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# The politics of margin squeeze in telecommunications: diverging paths of the US and EU

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**Abstract**

**Purpose** – *This paper aims to study the historical origins of margin squeeze cases in the USA and Europe.*

**Design/methodology/approach** – *The author compares and contrasts major margin squeeze investigations in the USA and the European Union (EU) in terms of the role of efficiency and fairness and shows their roots in the socialist calculation debate of the 1940s.*

**Findings** – *It was found that the USA and EU diverge in their approaches towards margin squeeze claims. While the USA case law focuses more on efficiency, the European Commission makes decisions based more on fairness and "protection of rivals". This shows that political and ideological preferences influence legal decision-making.*

**Research limitations/implications** – *The paper is limited to major cases in telecommunications. It leaves aside cases in other areas. Thus, the author cautions that the generalization of the findings of the paper to all margin squeeze cases, or competition policy in general, may be difficult.*

**Originality/value** – *While there is extensive literature on margin squeeze cases in the USA and EU, there is little work on the historical and ideological connections. The paper contributes to the literature by drawing attention to political influences over technical decisions.*

**Keywords** *USA, Legal systems, Telecommunication, European law*

**Paper type** *Research paper*

> [H]ow is a judge or jury to determine a "fair price?" Is it the price charged by other suppliers of the primary product? None exist. Is it the price that competition "would have set" were the primary level not monopolized? How can the court determine this price without examining costs and demands, indeed without acting like a rate-setting regulatory agency, the rate-setting proceedings of which often last for several years?
>
> Justice Breyer, Town of Concord, at 25.

> The judgment is good news for consumers and for the economy in general as effective competition in the crucial network industries such as telecoms or energy translates not only in more choice and ultimately lower prices but also more growth and jobs.
>
> Joaquín Almunia, on the Deutsche Telekom decision[1].

## 1. Introduction

There has been substantial progress towards synchronizing competition law and practice around the world in recent years (Antitrust Chronicle, 2011). However, this progress also institutionalized differences in some areas. Courts in the USA and the European Union (EU) have taken diverse paths on a number of issues within competition law. Margin squeeze is a major area where they disagree substantially, even though divergence is not limited to telecommunications. Courts in the EU have broadened the scope of margin squeeze cases

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by applying it to non-regulated industries as well. Thus, an exception has turned into a rule for all markets.

The tension between competition and regulatory authorities creates different consequences in different legal traditions. Antitrust and competition authorities tend to see margin squeeze basically as an anticompetitive behaviour and within the limits of competition law. Regulatory authorities implement margin squeeze tests on incumbents and firms with significant market power (SMP) in the telecommunications markets. The diverging jurisdictions of the Supreme Court in the USA and the European Commission (EC) and courts in the EU reflect different attitudes towards the rules of the game on margin squeeze cases in telecommunications.

The source of these conflicting views is closely related to the relative place of competition policy and regulation in margin squeeze investigations. The historical orientation of both legal systems influences their current approaches to potential margin squeeze abuses.

The origins of the differences have much to do with the tension between free market competition and social goals such as fairness. While the economic model of margin squeeze is the same on both sides of the Atlantic, ideological preferences separate their case laws. The tension between efficiency and fairness as an extension of the socialist calculation debate helps to explain some of the differences between the USA and the European community on margin squeeze case law.

Margin squeeze cases in telecommunications started in the wake of regulatory reforms around the world. As competition increased, new entrants began to use the competition policy as a strategy to compete with incumbent operators. Similarly, policymakers who were not satisfied with the results of liberalization found a new means to regulate the telecommunications markets without using regulatory tools. In this system, the tension between the competition order and "ordered competition" has brought the EC and Courts to side with ordered competition. The distinction between "competition order" and "ordered competition" goes back to Hayek and reflects some of the diverging views in economics of regulation (Burton, 1997).

These developments may be related to the socialist calculation debate of the 1930s and its modern reinterpretations (Lavoie, 1985). Borrowing a term from the socialist calculation debate, one can rephrase the question, as "should competition authorities act as central planners, along with regulatory bodies?". In a sense, the margin squeeze debate has come to reflect the role of the government in markets.

This paper aims to address this connection between ideological position and case law. In Section 2, the author raises the issue within the context of recent developments. Section 3 describes margin squeeze in telecommunications. Section 4 elaborates on fairness and efficiency. Section 5 discusses the recent margin squeeze cases in the USA and EU. Section 6 rounds up the debate with an emphasis on the role of fairness in margin squeeze case law.

## 2. The nature of the problem

The aim of the regulatory reform in telecommunications was liberalization. National regulatory agencies (NRAs) were designed as tools to steer the industry towards a more competitive environment. The expectation was to reduce the role of an NRA as time passes and increase the role of a general competition policy. However, competition over the jurisdictional authority in the EU reflects the intention to keep the government control over prices, quantities and other dimensions of market transactions (Leveque and Shelanski, 2010).

