I. Introduction

1. The Business and Industry Advisory Committee (BIAC) to the OECD appreciates the opportunity to submit these comments to the OECD Competition Committee for its roundtable on Margin Squeeze of October 19, 2009.

2. The issue of whether margin squeeze is a stand-alone test for abuse of dominance or if it should rather be subsumed under other modalities of abusive conduct as well as the issue of its design are crucial to network industries and particularly to the telecoms industry, as they result in different incentives for market behaviour and particularly for investment.

3. Over the past few years, a number of jurisdictions have adopted different approaches towards the relevance and design of the margin squeeze test, most notably, the US and the EU. In the United States, the debate about margin squeeze has triggered a more general debate about whether the antitrust laws should protect competition (which would lead to barring margin squeeze as an independent claim) or competitors (whereby margin squeeze would remain a stand-alone form of abuse of dominance).

4. This US position is based on the fact, stated also by the OECD Secretariat in its background notes, that economically equivalent actions or economically equivalent market structures should receive equivalent treatment under antitrust law. This demands, first, that the application of an independent market squeeze test has to be critically evaluated and, second, that in the exceptional cases where a margin squeeze may be recognized as a stand-alone form of abuse, the principles and standards applied have to be identical to those applied in the prosecution of an equivalent alternative form of abuse of dominance.

5. In the EU, the concern has been raised that, where a vertically integrated firm controls an essential input and competes in the downstream segment, it may employ such control as a means to drive downstream competitors out of the market or deter them from entering in the first place. In particular, the vertically integrated firm may charge high wholesale prices and, at the same time, low retail prices so that downstream competitors cannot earn a positive
margin. In such situations regulators and competition authorities would attempt to either lower the infrastructure access price charged by the vertically integrated firm or increase its downstream price. Moreover, they may impose fines for anti-competitive behaviour.

6. If the margin squeeze test is conceptualized and applied in this extremely comprehensive manner, several concrete risk-areas can be identified.

- First, some business models could be induced to restructure (e.g. to de-integrate) only to reduce their liability risk, with no positive economic effects and even with a possible negative impact on consumer welfare due to efficiency losses. This is the case because a de-integrated firm can legally charge high prices upstream, as long as they are not abusive and low prices downstream, as long as they are not predatory. To the contrary, a vertically integrated firm might be found liable for the exact same market behaviour. Therefore, some firms could partially or completely escape liability for their behaviour while having been able to demand more beneficial terms and conditions from the vertically integrated market players.

- Second, there are a number of circumstances where the above described test may suggest anticompetitive behaviour whilst it does not exist, leading to price changes that hinder large-scale investments needed to increase competitiveness as well as economic and social growth.

7. In order to avoid these situations, BIAC submits that the recognition of the margin squeeze test as a stand-alone test for abuse of dominance should be carefully assessed and that, in those scenarios where its application may be appropriate, its design has to be adjusted to protect competition instead of competitors and foster large-scale investments for the benefit of consumers.

II. Comments on the Margin Squeeze Test as a Distinct Form of Abuse of Dominance

8. Different approaches to the issue of whether margin squeeze is a different form of abuse of dominance or if it should rather be subsumed under other modalities of abusive conduct have a direct impact on investment, especially in state of the art infrastructure with high sunk costs. For example, the EU lags behind other jurisdictions such as the US when it comes to the development of very high-speed broadband networks. Although this is not only a consequence of the differences in treatment of margin squeeze claims, this issue does play an important role.

9. In the US, the view has been taken that a firm with no antitrust duty to deal in the wholesale market has no obligation to deal under terms and conditions favourable to its competitors.¹ In other words, in the absence of a duty to deal in any terms, refusal to deal in specific terms cannot be sanctioned. This is a logical, effects-based approach which provides legal certainty and an adequate legal framework for large scale investments.

10. In the EU, the principle is that an antitrust duty to deal (as imposed under the essential facility doctrine) is a prerequisite for a margin squeeze test claim, but this principle has lost much of its meaning through the various exceptions introduced.  

11. First, the Commission and the Court of First Instance have both stated that the specific factual, economic and legal context of the case may indicate the adequacy of a margin squeeze test even in the absence of an antitrust duty to deal. This does not provide the legal certainty needed to make grand-scale investments, particularly those with high fixed costs and an uncertain level of demand, such as next generation access networks.

12. Second, the Commission has stated the margin squeeze test is applicable in the absence of a duty to deal if dominance in the upstream market has been achieved through state resources or special or exclusive rights. This criterion seems somewhat at odds with the principle of ownership neutrality guaranteed by the EC Treaty and therefore should be revised.

13. Third, the EU institutions have considered that an antitrust duty to deal must not be proven if the company is under a regulatory duty to supply. The underlying assumption is that a balancing of incentives to invest and/or innovate has already been carried out by the regulator. For the energy and telecommunications industries (among others) this means that all firms that must grant access to their infrastructure are potentially subject to a margin squeeze claim. This highly discourages investments, as it does not take into account that the objectives of regulation and competition law may differ and that sector specific regulation can impose access obligations where antitrust law cannot. Moreover, it deprives firms of an in-depth analysis by the Commission and/or the National Competition Authorities by substituting their assessment by the mere transposition of a regulatory decision.

