

**MARGIN SQUEEZE ABUSES: THE TELECOM SECTOR AS A
SPECIFIC EXAMPLE**

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INTRODUCTION

The telecommunications sector has been one of the sectors, about which perception has changed over time. It was regarded, along with railways and electricity (transmission and distribution), as one of the industries which was a natural monopoly. Initial investment in this sector was high due to various entry barriers such as infrastructure, technology, etc. However, over the years governments around the world have realized that the telecommunications industry does indeed lend itself to competitive practices; due to advancement in technology and regulations to facilitate this process and ensure competition.

The history of the industry and past experience suggests that incumbent companies have always resisted the entry of new players into what has traditionally been regarded as their turf. They are able to do that quite effectively as they control the infrastructure that is required to get into the market and which the new entrants cannot replicate, considering the same may have been built over years, even decades. Regulators have to ensure that the new entrants can avail these essential facilities, required to enter the telecom market.

One of the ways a new entrant is prevented from competing effectively, even after provision of the said facilities, is a margin squeeze abuse by the incumbent company. In simple words, a margin squeeze occurs when the incumbent, by its actions, reduces the difference between wholesale and retail prices, for the others, to such an extent, that entering the market becomes prohibitive and staying in the market becomes uncompetitive.

The project report, in its first part, proposes to examine the concept of margin squeeze and the necessary preconditions that are required for it to occur. The relevant legislation under which it is an abuse (both Indian and foreign legislation) is discussed. The opinion of various jurists is put forth, with regards to the theoretical aspect of the problem and how exactly it constitutes an exclusionary abuse and what is the relationship between margin squeeze and predatory pricing. This part will also examine the defences available to a firm accused of this particular abuse and thus try to differentiate between an abuse and a legitimate strategy for the market.

The next part deals with the jurisprudence that has evolved with regards to the application of the concept of margin squeeze to cases that have come up in the telecom sector. The different approaches taken by European and American courts will be explained. It will have a brief

overview of the economic theories used by the courts with regards to pricing structures in such cases. The difficulties in using such theories in emerging markets, like the telecommunications market, will be discussed with the solutions that have been offered by courts around the world.

In the third part, the report will discuss the aspect of sectoral regulation in the telecommunication sector. The dangers of over-regulation will be stressed on and that particular aspect of the *Deutsche Telecom* case will be discussed in detail and the conflict between a regulator and competition authorities will be brought out; especially with regards to the case of margin squeeze abuses. Relevant provisions of the Indian Competition Act, 2002 on this aspect of the problem are discussed, along with a hypothetical situation where the Competition Commission of India (CCI) could come into conflict with the Telecom Regulatory Authority of India (TRAI).

This will bring us to the fourth part of the project report, which will put forth some unanswered questions and some unresolved gray areas in the law, which are present even after so many years of litigation. In this part the author will put forth the various methods that have been put forth by jurists from all over the world to resolve these issues. The author will also submit his own views regarding the subject-matter.

The paper will aim to be an analysis of the above mentioned concept from a legal perspective. The economics of it are examined insofar as they are applied in the case laws cited. However, the focus will be on the evolution of the law *per se*; especially regards the dualism of control and the problems that may arise, and the application of the various theories to real-life cases. Finally, as stated above, the questions that have not been answered are put forth for further discourse, in the hope that we will eventually resolve them by asking the right questions.

PART I: DEFINITION AND THEORY

THE CONCEPT OF EXCLUSIONARY ABUSE

The concept of abuse was laid down in the now celebrated case of *Hoffman La Roche*¹

The concept of abuse is an objective concept relating to the behavior of a an undertaking in a dominant position which is such as to influence the structure of the market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or growth of that competition.

In other words, creating artificial barriers to entry or conditions where its not feasible for the competition to remain in the market, would in effect *exclude* the competition from that market. Hence it is an exclusionary abuse. This exclusion could be actual or potential, as discussed by the Commission in the *Commercial Solvents* case² where it said that it would be enough to demonstrate that the conduct is likely to hinder competition. However, it has been a controversial issue in the recent years, with courts debating the importance of demonstrating an *actual* rather than a potential anti-competitive effect.

THE DEFINITION AND CHARACTERISTICS OF MARGIN-SQUEEZE ABUSE

In a regulated industry, generally, an operator has to grant access to essential facilities. However, the facilities could be granted at monopolistic rates or rates at which it would be difficult for the competitor to realize a profit.

In theory, the definition and concept of a margin squeeze is quite simple. It refers to situations in which a vertically-integrated dominant firm uses its control over an input supplied to downstream rivals to prevent them from making a profit on a downstream market in which the

¹ *Hoffman La Roche v. Commission* [1979] ECR 461, para 91; for a definition of dominance and abuse of dominance see article 82 of the EC Treaty and section 4 of the Indian Competition Act, 2002.

² See, *Commercial Solvents v. Commission* [1974] ECR 223.

dominant firm is also active.³ If a vertically integrated operator of a telecommunications network and services has a dominant position in a certain market, he might be able to obstruct market entry and thus distort competition by operating a margin-squeeze type of abuse.⁴

Margin squeeze evolved as a way of excluding competitors from the market after the telecommunications sector was liberalized around the world. It could be done in a number of ways; the incumbent could raise wholesale prices to such an extent that the margin between that and the retail price could become negligible or even negative. Alternatively the existing operator could lower its prices in the retail market, while it makes an overall profit due to its wholesale charges. It could even carry out both these steps simultaneously.

