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Exclusionary Price Abuses in the EU

(A developmental approach with regards to networks)

Abstract. The liberalization processes, which started in the 90's in Europe, opened up a new area for competition policy and competition scrutiny and enforcement. Both ex-ante regulation and competition policy are responsible for the consumer friendly implementation and advancement of the legislation related to the liberalization of certain public utilities. Every industry that has incumbents faces the problem of granting access to the facilities owned by the "big ones". Competition policy targets best achievable market conditions which provide the customers with the lowest prices and the market with most efficient behavior. In the long term this is only attainable with colorful market scene, vibrant conditions to operate and more options for the final customers to choose form. This, however, can be turned down by anti-competitive behavior of the participants that intends to eliminate competitors from the market. One of the various ways to achieve this is to use pricing methodologies which may straightforwardly result in forcing dependent market players to leave the playing field. Is there a way to control dominant undertakings' pricing methodologies? Can Article 82 of the EC Treaty be generalized? How did the European Court of Justice and the Commission formulate the practice towards these type of behaviors?

Keywords: European law, competition law, access pricing, network industries

I. What classifies as price abuse in the EU?[1]

Under EU Competition rules price abuses are explicitly mentioned in Article 82 of the EC Treaty:

> "Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.

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[1] See also: Motta, M.–de Streel, A.: Exploitative and Exclusionary Excessive Prices in EU Law 8th Annual EU Competition Workshop, (2003) Florence; and Tóth, T.: *Az európai Közösség versenyjoga* [Competition Law of the European Community]. JATEPress, Szeged, 2003. 115–116.

Such abuse may, in particular, consist of:
(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions"

For economists, the keystone of price discrimination is efficiency. Generally speaking, they define price discrimination as the supply of different units of commodity during the same time period at various price sets not directly corresponding to the supply costs. This involves the supply of both same amounts of units to different buyers at different prices–under the same supply costs–, as well as supplying the same buyer with the same amount of units at different prices when the price differentials are not allocated to the supply costs.[2]

II. Exclusionary and exploitative price abuse

The Article 82 of the EC Treaty provides for two types of price abuses. However, the general concept of price abuse–seeing the aim of the action–may refer to two different price abuses.

An excessive pricing practice may be *an exploitative abuse*, i.e. direct exploitation of market power. In this case, the dominant firm charges a price being too high to its being end-users or undertakings with which the dominant firm does not compete in the market. [3] This is of less relevance for the topic of this article.

On the other hand, an excessive price may constitute an *exclusionary abuse*, aiming to strengthen or maintain the market power of the dominant firm by putting rivals at disadvantage. In this case, the dominant firm in market sets the price of the input so high that the margin between wholesale and retail prices is insufficient for an efficient firm to profitably operate in the related market. This is a typical form of price abuse of upstream-downstream market relations.

A good majority of the cases on abuse of dominance have concerned exclusionary conduct by dominant firms, rather than behaviour directly exploitative of consumers. Exclusionary practices can be also indirectly exploitative of

[2] See also: Valgiurata, L.: Price discrimination under Article 86 of the EEC Treaty: the United Brands case. *International and Comparative Law Quarterly,* 31 (1982) 36–59.

[3] Motta–de Streel: *op. cit.* 1.

consumers, and, as explained by Vickers (2005), there is a view that no conduct is properly characterised as exclusionary unless it is ultimately exploitative.[4]

Many EU cases have dealt with pricing issues, which involved predatory pricing, selective price cuts, margin squeezes, and discounts as well as rebates.

The cited abuses are different in economic and legal nature. For the purpose of this article I will deal with exclusionary abuse concerning pricing issues, namely with excessive pricing, price squeeze and predatory pricing.[5]

III. Excessive pricing in the practice of the ECJ and the Commission[6]

It is not an easy task to define what excessive pricing means. What constitutes unfair pricing has caused a heated debate amongst policy makers and academics, as well as amongst judges.[7]

According to Joliet (1970), a given price is unfair when dominant firms have taken advantage of their dominant position to set prices significantly higher than those which would result from effective competition. Along with this, a price is excessive when significantly above the effective competitive level.[8]

Others (Evans *et* Padilla: 2005) approach the problem from a practical point of view, which may lead us closer to the real issues.

From a down-to-earth approach, the question is how competition policy authorities and courts could distinguish between workable competitive prices and overcharged high prices, i.e. where the limit is. The answers to these formal–and moreover practical–questions are of utmost importance since the actual effect on consumer welfare of regulatory interventions on the pricing policies of

[4] See in: Vickers, J.: Abuse of Market Power. *The Economic Journal*, 115 (2005) 246 *et seq*.

[5] Predatory pricing is regarded as variant of price squeeze in an upstream-downstream market structure, where the dominant firm uses extremely low prices at downstream level in order to eliminate competitors. I will not deal with predatory price in the classical sense when the firm being present on the retail market sets low prices for the ultimate costumers therefore fishing them from its other competitors.

[6] See also: Wish, R.: *Competition Law*. 5th edition, London, 2003. and Kalleugher J.–Sher, B.: Rebates revisited: Anti-Competitive effects and exclusionary abuse under Article 82. *European Competition Law Review,* 5. 263–285; and Vickers: *op. cit.*

[7] See also: Lang, J.T.–O'Donoghue, R.: Defining Legitimate Competition: How to clarify pricing abuses under Article 82 EC. 26 *Fordham International Law Journal* 83; and Fox, E. M.: What is harm to competition? Exclusionary Practices and Anticompetitive Effect, 70 *Antitrust Law Journal*, 2002. 371.

