



## Margin squeezes and the inefficient “equally efficient” operator

Competition authorities typically favour an “equally efficient operator” (EEO) standard when assessing margin squeeze allegations under Article 102 or equivalent provisions.<sup>1</sup> Generally speaking, an EEO standard ensures protection only for downstream firms that are as efficient as the dominant vertically integrated firm. In its *Telefónica* decision, the European Commission proposes that the application of the EEO standard under Article 102 should be limited to considerations of efficiency at the downstream level.<sup>2</sup> However, firms that are equally efficient at the downstream level – that is, in the way in which they convert upstream inputs into downstream products and services – may still be inefficient with respect to the upstream inputs they require. An appeal by Telefónica to the General Court of the European Union is pending. This memo discusses why upstream as well as downstream efficiency is potentially important. In short, if upstream inefficiency is not accounted for in margin squeeze assessments, higher cost modes of supply and higher prices for end-customers may result.

### Background on margin squeeze abuses

A margin squeeze occurs when a vertically integrated firm that is dominant in the supply of essential upstream inputs sets prices at the upstream and downstream levels such that the margin between these prices is insufficient for a downstream competitor to cover its costs. If a margin squeeze forecloses efficient downstream competitors, then it may harm end-customers and constitute an abuse under competition law.

Margin squeeze cases are most common in regulated industries such as telecommunications where there are clear requirements on certain firms to supply upstream inputs to downstream competitors. However, margin squeeze cases have also arisen from time to time in industries where regulatory obligations to supply do not exist, such as primary metals, sugar and drugs.<sup>3</sup>

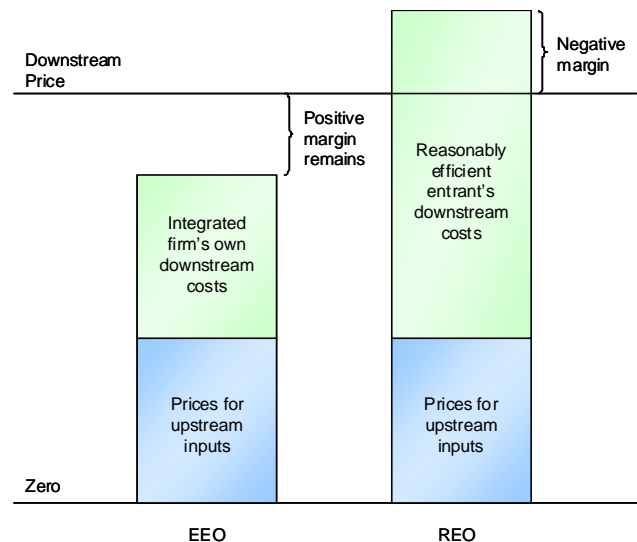
### The EEO and REO standards

A conceptual issue that arises in any assessment of a margin squeeze allegation is how efficient a downstream competitor must be in order to be protected from a squeeze. One approach is to require that a downstream competitor be *as efficient as* the vertically integrated firm’s own operation. This gives rise to the “as efficient” or

“equally efficient” operator standard: could a downstream competitor that is at least as efficient as the vertically integrated firm cover its costs in the relevant downstream market given the prices set by the vertically integrated firm? This formulation of the test requires a comparison of the margin available between the upstream and downstream prices set by the vertically integrated firm with the vertically integrated firm’s own downstream costs.

An alternative to the EEO standard is known as the “reasonably efficient operator” (REO) standard. Under this standard, the vertically integrated firm is expected to set its prices so as to allow room for a downstream competitor that is not as efficient as the vertically integrated firm, but is considered reasonably efficient given its smaller scale, or ignoring other incumbency cost advantages. To implement the REO standard the margin between the upstream and downstream prices must be compared to the actual or estimated costs of a “reasonably efficient” downstream competitor.

The figure below illustrates a situation in which a margin squeeze test would be passed under the EEO standard, but failed under the REO standard.



The EEO standard is typically preferred in ex post competition law contexts (such as allegations under Article 102).<sup>4</sup> One of the attractions of the EEO standard in ex post contexts is that it offers legal certainty, since a vertically integrated operator knows its own costs. By contrast, a vertically integrated firm will typically not have information on its competitors’ costs or clear guidance as to how inefficient a “reasonably efficient” competitor is.

<sup>1</sup> The views expressed in this memo are those of the author only, and do not necessarily reflect the opinions of other CRA staff or CRA’s clients.

<sup>2</sup> Commission Decision of 4 July 2007, Case COMP/38.784 – *Wanadoo España v Telefónica*, ¶315.

<sup>3</sup> Case T-5/97 *Industrie des Poudres Sphériques SA v Commission* [2000] ECR II-3755 (Court of First Instance); Commission Decision of 18 July 1988, IV/30.178 – *Napier Brown v British Sugar*, OJ 1988 L 284/41; and the UK Competition Appeals Tribunal (CAT) decision in *Genzyme Ltd v Office of Fair Trading* (Case no 1016/1/1/03) [2004] CAT 4, [2004] CompAR 358.

<sup>4</sup> This has recently been confirmed by the ECJ in *Deutsche Telekom AG v Commission*, Case C-280/08 P, 14 October 2010, ¶196-204.

Another attraction of the EEO standard is that it promotes efficient outcomes (at least in a static sense). Under the EEO standard, only downstream competitors that are at least as efficient as the vertically integrated firm will be protected, and consumers will not have to pay high prices in order to shelter inefficient downstream operators.

