to the opening of the downstream market to competitors and to whether the NCA should intervene promptly to allegations of margin squeeze or wait until the market matures as we will see below. Furthermore, as Sidak (2008) points out "...attempting to implement regulatory policy through section 2 of the Sherman Act is ill-advised, both because it makes no sense for courts to re-regulate deregulated or lightly regulated industries, and because courts lack the institutional competence to implement regulation". On the other hand a crucial question arises: what should be the remedy? How the regulator should set the "sufficient" margin?

### **Recent margin squeeze cases in Telecommunications**

In 2003 Telecom Italia, the incumbent telecom operator, abused its dominant position in the market of fixed line telecom services. The practices involved a price squeeze in the procurement for the provision of telecom services to the Public Administration and the use of restrictive vertical contracts with the top business clients. The wholesale interconnection services were regulated, while retail prices to the Public Administration were unregulated and were determined through a procurement auction. Telecom Italia accused for bidding below costs (see Polo (2007).

The European Commission found that between September 2001 and December 2006, the margin between Telefonica's retail prices and the prices for wholesale broadband access at the regional and national level was insufficient to cover the costs of an operator as efficient as Telefonica (see European Commission (2007)). Furthermore, according to the European Commission, Deutsche Telekom from 1998 to 2001 has infringed Article 82 EC by operating abusive pricing in the market for direct access to its fixed

telephone network in the form of a margin squeeze. DT was charging its competitors prices for regulated wholesale access that were higher than its prices for retail access to the local network (see European Commission (2003) and CFI (2008)).

Wanadoo Interactive has been fined for predatory pricing. France Telecom's Internet access subsidiary, Wanadoo, had charged predatory prices for its consumer broadband internet access services. The company was not vertically integrated so the case was one of predation instead of a margin squeeze (see Commission Decision (2003a)).

### **Is there an efficient rule for pricing the input?**

The efficient component pricing rule (ECPR) has been proposed by Baumol (Baumol and Sidak, (1994); Willig, (1979)) as the proper way to assign access charges to an entrant wishing to join a network which is operated by an incumbent monopoly. When the services offered by the potential entrant are substitutes to the ones offered by the monopoly, the ECPR states that the access price that must be charged by the monopoly must be equal to the average incremental cost incurred by the entrant plus the opportunity cost or profit foregone with the entry of the competitor.

Laffont and Tirole (1994) have analyzed the conditions under which the ECPR attains productive efficiency and notice that they are quite restrictive. Armstrong, Doyle, and Vickers (1996) have also examined the optimality properties of the ECPR, and their main conclusion is that since the notion of the opportunity cost is vague and very hard to estimate, the simple ECPR does not offer any advantage over the complex Ramsey pricing rule. The ECPR can be derived under the assumption that the monopoly is willing to provide entry to the competitor as long as its profits will remain the same (the “indifference principle”). However, the monopoly may not know in advance how the entry of the competitor is going to affect its profits, especially if the services offered by the entrant are not perfect substitutes to the ones offered by the monopoly. Therefore, opportunity costs may not be known in advance.

The fact is that this rule is only a partial one and has nothing to say in an unregulated environment. In the absence of regulation, the incumbent can invite entry and keep increasing the price of the wholesale input together with the retail price in the downstream market at the expense of consumers.

### **Margin squeeze in practice**

It is well known (see ERG (2009)) that there are two imputation tests that can be applied to test for a margin squeeze. The first test known as the Equally Efficient Operator (EEO) test is based on the costs of the incumbent: If  $P - c \geq d_i$  then there is no margin squeeze, where  $c$  = wholesale price of

essential input,  $P$  = downstream retail price of incumbent and  $d_i$  = downstream costs of incumbent. The second test known as the Reasonably Efficient Operator (REO) test is based on the costs of the entrant: If  $P - c \geq d_e$ , then there is no margin squeeze where  $c$  = wholesale price of essential input,  $P$  = downstream retail price of incumbent and  $d_e$  = downstream costs of entrant. In almost all recent cases regarding margin squeeze abuse the first test has been used. It is known that (see ERG (2009)) the second test is used in mature markets where the aim of the regulator is to promote competition.

However, there are certain limitations to the REO approach: 1) It does not provide a clear way of calculating the downstream costs of a hypothetical "reasonably efficient" entrant. 2) It may attract a non-efficient entrant and may provide proof of margin squeeze when the non-efficient entrant has very high costs. 3) It is inconsistent with the first test, which in fact has always been used by the European Commission and the Community Courts. 4) It does not assist in cases where the incumbent operator is more efficient than the entrants or some of the entrants are more efficient than others. 5) It is in contrast with the rule of competition law. Margin squeeze is based on ex ante assumptions and forecasts rather than on ex post facts.

