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Margin (Price) Squeeze: a landmark December 2006 UK Judgment

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UK's Competition Appeal Tribunal has developed margin (aka price) squeeze principles in this judgment that covers many issues.

Summary

This article deals with important developments in relation to price squeeze, also called margin squeeze. It supplements another article on the same case on our website: *Retail-Minus Pricing (aka ECPR) panned by UK's Competition Appeal Tribunal*.

As the new case shows, price squeeze can be an issue for many industries including some in which it is not yet perceived to be problematic.

Price squeeze typically applies where:

- a vertically integrated incumbent supplies into a retail market that is serviced also by a competitor;
- the competitor uses components of the incumbent's services to supply that market.

As we outline below in more detail, a price squeeze revolves around the margin between the price the competitor pays for the incumbent's input service, and the incumbent's retail price in the downstream market. If the margin is too small (so an efficient competitor can't make a profit) there may be a breach of competition provisions in legislation in many jurisdictions.

While there will be some variations in particular factual situations and differences under national laws, price squeeze principles are largely evolving in parallel.[1]

For those unfamiliar with price squeeze principles, this summary is followed by an overview. Then we turn to the December 2006 judgment that the Competition Appeal Tribunal delivered in *Albion v. Water Services Regulation Authority and Dŵr Cymru*[2].

In *Albion*, the CAT applied both of the generally accepted tests to establish price squeeze. In doing so, it illustrated the wide array of:

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[1] For example: in the EU, the EC's *Deutsche Telekom* decision (currently under appeal to the Court of First Instance); in the UK, the Competition Appeal Tribunal decision in *Genzyme* (and decisions of other bodies, eg: *Freeserve*); in Australia, the ACCC Guidelines, *Assessing vertical price squeezes for ADSL services* (and ACCC's Competition Notices against Telstra under the Federal Trade Practices Act (note that these in effect are allegations by ACCC which were settled, applying the telco-specific legislative framework in Australia)).

To illustrate the overlap internationally, there are differences between the Australasian competition provisions (such as the largely identical s36 Commerce Act (NZ) and s46 Trade Practices Act (Aust)) and the EU's Article 82, as noted by the Privy Council in *Carter Holt v. Commerce Commission* [2006] 1 NZLR 145. But, particularly after the 2001 amendment to NZ's s36, European decisions remain material on many issues. We consider that the NZ Courts will, despite arguments to the contrary, utilise that 2001 amendment to rely more on Australian and European jurisprudence (that is consistent with the reasons advanced by the NZ Government when introducing the legislation, and consistent with the approach expected from the NZ Supreme Court that has replaced the Privy Council as the final appellate court).

However, while price squeeze *per se* can constitute breach of Art 82 (as confirmed in *Deutsche Telekom*), that may not be the case under the Australasian legislation. Price squeeze, applying the same principles, will at least form a key ingredient in what must be proven to establish breach. The ACCC paper on ADSL and price squeeze (noted above) provides valuable guidance.

[2] [2006] CAT 36 (18 December 2006): http://www.catribunal.org.uk/documents/Jdg1046Albion181206.pdf (see also earlier judgments in the same matter, particularly [2006] CAT 23 (6 October 2006): http://www.catribunal.org.uk/documents/Judge1046Albion061006.pdf

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- Products covered by price squeeze issues (water in this instance, added to other cases involving products ranging from sugar and health drugs to ADSL and calcium); and
- circumstances to which price squeeze can apply (here the relevant retail market consisted of only one or two large customers, and the service provided by the new entrant largely replicated that provided by the incumbent)

The case dealt with important new issues including:

- Price squeeze is about the **difference** between the upstream and retail prices, not about the **absolute** amount of any one of the 2 prices (input and retail price respectively). Therefore, the question of whether the upstream input price is abusive/anti-competitive in itself is immaterial.
- A retail-minus pricing model (aka ECPR) does not necessarily avoid price squeeze (indeed it can inherently cause price squeeze). This is appellate recognition of a problem already recognised by regulators. We have dealt with the retail-minus aspects of this case in another article today on our website: *Retail-Minus Pricing (aka ECPR) panned by UK's Competition Appeal Tribunal*.
- A competitor largely replicating the incumbent's services can still raise price squeeze allegations.
- The Tribunal touched on the question of whether a competitor could force a dominant supplier to provide any component of the dominant provider's services, at a price which meets the price squeeze test.