The European Commission has this definition of a margin squeeze (or price squeeze):

A price squeeze could be demonstrated by showing 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.... In appropriate circumstances, a price squeeze could also be demonstrated by showing that the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient).⁵

So essentially we see that the Commission lays down two tests to determine price squeeze. It can be shown by comparing the wholesale and retail prices on the upstream and downstream markets, respectively, and seeing whether the incumbent's own downstream concern could operate competitively with a similar margin. Alternatively it could also be examined as to whether a *reasonably efficient provider* (emphasis supplied) could obtain a normal profit. These

³ Damien Geradin & Robert O'Donoghue, *The Concurrent Application of Competition Law and Regulation: The case of Margin Squeeze Abuses in the telecom sector*, 1 J. Competition L. & Econ. 355, Oxford University Press.

⁴ Robert Klotz, *The Application of EC Competition Law (Articles 81 and 82 EC)* found in *EC Competition and Telecommunications Law*, Edited by Koenig, Bartosch, Braun & Romes, 2nd Ed, Vol. 6, Kluwer Law International, Wolters Kluwer, 2009 at pg. 134

⁵ Notice on the application of the competition rules to access agreements in the telecommunications sector, OJ 1998 C 265/2, paras 117-118.(hereinafter referred to as the Access Notice)

three words are of extreme legal import and a number of jurisprudential questions have been raised about them.⁶

THE PRE-CONDITIONS FOR A MARGIN SQUEEZE

From the above explanation it is clear that amongst the necessary elements in establishing margin squeeze, one whether the firm in question is vertically integrated i.e. is it a provider of the necessary input in the upstream market as well as a competitor in the downstream market?⁷ In this setting the incumbent plays the double role of wholesale provider to the other operators and of their competitor in the retail market.⁸ Geradin and O' Donoghue, explore a potential solution at this juncture;

*In theory, only a full separation of the wholesale and retail activities (i.e., through the creation of two distinct companies with separate ownership) could fully eliminate the incumbent's incentives to discriminate against downstream rivals. In practice, however, this solution only makes sense when the costs of the inputs provided by the incumbent represent a significant part of downstream operators' overall costs.*⁹

In practice this structural separation is not enforced on telecom service providers by the government as it would probably be an unreasonable restriction on the freedom of trade and commerce and would also lead to inefficiencies due to absence of economies of scale. Thus, almost always, it has to be first established that the operator in question operates at both levels, upstream and downstream, to be imputed in a case of margin squeeze abuse.

Another precondition to establishing a margin squeeze is the incumbent's control over the input and how essential that input for entry into the relevant market.¹⁰ T A facility that is controlled by

⁶ See infra at 44.

⁷ See generally Damien Geradin & Robert O'Donoghue, *supra at 1*.

⁸ Michele Polo, *Price Squeeze Lessons from the Telecom Italia Case*, 3(3) J. Competition L. & Econ. 454, Oxford University Press.

⁹ Damien Geradin & Robert O'Donoghue, *supra at 1*, discussing D. Geradin and M. Kerf, *Controlling Market Power in Telecommunications: Antitrust v Sectorspecific Regulation*, Oxford University Press, 2000

¹⁰ A price squeeze assumes that the incumbent has an upstream monopoly over an essential input. In practice, the incumbent's upstream market power may not be that strong. While the incumbent operator typically owns the copper line, substitute networks in the form of cable, wireless etc ... are available. In other words, the incumbent's essential facility is not absolute. The downstream competitors may therefore bypass the incumbent's network and consider

a single firm will be considered 'essential' only if control of the facility carries with it the power to eliminate competition in the downstream market.¹¹ Mere economic inconvenience to the plaintiff will not be enough; it has to be shown that duplication of the facilities or an alternative is not feasible.¹² The obvious deduction is that when there are other feasible options available with regards to the input, a finding of margin squeeze will probably not be in order. The important word here is, of course, *feasible*. It has to be decided on a case to case basis what it exactly connotes in a given circumstance.¹³

The most important question, of course, is determination of the existence of a margin squeeze. As already mentioned, one of the ways to determine a margin squeeze is by showing that the dominant operator's own downstream concern would not be able to compete effectively at the prices at which the input is being supplied to the competitor. As an illustration, if a new entrant like Uninor is being charged by Reliance for use of its infrastructure and it complains of a margin squeeze, it has to be seen whether Reliance's concern in the retail market would be able to compete effectively with the same difference in prices.

The second way one could test for a price squeeze is by seeing if the margin is sufficient for a reasonably efficient service provider to obtain a normal profit. Under the European Commission guidelines if the incumbent service provider can show that its downstream operations are extremely efficient, then that is a factor to be taken into account while deciding a case for abuse.¹⁴

OBJECTIVE JUSTIFICATIONS FOR PRICING STRUCTURES

Sometime there are objective justifications for the incumbent operator making losses in the retail market. Firstly there are justifications with regards to access itself. The company not having

purchasing access from alternative providers, or investing in an own network. Damien Geradin & Robert O'Donoghue, *supra* at 1, at FN 2, quoting J. Bouckaert & F. Verboven, *Price Squeezes In A Regulatory Environment*, Centre For Economic Policy Research, Discussion Paper Series, available at <http://ssrn.com/abstract=405122>

¹¹ *Alaska Airlines*, 948 F.2d at 544

¹² See, *Twin Laboratories, Inc. v. Weider Health & Fitness*, 900 F.2d 566, 569 (2d Cir. 1990)

¹³ See, *Oftel, Investigation by the Director General of Telecommunications into the BT Surf Together and BT Talk & Surf Together Pricing Packages*, 4 May 2001, whereby the application was rejected due to availability of alternative technology.

¹⁴ *Supra* at 5.

enough capacity to satisfy its own needs¹⁵, not dealing with a company on the verge of bankruptcy¹⁶, and favoring regular customers over occasional ones in times of shortage¹⁷; are legitimate reasons to deny access and they have been taken into account by courts.