[8] Joliet, R.: *Monopolization and abuse of dominant position.* Liège, 1970.

dominant firms depends on the ability of competition policy authorities and courts to establish whether or not prices are excessive in practice.[9]

1. The first cases

The first case to deal with the sensitive issue of excessive pricing has been decided by the ECJ in 1975. In *General Motors* the Court–annulled the decision of the Commission on the facts–stated in point 12 of its decision that [it is possible to abuse the exclusive position of a firm by fixing prices and]

> "… such an abuse might lie, *inter alia*, in the imposition of a price which is excessive in relation to the economic value of the services provided, and which has the effect of curbing parallel imports by neutralizing the possibly more favourable level of prices applying in other sales areas in the Community, or by leading to unfair trade in the sense of Article 86 (2) a)".[10]

It is worth noting that already in this early decision the Court identifies the abuse of such pricing as being an interrelated dilemma between the excessive nature in relation to the economic value *and* the effect on parallel or unfair trade. In other words, mere excessive pricing with relation to the economic value of the service in question would not suffice the establishment of the abuse.

A year later, in the *United Brands* case, the ECJ went one step further and applied another mechanism.[11]

The Court observed that the UBC abused its dominant position on the banana market by partitioning the national markets and consequently by applying different prices in different countries, sometimes with a 100% difference, which actually had no relation to the economic value of the product.

It held that:

> "It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.

[9] Evans, D.–Padilla, J.: Excessive Prices: Using Economics to define Administrable legal rules. *Journal of Competition Law and Economics,* 1 (2005) 97–122.

[10] Case 26/75 *General Motors Continental NV v Commission of the European Communities*, European Court Reports (1975) 1367.

[11] Case 27/76, *United Brands Company and United Brands Continentaal BV v Commission of the European Communities*, European Court Reports (1978) 0207.

> In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product would be an abuse."[12]

While the Court turned down partially the decision of the Commission it pointed out that the lack of the appropriate cost-accounting system did not enable the Commission to sufficiently assess the real costs of UBC, and therefore the proper comparison had been the contrast of the prices on the territories where the undertaking was operating and where the bananas were sold.[13]

The Court therefore used the methodology to prove an excessive price in *United Brands* as follows:

> „This excess could, *inter alia*, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its costs of production, which would disclose the amount of the profit margin (...).
> …
> Other ways may be devised and economic theorists have not failed to think up several of selecting the rules for determining whether the price of a product is unfair".[14]

Overall, the Court stated that in order to show that the prices are unfair the Commission has to prove that the compared prices are profitable and are different without just reasons.[15]

2. Progress in the practice of the Court–the eighties

Some years later the Commission fined *British Leyland* for the abuse of dominant position on the market of issuing national certificates of conformity because of excessive pricing, which were aimed to curb parallel imports of certain cars from other Member States.[16]

The Court of Justice upheld the Commission's decision considering that the costs did not relate to the service performed–rather, they reflected a simple

[12] *Ibid.* points 249–250.

[13] *Ibid.* points 251–254.

[14] *Ibid.* points 251–253.

[15] In this case, the Commission failed to do this, therefore the Court has decreased the fine.

[16] Commission Decision of 2 July 1984, *British Leyland*, Official Journal (1984) L 207/11.

administrative check–, and reiterated that the aim of such costs was to discourage imports from other Member States.[17] Moreover, the discriminatory prices for the issued certificate–more expensive for dealers than for private individuals– also represented that the sole reason for the charge was to discourage dealers from fierce competition by re-importing vehicles.

Consequently, the Court found that applicant was acting afoul of Article 82 (ex 86) specifically, by gravely restricting the opportunity for parallel trade.

The further filtered price and cost analysis of the Commission had been upheld by the Court in the *CICCE case*.[18] In its decision the ECJ upheld the Commission's decision that prices should not be compared in a generalized way but rather taken into account the different costs of different firms, even if they produce similar products due to the substantial variance of costs.[19]

In the *SACEM II case* the Court came to two important conclusions.[20] The first one concerns the X-efficiency, which is when the costs of an inflated firm are taken into account as opposed to the cost of a competitive firm with lacking monopoly power. In its judgment the Court declared that

> "… Where … the staff of a management society is much larger than that of its counterparts in other Member States and, moreover, the proportion of receipts taken up by collection, administration and distribution expenses rather than by payments to copyright holders is considerably higher, the possibility cannot be ruled out that it is precisely the lack of competition on the market in question that accounts for the heavy burden of administration and hence the high level of royalties."[21]

The Court elaborated on the matter of market prices on different markets in the *Bodson case*.[22] In paragraph 31 of its decision the ECJ concluded that it is possible to make a comparison between prices charged by the undertaking that

[17] Case 226/84, *British Leyland Public Limited Company v Commission of the European Communities*, European Court Reports (1986), 3263, para. 28.

[18] Case 298/83, Comité des industries cinématographiques des Communautés européennes (CICCE) v Commission of the European Communities, European Court Reports (1985) 1105.

[19] *Ibid.* para 24–25.

[20] Case 110/88, 241/88, 242/88, *François Lucazeau and others v Société des Auteurs, Compositeurs et Editeurs de Musique (SACEM) and others*, European Court Reports (1989) 2811.

[21] *Op. cit.* Case 110/88, 241/88, 242/88, para 29.

[22] Case 30/87, *Corinne Bodson v SA Pompes funèbres des régions libérées*, European Court Reports (1988) 2479.

holds a dominant position and the prices of a competitive market where prices are defined according to the fierceness of the competition.