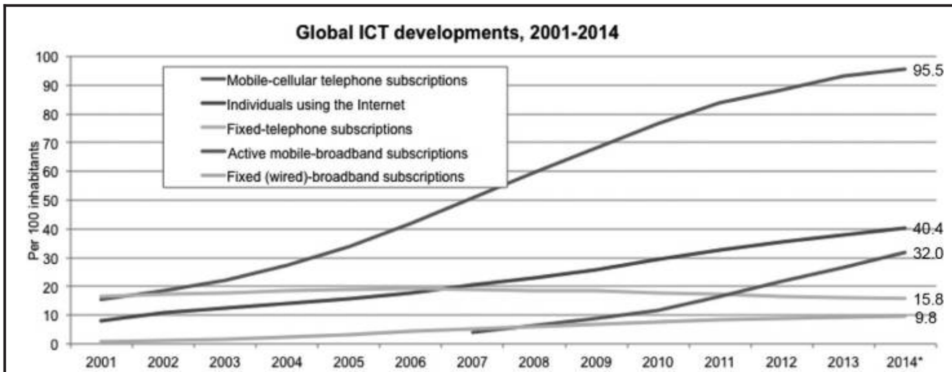
The competition over which authority should have the jurisdictional power, of course, is not limited to telecommunications. However, increasing competition in this market, interestingly, increased the number of margin squeeze cases. In the EU, 71 per cent of all margin squeeze cases were in telecommunications in the past decade. The fines in telecommunications margin squeeze cases were four times higher than the ones in other markets (Veljanovski, 2012). These numbers tell us that margin squeeze has a very high likelihood of being used as a strategic tool, as firms use legal means to increase their rivals' costs. Firms and policymakers find alternative ways of going around regulatory decisions. In this environment, the EC's investigations may become instrumental in making it harder to institutionalize competition in the telecommunications markets. Competition policy can be used as a commercial strategy for increasing costs of the incumbent in the industry. As a result, the regulatory function of margin squeeze investigations becomes weaker as their costs increase and benefits decrease.

The intervention of competition authorities should be assessed together with the relative place of regulation in the industry. The rivalry between two institutions determines if regulatory reform will give way to competition in the telecommunications industry. The relationship between competition authorities and regulatory institutions plays some role on uncertainty over margin squeeze cases. Regulation and competition law have different institutional structures and goals. Efficiency and other economic considerations play a prominent role in competition law. Regulation, however, aims to consider factors beyond efficiency such as redistribution, universal service, protecting competition and promoting investment (Geradin and O'Donoghue, 2005).

The telecommunications markets have changed substantially over the past decade. Technological advances, changes in consumer preferences and, finally, the reorganization of market structures made the natural monopoly model inadequate (Shelanski, 2007). These changes gave way to a new approach towards anticompetitive behaviours in the telecommunications markets.

A major change in terms of the viability of margin squeeze cases is the increasing fixed-to-mobile substitution (FMS) in voice and broadband markets (Briglauer *et al.*, 2011; Vogelsang, 2010). FMS has started in voice and is now transforming broadband markets. Figure 1 gives a picture of the FMS in voice and broadband markets. As the figure shows, the number of mobile telephone subscribers increased substantially in the 1990s and exceeded fixed-line subscribers in the 2000s around the world. At present, the number of fixed-line subscribers is stagnant in some countries and falling in others. In terms of traffic volumes, mobile traffic has exceeded fixed-line traffic in many countries. The trend towards "mobile only" individuals threatens the viability of fixed-line networks (Barth and Heimeshoff, 2012). The story is similar in broadband markets. Mobile broadband subscriptions overtook fixed broadband in 2008 and have had a high growth rate since then around the world. By 2016, over 80 per cent of broadband is expected to be mobile

**Figure 1** Total fixed and mobile subscriptions in the world




**Note:** *Expected
**Source:** ITU

(ITU, 2013). The change is not temporary. Customers change their behavioural patterns and non-price differences between fixed and mobile services in terms of the demand of the final customer disappear. Customers no longer care about the origin of their voice or data services (ITU, 2013). These changes have made the old model of regulating fixed and mobile markets separately inefficient and increased demands for deregulation of fixed-line networks (BEREC, 2011; Briglauer *et al.*, 2011).

As the intermodal competition between fixed and mobile networks increases, it becomes harder to gain from margin squeeze practices, as incumbents are no longer powerful enough to harvest monopoly profits through predatory pricing after excluding their rivals. Increasing level of competition also makes it harder to control and plan the market structure. As the gap between fixed and mobile markets closes, competitive forces encourage arbitrage opportunities and innovations that use both modes of communications through bundles and other methods of competition.

A major consequence of having two different institutions for the same anticompetitive behaviour is double investigation for the same behaviour. In many cases, competition authorities and regulatory agencies reach conflicting decisions on the same margin squeeze claim. For example, when a regulatory agency finds (*ex ante* or *ex post*) no anticompetitive behaviour in a case, the competition authority may find abuse of dominance, even if there is no change in the firm's strategy and behaviour after the initial NRA approval.

Margin squeeze cases are just an example of a wider problem of jurisdictional authority. It reflects competition for the market between institutions. The existence of two authorities to deal with a specific abuse of dominant position is not sustainable. Competition between institutions naturally arises and one of the authorities becomes dominant as a result. One of the factors to consider is the belief about the efficiency of the market system. As reflected in court decisions, the relative place of efficiency reflects political preferences. In this way, the political preferences implicitly influence economic decisions.