Similarly there are legitimate reasons why a company may price below its marginal costs for a period of time: Market conditions may be temporarily bad but expected to improve; the company may be setting low prices as a temporary marketing initiative; it may have introduced a new product and currently has low volumes, but expects volumes to increase; a competitor may be charging unsustainable prices but will probably exit the market or revise its strategy; the market may be in decline and some market participants are expected to exit; the company may have misjudged and entered the market on too large a scale; it may be inefficient but believes it may be able to improve its performance or its products; and so on.¹⁸ These conditions, if present and accounted for, will generally result in a finding that there has been no abuse.

MARGIN SQUEEZE AND PREDATORY PRICING

All the definitions and conditions discussed above suggest a relationship between a margin squeeze abuse and predatory pricing, as both relate to pricing, *albeit*, in different ways. Predatory pricing is a commercial strategy by which a dominant firm first lowers its price to a level which will ultimately force its rivals out of the market.¹⁹ The incentive is short-term losses for an overall control of the market in the long run. Generally the average variable costs are taken into account while calculating what price would be predatory.²⁰ While this is a purely objective test, the European Courts have taken a different approach; it is based partly on the proven intent of the dominant firm.²¹

¹⁵ *Filtrona tabacalera*, XXIVth Report on Competition Policy (1989), point 61.

¹⁶ Faull & Nikpay, *The EC Law of Competition*, 2n Ed., Oxford University Press at § 4.184

¹⁷ Case 77/177 *BP v. Commissioner* [1978] ECR 1513, para 34.

¹⁸ Paolo Palmigiano, *Abuse of Margin Squeeze under article 82 of the EC Treaty and its application to new and emerging markets*, available at <http://www.coleurope.eu/content/gclc/documents/Palmigiano.doc>

¹⁹ Faull & Nikpay, *The EC Law of Competition*, 2n Ed., Oxford University Press at § 4.263.

²⁰ The test was devised by Prof. Areeda and Prof. Turner. See, Areeda & Turner, *Predatory Pricing and related practices under section 2 of the Sherman Act*, (1975) Harvard Law Review.

²¹ *AKZO* [1985] OJ L374/1; Case C-62/86 *AKZO Chemie BV v. Commission* [1991] ECR I-3359, para 71.

When a firm is engaged in retailing its products at prices which make it unfeasible for the competitor to remain in the market at a similar price, it could be a case of margin squeeze as well as that of predatory pricing. However, for predatory pricing it is not essential that the dominant firm be present in the upstream market as well as the downstream market.

In cases of predatory pricing, the incumbent makes a loss with regards to that specific product. However it may be recovered through profits from other products; but it is able to sustain that loss for the period of time it takes to exclude the competitor from the market. In price squeeze the incumbent might not be making a loss because in all probability its wholesale charges on the upstream market ensures that it makes an overall profit. The remedies available could also differ.²²

Thus we see that with regard to the concept of margin squeeze there is a lot of debate about the definition of specific terms, imputation tests and available defenses. These queries have been solved to quite an extent by courts and regulatory authorities in the various cases that have come before them. However, as always, approaches around the world have differed with regards to similar questions raised. The approach in the United States of America has always been a bit lenient towards the incumbent and they have generally not favoured too much interference by the courts if the subject-matter is within the ambit of the regulatory authorities.

²² Damien Geradin & Robert O'Donoghue, *supra at 4*, at pg 19, "...the scope of the available remedies may differ as between a margin squeeze and pure predation case. In a pure predation case, the remedy is usually to increase the (loss-making) price. In a margin squeeze case, the dominant firm could be required to lower the input price, increase the retail price, or slightly adjust, either upwards or downwards, the upstream and/or retail prices."

PART II: THE RELEVANT JURISPRUDENCE EVOLVED

DOCTRINE OF ESSENTIAL FACILITIES

The notion of essential facilities started with the *Terminal Railroad Case*²³ in the United States Supreme Court. The Terminal Railroad Association controlled passages into and out of St. Louis, which was an important railroad junction. Some of the railroads which used the facility jointly bought it and then denied access to other competitors on reasonable terms. The United States Supreme Court concluded by saying that the most effective remedy was to allow non-member competitors to be part of the association. However, as pointed out quite correctly by Prof. Areeda in his seminal article²⁴, nowhere did the Court actually say that every competitor had to be admitted. In *Associated Press*²⁵ also the Court did not actually mention that the Associated Press had to admit everyone. Justice Frankfurter compared the Associated Press to a public utility, a business infused with the public interest that was required to serve all.²⁶

Another aspect of the doctrine which has to be noted here is the fact that the railroad link was quite indispensable to the functioning of the other competitors, as it was a facility which had no substitute and which could not be feasibly reproduced or procured from any other source. The Court gave further credence to this particular aspect of the doctrine when in *Hecht*²⁷, when it affirmed that since it was not feasible that a stadium of such dimensions could not be duplicated by potential competitors, the prohibition to share in the lease agreement was not legal.²⁸

Thus according to Prof. Areeda, the essential facilities doctrine is extremely limited and the following propositions emerge from it: (1) ~~whenever competitors jointly create a useful facility,~~ (2) that is essential to the *competitive vitality of rivals*, (3) and (perhaps) essential to the

²³ *United States v. Terminal Railroad Association* 224 US 383

²⁴ Phillip Areeda, *Essential facilities: An epithet in need of Limiting Principles*, 58 Antitrust L.J. 841

²⁵ *Associated Press v. United States*, 326 U.S. 1 (1945); The case was one where some 1200 newspapers got together to achieve economies of scale. That, in itself, was not the problem. However the Court found the consortium's policy, i.e. not admitting new members if they competed with any of the incumbent members, untenable under the Sherman Act.