However, in the previously mentioned *SACEM II case* the other significant conclusion made by the Court was when answering the referring French court's question, it stated that–with the lacking requirement of the competitive market in the other Member State–the abuse of dominant position by a firm is indicated by charging higher prices in one Member State than in the other where the costs are compared on a consistent basis. And this also requires the dominant firm to prove opposite of this allegation.[23] Consequently, the geographical market comparison was applied as ancillary to the cost and price analysis by the both the Commission and the Court of Justice.[24]

Nevertheless, as Motta and de Streel point out (Motta *et* de Streel, 2003) it is likely that the investigating national authorities or the Commission would take into consideration the false national markets where all compared markets would be monopolised by different market players. This would, indeed, create a biased situation.

The differentiation of national markets or even sub-markets within one member state should be considered as not being the only difficulty when comparing several cost structures. As the ECJ held in the *CICCE* case, the variance of cost structures and methodologies for allocating costs are central too. It is hard to imagine that two different enterprises are using accidentally identical costing schemes.[25] Therefore when the responsible authority carries out an investigation it should focus on specific issues and in-depth economic cost examination. A statement whether the practice is anti-competitive should only follow a substantial and detailed enterprise-specific analysis.

[23] *Op. cit.* Case 110/88, 241/88, 242/88, para 25.

[24] The method of geographical comparison of prices had been applied by the Commission earlier in the 70's. In the *Deutsche Grammophon* case the ECJ stated that it is not necessarily an abuse if the market prices are different in various Member States, however it is a definite indicator of such abuse if these differences are not objectively justified. Case 78/70, *Deutsche Grammophon Gesellschaft mbH v Metro-SB-Großmärkte GmbH & Co. KG*, European Court Reports (1971) 487, para 19. See also: Case 24/67, *Parke, Davis and Co. v Probel, Reese, Beintema-Interpharm and Centrafarm*, European Court Reports (1968) 55.

[25] It is also an indication if two firms are "accidentally" using exactly the same structure but differ in prices with regards to the same product. This may result in the founding of anticompetitive behavior but this is a different issue.

3. Sector specific regulation and price abuse

Pricing issues become more complex when there is a sector specific regulation that–at least to some extent–"ties the hands" of the market participants.

The first case to deal with the dubious relation between sector specific regulation and competition law with regards to pricing issues was the *Ahmed Saeed case*.[26] This was the initial case when the Commission and the ECJ has touched upon prices that were somehow indicated by sector specific regulation, in this case concerning air carriers. With regards to the relation of the two above, in paragraph 43 of the decision, the Court stated that

> "Certain interpretative criteria for assessing whether the rate employed is excessive may be inferred from Directive 87/601/EEC, which lays down the criteria to be followed by the aeronautical authorities for approving tariffs. It appears in particular from Article 3 of the directive that tariffs must be reasonably related to the *long-term fully allocated costs* of the air carrier, while taking into account the needs of consumers, the need for a satisfactory return on capital, the competitive market situation, including the fares of the other air carriers operating on the route, and the need to prevent dumping."

By this, the Court suggested that given the sector specific regulation, prices are indicated through the method of long-term fully allocated costs, and therefore if the undertaking is charging fees which are afoul of this accounting method they are reliable for both the breaching of the sector specific regulation and (ex) Article 86 (1) a).

However, it is not indicated in the decision what type of rule should be applied if there is no regulation specific to the industry. Also, it still remains an open question whether there is a possibility to use benchmarking methods from other sectors.

Generally, it is highly supported if there is an efficient regulatory scheme in the complementary markets via which non-discriminatory access is guaranteed to the targeted markets. The basis of this establishment should be an efficient and forward-looking price regime, where feasible.

[26] Case 66/86, *Ahmed Saeed Flugreisen and Silver Line Reisebüro GmbH v Zentrale zur Bekämpfung unlauteren Wettbewerbs e.V.,* European Court Reports (1989) 803.

4. Development in the practice of the Commission

A) Belgacom v. ITT Promedia

A positive outcome was reached in the *Belgacom* case,[27] referred to the Commission in a complaint for abuse of dominant position filed by ITT Promedia NV in 1995.

ITT Promedia NV, the Belgian subsidiary of ITT World Directories Company, accused Belgacom, the Belgian telecommunications operator, of charging discriminatory and excessive prices for access to data on subscribers to its voice telephony services. The company alleged *inter alia* that the conditions which Belgacom intended to apply for access to its subscriber data for publishing telephone directories were excessive and discriminatory and thus caught by Article 86 (now Article 82) of the EC Treaty.

Following a formal statement of objections issued by the Commission, Belgacom endeavoured to meet the Commission's concerns and submitted a business proposal regarding access to its subscriber data for publishers which has now culminated in the present settlement. In assessing Belgacom’s proposal, the Commission’s services were assisted by an expert consulting firm to verify the cost-oriented basis of the proposal.

Consequently, the Commission reached a settlement with Belgacom on the conditions under which publishers of telephone directories in Belgium had access to data regarding subscribers of Belgacom’s voice telephone services (access to listing services). Following the settlement, directory publishers in Belgium were to be charged a price which was set in such a way that Belgacom could recover the costs it incurred in the collection, treatment and provision of the subscriber data required for publishing purposes, plus a reasonable profit margin.

The Commission considered that, insofar as publishers of directories were dependent on telecommunications operators, access to data should be non-discriminatory and based on prices calculated according to the operator’s own costs.