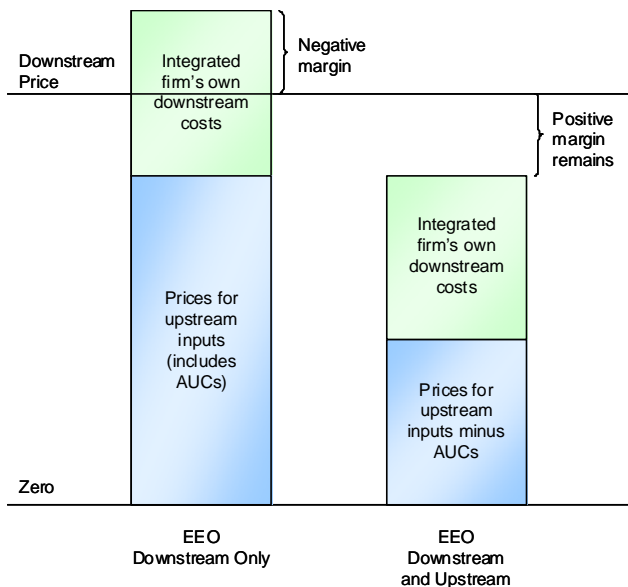
The most common application of the REO standard is in ex ante rule settings by sector regulators, where legal certainty is less of an issue, and where the goal of the regulatory authority is to promote entry by firms that initially might not be as efficient as the incumbent, but that may, over time, contribute positively to competitive outcomes if allowed room to enter.

### Additional upstream costs

The efficiency of a downstream competitor depends not only on the efficiency with which it converts upstream inputs into downstream products and services, but also the upstream inputs that it requires. Additional upstream costs (AUCs) arise when it costs more to supply upstream inputs to downstream competitors than to the downstream arm of the vertically integrated firm, or when downstream competitors require additional upstream inputs that the downstream arm of the vertically integrated firm does not require.

An approach consistent with the EEO standard would exclude AUCs from the margin squeeze test. This would protect only a downstream competitor that is as efficient as the vertically integrated firm both at the downstream level and with respect to the upstream inputs that it requires. Conversely, including AUCs is akin to the REO standard, in which the vertically integrated firm is required to provide some "headroom" to allow for inefficient modes of supply.

In the following figure, the column on the left illustrates the components of an EEO standard applied only at the downstream level when there are AUCs. To apply a full EEO standard – both at the downstream level and with respect to the upstream inputs used to provide the downstream product or service – the AUCs should be deducted from the prices for the upstream inputs. In the figure, a margin squeeze test would be failed applying an EEO standard only at the downstream level, but passed if a full EEO standard was applied.



Admittedly, the exclusion of AUCs from margin squeeze tests might facilitate strategic behaviour by dominant vertically integrated firms. It is possible to conceive of situations in which such a firm might deliberately structure its network in such a way as to generate AUCs when supplying downstream competitors. Although these cases would be atypical, competition authorities need to be awake to such possibilities, and in such cases the AUCs should rightly be included in the margin squeeze test.

### The treatment of AUCs in European cases

AUCs are not a new phenomenon in European case law. The *Industrie des Poudres Sphériques* case in 2000 concerned the supply by a vertically integrated firm to a downstream competitor of an upstream input that had been modified to suit the competitor's downstream processing requirements. The AUCs due to the modifications were taken into account (i.e. excluded) by the Court of First Instance (now the General Court) in its rejection of the margin squeeze complaint. The CFI noted that even a firm in a dominant position in an upstream market is not obliged to sell a modified upstream input below cost. A couple of competition decisions in Italy and the UK have also carefully accounted for AUCs.<sup>5</sup>

More recently, however, the Commission has taken a different path. In *Telefónica*, although the Commission adopted an EEO standard with respect to downstream costs, it applied a test that ensured that downstream competitors using different and more expensive upstream inputs than those used by the vertically integrated firm would not be squeezed. The Commission's rationale for this was to prevent foreclosure of "new entrants that are climbing the ladder of investment" (¶1392). It appears from the decision that the Commission is seeking to introduce into competition law concepts that are traditionally the preserve of regulatory policy (i.e. the promotion of initially inefficient entry with a view to generating longer-term benefits). Whether the General Court will view this as appropriate remains to be seen.

### Conclusions

Unlike the REO standard applied at the downstream level, including AUCs does not necessarily compromise legal certainty (because the vertically integrated firm typically knows the quantum of the AUCs). However, like the REO standard, including AUCs compromises efficiency, at least in the short-run, and may raise prices to be paid by end-customers.

It might be argued that allowing inefficient entry in the short-term will lead to longer-term benefits for end-customers that more than compensate – from greater rivalry and ultimately efficiency enhancements at the downstream level. However, judgments of this nature fit more comfortably within the realm of ex ante regulatory policy, rather than ex post competition law. There is much to be said for the argument that, like the REO standard, including AUCs is something that should remain the preserve of sector regulators with a mandate to promote entry, and with the time and resources to verify that long-term benefits outweigh the short-term costs.

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<sup>5</sup> See AGCM, A351 – *Comportamenti Abusivi di Telecom Italia - Provvedimento n. 13752*, 16 November 2004; and Ofcom, *Complaint from Gamma Telecom against British Telecommunications Group plc about Reduced Rates for Wholesale Calls from 1 December 2004*, 13 June 2005.