Disclosure

We have been acting, for example, for major ISPs alleging price squeeze, in respect of DSL access, against an incumbent telco. However, this article has not been prepared on instructions from clients.

Price Squeeze 101

Application of competition provisions, such as the EU's article 82, UK's Competition Act 1998, US anti-trust law, and Australasian provisions[3], are marked by the difficult balance between encouraging healthy competition and discouraging anti-competitive conduct. For example, while reduced prices are often reflective of healthy competition, a dominant supplier's price drop may be anti-competitive. To distinguish the two, regulators and tribunals typically use "set pieces" (eg; predatory pricing, refusal to supply, etc) and standard tests (eg to determine whether a dominant supplier is predatory pricing). Those set pieces are methods to determine whether broadly framed competition legislation has been breached. "Price squeeze" is evolving as another such "set piece". It has overlaps with existing set pieces (eg; predatory pricing). But it differs, as this *Albion* case illustrates.

In describing margin/price squeeze, the CAT in *Albion* noted[4]:

> "*… a margin squeeze typically arises where a vertically integrated undertaking that is dominant in the supply of an important input in a downstream market sets such a low margin between its input price … and the price it sets in the downstream market … that an efficient downstream competitor … is forced to exit the downstream market or is unable to compete effectively …*".

The application of price squeeze has evolved from more "traditional" industries such as sugar and calcium, through to newer technologies such as broadband. The *Albion* case deals with a public sector water utility, and so is a good illustration of the potential application of price squeeze to network industries of various types, including deeply entrenched natural monopolies (such as water), often characterised by heavy public sector involvement.

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[3] Such as section 36 Commerce Act (NZ) and section 46 Trade Practices Act (Aust).

[4] Para 285

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Price Squeeze: an example

A relatively frequent recent example[5] is the supply of local access in the Telco sector. This has raised various price squeeze allegations and decisions, and also led to the leading EC price squeeze decision, *Deutsche Telekom*, which is currently under appeal to the Court of First Instance.

Generally there is a vertically integrated operator (eg: BT, Deutsche Telekom, Telstra, Telecom NZ) with a dominant position in relation to local access (predominantly the copper local loop). Often the telco is required by regulation to make available, to competitors, that local access to a greater or lesser extent (eg: ULL, wholesale access, and/or access to DSL components over the local loop).

A competitor can buy those components and combine them with other components supplied by it to supply to customers. In this way, it can compete with the vertically integrated incumbent in the same retail market (such as the consumer broadband and/or voice market).

The price squeeze test centers on the difference (or margin) between (a) the upstream price for the input service provided by the incumbent to the competitor (in this example, the input such as DSL access) and (b) the incumbent's retail price in the shared retail market. If the upstream price is too high, and/or the retail price is too low, a price squeeze can result so that an efficient competitor cannot make a profit. This, depending on the relevant national legislation, can either constitute a breach of the competition legislation in itself (that's the situation in the EU: *Deutsche Telekom*) or form the basis for such an allegation.

The idea is to put the incumbent and the competitor on an equal footing, said the Tribunal in the *Albion* case.

The price squeeze tests[6] are designed to ensure that the incumbent does not subsidise inefficient competitors. There are two tests that are used to achieve this outcome. The first is based on the incumbent's business and the second on an efficient competitor's. Breach of either constitutes a price squeeze. The first test exists as the incumbent itself may be the closest proxy to an efficient competitor.

The CAT summarised the two tests as follows:

> "*Those tests are either (a) that 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; or (b) that the margin between the price charged to competitors in the downstream market for the input product and the price which the dominant firm charges in the downstream market is insufficient to allow a reasonably efficient downstream operation to earn a normal profit*."[7]

The *Albion* Case: what happened?

Refer to the diagram below setting out the relationship between the parties.

Water is typically supplied by utilities which are natural and vertically integrated monopolies, of which the large Welsh utility, Dŵr Cymru, is one.

The United Kingdom Government decided to encourage competition in the water sector[8]. Legislative changes allowed a company such as Albion to step into the water supply chain, utilising particular services available from existing providers, such as Dŵr Cymru, to sell to retail markets.

In dealing with these legislative changes, the Tribunal, when considering the appeal, had to deal with the interplay between EU competition law, UK general competition/regulatory law and water-specific law. However, the principles are of general application. In particular, the relevant legislation adopts the frequent approach of

[5] With decisions and/or allegations in jurisdictions that include UK, Germany and Australasia.