[27] *Competition Policy Newsletter* 3 (1997) 13–14. Available on: http://europa.eu.int/comm/competition/publications/cpn/cpnv3n01.pdf, consulted on 14 February 2006. Also: Press release IP/97/292 of 11/04/1997, on: http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/97/292&format=HTML&aged=1&language=EN&guiLanguage=en, consulted on 14 February 2006.

This cost-oriented approach led to a very substantial reduction of more than 90% in the amount originally charged to telephone directory publishers and was declared to be applicable throughout the EU.

On the other hand, the Commission left level playing field open for further–mainly technical–developments, which could allegedly lead to alterations in applied pricing mechanisms.

B) Deutsche Telekom I.[28]

The Commission initiated proceedings against Deutsche Telekom AG (DT), the German telecommunications operator, following a complaint in 1996, made by a competitor against the conditions imposed on third parties for access to DT's infrastructures.

After DT had submitted a draft new contract offering network access to competitors, the Commission had a price survey carried out by an accountancy firm which demonstrated DT's inability to prove that its prices were cost-orientated and found the price level to be 100% higher than on comparable competitive markets.

The Commission emphasized that it did not wish to act as a price regulator, but as a result of the comparative market analysis, which showed that the prices of DT were exorbitant, DT was invited to adjust the tariffs it charged to real economic conditions so that they could not constitute an abuse of a dominant position–in terms of price-squeeze–under the relevant Article of the EC Treaty.

Thus, at long last, DT agreed to substantially lower its network access tariffs, in particular for providers of business services, by 38% for access to the local network and 78% for access to the long-distance network, and the Commission decided to terminate the proceedings.

C) Deutsche Telekom II.[29]

In January 1998, the Commission opened a procedure against DT on the basis that DT's fees for carrier-pre-selection and number portability were excessive, and hence, allegedly constituted an infringement of Article 82 of the EC Treaty.[30]

[28] XXVIIth Report on Competition Policy (1997), point 77. Available on: http://europe.eu.int/comm/competition/publications/broch97_en.pdf, consulted on 15 February 2006.

[29] Press release IP/98/430 of 13/05/98, on: http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/98/430&format=HTML&aged=1&language=EN&guiLanguage=en, consulted on 16 February 2006.

During the investigation period, the Commission sent out information requests to 35 telecommunication operators throughout Europe. In this request, the operators were asked to indicate their terms and conditions of carrier pre-selection and number portability, and notably the fees charged for such services. The analysis of the replies showed that the fees charged by incumbent operators in other Member States, as well as the ones submitted by various German alternative providers, were considerably lower than those of DT.

In April 1998, the German Regulatory Authority rejected DT's announced fees–which were already the corrected amounts–in the case of number portability for being too high; and parallel, the incumbent operator withdrew the requested fees for pre-selection.

As a result of the National Regulatory Authority's decision and the taking into consideration of the results of the information request's analysis, the European Commission terminated its inquiry into Deutsche Telekom's DT fees because it observed no reason for pursuing its own initiative procedure on the grounds of excessive pricing.

Following the decision, on the basis of DT's corrected request with new fees, the Commission decided to transfer the case to the German authorities for further examination of a possible abuse of dominant position by the incumbent.

D) Commission's investigation into international phone call prices[31]

The investigation concerning the charges for international phone calls paid to dominant operators in 1997 had been initiated by the Commission because charges for international calls were at the time generally higher than for making calls within a single member state.[32]

[30] The initiation of the proceedings was based on the incumbent's announcement of the proposed fees for the services concerned. The Commission considered that these fees may constitute a barrier to market entry for alternative operators in Germany, and consequently, could also serve as a negative example for other incumbent operators in Europe. Thus, it was important for the Commission to carry out and international comparison in this respect.

[31] Press release IP/97/1180 of 19/12/1997, on: http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/97/1180&format=HTML&aged=1&language=EN&guiLanguage=en, and Press release IP/98/763 of 13/08/1998, on:http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/98/763&format=HTML&aged=1&language=EN&guiLanguage=en, and

[32] The proceedings started before the telecommunications markets were fully liberalised on 1 January 1998.

The investigation mainly concerned the so called accounting rates, which were originally set to cover the total cost of transporting the telephone call but–at the commencement of the proceedings–were no longer justified as technological development made it possible to make noticeable reduction in such costs.

At the time of the initiation of the investigation two sets of policies required that accounting rates charged by major European operators were cost-oriented: under competition rules, the prohibition of abuses of dominant positions Article 86 (now Article 82) of the EC Treaty; and respectively, under harmonisation rules, the so called "interconnection Directive" (based on Article 100A of the EC Treaty).[33]

Requests for information had been sent to all dominant telecommunication operators at the time in the EU in order to collect the information necessary to assess the competition aspects of the accounting rate arrangements.[34]

The investigation dealt with accounting rates, which is one of the ways for an operator to account for its customers' calls to another country, and focused more specifically on intra-Community calls.

Although liberalization of the EU telecoms markets allows other systems to be used, an important proportion of cross-border calls within the EU was at the time still forwarded through the traditional accounting rates system, based on bilateral agreements between operators.

Accounting rates had an important influence on the prices that users paid for international phone calls. The investigation did not focus on the end-user international prices, but it was indirectly relevant to these prices, since reductions in accounting rates should have led to substantial price reductions for consumers. A number of criteria were used in order to focus a second phase of procedures.

Where actual costs for international calls could not be provided, the criteria included the margin between the accounting rates applied and "interconnect +", defined *as national interconnection rates plus additional costs* specific to the international routes.