14. Indeed, the Commission has stated in the aforesaid communication that in pursuing refusal to deal cases, it will consider

- If such refusal is necessary to allow the firm to realize an adequate return on the investments required to develop its input business, taking the risk of failed projects into account;
- The fact that innovation by the sanctioned firm will be negatively affected by the obligation to supply or by the structural changes in the market conditions that imposing such an obligation will bring about, including the development of follow-on innovation by competitors.

15. Such analysis is in line with the opinion of academics, that the imposition of a duty to deal should be contingent upon two cumulative conditions

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There must be scope for significant added-value in the downstream market;

The ex-post consumer benefits of the duty must outweigh its negative impact on the undertakings’ ex-ante incentives to invest.

16. BIAC agrees with this approach, which is crucial to businesses as it directly affects their return on existing investments as well as their incentives to invest in the future.

17. Disregard for these conditions (by wrongly imposing a duty to deal or by applying a margin squeeze test in its absence merely because a regulatory obligation has been imposed) may lead to finding conduct abusive although it would most likely not lead by itself to the elimination of effective competition downstream or to consumer harm. This is the case when competitors can either replicate the facility or input in question and/or use alternative facilities or inputs to provide the downstream service. Indeed, the fact that sector specific regulatory obligations facilitate the finding of abusive conduct allows the EU institutions to intervene even in situations where competitors are able to develop their own network and where as a result the incumbent’s network is not a monopolistic bottleneck.

18. For all of the above, BIAC contends that the assessment on whether to impose a duty to deal (thereby making a firm potentially liable under a margin squeeze claim) should be conducted by the Commission and/or the National Competition Authorities on a case by case basis rather than automatically presumed whenever an access obligation has been imposed.

19. Even where an antitrust duty to deal exists, there may be no need for a margin squeeze test if the abusive conduct can be subsumed under another category of anti-competitive behaviour. As stated by the OECD Secretariat in its background notes, the price of the upstream input can be imputed as either excessive or discriminatory and the price of the downstream component can be found to be predatory. For this to be possible, the price of the upstream product must be reliably determined. This occurs if the firm is either partially integrated downstream (so that the upstream price is observable on the market) or, being fully integrated downstream, it is still possible to impute or infer the upstream price using an economically clear and reliable methodology. Although BIAC agrees with the OECD Secretariat that several methodologies coexist and may even lead to divergent results, it proposes the sharing of best practices and/or the fostering of a common methodology to impute and/or infer prices for upstream products offered by a fully vertically integrated firm to its downstream component.

20. Again, this has been the US position. The US Supreme Court held that in order to have anticompetitive effects, the prices charged must be either abusive upstream or predatory downstream. Otherwise, the alleged insufficient margin between the two prices cannot give rise to an abuse where none existed otherwise.8

21. In the EU the trend has gone in a different direction. Indeed, the Court of First Instance held that if prices are neither abusive upstream nor predatory downstream, the fact that the applicant cannot remain competitive because of its cost structure does not mean that the pricing policy of the vertically integrated firm is abusive, since even a dominant undertaking is

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not obliged to sell its products below costs. However, in a more recent case, the same Court concluded that the abuse can be connected to the unfairness of the spread between the wholesale and retail prices and not to the fact that the prices are, as such, abusive. According to this position, margin squeeze constitutes a constructive refusal to deal, because the upstream product is offered on terms that are unviable and hence do not allow competitors to operate on the downstream market.

22. Although this approach is meant to increase consumer benefits by fostering competition in the downstream market, the fact that the spread between the wholesale and retail prices is considered abusive without any reference to the underlying cost structure may have a negative impact on consumer welfare by artificially eliminating the economic efficiencies of vertical integration. This is certainly the case if the benchmark of a “(hypothetically) reasonably efficient competitor” is applied instead of that of an “equally efficient competitor.”

23. Consumers are harmed when a margin between upstream and downstream prices based on economic efficiencies is increased by raising the retail price, thereby forcing the integrated firm to create a downstream “price umbrella” which ensures the survival of non-equally efficient competitors. Consumer welfare is also negatively impacted when a merely formal margin squeeze is sanctioned by imposing a decrease of the wholesale prices, thereby adversely affecting incentives to invest.

24. Moreover, discrimination of integrated firms takes place when abuse shopping is viable. As stated by the FTC and US Department of Justice, “in Europe, (...) different abuses may well have different tests or different cost benchmarks, although the economic effect is the same, and sometimes, it's easier to prove one form of abuse than another. That shouldn't be the position. It should not enable (...) to abuse shop, to use the easiest form of abuse to prove.”