While there is extensive literature that compares margin squeeze cases in the USA and the European community, it rarely focuses on the institutional dimension of their differences. The relationship between non-economic factors such as "equality of opportunity" and "fairness" is not usually attributed to the political preferences and institutional structure. This paper aims to draw attention to the institutional dimension of the behavioural patterns on both sides of the Atlantic.

## 3. What is margin squeeze in telecommunications?

In a typical margin squeeze case, a vertically integrated firm is dominant in the upstream market and supplies an essential input to downstream rivals. The dominant firm uses its control over the input to prevent competitors from making a "living" profit in the downstream market. It has a number of ways of making life harder for rivals. It may increase the price of the input. Alternatively, it may reduce its retail price in the downstream market. Or, it could choose to do both of them at the same time (Geradin and O'Donoghue, 2005; Biro *et al.*, 2011).

The intended goal for an incumbent is to squeeze profit margins of competitors in the downstream market so as to raise rivals' costs and forcing them out of the downstream market with the hope that it will obtain monopoly profits later. Thus, the success of margin squeeze depends on the existence of a bottleneck monopoly in the upstream market by the vertically integrated firm and its power to keep its potential rivals in the downstream market under control.

The existence of margin squeeze is widely questioned. Carlton (2008) and Sidak (2008) contest the viability of margin squeeze behaviour following the Chicago tradition on the one monopoly profit theory. In this view, margin squeeze cases have to make a distinction between protecting competitors unconditionally and comparing social costs and benefits of protecting competitors. Carlton (2008, p. 274) argues that the real policy question is about the comparison between gains from punishing margin squeeze and costs of “chilling” competition.

Competition policy on margin squeeze may be more concerned with preventing the exclusion of existing rivals than increasing the welfare of consumers (Vickers, 2010). The defenders of margin squeeze investigations sometimes claim that protecting competitors today increases consumer welfare later, taking their cue from the neoclassical model of perfect competition. However, in the wake of FMS, this view seems less sustainable as the nature of competition shifts from intramodal to intermodal competition. The boundaries of voice and broadband markets have become invisible as mobile operators vie for fixed-line subscribers.

Economic theory of margin squeeze does not make the implicit assumption that pushing rivals out of the market inevitably creates net social costs in the sense that it creates harm to consumers. This assumption is, however, accepted in the margin squeeze case law. The distinction between the economic literature and case law sheds light on understanding differences between margin squeeze policies in the USA and the EU.

In most cases, the existence of small, or even negative, profit margins in the downstream market creates a reason to intervene in the market in the name of fairness. However, low profit margins may be an indicator of efficiency of the market (Sidak, 2008, p. 300). One way to see the relationship is to use the efficient component pricing rule. This rule refers to the relationship between the wholesale price for competitors and the incumbent’s retail price (Weisman, 2002). If the wholesale price were greater than the incumbent’s retail price, the profit margin of the competitors would be negative. At first sight, this situation is easily interpreted as the existence of margin squeeze. However, there may be a number of reasons for the negative profit margin for competitors. Baumol and Sidak (1994) contend that a negative avoided cost reflects a foregone opportunity by the incumbent. In this way, efficiency may require the incumbent to have a higher wholesale price than retail price. This pricing principle aims to discourage inefficient competitors. This point, which is overlooked in the EU cases, makes an important point about the workings of the market process. Fairness puts the well-being of downstream competitors before the well-being of consumers by neglecting the opportunity cost restricting the competitive ability of the incumbent in the retail market.

According to the Chicago critique of margin squeeze, if the vertically integrated firm were the monopoly in the upstream market, it would already maximize its profits regardless of its rival in the downstream market (Sidak, 2008). Even, if the upstream is regulated, the situation does not change. This theoretical point is widely accepted by the Supreme Court, even though some lower courts in the USA reached rulings closer to the EC’s approach. In a vertically integrated product, there is not an infallible causality from margin squeeze to harm. The necessary data to resolve the issue of the cause of the harm, even if it exists, are quite substantial and usually unavailable in a tightly regulated market (Carlton, 2008, p. 276).

This point reflects the difference between economic and legal uses of the concept. In the economic literature, margin squeeze can be dealt with as the sum of two different behaviours: price discrimination in the upstream market and predatory pricing in the downstream market. An efficiency-based analysis of these situations requires an empirical analysis. However, in its legal form, price squeeze turns into a separate abuse, as it threatens existing rivals in the market. Its effects on social welfare are usually ignored in investigations.

What makes margin squeeze different from these two conducts is that it is about the connection between them. As a result of interaction of two separate behaviours, a new form abuse is created. In the telecommunications markets, regulation eliminates the possibility of price discrimination in the wholesale market. The necessary conditions for predatory pricing in the downstream market are stricter than margin squeeze. This new form of abuse provides downstream rivals a new method of using competition policy without getting into difficulties of proving predatory pricing.