[33] Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in Telecommunications with regard to ensuring universal service and interoperability through application of the principles of Open Network Provision (ONP), Official Journal L 199 of 26 July 1997. 0032–0052.

[34] At the time, in parallel, national telecommunications regulators were implementing the interconnection Directive, which required that the principles of cost orientation and non-discrimination were to be applied to both national interconnection and cross-border interconnection.

Tests were made both using the operators' interconnection rates on their domestic markets and using the EU "best practice" interconnection rates, in order to avoid discrimination against operators with lower interconnection rates.

IV. The first formal Commission decisions on price abuse in the telecom sector[35]

The leading Commission decisions with regards to abusive pricing behaviour emerged in the specific field of margin–i.e. also: price–squeeze. Before examining the first formal decisions and terminated procedures of the EC Commission concerning price squeeze, it is necessary to talk about the phenomenon in general.

1. Margin squeeze as an exclusionary abuse

A) Margin squeeze in general

Margin squeeze occurs when a vertically integrated dominant firm sets the wholesale price for an upstream product–available for downstream competitors–and the retail price for its final product such that the margin between them is disproportionately low, thereby anti-competitively squeezing rivals downstream or making it impossible for would-be competitors economically to enter the market.

This occurs also, when the retail-wholesale margin is zero, in other words the wholesale price is unduly high relative to the retail price or when the retail price is unduly low relative to the wholesale price. It can also be seen as akin to undue discrimination between self-supply and supply to others.[36]

In economic terms, anti-competitive price squeeze arises when a vertically integrated undertaking, with market power in the provision of an essential upstream input, prices it and/or its downstream product service, in such way and for a sufficiently long period of time to deny an equally or more efficient downstream rival a sufficient profit to remain in the market.[37]

For those vertically integrated firms who serve upstream access it is critical how wide the retail-wholesale margin is. As pointed out by Vickers (2005),

[35] See also in: R. Klotz et al.: The Commission decisions on price abuse in the telecommunications sector. *Competition Policy Newsletter* (2003) 8–13.

[36] See also in: Vickers: *op. cit.* 250–251.

[37] Crocioni, P.–Veljanovski, C.: Price Squeezes, Foreclosure and Competition Law: Principles and Guidelines. *Journal of Network Industries* 4 (2003) 30 *et seq.*

while too small a margin can squeeze out efficient rivals, too large a required margin would shelter inefficient rivals to the detriment of productive efficiency.

The other question is always whether there is a right benchmark by which to judge rivals efficiency. This is one of the hardest scales to determine in competition law.

B) Margin squeeze in the EU[38]

The definition of margin squeeze refers to situations in which a vertically-integrated–usually dominant–firm uses its control over an input supplied to downstream competitors to prevent them from making a profit on a downstream market in which the–usually dominant–firm is also present. The supplying firm could do this in several ways.

It could raise the input price to levels at which rivals could no longer sustain a profit downstream. Alternatively, it could engage predatory 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.[39]

Unless the dominant firm is actually discriminating in the prices charged to downstream rivals and its own integrated business the transfer charge that its downstream subsidiary pays to its upstream business should to be the same as the input charge paid by downstream competitors. This practice however, may already fit into the non-discriminatory derogations of Article 82.

1. The question of dominance

The first question arises with regards to the abuse of dominant position concerning this type of abuse when we want to define the firm’s dominance.

Should there be dominance in both markets, or is it enough if the firm is dominant in the upstream market and uses the price squeeze to leverage dominance on the downstream market?

According to Article 82 of the EC Treaty, there is no need for dominance in both markets.

[38] See also: Geradin, D.–O’Donoghue: The Concurrent Application of Competition Law and Regulation: the case of margin squeeze abuses in the telecommunications sector. *Journal of Competition Law and Economics* 2 (2005) 355–425.

[39] See also: Geradin–O’Donoghue: *op. cit.* 357–358.

There are, however contradictory opinions (Bellamy and Child: 2001),[40] which conclude that double dominance is needed.

The ECJ has pointed out in its case law[41] that:

> "Price squeezing may be said to take place when an undertaking which is in a dominant position on the market for an unprocessed product and itself uses part of its production for the manufacture of a more processed product while at the same time selling off surplus unprocessed product on the market, sets the price at which it sells the unprocessed product at such level that those who purchase it do not have sufficient profit margin on the processing to remain competitive on the market for the processed product."

This concept is controversial for example because it does not deal with the duration of the price squeeze, however it is economically more acceptable and logical given that it is enough to have dominant position on one market rather than having market power equal to dominance on both because this position already creates an incentive for the dominant company to behave abusively by leveraging its power from one market to the other.

2. Legal price squeeze

On the other hand, not all types of price squeeze are prohibited under Article 82.

The essence of exclusionary abuse plays an important role when judging pricing behaviour hence competition on the merits is not at all afoul of competition rules. Only certain practice is contrary to EC competition rules and therefore is to be condemned, i.e. which aims at eliminating efficient competitors from the market or hinders would-be–but still, efficient–competitors from entering into the market.[42]

Such pricing can also be a rational business strategy, even if not in many cases.

For example, price squeeze would be acceptable under changing market conditions, where even firms with significant market power (i.e. it is stated in the framework of Electronic Communications) have to fight for costumers in

[40] Bellamy and Child (ed.: Roth P.): *European Community Law of Competition.* London, 2001, 730. Also, on the controversial issue of dominance, see: Kapitány, I.: Az európai bizottság kontra Microsoft ügy; avagy hátrány-e az előny? [The European Commission v. Microsoft Case. Is Advantage Disadvantageous?] *Jogtudományi Közlöny*, 2006/3. 91–108.