[6] See for example *Albion* at para 292 . See also the ACCC information paper, *Assessing Vertical Price Squeezes for ADSL Services*

[7] *Albion,* para 292

[8] These initiatives evolved during the course of this case and we have kept to a brief description: for more detail see both judgments.

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encouraging competition, by reference to the interests of consumers.

Shotton, a large newsprint manufacturer operated by Finnish multi-national, UPM, is one of the largest users of "*industrial*" (ie: non-potable) water in Wales. Its needs equate to those of a town of around 35,000 people.

Before Albion came along, Dŵr Cymru supplied this water to Shotton. It did so by buying the water from a neighbouring utility, United[9] and then transporting the water to Shotton (accompanying by additional steps such as processing the water). Key to this case is that the water is carried over a 16km pipe to Shotton, which is owned and operated by Dŵr Cymru.

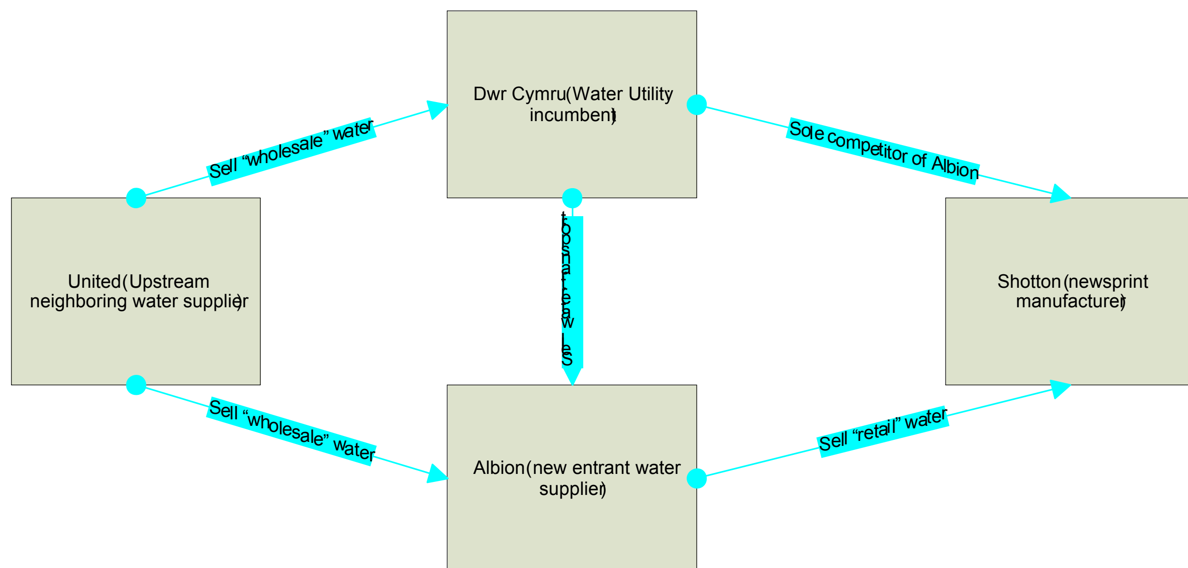
Following the changes that encouraged competition, Albion obtained the contract to supply water to Shotton using, just like Dŵr Cymru, water supplied by United, and the 16km pipeline. Albion of course had to pay Dŵr Cymru for this upstream service (that is, common carriage over Dŵr Cymru's pipe).

Dŵr Cymru is the dominant supplier in the downstream market (that is, the market in which Shotton is supplied)[10].
Albion complained that the margin was too low as between (a) the input price (the price it had to pay for provision of the common carriage transport services across the 16km pipe) and (b) Dŵr Cymru's retail price in the retail market. To get to the input price, Dŵr Cymru took its retail price and deducted the price it paid United for the water.[11]

The regulator however concluded that there was no margin squeeze. That happened even though all accepted (the regulator and the incumbent included) that Albion would have to withdraw from the market and there would be no competition. At best, an efficient competitor such as Albion faced a zero margin (ie: no prospect of profit). Much more likely, partly as Albion would pay more for the water it buys from United than Dŵr Cymru, was that it faced a severe negative margin squeeze (ie: as a result of the price squeeze, Albion would trade at a substantial loss and thus could not continue to supply).

The effect would be to squeeze all competition out of the market.

On appeal the Tribunal reversed that decision and confirmed there was a severe price squeeze, based on both of the alternative tests.