²⁶ *Id.* at 28-29, Justice Frankfurter concurring.

²⁷ *Hecht v. Pro Football Inc.*, 436 US 956 (1978)

²⁸ See also, *MCI Communications Corp. v. AT & T*, 464 US 891 (1983) at 1132; "A monopolist's refusal to deal under those circumstances is governed by the so-called essential facilities doctrine. Such refusal may be unlawful because a monopolist's control of an essential facility (sometimes called a bottleneck) can extend monopoly power from one market into another. Thus, the antitrust laws have imposed on firms controlling an essential facility the obligation to make the facility available on non-discriminatory terms."

competitive vitality of the market, (4) and admission of rivals is *consistent* with the *legitimate* purposes of the venture, then (5) the collaborators must admit rivals on *relatively equal* terms.²⁹

According to the American Bar Association, the following elements have been identified under this doctrine to impose liability:

- 1) Control of the essential facility by a monopolist;
- 2) A competitor's inability practically or reasonably to duplicate the essential facility;
- 3) The denial of the use of the facility to a competitor and
- 4) The feasibility of providing the facility.³⁰

In Europe too, the courts have referred to the doctrine of essential facilities; relevant case law shows that even it has been used quite extensively.³¹ In the *British Telecommunications-Italy v. Commission*³² the Commission frowned upon exclusionary terms of access with regards to what were considered essential facilities.

From the case laws it could be concluded that in Europe the essential facilities doctrine has the following elements:

- 1) Facilities consist in infrastructure, or infrastructure combined with services related to them, which are of an auxiliary nature to the economic activity in a separated but related market;
- 2) It is practically impossible (economically) for any new competitor to duplicate such facilities.
- 3) Such facilities, *access to which is necessary to compete* (emphasis supplied), are considered essential facilities.³³

²⁹ Philip Areeda, *supra* at 24, at pg. 4.

³⁰ See, *ABA Antitrust Section, Antitrust Law Developments*, American Bar Association, 1992 (3rd Ed.), at 246 footnote 292.

³¹ See, *B&I Sea-link*, [1992] 5 CMLR 255; see also *Port of Genoa*, C-179/90 [1991] ECR I-5889, where the Court referred to the essential facilities doctrine implicitly as it did not even deal with definition of the market but instead chose to rely on the significance of the port. However it would have been interesting to note the Court's opinion if Italy's rule i.e only companies hiring Italians could load and unload was indeed more efficient.

³² Case 41/83, [1985] ECR 873.

³³ Daniel Glasl, *Essential Facilities Doctrine in EC Antitrust Law*, discussing the ideas of Kurt Reiter, *EC Antitrust Law and Energy*, in Twentieth Anniversary Fordham Corporate Law Institute, 21 to 22 October 1993 at p. 6/339.

UNREASONABLE EXTENSION OF THE DOCTRINE

A judicial doctrine is always constructed in a certain social and economic context. Frankfurter's opinion, probably the only one in the *Associated Press*³⁴ case which offers an explanation of the essential facilities doctrine, was that it was necessary for the Court to step in to protect the free press; an essential feature of any democracy.³⁵ Justice Douglas, who joined in the opinion, wrote separately to highlight the fact that the Court was not requiring the Associated Press to admit anybody, but was simply banning its practice of discriminating against competitors.³⁶ Thus it is quite clear that the notion of essential facilities was construed as an extremely narrow doctrine, to be applied only in certain exceptional cases; it was to be the exception rather than the rule.

However, as subsequently cases have shown, the scope of the doctrine has been extended beyond what those jurists had intended. There is a distinction between complaints that deal with exclusionary conditions with regards to access and those which allege that the defendant must expand its facilities in order to meet the orders of the plaintiff.³⁷ The Supreme Court has subsequently affirmed that such facilities as described above cannot be held as indispensable in any way.³⁸

The doctrine is important because it helps define whether the market in question, at the upstream level, is relevant or not. The corollary of the doctrine is that, if the facility is not essential, there are other substitutes and hence a case for margin squeeze will probably not succeed.

DETERMINING THE EXISTENCE OF A MARGIN SQUEEZE

It is quite obvious that holding an essential facility is not an abuse by itself in the same way that a monopoly acquired as a "result of historical accident, business acumen, or the like"³⁹ is not

³⁴ *Supra* at 25.

³⁵ "The relation of such restraints upon access to news and the relation of such access to the function of a free press in our democratic society must not be obscured by the specialized notions that have gathered around the legal concept of a 'public utility.": Justice Frankfurter in *Associated Press* at 29.

³⁶ Philip Areeda, *supra* at 24 at pg 3 discussing the separate opinion of Justice Douglas.

³⁷ See, *Convad Communications Co. v. Bellsouth Corp.*, 299 F.3d 1272 (11th Circuit 2002) where the allegation was that the defendant had deliberately under-staffed its order-filling department for interconnection services. Ideally these are questions of contract and should not be entertained in anti-trust claims.

³⁸ *Verizon Communications Inc. v. Law Offices of Curtis v. Trinko, LLP* 540 U.S. 682, (2004).

³⁹ *United States v. Grinnell Corp.*, 384 U.S. 563 (1966) at 571.

improper. The obvious question is: How is exclusionary conduct imputed to a dominant telecommunications service provider who holds the essential facility in question?

The first step is to define a relevant product market on the downstream level and identify whether the retail products in question are sufficiently similar to subject them to the same price tests. For example the decision of the European Commission to bundle together analogue, ISDN and ADSL services was criticized in the *Deutsche Telecom Case*⁴⁰ because it was done in spite of the fact that the Commission identified these as separate markets, it did not explain why it chose to not test each of these separately rather than take a weighted average.⁴¹

Along with the product market, another important concept is the geographical market. In the *Deutsche Telecom* case, the CFI counted the whole German telecom market as one market. However, in view of the fact that the incumbent was able to show that in certain urban areas the market share of rivals had actually increased (thus allaying fears of a price squeeze in that limited market)⁴², the Court should have divided the whole market into further smaller divisions and considered each separately.