25. BIAC notes that in these cases, antitrust law would protect competitors that have chosen alternative business models to vertical integration, to the detriment of others and of the competitive process. In order to avoid the aforesaid discrimination BIAC contends that

- The application of a margin squeeze test should be confined to situations where the upstream price cannot be reliably imputed or inferred and the abusive conduct can therefore not be otherwise addressed;

- Where the application of the margin squeeze test is appropriate, such test should be purely effects based and guided by the same standards and principles as other forms of abuse of dominance under competition law.

III. Comments on the Design of the Margin Squeeze Test in Situations Where it Remains Applicable

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9 Case T-5/97 Industrie des poudres sphériques SA v Commission of the European Communities [2000].
10 Case T-271/03 Deutsche Telekom AG v. Commission [2008].
11 FTC and US Department of Justice Sherman Act Section 2 Joint Hearing of September 12, 2006.
26. BIAC notes that in those situations where the margin squeeze test is appropriate, multiple reasons call for a thorough effects based analysis (rather than the per se approach as generally applied) in order to promote investments and avoid consumer harm.

27. Since in some network industries many (if not all) of these situations prevail simultaneously, BIAC has taken the example of the telecommunications industry to illustrate the issues at hand.

28. The telecommunications industry is currently in the midst of a quantum leap technological development. Next generation networks allow the increase of data transmission speeds in the local fixed network from the current 16Mbit/s up to 100Mbit/s. This enables new applications such as IP based and high definition TV as well as interactive gaming and TV and has the potential to re-shape society by enabling the development of e-health, e-education and e-governance. However, the rollout of these networks requires substantial investment while the returns on the investments are highly uncertain. Most notably, at this stage, consumers’ willingness to pay for new services is unclear, but there are additional uncertainties in the form of upcoming infrastructure competition (e.g. cable and mobile networks) and complementary services (most notably content, e.g. games).

29. The characteristic problematic of investment in next generation access networks is that the price for the wholesale input is related to the investment case, while the price for the retail product has to meet consumers’ willingness to pay and is therefore ruled by market conditions.

30. New services based on new technologies usually involve start-up costs as well as a period of trial and error before processes run smoothly. In such situations, average unit production costs decrease as output increases due to economies of scale and learning by doing.\(^{12}\) Therefore, the situation may arise where the retail price per user with only few network users is lower than the wholesale price, which constitutes a formal margin squeeze.

32. As a consequence, investments would be made in fewer regions, not be as extensive in quality or quality or simply be delayed. And for what is still being deployed, the vertically integrated firm might be forced to increase the retail price above the optimal level so as to exceed the wholesale price. In either case, the application of the margin squeeze test in the early stages of development of new technologies leads to consumer harm.

33. On these grounds, BIAC submits that the margin squeeze test should therefore be designed on the basis of a time period that is sufficiently long as to allow the firm a positive margin after a start-up period.\(^ {13}\)

34. Furthermore, BIAC notes that the margin squeeze test as generally applied seems at odds with newly developed regulatory instruments to promote investments, such as risk sharing and risk premiums. Firms that engage in risk sharing will typically receive lower access prices than those firms that do not carry any risk. Under a risk premium, the investor is allowed to increase wholesale prices in relation to risk and without regard to retail prices.

\(^{12}\) Cabral and Riordan (1997).

This might result in situations which could be subject to sanctions under a generally applied, formal margin squeeze.

35. Therefore, BIAC considers that the margin squeeze test should be designed in a way that does not undermine the purpose of regulatory instruments specifically put in place to foster large scale investments.

IV. Conclusions

36. First, BIAC submits that the margin squeeze implies a duty to deal on certain terms and conditions and is therefore logically contingent upon the existence of a general antitrust duty to deal - and not necessarily of a regulatory duty to supply.

37. Second, BIAC is of the opinion that the margin squeeze as an independent modality of antitrust control should applied to situations where the upstream price cannot be reliably imputed or inferred and the abusive conduct can therefore not be otherwise addressed. For this purpose, BIAC proposes that best practices are shared and/or a common methodology for imputing upstream price of a fully integrated firm is fostered.

38. Third, BIAC contends that, where a margin squeeze test is appropriate, such test should

- Be purely effects based and guided by the standards and principles of competition law in order to avoid abuse shopping and provide legal certainty. In particular, the application of the test should neither be facilitated by the imposition of sector specific regulatory obligations nor contingent upon vague benchmarking criteria;

- Be designed in a way that takes due account of the sector particularities and does not discourage firms to make the large-scale investments needed to keep up with technological change.

39. Fourth and lastly, BIAC notes that disregard for these principles could lead to disrupting competition by protecting some competitors to the detriment of others. The business model of vertical integration is being discriminated against when economic efficiencies are being artificially eliminated and competitive behaviour is being sanctioned. The concern is that such discrimination unavoidably leads to consumer harm by increasing retail prices and/or reducing incentives to invest, thereby hindering competitiveness as well as economic and social growth.