More importantly it contradicts the fundamental assumption of economic theory that each firm sets its prices so as to maximize its *own* profits or minimize its *own* costs. Furthermore, objections to the use of the REO test are related to the question whether the market under consideration is mature or rather at the stage of commercial and technical experimentation. It is suggested that the REO test is used a) in mature markets and b) where the aim of the regulator is to promote competition. Otherwise, it is very difficult to know whether the 'hypothetical' reasonably efficient competitor is as-efficient-as the incumbent, and in any case it is not appropriate to induce less efficient entry if there are no structural deficiencies in the market.

Limitations also apply to the EEO test. At the core of all the criticisms lies a realization that the construing elements of the margin squeeze test under competition law depend on a number of *ad hoc* assumptions. The timeframe in estimating the cash flow analysis is important since it considerably affects the Net Present Value (NPV) under the price squeeze test. The range of timeframe considered in international practice is striking ranging from five to ten years. This considerably affects the value of the NPV and, therefore, the validity of the margin squeeze test. Another important factor is the type of costs and revenues included in the test. When a company enters a new market, it normally incurs significant early on-going costs, which may be reduced in the future once the company becomes more established. These higher early costs include marketing costs, advertising costs and early learning costs, as the company acquires greater knowledge of customer demands etc. The company's costs are also likely to fall as it

increases output towards an efficient scale. It is therefore, very hard for a new entrant to compete the incumbent that fully exploits the benefits of economies of scale and scope.

In any case, the courts must heavily rely their decisions on ex ante calculations based on assumptions that may prove irrelevant or simply false.

### **The US approach**

The US approach is different than the EU approach as the margin squeeze cannot be recognized as a stand-alone violation of antitrust law. Two important cases by *Trinko* and *linkLine* suffice to show the differences in the two approaches. In *Trinko* the Supreme Court led to the following statements: 1) the existence of a regulation does not create an antitrust duty to deal, which was the case of the then incumbent regulated carrier Verizon. 2) if a firm has no duty to deal with its competitors at wholesale, it has no duty to deal under conditions that the rivals find advantageous. The Supreme Court in the *linkLine* case applied the reasoning in *Trinko* to pricing conditions (rather than service assistance) to conclude that if there is no antitrust duty to deal at the wholesale level and no predatory pricing at the retail level, then a firm is not required to price both upstream and retail services in a manner that preserves its rival's profit margin. The Court found that in order to establish harm from the margin squeeze accusation, it must be shown that the incumbent's retail price was predatory. *Sidak* and *Bork* intervening as *Amici Curiae* in *linkLine* case stressed the regulatory nature of the price squeeze issue, “which makes sense only as a rule of price regulation in an industry already subject to duties to deal and to control by institutionally competent regulators. Attempting to implement regulatory policy through Section 2 of the Sherman Act is ill advised, both because it makes no sense for courts to re-regulate deregulated industries, and because courts lack the institutional competence to implement regulation”.

However, the two approaches may be reconciled if we can show that margin squeeze and predatory pricing constitute the same abuse. In our notation margin squeeze according to the equally efficient operator test occurs when  $P - c < d_i$ . Predation would imply that the retail price  $P$  is lower than the average cost of producing in the downstream market  $P < c + d_i$ . This may be the reason that US courts refuse to see the margin squeeze itself as a breach to antitrust law. In effect, the EU approach cares about the gap between  $P$  and  $c$  whereas the US does not pay any attention to the gap and considers these two variables as independent. The US approach is valid if one ignores the opportunity cost in the measurement of costs. Therefore, if the ECPR pricing is applied, so that the opportunity cost is covered by the entrant, then the US approach on predation is no different than margin squeeze. In this case the Chicago School of one monopoly profit is valid.

## Conclusion

In this paper we tried to pinpoint the differences in the treatment of margin squeeze as a stand-alone abuse in the EU against the US. In effect, the EU approach cares about the gap between P and c whereas the US does not pay any attention to the gap and considers these two variables as independent. The US approach is valid if one ignores the opportunity cost in the measurement of costs. Therefore, if the ECPR pricing is applied, so that the opportunity cost is covered by the entrant, then the US approach on predation is no different than margin squeeze. In this case the Chicago School of one monopoly profit is valid. All profit forgone (the opportunity cost) is covered through the increase in the access price, so that the incumbent has no incentive to engage in excessive pricing in the downstream market. The profit of the incumbent remains the same before and after entry of the competitor. The US reasoning is simple: if the regulator supports fair access to all players, then the only abuse by the incumbent should be that of predation. Note that excessive price is not considered an abuse in the US so that a high enough access price would not be considered as an abuse.

In other words the difference between the EU and US approach is about how they perceive the “public” network of the incumbent. If it is the result of public investment over the years, it should be provided at cost and predation is the only abuse of dominance.

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