The other question that European Courts have tried to answer is with regards to the two tests that the Commission has laid down to determine a margin squeeze.⁴³ Courts have shown a bias towards test 1, as it uses a criteria that is more objective than test 2 which is that of a 'reasonably efficient service provider'.

Palmigiano enumerates the criticism against test 2 and the reasons why test 1 has been preferred by Courts:

- 1) *Its vague, since it provides no way of calculating what the downstream costs of a hypothetical "reasonably efficient" entrant would be;*
- 2) *it is inconsistent with the use of the dominant firm's costs (i.e., the first test) which is in fact which has always in fact been used by the European Commission and the Community Courts;*

⁴⁰ *Deutsche Telecom v. Commission*, Case T-271/03

⁴¹ Id. at para 206.

⁴² Id. at para 230; Here the Court admits the contention of *Deutsche Telecom* that a rival called KomTel had achieved a 43% market share in Flensburg.

⁴³ *Supra* at 5; The tests may be called test 1 and test 2, with the former being based on actual costs and the later being the 'reasonably efficient' service provider test.

- 3) *it does not assist in cases where the dominant company is unusually efficient, or some of its rivals are clearly more efficient than others;*
- 4) *it seems contrary to legal certainty and the rule of law; the law must provide a precise test or tests which a dominant company can apply*
- *without the need for confidential information about its downstream competitors' costs; and*
 - *before it adopts the pricing policy the lawfulness of which is under consideration.*⁴⁴

In the United Kingdom too, the Office of Free Trade has adhered to test 1 while investigating margin squeeze abuse.⁴⁵ The OFT said that “if DisCo [BSkyB's downstream division] failed the test, then rivals with similar efficiency to DisCo would be prevented by BSKyB's pricing strategy from competing on the merit to expand their businesses, or perhaps even from staying in the market at all”⁴⁶ and hence it was a better way of assessing the situation than test 2.

If the competitors were more efficient than the incumbent's downstream concern then it would mean that their returns would be higher. However, since the test provides only for an operator who is reasonably efficient and earns a normal profit, the extra profit earned can be ‘squeezed’ by the incumbent and there will still be no finding of margin squeeze because the normal profit obtained is still there. Thus, by applying test 2, a situation might arise, where a competitor is punished for his being more efficient than the incumbent.⁴⁷ This has a negative impact on competition in the relevant market because appropriation of profits by the incumbent, by reason of the entrant being efficient is a disincentive to enter the market. Hence this will be contradictory to the goals of the Commission. So, generally, we see that the use of test 1 is widely prevalent.

The question with respect to test 1 is which costs are to be used, since it has to be shown that the incumbent's downstream concern could not trade profitably at that margin. That consequently

⁴⁴ Palmigiano, *supra* at 18, at pg. 15.

⁴⁵ See *OFT, BSKyB investigation: alleged infringement of the Chapter II prohibition*, CA 98/20/2002, December 17, 2002 (hereinafter BSKyB) and *OFT, Exclusionary Behaviour by Genzyme Limited*, CA 98/3/03, March 27, 2003. (hereinafter Genzyme)

⁴⁶ *BSkyB*, at para 368.

⁴⁷ See generally, Pietro Crocioni, *Price Squeeze and imputation Tests: Recent Developments*, ECLR 2005, 26(10), 558-571 at pg 11 discussing the feasibility of test 2.

means that some of the marginal costs have to be taken into account to decide what this profitable margin should be. The debate is centred on what costs of the company should be taken into account and which costs should be ignored.

AVOIDABLE OR INCREMENTAL COSTS

A concept called avoidable downstream costs is used in such cases to decide which costs are to be taken into account. Crocioni discusses what these costs are;

“...the downstream costs should be those that the vertically integrated firm would avoid if it decided to no longer provide its products in the downstream market, though continue to sell the upstream input to downstream firms and all its other downstream products, if any. This means that common or joint costs and overheads that are not specific to the product's downstream activities should be excluded.”⁴⁸

As regards the cost standards that are required to calculate the magnitude of such costs, similar accounting standards have been used by the UK Competition Authorities and the European Commission. The British Authorities were the first to explicitly reject the use of a fully allocated costs (FAC) standard for the long run average incremental costs (LRAIC) accounting standards. The basic difference between the two is the fact that in FAC if there are common overhead costs for two different products or services, the overhead would contribute somewhat for calculating the profit margins for both the services, while in LRIC it would count towards only one.⁴⁹

The Commission subsequently approved of this approach in the Deutsche Telecom Case, where it said that to determine product-specific costs; one has to deduct the cost of the infrastructure to

⁴⁸ Id. at pg. 13

⁴⁹ OFTEL discusses this in *Oftel, Investigation by the Director General of Telecommunications into alleged anti-competitive practices by British Telecommunication (BT) in relation to BTOpenworld's (BTOW) consumer broadband products*, (hereinafter *Freeserve*), November 20, 2003 at para 6.30 ; “...the difference between FAC and LRIC (or LRAIC) is illustrated in the following example. Suppose that a business operates two services, A and B, both of which use a common overhead. Assume that the total expenditure on this overhead does not increase whether the firm operates only one or both of the services. If the profitability of services B is assessed on a LRIC basis, then the cost of the overhead would be excluded if the firm is already producing service A. This is because given that the firm is already producing services A, the incremental overhead expenditure required to produce service B is zero. However, on a FAC basis, service B would be expected to bear some of the costs of the overhead.”

provide the product to the end-user.⁵⁰ Thus, for example if there was an overhead which was required to provide broadband access (ADSL) but not for the analogue service, it would be part of the costs which would be included to calculate the profit margin for the ADSL service. However, if the overhead was common to both, it would be excluded.