[41] Case T-5/97, *Industrie des Poudres Sphériques SA v Commission* (2000) European Court Reports II-3755., para 178, detailed later.

[42] See also: Crocioni–Veljanovski: *op. cit.* 31–35.

the new–regulatory–environment. A broader geographic and product or service market definition may also create fierce competitive environment when the dynamism of the market entails the companies to act in a different way.

2. Price squeeze in the practice of the ECJ

A) The *National Carbonising* case[43]

The National Carbonising Co. (NCC) purchased all its coal from the National Coal Board and competed downstream with the National Coal Board's subsidiary–National Smokeless Fuels Limited–in the supply of industrial and domestic hard coke to UK consumers. Coal has to be technically transformed in order to be sold as domestic or industrial hard coke. National Coal Board held a monopoly position in coal production and its subsidiary almost 90% of the downstream coke market. As a result of continuing increases in the cost of the supplied raw materials sourced from National Coal Board, the costs of production rose by a significant amount so that NCC would not have been able to operate economically on the basis of these pricing structures and sought interim relief.

The Commission's decision–the complaint was refused after the interim measures–does not enter into detail on the appropriate 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."[44]

The Commission held, at paragraph 14 of its decision, that:

> "… an undertaking which is in a dominant position as regards the production of a raw material (in this case coking coal) and therefore able to control its price to independent manufacturers of derivatives (in this case, coke) and which is itself producing the same derivatives in competition with these manufacturers, may abuse its dominant position if it acts in such a way as to eliminate the competition from these manufacturers in the market for derivatives. From this general principle the services of the Commission

[43] Commission Decision 76/185/ECSC of 29 October 1975, *National Carbonising*, Official Journal (1976) L 35/6.

[44] Geradin, D.–O'Donoghue: The Concurrent Application of Competition Law and Regulation: the case of margin squeeze abuses in the telecommunications sector. *GCLC Working Paper* (2005) 04/05, Bruges, 25.

> deduced that the enterprise in a dominant position may have an obligation to arrange its prices so as to allow a reasonably efficient manufacturer of the derivatives a margin sufficient to enable it to survive in the long term."

B) The *British Sugar* case[45]

In the *British Sugar case*, British Sugar was found to have abused its dominant position by setting its retail and wholesale sugar prices so that the margin between the two was insufficient to reflect its own costs of transformation, i.e. the repackaging costs.[46]

According to the investigation of the Commission, British Sugar was found dominant in the upstream market for the supply of raw sugar in the UK. Derived sugar sold in the UK, which can only be produced from raw sugar, was defined as the relevant downstream market. British Sugar was vertically integrated competing in the downstream market for derived sugar with Napier Brown, which purchased raw sugar from British Sugar.

The EC Commission found that the difference between British Sugar's prices for derived sugar and the price it charged its competitor for raw sugar was insufficient for the latter to cover its own costs of transformation, consisting mainly of repackaging costs.

Therefore, the Commission concluded that British Sugar's pricing scheme was a price squeeze and so an abuse of its dominant position under Article 82 of the EC Treaty aimed at forcing Napier Brown to leave the downstream market.

C) The *Industrie des Poudres Sphériques* case[47]

In this case the Court of First Instance rejected the appeal by the complainant but at the same time laid down some important principles.

Industries des Poudres Sphériques (IPS) applied for the annulment of a 1996 Commission decision 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, which is a derivative of primary calcium metal. IPS and PEM were competitors in the derivative market for broken calcium metal.

[45] Commission decision 88/518/ECC of 18 July 1988, *Napier Brown-British Sugar*, Official Journal (1988) L 284/41.

[46] *Ibid.,* para 66.

[47] Case T-5/97, *op. cit.*

The applicant–IPS–alleged that PEM set the price of primary calcium metal oddly 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 gave rise to a margin squeeze.

The Court of First Instance (CFI) 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."[48]

The CFI 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.[49] The CFI added that 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;"

The Court has also found that it is relevant to ask whether the dominant firm has the best price on the downstream market or whether prices are influenced by other factors and would allow competitors to charge higher prices.[50]

At the end, the Court of First Instance rejected the applicant's appeal–particularly because there were alternative means for IPS to purchase relevant raw material from China or Russia- and came to the conclusion that there was no margin squeeze.

As it was observed by the CFI the margin squeeze could occur in two ways: either in the form of predatory pricing in the downstream market or abusive pricing in the upstream market, but always taking the efficient competitor's ability to survive.[51]

3. Margin squeeze in the practice of the Commission

The first two formal prohibition decisions up to date, however, only came in the first half of 2003, when the Commission adopted its decisions pursuant to Article 82 of the EC Treaty regarding abusive pricing for the provisions of certain telecommunication services offered by two incumbents respectively in Germany and France.[52]

[48] Case T-5/9, para. 178., *op. cit.*
[49] Case T-5/97, para. 180., *op. cit.*
[50] Case T-5/97, para. 183 et seq., *op. cit.*
[51] Case T-5/97, para. 179., *op. cit.*
[52] *Wanadoo* and *Deutsche Telekom*. To be detailed.

These decisions represent in reality the first formal actions of the Commission resulting in condemning business behaviour as being afoul of the provisions of Article 82 of the EC Treaty ever since the British Telecommunications had been found to abuse its dominant position in 1982, still acting as a state monopoly.[53]

The decisions have generated a disagreement and academic debate not only because they concern a sector where the member states play a crucial role throughout the decision making process of the respective regulatory authorities, but also, because the industry is subject to ex ante regulation.