While the ground for margin squeeze is already shaky, recent developments in FMS have made it harder to successfully implement any margin squeeze policy on rivals. FMS made bottleneck monopoly mostly irrelevant in margin squeeze cases. As a result of FMS, bundled services have begun to dominate products in telecommunications. Interdependencies in bundled products brought economies of scale and scope to the forefront. A rival can claim that its inability to replicate the incumbent's offerings at similar costs is a result of margin squeeze abuses by the incumbent. Especially, bundles that include both SMP and non-SMP services add to the difficulty of defining the relevant market. As more products are converged, the line between exclusionary practices and competitive behaviours as a result of market pressure becomes blurred to competition authorities and courts.

As a result, margin squeeze has lost its economic core, even though it has gained ground in the EU case law because of increasing intermodal competition. The increasing number of cases in recent years in the EU and other countries supports the thesis that it has become part of the competitive strategy of downstream rivals. Margin squeeze cases have turned into a tool to ensure competitors' profitability (Sidak, 2008, p. 294). Along the similar lines, Carlton (2008) argues that antitrust law on margin squeeze encourages inefficiency in the market, as avoiding liability becomes a major concern for vertically integrated incumbents.

## 4. Between efficiency and fairness

In the EU, margin squeeze cases are pursued to protect the rights of existing firms in the industry. The European competition law protects profits of existing rivals. Needless to say, this creates a conflict of aims. The tension between efficiency and fairness reflects the divergence between economic and political preferences in recent decisions.

As a rule, competition policy is about competition. Fairness is a way to solve issues of justice without having recourse to competition. Kaplow and Shavell (2002) make a bold argument in favour of consumer welfare in opposition to fairness. In this view:

> [. . .] legal rules should be selected entirely with respect to their effects on the well-being of individuals in society and that notions of fairness [. . .] should receive no independent weight in the assessment of legal rules (Kaplow and Shavell, 2002, p. 37).

In terms of efficiency, any goal other than individual welfare will be optimal only if it coincides with efficiency-based rules. In practice, other rules are usually preferred because the results of efficiency-based rules are not politically acceptable. Fairness and efficiency distribute wealth differently in the society. Otherwise, there would not be a will to change existing rules. This point shows the difference between the USA and EU on margin squeeze case law.

In the USA, academic literature gives priority to economic efficiency (Crane, 2009). The Amici Brief on the *linkLine* case is an example of the efficiency view. In this view, an antitrust claim is not viable when it harms competitors but not consumers. This approach has been widely accepted by the courts. Recent decisions that are discussed below reflect this mainstream view.

In the EU, fairness has its historical reasons in competition law (Gerber, 2001). Fairness is central to the EU integration. It is used to integrate independent societies in a common market. The old Article 82 was in favour of fairness and remained silent on efficiency when it comes to the tension between efficiency and fairness (Gormsen, 2010, p. 48). This tension has its roots in the political preferences between economic freedom and egalitarianism that have dominated the European integration ideal.

The sources of the European approach can be found in Ordoliberalism (Gerber, 1994; Padilla, 2007). Ordoliberalism was developed in Germany when the socialist calculation debate was in full swing. Ordoliberal thinkers such as Walter Eucken were looking for a middle road between socialism and free-market liberalism. The result was a competitive system under the control of the government supervision (Vanberg, 2004, pp. 37-51) The Article 82 of the Rome Treaty reflected Ordoliberal principles. The current article 102 of the Treaty on the Functioning of the European Union (TFEU) does not differ much from the Ordoliberal approach as well (Gormsen, 2010; Nedergaard, 2013).

In the Ordoliberal tradition, free markets can function efficiently only if they are protected by a strong state. Competition may become self-destructive if not overseen by the central government. In this tradition, "strong state" is understood as the guarantor of the market process. This thinking gave way to the necessity of economic constitution as a result of the belief that all economic systems are the result of legal and political processes.

Ordoliberal principles dominate the EC's attitude towards vertically integrated incumbents in telecommunications. The belief on the need to keep the system under control, like a "gardener", explains a lot about the political environment of margin squeeze cases.

The transformation of margin squeeze from protecting competition to competitors is reflected in the differences between the USA and the Europe in terms of political economy of competition policy. In the next section, the author briefly looks at major recent cases that are discussed extensively in the literature. While legal issues surrounding these cases seem technical at first, such as the relationship between indispensability and duty to supply, ideological preferences shape the decisions in the end. Political preferences and views on the market system play a major role over the fate of these cases.

## 5. A brief interpretation of the USA and EU positions

As a general rule, regulated activities may be subject to antitrust laws if there is no explicit antitrust immunity. Economic considerations give priority to regulation over competition law in telecommunications (Geradin and O'Donoghue, 2005). It is sometimes argued that regulation should take a prominent role and antitrust law must conform to it (Rudaz, 2010 p. 1,111). According to this view, if there is full regulation in both upstream and downstream markets, competition does not have much to contribute to the competitiveness of the market, under the general assumptions that regulation works in the public interest and efficiently. This interpretation finds widespread acceptance in the USA case law, but mostly suspected in the European cases. On the other hand, margin squeeze has become a stand-alone abuse of dominance in the EU in recent years. This shift reflects the European political agenda and legal framework rather than the economic logic of margin squeeze claims (Leveque and Shelanski, 2010). As a result, any interpretation of recent cases in margin squeeze should include the tension between regulation and competition law as a major factor.