The previous cases of price squeeze involved “raw materials, homogenous products and mature markets”⁵¹; that being the case in both the USA and Europe.⁵² However, in the telecommunications sector, though most of the costs are incurred in the upstream market; the market is dynamic, in the sense that prices and technologies change quickly and most of the time there is not enough historical data to consider reliably and then check if there is a margin squeeze. The initial investment in the sector is likely to be quite heavy and the companies will suffer a loss for the first few years before they begin and the initial investment is generally recouped after a period of some years; and the pricing policies are adjusted accordingly.⁵³ In such situations a forward looking test is needed, since analysis of the data at hand will not suffice.

The British have favoured an approach called discounted cash flow (DCF) because “a requirement that all costs are recovered instantaneously would be unduly onerous in a new market where a company may legitimately stimulate demand and may reasonably expect some reductions in underlying costs as its subscriber base grows and it becomes more familiar with the product and its subscribers' requirements.”⁵⁴ Essentially in this system the trade-off between the product's shelf-life and the profit expected from it; given the capital invested; is analysed. In Freeserve, the Oftel “forecasted demand, revenues and associated costs using based on BT's

⁵⁰ *Deutsche Telecom* at para 150; “To determine DT's product-specific costs for providing retail access to the local network, it is necessary to deduct overheads, i.e. the costs of merely providing the network infrastructure, from the total costs. Product-specific costs would arise from any special equipment required to provide analogue, ISDN and ADSL services and from DT's customer relations”

⁵¹ Pietro Crocioni, *supra* at 47, at pg. 17.

⁵² See, *EC Commission, National Carbonising* [1976] O.J. L35/6; Case 88/518/EEC *Napier Brown--British Sugar* (1988); Case T-5/97, *Industrie des Poudres Spheriques v Commission*, November 30, 2000, 178; *United States v Aluminium Company of America*, 148 F.2d 416 (2d Cir. 1945)

⁵³ *Freeserve* at para 5.20 ; “In an immature market there is often insufficient actual accounting data to make a firm conclusion on anticompetitive behaviour. It is common for firms producing and marketing a new product or service to make initial accounting losses without engaging in anti-competitive behaviour”

⁵⁴ *Id.* at para 6.149

business plan available at the time and calculated its net present value (NPV)".⁵⁵ A positive NPV would mean that the venture would be profitable in the long run.

However, as admitted in the case, there are problems with this approach. Since it is a forward looking approach, it involves some amount of speculation, especially with regards with regards to the time period. If the period chosen is too short, then there is a chance that it will not reflect the actual picture because the incumbent might not have calculated recovering within that period. If the time period chosen is too long, then there a risk of actually overlooking anti-competitive behaviour. In the Freeserve case, more than one test, including both, the LRIC and the FAC estimates, was conducted to forecast whether the venture would be profitable or not. As the downstream arm of BT was making losses only under the most stringent conditions, the conclusion was that there was no margin squeeze.⁵⁶ Thus a combination of approaches might serve the complex dynamics of the telecommunications sector, as it would invariably be defined as an emerging and immature market. The Commission's most recent guidelines on the matter of pricing seem to suggest that the cost benchmarks to be adopted by the Commission are to be average avoidable cost (AAC) and LRIC.⁵⁷

A MORE CONSUMER-ORIENTED EUROPE?

In recent times, consumerism has been gaining ground as the philosophy that should guide competition concerns; rather than competitors.⁵⁸ It has been *apriori* assumed till very recently that more competitors would mean that it is better for the consumer. However, there may be

⁵⁵ Pietro Crocioni, *supra* at 47, at pg 18-19.

⁵⁶ *Freeserve* at para 6.148

⁵⁷ *Guidance on the Commission's enforcement priorities in applying Article 82 of the Treaty to abusive exclusionary conduct by dominant undertakings* (2009/C 45/02), at para 26 (hereinafter the Guidance)

⁵⁸ Speech of the Competition Commissioner Neelie Kroes of November 16, 2006 at the Fordham Corporate Law Institute, accessible at

<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/691&format=HTML&aged=0&language=EN&guiLanguage=en> "Whether we are looking at the actions of dominant companies, breaking up cartels, vetting mergers, or approving State aid--the potential harm to consumers is at the heart of what we do. We are applying this 'consumer welfare standard' through better use of economic analysis in our work."

"My own philosophy on this is fairly simple. First, it is competition, and not competitors, that is to be protected. Second, ultimately the aim is to avoid consumers harm." [accessed on 10th June, 2010]

situations where that is not a justifiable assumption to make. In fact, the recent European Commission guidelines reflect that change in thinking.⁵⁹

However, as regards evidence of actual threat to competition and the possibility of a threat, the Guidance still reflects the thinking that a market analysis is not required in all cases.⁶⁰ In the USA, the approach has been non-intervention by the courts till there is actual evidence of harm to the market being perpetrated. The courts consider that sectoral regulators are better equipped to handle *ex-ante* measures, as judges might not have the necessary expertise of the market structure and the economics of it to handle such cases.

However, in Europe the situation is slightly different because the Commission consists of economic experts who are well qualified to deal with situations of *potential* harm in the market. So, it is understandable that they would be in a better position to take decisions before actual evidence of price squeeze is put forth. In India too, the situation is somewhat similar, with the Competition Authorities having the necessary expertise to conduct the tests that have been discussed above.