A) The *Deutsche Telekom* case[54]

Following several complaints starting already in 1999 by new entrants in the German fixed-line telecommunications market, in May 2003, the Commission adopted a decision denouncing the abusive behaviour of the German incumbent for its pricing strategy for local access to fix telephony network. According to the Commission decision this appeared in a margin squeeze when Deutsche Telekom (DT) charged higher prices for access to the local loop[55] at wholesale level for new entrants than it charged at retail level for its subscribers. On the basis of standard economic theory and the previous decision of the Commission[56] a clear anticompetitive attitude thus resulted in discouraged alternative suppliers, and consequently in less choice of telecom services and price variations for final consumers.

True, that local loop unbundling–as an obligation on the incumbent operators–was introduced at EU level by way of legislation only in 2000,[57] however, some

[53] Official Journal L 360, 21 of December 1982, 36.

[54] Commission Decision of 21 May 2003, *Deutsche Telekom*, Official Journal L 263/9. The decision was severely criticized by DT because of the price cap mechanisms and the super-regulatory pseudo functions of the EC Commission.

[55] The local loop is a critical strategic point in providing telecommunications services because this is the physical connection between the costumer's premises and the operator's local switch. Generally it appears in the form of pairs of copper wire. As a result of telecom being a network industry, it is highly unlikely for new service providers to build an entire network including local loops to be able to arrive at the consumer's premises. Therefore it is vital for the new entrants to have access to local loops at reasonable and non-discriminatory terms.

[56] Decision 88/518/EEC, *Napier Brown–British Sugar*, Official Journal L 284, 19. 10. 1988, 41, par. 66.

[57] Regulation (EC) No 2887/2000 of the European Parliament and of the Council of 18 December 2000 on unbundled access to the local loop, *Official Journal* L 336, 04–08.

member states–such as Germany–have earlier introduced the aforesaid obligation. The Commission however, reached the conclusion that the regulatory framework is not the only tool available to solve competition problems in this area. Pricing, as one of the conditions of local loop unbundling is also subject to scrutiny under the EU competition rules.

The Commission found that the incumbent was active both on the upstream market for wholesale local loop access to competitors and on the downstream market for retail access services to end-customers. Given that both markets were closely linked to each other and there were no adequate alternatives for newcomers to enter to the market and the incumbent was the only provider with nation-wide network coverage, Deutsche Telekom was in dominant position on the upstream market of wholesale access, and given that Deutsche Telekom was present 95% on the retail market–even after the national obligation of unbundling was introduced in early 1998–it was also affirmed that the incumbent was also in dominant position on the downstream market.[58]

During the proceedings DT argued that the margin squeeze test could not have been applied because the wholesale charges are imposed by the German regulatory authority (RegTP). The incumbent was also pleading that any margin squeeze must be the result of excessive wholesale prices or predatory retail prices, or a combination of the two, and it must be legally possible to terminate the squeeze by modifying either of those prices, which was not the case here.

The Commission rejected this argument[59] and found an abusive margin squeeze, because the difference between DT's retail and wholesale prices was either negative or slightly positive, but insufficient to cover DT's product-specific cost of providing its own retail services, creating therefore a situation for new entrants when they would have no scope to compete with DT for fixed-line access to end-consumers.[60]

[58] The Commission compared upstream access to the local loops with a bundle of different types of retail offerings, namely analogue, ISDN and ADSL connections.

[59] The Commission argued, that in the present case–and also generally–the margin squeeze test can exist with regard to regulated tariffs. In these cases it has also to be shown that the undertaking subject to price regulation has the commercial freedom to avoid or terminate the margin squeeze on its own initiative. If the company has that freedom, the question if and how the prices are regulated ex ante is relevant only for the choice of the correct remedy to bring the margin squeeze to an end.

[60] In order to achieve a coherent comparison, the Commission used a weighted approach, taking into account the numbers of DT's customers for the different access types at retail level. The Commission thus compared the tariffs for wholesale access to the local loops

The Commission had also demonstrated that the abusive behavior was not imposed on the company by any way of public intervention, by setting out the scheme under which the incumbent operator could have managed the wholesale prices more entrant-friendly. The decision thus suggests that an increase–within the set-up price cap system–in retail charges, and a systematic parallel decrease in call charges would have created a better level playing field for new entrants.[61]

The Commission stated that via this abuse, DT was jeopardizing the objective of achieving EU-wide establishment of an internal market for telecommunications networks and services with undistorted competition.[62]

As a result of the decision the national regulator (RegTP) had decreased the wholesale fees by 20%, adopted a new price cap regime, and DT had increased its retail fees by 10%, but simultaneously, lodged an appeal at the Court of First Instance claiming that the Commission's price/cost analysis was misconceived in its methods and there is no restriction on competition.[63]

B) The *Wanadoo* case[64]

In its decision the Commission–concerning the retail charges of France Telecom's internet access subsidiary, Wanadoo–had not come to the conclusion that the case was a clear margin squeeze, however concluded that Wanadoo was charging predatory prices for its consumer broadband internet access services.[65]

In consistency with the case law of the ECJ,[66] referring to the current situation on the basis of the information collected during the examination of the companies, the Commission reached the following conclusion:

> "Broadly speaking a distinction can be made between three separate periods since the beginning of 2001: (i) from 1 January to 31 July 2001, Wanadoo Interactive was far from recovering the (adjusted) variable costs of the

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with those for a number of different retail offerings–analogue, ISDN and ADSL connections–at the end of every year.