[9] United also has regulatory issues and faces a hefty fine: http://business.timesonline.co.uk/article/0,,9078-2513739.html

[10] Even though this is a market of only one or two, given the unique circumstances of Shotton, margin squeeze principles still apply.

[11] This was based on retail-minus approach. As we note in our other article the Tribunal concluded the "retail" component was excessive and the "minus" component (set at zero) was insufficient.

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We now turn to the other matters which the Tribunal covered, which further develop price squeeze principles.

Does the upstream price have to be anti-competitive in itself for there to be a margin squeeze?

No. The two are conceptually different. The Tribunal noted:

> *"It seems to us that an unfairly high price and a margin squeeze are essentially quite different concepts. The former is an exploitative abuse, while the latter is an exclusionary abuse, aimed at eliminating competitors. …The margin squeeze test is about the difference between the input price and the downstream price of the dominant supplier, not about the absolute level of either price …. Even if, for example, Dŵr Cymru were to have succeeded in showing that there was no abuse of excessive pricing, the margin squeeze tests would still be met in this case: a notional retail arm of Dŵr Cymru would not be able to trade profitably at the [input price], nor would Albion be able to survive in the market".*[12]

Does the use of retail-minus pricing (aka ECPR) mean there is no price squeeze?

New Zealand punches well above its weight, internationally, when it comes to retail-minus pricing (this isn't necessarily something that all Kiwis would be proud of!). The controversial Privy Council *Telecom v Clear* decision (and the so-called Baumol-Willig rule that underlies that decision and retail-minus/ECPR generally) are frequently referred to in the international debate. The CAT focussed particularly on NZ in its international comparative exercise. Ironically, it erroneously relied on NZ's rejection of ECPR (in fact the contrary has happened).

We deal with that issue, and retail-minus pricing generally, in more detail in our companion article on our website, *Retail-Minus Pricing (aka ECPR) panned by UK's Competition Appeal Tribunal*.

[12] *Albion* para 301

Here, the regulator had applied a retail-minus methodology. It claimed (as did Dŵr Cymru) that retail-minus pricing in itself meant there was no price squeeze. The Tribunal rejected this, both (a) as a matter of general principle and (b) on the facts of this case, as the implementation of retail-minus was incorrect.[13]

It is *possible* in some circumstances that the retail-minus methodology will comply with the price squeeze test but this will frequently not be so.

This is illustrated in our accompanying article, which notes the Tribunal's observation that a competitor facing pricing on a retail-minus basis generally will need to be "*a super efficient*" provider, not just an "*efficient*" provider.

Regulators have been grappling with the failure of "standard" retail-minus to meet price squeeze concerns. They have come up with ways to minimise the problem. Generally, they have moved away from retail-minus pricing for this and other reasons.

The *Albion* appellate decision confirms the concerns held by many regulators.

For an excellent recent summary of the issues, the approach by regulators in various jurisdictions, and solutions, see Appendix 1 in the NZ Commerce Commission's August 2006 submissions to the Select Committee that considered NZ's Telecommunications Amendment Bill 2006.[14]

Do price squeeze principles apply even where the competitor largely replicates the incumbent's service?

Yes, said the Tribunal, even where, as here, there was much closer overlap in the services than is often the case. The general competition drivers confirm it is appropriate to have price squeeze applying even in these circumstances (otherwise there would be no competition at all).

[13] See for example paras 287,288 and 305 of *Albion*.

[14] http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/GeneralInformation/submissionsonlegislation.aspx

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Does the price squeeze approach mean that a new entrant can force a vertically integrated incumbent to provide any services and products it chooses?

The Tribunal did not have to finally decide this question because Albion got regulated access anyway. Implicit, incidentally, is that access which is regulated can still be the subject of a price squeeze allegation.

To be played out further are the circumstances in which price squeeze does apply where access to the incumbent's services is not regulated (for example, how does general competition law fit in this situation?).

Conclusion

Price squeeze principles usefully supplement other "set pieces" such as predatory pricing. They are developing incrementally and this case moves things forward considerably, resolving a number of important issues. The appeal to the Court of First Instance in *Deutsche Telekom* (and any appeal from the CAT in this case) are likely to be significant too.

We welcome your feedback on this article and any enquiries in relation to its contents. This article is intended to provide a summary of the material covered and does not constitute legal advice. We can provide specialist legal advice on the full range of matters contained in this article.

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