### *5.1 USA cases*

*5.1.1 The Alcoa case.* Margin squeeze cases start with the Alcoa case and Judge Learned Hand's conclusions in the USA. Alcoa operated in two markets. In the upstream market, it sold aluminum ingots to its rivals. It sold aluminum sheets in the downstream market. Judge Hand found that Alcoa abused its monopoly power by holding the price of ingot artificially high. In the end, the sum of the cost of ingot and the cost of transforming the ingot into sheet was higher than the Alcoa's price in the downstream market. So, according to Hand, Alcoa squeezed the competitors in the downstream market by not allowing them to obtain enough profits. In the decision, Hand emphasized the importance of "living profit" for competitors (Rudaz, 2010, p. 1,088). Hand's decision implicitly assumed that competitors "should" have the legal entitlement to stay in the market. While the decision refers to "fair price", it does not tell much about its nature and level, nor does it explain why complainant firms should have the privilege of protection and the guarantee of a place in the market. The

Alcoa formulation has become a benchmark for many cases before the Supreme Court. It also provided guidelines for the recent cases in the EU. The opacity of "fair price" and "living profit" has not been clarified until today and keeps the doors open for non-economic preferences in margin squeeze cases.

The Alcoa case is also important because it reflects the difference between the USA and EU with respect to the role of fairness in decisions. Margin squeeze is possible only in markets with a dominant operator in upstream and downstream markets. In telecommunications, the upstream price is usually regulated and accepted as legally fair and reasonable. In most cases, the downstream market is not regulated at all. Thus, fairness is ensured by the regulator in the former case and by the market process in the latter. The implicit assumption of fairness forces competition authorities to leave aside the more fundamental issues and focus on the calculation of margins on the basis of accounting principles (Veljanovski, 2012).

*5.1.2 The Trinko case*. The major turning point in the case law was the *Trinko* case. In this case, Verizon, the incumbent local exchange carrier, was accused of not providing sufficient support to its rivals in the upstream market. While the legal proceedings were quite complicated and included many issues, the Supreme Court warned against the use of competition rules to impose duties to deal on incumbent firms. It also broke the link between the wholesale and retail markets in cases where there is no duty to deal in the wholesale market.

This case was also a turning point in terms of weakening the use of essential facilities doctrine in telecommunications. The essential facilities doctrine was usually used as a tool to ensure "fairness" in the upstream and downstream markets. This case emphasized that to justify an essential facilities case, a plaintiff has to prove that the defendant had an intention to harm its rivals. Being a competitor is not a sufficient indicator of harmful behaviour. The rivals have to prove a pro-competition justification of their actions. This view put efficiency before fairness explicitly.

Trinko set the precedent on the relationship between competition authorities and regulatory agencies (Rudaz, 2010; Spulber and Yoo, 2009). It has also effectively closed doors to further margin squeeze cases in the USA. According to the Supreme Court, the Telecommunication Act of 1996 was intended to be a stand-alone regulatory regime (Larouche, 2010, p. 79). It was sufficient to provide necessary provisions on anticompetitive behaviour. Competition over jurisdictional power damages the market structure, as it discourages innovation and competition within the market.

A major institutional issue in this case was whether marginal cost of using competition law, in this environment, is higher than its marginal benefit. Both transaction and information costs of applying competition law can be substantial. It might even render a negative effect on restraining abusive behaviour in the market, as it would encourage forum shopping by the firms in the market. In those cases, eliminating these costs might improve the efficiency of regulation and reduce uncertainty in the market about which legal rules to follow.

*5.1.3 The linkLine case.* In a more recent case, the linkLine group argued that AT&T (as Pacific Bell) illegally squeezed their profit margins. The plaintiffs in this case were four independent Internet service providers. Pacific Bell owned local phone infrastructure. linkLine leased wholesale DSL transport from Pacific Bell. Pacific Bell was also present in retail market and competing with linkLine. They claimed that incumbent telephone companies that owned the physical infrastructure monopolized the DSL market. The claim was that AT&T used its monopoly power to raise prices in the wholesale market and reduced prices in retail to increase its market share and exclude competitors. While lower courts sided with linkLine, the Supreme Court concluded that the Sherman Act did not recognize a price squeeze claim (Rudaz, 2010, p. 1,082). It left no doubts about its approach following the Trinko case.

The Court separated upstream and downstream markets and concluded that AT&T had no antitrust duty in upstream market. Thus, it had no duty to sell at reasonable (or, "fair") prices. The case thus turned into a predatory pricing one. The Court decided that conditions of predatory pricing were not satisfied in this case.

A quotation from the Court's decision reflects its view on the relationship between competition authorities and regulatory agencies:

> [R]ecognizing price-squeeze claims would require courts simultaneously to police both the wholesale and retail prices to ensure that rival firms are not being squeezed. And courts would be aiming at a moving target, since it is the interaction between these two prices that may result in a squeeze[2].

More fundamentally, the Court emphasized that it is very difficult for courts to administer prices directly. The Court underlined the nature of the market process and the impossibility of determining just prices in a continuously changing market environment.