In essence, a shift towards a more consumer oriented philosophy means that efficiency considerations will play a greater role in determining the existence of a margin-squeeze. In this light it is important to note the Commission's guidelines on objective necessity and efficiencies. The commission basically lays down some conditions in case there is conduct by the dominant operator which leads to the foreclosure of competitors, with no net harm to consumers:

- the efficiencies that arise do so because of the conduct in question. It could include technical improvement and reduction in cost of production, etc.
- there is no less anti-competitive alternative to the conduct in question to realise the efficiencies

⁵⁹ *Guidance*, at para 6; "...the Commission is mindful that what really matters is protecting an effective competitive process and not simply protecting competitors. This may well mean that competitors who deliver less to consumers in terms of price, choice, quality and innovation will leave the market."

⁶⁰ *Id.* at para 22 ; "There may be circumstances where it is not necessary for the Commission to carry out a detailed assessment before concluding that the conduct in question is likely to result in consumer harm. If it appears that the conduct can only raise obstacles to competition and that it creates no efficiencies, its anti-competitive effect may be inferred.": Here it may be argued that the Commission's decision in the *Deutsche Telecom* case actually increased retail prices in the market, thereby reducing efficiency.

- any negative effects on competition and consumer welfare are outweighed by the efficiencies
- the conduct does not eliminate all effective competition⁶¹

The presence of these guidelines at the time the *Deutsche Telecom* case was decided might have meant that the decision could have gone in favour of the incumbent. However, as the CFI demonstrated there, the market share of the rest of the competitors in the whole of the German market was miniscule compared to the incumbent.⁶²

It is expected that in the Indian market too, the authorities will show restraint while exercising the powers granted to them. The telecommunications sector is a new and emerging industry. It is expected that new technology and alternative methods of service provision will come into the fore-front quite frequently as the innovation quotient of such a market is high. Keeping this in mind and the fact that efficiencies are bound to arise out of the same, it would be quite natural for competitors to foreclose due to legitimate reasons. In this scenario authorities have to keep in mind that it is not their job to see a competitor succeed; it is merely to ensure that they have a chance to succeed.

⁶¹ See, *Guidance* para. 30.

⁶² See *Deutsche Telecom* para 234; However, here the CFI emphasizes yet again that it is not necessary to demonstrate an anti-competitive effect. One assumes that this attitude will undergo a change, *albeit* slight, in the years to come as shown by the discussion above.

PART III: CONFLICTS BETWEEN THE REGULATOR AND THE COMPETITION AUTHORITIES

The natural question that comes to mind when one realizes that the telecommunication industry is subject to both the TRAI and the Competition Commission of India is; will that lead to duality of control and legislation? That is a question that has been asked around the world and that has been answered in different ways in different parts of the world. Nihoul puts forth the basic distinction here quite succinctly:

*Regulation is seen as sector-specific whereas Competition (law) would be more general. That feature - it is said - implies that Competition (law) would probably offer the best tool to govern the markets, as a general intervention is apparently better designed to cope with a converging world where specificities should be removed.*⁶³

We will go on test the veracity of that statement in this section and see where exactly that would fit in the Indian scenario and whether specificities should indeed be removed. In context of the report this will not be considered in isolation but in reference to the specific question of price squeeze abuses.

The most important case law on this point i.e the *Deutsche Telecom* case has already been discussed. There the incumbent was brought before the Commission inspite of the fact that it had complied with the price-caps of the German national regulator. The CFI refused to acknowledge this point at all.⁶⁴ The court's reasoning seemed to be that the incumbent had enough autonomy, within the scope of the prices set, to see that its own prices did not result in a squeeze.

The problem with this is that it presupposes transparency of information about pricing structures, costs, overheads and the detailed business plan of the rivals on part of the dominant undertaking.

⁶³ Paul Nihoul, *Convergence in European Communications*, International Journal of Communications Law and Policy, Issue 2 Winter 1998/99.

⁶⁴ *Deutsche Telecom* para. 76 where the CFI takes cognizance of the fact that the applicant had indeed mentioned in its application that "charges which are checked and authorized cannot be described as an abuse on part of the undertaking which adopts them." At para 114 the CFI says that at no point did the German Regulatory Authority mention Article 82 of the EC Treaty and also says in para 113 that the national regulator may not have been concerned with competition at all; that the objectives of such regulation may have been different from that of the Commission.

As has been discussed above, the British Authorities themselves have admitted to the difficulty of a forecast about the market with regards to the question of price squeeze in the Freeserve case.⁶⁵ Since the German authorities had decided a range for the prices, it is logical to assume that such prices were not *prima facie* unreasonable. In fact the German Regulator notes this fact in its decision of 29 April, 2003, where competitors had applied to it;

*“Competitors are not so prejudiced with regard to their competitive opportunities in the local network by the slight difference between retail and wholesale prices as to make it economically impossible for them to remain in the market or even to remain in the market.”*⁶⁶

After this has been ascertained by the authorities themselves, it does not seem reasonable to expect the incumbent to look out for that slight difference in prices. That would be tantamount to saying that the incumbent has a positive duty to ensure that its rivals succeed in taking its own market share.

Also, one of the ways in which the CFI substantiated its findings was actual market analysis of the shares that rivals held, even after the fixing of prices by the German regulator.⁶⁷ It seems that the only feasible way for a dominant operator to know whether there is an inadvertent price squeeze would be an *ex-post* market share analysis after price fixing. Now here we need to ask: Is it really the job of the incumbent to see its rivals succeed? It is quite natural for a dominant operator to want to maintain its dominance and that *per se* is not illegal; in fact it is quite expected.