[61] DT had previously introduced several reductions in call charges.

[62] Commission Decision of 23 May 2003, *Official Journal* L 263/9, point 203.

[63] Pending case T-271/03. See: *Official Journal* C 264/29 of 1 November 2003.

[64] Commission Decision of 16 July 2003, *Wanadoo*, *Official Journal* L 075.

[65] The reason for the "easier" examination was that France Telecom and Wanadoo were not 100% vertically integrated rather had a close relation with France Telecom owning 70–72.2% of the subsidiary.

[66] Referring to: Case C-62/86, *Akzo Chemie v Commission* (1991) *European Court Reports* I-3359, paragraphs 71 and 72; Case C-333/94 P Tetra Pak v Commission (1996) *European Court Reports* I-5951, paragraph 41.

> services at issue; (ii) from 1 August 2001 to 15 October 2002, Wanadoo Interactive came close to satisfying the test applied by the Commission, but without ever actually doing so: Wanadoo did not recover its (adjusted) full costs; nor–although it did recover its (outturned) adjusted variable costs for part of the period–was it able before March 2002 to forecast the achievement of such recovery in advance; (iii) from 15 October 2002 onwards, Wanadoo Interactive clearly satisfied the cost recovery test applied by the Commission, both for full costs and for variable costs, even though its instantaneous revenue may have been lower than its accounting costs."[67]

There is an interesting point in the decision. The Commission makes note of the fact that there is no such economic theory that reduces the application of predatory pricing methods–i.e. the requirement of the under pricing of the average variable cost being *per se* abuse, and the under pricing of the average total cost but aiming at eliminating a competitor being also but not *per se* abusive–is not limited to mature markets or which are taken as emerging markets.[68]

> "To subordinate the application of the competition rules to a complete stabilization of the market would be to deprive the competition authorities of the power to act in time before the abuses established have exerted their full effect and the positions unduly acquired have thus been finally consolidated. It follows, on the contrary, from the case-law that it must be possible to penalize predatory pricing whenever there is a risk that competitors will be eliminated, as the aim pursued by the Treaty, which is to maintain undistorted competition, rules out waiting until such a strategy leads to the actual elimination of competitors."[69]

This argument is twofold. It does not take into account that there is differentiation between mature and emerging markets.

Indeed, there could be a difference between a market sector where competition is developed and functioning, also, where more or less demand and supply define the prices for services or products and an emerging market where costs are to be recovered in the long run. There are different commercial tactics, which come forth when a market player wants to establish steady position and attempts to win as many costumers as possible in order to be able to be profitable in the long run.

[67] *Wanadoo*, point 257., *op. cit.*
[68] This was the case with *Wanadoo* with the high-speed internet access market.
[69] *Wanadoo*, point 301., *op. cit.*

It could therefore be stated that in the case of substantial upfront costs, which are recoverable over time a period of below-cost pricing is not necessarily exclusionary.

The same business plans and pricing tactics cannot be applied in a functioning market where conditions are set and the profitability is ideally only attainable by innovation and production efficiency.[70]

However, the argument of the Commission is well-based on the famous paper of Areeda and Turner[71] when the authors argue that a firm in dominant position does not have to practice the predatory pricing strategy in order to attract new costumers and draw consumers' attention to the product.[72] Therefore it is rather irrelevant whether the market at stake is mature or emerging.

The question is whether it is fortunate to try to specify market power–and therefore dominance–in an admittedly new market shortly after the opening up or competition authorities should wait until more stable environment is created but by doing so risking the exit of would-be efficient competitors from the market.

Conclusion

The clear solution for the issue of margin squeeze remains dubious.

This is so firstly because testing a price squeeze is extremely difficult. There has not been set a common EU-wide test that should be used when deciding upon behaviours allegedly applying price squeeze techniques. However, based on the decisions of the ECJ and the Commission it seems that the equally efficient competitor test–taking into account the dominant company's own cost–is more suitable than examining the competitors' costs. This seems to be a better solution because it leaves no ground for less efficient firms to enter or remain on the market.[73]

The second reason for this conclusion is that the assessment of future profitability and uncertainties in the game is vague. The best approach seems

[70] That is why there is difficulty to set up a clear legal test to ex ante define pricing strategies. The assessment of future probabilities is also complicated and debated.

[71] Areeda, P.–Turner, D.: Predatory Pricing and Related Practices under Section 2 of the Sherman Act. *Harvard Law Review* 88 (1975) 714.

[72] Wanadoo, point 311., *op. cit.*

[73] Standard economic sense suggests that if the dominant firm's downstream unit would be loss-making if it paid the wholesale prices charged to rivals, there is a margin squeeze; otherwise there is not.

to be the economics-based approach as it was used in the Wanadoo case by the Commission.

However, this involves the evaluation of predatory pricing being *per se* abuse of dominance or the need for anti-competitive effects of the pricing conduct to be qualified as exclusionary practice.

With regards to excessive pricing, it is fairly difficult to define the right benchmark. The differences in cost schemes and allocation are so many depending on the firms' will that there cannot be a general rule that is applicable in all sectors and all markets. The best way to tackle this problem is the in-depth economic analysis that serves the core of the legal reasoning, a more economic approach with eye for specificity and legal burdens.

The nature of such investigations develops the problem when the authorities responsible for carrying out the inspections are held back because of lack of capacity and human resource for such analysis.