### *5.2 EU cases*

Regulation and competition rules apply concurrently in the EU (Geradin and O'Donoghue, 2005). Firms that are abiding sector-specific regulations are not exempt from observing competition law. As the cases below show, even if there is a rule by a national regulatory authority, the Commission intervenes if it finds a competition law infringement. As a rule, EU competition authorities give priority to opening the market to competition. It sees itself as a central planner that oversees the market. In a sense, it is the "gardener" as opposed to the night watchman (Nedergaard, 2013).

There have been a number of EC and European Court decisions on the abuse of margin squeeze under Article 102 of the TFEU, and Article 82 in earlier cases (Hay and McMahon, 2012). While there were earlier cases of margin squeeze in other industries, the Deutsche Telekom (DT) investigation was the first case in telecommunications.

*5.2.1 The DT case.* Deutsche Telekom AG is the former monopoly operating the fixed-line network in Germany. It operated both in the upstream and downstream markets. The German market was liberalized in 1996 and DT was imposed access requirements. It operated in the wholes and retail markets. The starting point of the DT case was not much different from *Trink*o. In terms of legal framework, simultaneous application of competition law and regulation was possible. The regulatory authority controlled wholesale access price, but left DT some room to act independently. The existence of sector-specific regulatory rules and decisions did not preclude competition law. It was subject to European competition rules. DT was fully regulated at the wholesale level, but had some discretion on prices at the retail level. The price regulation system provided room for DT to manipulate prices. The claim was that DT did not leave a fair level of positive margin for competitors in the retail market. Thus, it was argued that it squeezed profit margins of rivals in the downstream market.

The Commission's claim was that DT imposed "unfair" prices on competitors. In this view, a vertically integrated dominant firm had an obligation to make sure that it provided a sufficient level of profits for its rivals[3]. The Commission aimed to guarantee that the market was open to potential entrants that were "as efficient as" the incumbent. New firms have to be able to enter the market without suffering losses[4]. Leaving aside the issues of economies of scale and scope, the Commission wanted to level the field for competitors in the market.

This approach makes a strong assumption about the nature of the competition in the market. Following the neoclassical description of perfect competition, the Commission assumed that protecting existing competitors makes it possible for new entry as well. However, the link between these two claims does not necessarily hold in all situations. The

Commission's approach is based on its preference on fairness as opposed to consumer welfare and efficiency.

The emphasis on fairness allowed the Commission to evade analytical questions about predatory pricing. By limiting DT's ability to lower prices, the Commission opened the door to another type of abuse: excessive pricing (Hay and McMahon, 2012, p. 273). Apparently, this was not a problem for competition policy. The trade-offs among the negative effects of excessive pricing, predatory pricing and margin squeeze reflect the political preferences of the Commission. It shows that the Commission gives priority to protect competitors rather than maximizing social welfare. This policy makes the Commission comfortable in terms of protecting the market environment for less efficient firms. As consumers are not very familiar with the Commission's policies and the consequences of its decisions and rivals are well-prepared to counter any efficiency-increasing decision effectively, the result is wealth transfers from consumers to suppliers.

The Commission's protection of equally efficient competitors was also accepted by the European Court of Justice[5]. Indeed, the ECJ went one step further than the Commission by stating that it was not necessary to show the concrete effects on the markets. It was enough to show that the dominant firm had the intention for margin squeezing[6]. The ECJ's argument was based on "equality of opportunity".

"Equality of opportunity" is a misnomer in the telecommunications market. Its social context gives the impression that the Court tried to level the field for all players in the market. However, in this case, the dominant firm was vertically integrated, fully regulated in the upstream market and tightly observed in the downstream market. Rivals are not in the same position. They are not regulated. They operate only in the downstream market and buy inputs from the monopoly in the upstream market in regulated price under tightly regulated conditions.

How can a competition authority calculate costs and benefits by taking all these factors into account? Even if one accepts that it was possible, neither the Commission nor the ECJ took this path. Calculating these costs and benefits creates issues that are raised against the "reasonably efficient competitor" test (Hay and McMahon, 2012, p. 276). The reason for using the "equally efficient competitor" test was to avoid such problems.

If FMS would not constrain the monopoly power of dominant firms, they would not be against this policy. However, as their share of the market diminishes as a result of FMS, keeping rivals in the market makes them less profitable in a more competitive market. All incumbent firms suffer from FMS, as they lose business to mobile operators. They can no longer get monopoly profits out of their fixed-line wholesale network.

This was the Commission's first margin squeeze case in telecommunications. It imposed a fine on DT based on the "unfairness" of its behaviour and signalled that its priority is fairness rather than efficiency.

*5.2.2 The* Telefónica *case*. Another major case was the *Telefónica* case. *Telefónica* was the former monopoly in Spain. As in many countries, it had the physical infrastructure and controlled the network. It dominated both wholesale and retail markets. Downstream rivals had to buy access from *Telefónica*. The Commission claimed that the difference between *Telefónica*'s prices in the wholesale and retail markets restricted competition in the retail market[7]. *Telefónica* defended itself by arguing that the margin squeeze was a refusal to supply. It constructed its defence on the indispensability theorem and claimed that the proof of indispensability was necessary before a price squeeze claim to be made (Rudaz, 2010, p. 1,086). The Commission, on the contrary, established that *Telefónica* had a regulatory duty to offer access to downstream rivals. The Commission concluded that *Telefónica* abused its dominant position and squeezed profit margins of its rivals. In this way, *Telefónica* imposed losses on equally efficient competitors. The Commission stated that[8]:

> [. . .] even if they met *Telefónica* both on prices and marketing expenditure, they were poorly placed in the long run to offer a vigorous competitive challenge to *Telefónica* as a result of their continuing losses.

In this way, it became clear that the Commission wanted to protect the health of existing rivals in the long run. The *Telefónica* case eliminated doubts about the Commission's approach on the margin squeeze cases. Another case has shown that what the Commission had in mind was not restricted to the fully regulated wholesale market. The *TeliaSonera* case clarified the role of the Commission as central planner that decides who has the right to stay in the market.

*5.2.3 The* TeliaSonera *case.* The *TeliaSonera* case closed the circle over the central planning function of the European approach. In *DT* and *Telefónica*, sector-specific regulation was part of the issue. TeliaSonera, the Swedish operator, was not subject to regulation at the wholesale and retail level.

This judgement was the result of a preliminary ruling by a Swedish court. The Swedish Competition Authority asked the court to impose a fine on TeliaSonera for a margin squeeze. TeliaSonera was accepted to have dominant position in the unregulated wholesale access market. The claim was that it set its upstream/downstream price spread narrowly to exclude its rivals in the downstream market. The court turned to the ECJ to clarify the nature of margin squeeze.

This case clarified the ECJ's approach and eliminated ambiguous points in earlier decisions. The ECJ stated that margin squeeze is "an independent form of abuse distinct from that of refusal to supply"[9]. The Court made it clear that the insufficient level of profit that originated from the difference between wholesale and retail prices was sufficient for the existence of margin squeeze. By accepting price difference accepted as a barrier to entry, the ECJ put equality and fairness before considerations about efficiency and competition.

The case law in the EU relates indispensability and regulated duty to supply. If there is a regulated duty to supply, it is not necessary to consider a margin squeeze within the elements of a refusal to supply. The trade-offs between creating incentives to invest for the dominant firm and the promotion of competition in the downstream market remained as a key factor in the Commission's *Telefónica* decision[10]. In this way, the Commission went beyond the boundaries of an enforcer of competition law and undertook a regulatory function. By considering the investment environment and other institutional factors in the telecommunications market, it extended its jurisdictional authority and became a regulator (Hay and McMahon, 2012, p. 282).

Since the times of the Alcoa case in the USA, "fairness" has always been implicitly sought in margin squeeze cases. In this way, the margin squeeze test was applied to make sure that competitors could obtain a "fair" amount of profit. This view found more support in natural monopoly situations and in transition to a liberal market system as part of the investment ladder approach. In this approach, encouraging new entrants in the fixed-line market would bring more competition to the telecommunications markets. As competitive firms start to invest in the infrastructure, competition is expected to increase in the market. After FMS became widespread, the old system has changed substantially. Competitive firms no longer have intentions to invest in the infrastructure because of increasing competition from mobile networks. This is a major reason to reconsider the existence of margin squeeze in telecommunications.

Fairness is accepted as part of the Article 102 of TFEU, where abuse is related to "unfair" prices and has become an independent objective of the EU competition law with recent cases. The objective of fairness is understood as the promotion of long-term social welfare (Nazzini, 2011, p. 145). Similarly, In the DT case, the Commission related fairness to protecting competitors in the market[11].

The EU case law remains close to Hand's original principles in the Alcoa case. "Fairness" continues to play a central role in decisions. On the other hand, the USA has distanced itself from the Alcoa decision by taking a more free-market view of Chicago school. The recent *linkLine* decision by the Supreme Court reflects this view.

In the EU, it is not necessary to show the concrete effects of margin squeeze. It is sufficient to show the possibility of restricting competition by focusing on the effect on "existing" rivals (Rudaz, 2010, p. 1,116). By contrast, the USA requires actual harm to be shown. This difference between two approaches reflects their priorities. In the USA, market process becomes more important than the effect on rivals in the market. In the EU, protecting rivals, if they are equally efficient, takes priority.

In sum, the Commission linked anticompetitiveness to equality of opportunity. This narrowed down the domain of factors that should be considered in the investigation.

## 6. Competition law or regulation? Another way to look at fairness

In understanding the nature of margin squeeze, the relationship between competition authorities and regulatory agencies plays a key role. The conflicting views on the role of regulatory institutions in the USA and the EU make it impossible to have a common approach to margin squeeze claims, even though the economic issue at stake is the same.

In the USA, regulatory legislation is very extensive. The Telecommunications Act of 1996 is more than 600 pages long and deals with every aspect of telecommunications markets. In the EU, however, Commission Directives are short and leave much discretionary power to NRAs in terms of secondary regulations.

The difference in the institutional environment brings about different approaches to margin squeeze cases. The introduction of the equally efficient competitor test was used as a tool to measure the fairness of the incumbent's pricing behaviour. This practice does not encourage competition between small and big firms. It also ignores the role of innovation and other destructively competitive actions. Rather, it envisages a static market and puts forward an egalitarian approach.

In a market where technology is stable and market structure does not change much, this policy would provide some economic benefits as well. For example, in electricity generation and distribution, the equally efficient competitor test makes more sense, as technology does not change quickly. However, recent advances in telecommunication technologies and FMS increase the costs of egalitarian policies.

This point represents a major difference between consumer welfare and welfare of competitors. The EC implicitly assumes that any conduct that leads to the exit of equally efficient rivals is necessarily anticompetitive. However, this is not a theoretical necessity. In a system where market integration and short-run rivalry is a priority, negative long-run consequences on consumer welfare are ignored. There may be cases where the conduct of the incumbent may harm competitors but benefit consumers (Carlton, 2008, p. 273). Thus, the EC's ruling reflects a political preference rather than a consideration based on economic efficiency.

The role of actual harm is another indication of the difference between these two regimes. In the EU, it is not necessary to show the concrete effect of margin squeeze. It is sufficient that rivals are disadvantaged and consequently led to compete less aggressively (Rudaz, 2010, p. 1,116). This is in stark contrast to the USA, where actual harm to the consumers has to be shown (Hovenkamp and Hovenkamp, 2009).

In the end, the EC keeps its monopoly position in margin squeeze cases by putting national regulations to a secondary place. As a result, the Commission acts as a regulatory agency. It goes beyond competition law and addresses issues of fairness and protecting competitors. It follows the old approach of the investment ladder; under the assumption that natural monopoly characteristics still dominate the market structure. On the other hand, the

Supreme Court of the USA is concerned about transforming antitrust courts into regulatory agencies. It recognizes increasing competition from mobile, fibre and cable and focuses on keeping market open[12].

Quoting from the Amicus Brief, normative preferences shape industrial policy:

> More than ever before, the USA and Europe appear to be at a fork in the road over whether the law of monopolization exists to protect consumers or to ensure that a specified number of firms will profitably populate a market (Amici Brief, 2009).

In the Amicus Brief, it is argued that "price squeeze theory is a regulatory undertaking, not an antitrust cause of action". Economists of the Brief also note that the behavioural pattern of the EU in cases of margin squeeze reflects the view that competition law is another tool of industrial policy (Amici Brief, 2009, p. 5). This explains the tension between consumer welfare and the welfare of competitors.

Competition over which authority control telecommunications markets should not be a step towards more government control over the markets. Competition authorities increasingly undertake the role of a central government by determining prices, quantities and other variables in the market. They are not well-positioned to answer these questions. For example, deciding that all equally efficient competitors should have the right to a positive level of profits reflects egalitarian thinking, under the assumption that it will benefit consumers in the long run, even though it reduces welfare in the short run. The proof of these propositions requires extensive calculations of economic impacts. Competition authorities are not well-prepared for these analyses.

In Sidak's (2008, p. 309) words:

> Antitrust courts do not exist to provide broad opportunities to regulate and second-guess the business decisions of firms or to review and nullify the decisions of regulators in the areas that the legislature has entrusted to them.

In the EU, competition law strives to further the regulatory reform by trying to increase the number of firms in the telecommunications markets. It turns into a means for liberalization. Rather than protecting the competitive market process, it plays the role of a central planner who wants to design the market.

In the end, the current EU law on margin squeeze protects producers as well as consumers (Zimmer, 2007). Protecting the rights of existing producers becomes part of the goals of competition policy on margin squeeze cases. In another words, protecting the structure of existing competition takes priority over protecting competitiveness. These are conflicting goals. As Hayek would remind us, protecting competition refers to protecting the discovery procedure in the market. Protecting existing structure, along the lines of the perfect competition model, does exactly the opposite by discouraging discovery and innovation in the market. The incumbent and its rivals in the downstream market use their resources to find ways to stay away from margin squeeze accusations.

In the end, the EC has made a decision on which party is more important in terms of protecting competition. Protecting existing firms in the market has become a dominant issue in its recent decisions. The egalitarian attitude on fairness permeates its decisions from the DT case to the *TeliaSonera* case. The Commission has undertaken the job of the regulator and more importantly the role of central planner by deciding who deserves what by not leaving price squeeze claims to their more appropriate field of regulation.

More fundamentally, intermodal competition and the obsolescence of bottleneck monopoly left no room for benefits from squeezing the margins to get profit later and exclude rivals in the retail market. The differences in margin squeeze cases reflect relative importance of changing economic environment in legal interpretations.

## Notes

1. Joaquín Almunia was the Commission Vice President in charge of competition policy. This extract is taken from a speech in 2010.
2. linkLine, 129 S. Ct. at 1120 (citing Brooke Grp., 509 US at 1121).
3. Deutsche Telekom, 2003, par. 107.
4. Deutsche Telekom, 2008, E.C.R. II-477, par. 237.
5. Deutsche Telekom, 2010, ECJ EUR-Lex LEXIS 882.
6. Deutsche Telekom, 2010, ECJ EUR-Lex LEXIS 882, Par. 183, 253-54.
7. Commission Decision of 4 July 2007, Case COMP/38784, para. 285.
8. Summary of Commission Decision of 4 July 2007, 2008 O.J. (C 83) 8.
9. *TeliaSonera*, 2011, ECJ EUR-Lex Lexis 42, par. 54.
10. *Telefónica*, par. 303.
11. Deutsche Telekom, 2003, recital 201.
12. linkLine at 1122.

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