It would be an interesting scenario if this jurisdictional conflict ever happened in the India. In Europe, it is a slightly different situation because the courts of the EU remain the final authority on matters involving the common market, and this includes competition in the market.⁶⁸

⁶⁵ Supra at 53; In light of the fact that the authorities admitted that it is a difficult job because of insufficient data about accounting, it is indeed difficult to understand how the CFI and the Commission thought that it would be possible on part of the incumbent to do that.

⁶⁶ Decision of 29 April, 2003 of the Regulierungsbehörde für Telekommunikation und Post (German Regulatory Authority for Telecommunication and Post)

⁶⁷ *Deutsche Telekom* at para. 239. Here the CFI goes on to look at market shares of rival operators after ascertaining that such a measure would not be a pre-condition to a finding of a price squeeze abuse.

⁶⁸ See Case 66/86 *Ahmed Saeed* [1989] E.C.R. 803; [1990] 4 C.M.L.R. 102, para. 46: A regulator which is called upon to approve tariffs or other agreements between operators must not take any measure “*which might be construed as encouraging*” (emphasis supplied) operators to conclude agreements contrary to the Treaty.

The Competition Act of 2002 gives wide powers to the Competition Commission to preserve and protect competition in Indian markets.⁶⁹ The moot point is the interpretation of the terms and the definitions and the extent of the powers which emerge therein. The Act lays down the scope of the interaction between the Commission and a statutory authority in section 21.⁷⁰ The nature of the interaction under this provision is a reference and an opinion therein. It is quite obvious that this would not, in any circumstances, bind the party asking for the reference. So, as far as this provision is concerned, it seems quite clear that both the Commission and the statutory authority are placed on an equal footing.

However there is a provision that explicitly states that the Act is to have an overriding effect⁷¹ and probably in that non-obstante clause would lie the solution to the conflict that might arise between the CCI and the TRAI and it would seem to lend itself to the interpretation that the CCI would be the superseding authority. On closer inspection of section 62, the intention of the legislature seems to become clearer and the concept of harmonious construction emerges.⁷² Read together, they seem to suggest that the final word is given to competition law; however, as far as possible, direct conflict should be avoided and decisions of the CCI should be construed in harmony with the regulations of the TRAI.

Generally price can be regulated in three ways. The regulator can fix a price for a product or the regulator can fix a maximum and a minimum limit for a product or it can fix a price cap, which would mean that there is a maximum but no minimum. In India the TRAI follows a price cap system. It means that there is autonomy for the operator to fix the lower ceiling of the price, hence giving rise to margin-squeeze considerations.

⁶⁹ **Section 18 of the Competition Act, 2002:** Subject to the provisions of this Act, it shall be the duty of the Commission to eliminate practices having adverse effect on competition, promote and sustain competition, protect the interests of consumers and ensure freedom of trade carried on by other participants, in markets in India: Provided that the Commission may, for the purpose of discharging its duties or performing its functions under this Act, enter into any memorandum or arrangement with the prior approval of the Central Government, with any agency of any foreign country.

⁷⁰ The section lays down that either the statutory authority may make a reference to the Commission or vice-versa, following which the authority to whom the reference is made shall give an opinion.

⁷¹ **Section 60 of the Competition Act, 2002:** The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force.

⁷² The provisions of this Act shall be in addition to, and not in derogation of, the provisions of any other law for the time being in force.

Thus the competition authorities will have a role to play inspite of the fact that this would give rise to allegations of dual control. One has to understand that the role of the CCI is much more extensive, vis-à-vis the economy, than that of the TRAI.

The concept of self-correction has to be taken into account. It has to be understood that at the upstream level, the other competitors are customers of the incumbent, who are paying rates fixed by the TRAI; which means that they probably are fair rates for the usage of the said essential facilities. This reduces the incentive for the dominant operator to indulge in a margin squeeze abuse, assuming it has enough autonomy to do so within the price ceilings defined by the TRAI.

Also, the fundamental question of who is at fault would have to be answered. If the rates are anti-competitive, would the TRAI be brought before the CCI? Or would we need a super-regulator to decide these kinds of conflicts?⁷³ Both these measures, especially the later, would lead to unnecessary litigation in a country already groaning under the weight of unresolved cases. A more balanced solution would probably be to have a kind of an informal advisory from the CCI to the TRAI in cases where disputes could arise because of the prices that have been decided upon. This could be in addition to the provisions of section 21 with regards to references to the CCI. It would ensure that the number of conflicts that arise between the authorities themselves are minimised and that companies are not harassed unnecessarily, even after following regulations of the TRAI.

⁷³ See Rahul Singh, *The Teeter-totter of Regulation and Competition: Balancing the Indian Competition Commission with Sectoral Regulators*, 8 Wash. U. Global Stud. L. Rev. 71 at pg. 28: “In order to ensure that the default rule conferring primacy to the Commission does not mean the public loses out on the expertise of the sector-specific regulator, it would be desirable to constitute an across-the-sector Common Regulatory Appellate Tribunal (“CRAT”) empowered to hear appeals from all the regulatory authorities in India. Most importantly, such a body would lead to a semblance of certainty and predictability in regulatory jurisprudence, which is currently in a state of disarray.”

PART IV: SOME UNRESOLVED QUESTIONS

ESSENTIAL FACILITIES: A RATIONAL APPROACH

There has always been a lot of controversy regarding this particular doctrine and its application and as we have seen, on numerous occasions it has been applied in circumstances which do not warrant its application. However, it is quite important in demonstrating the abuse of margin squeeze and hence it is a doctrine that cannot be ignored at the present moment. It is important to note here that some principles have been advocated around the world to make this doctrine viable to apply and not suffer from ridicule as it has in the past.

In this respect certain principles were enumerated by Prof. Areeda:

1. Sharing of essential facilities is the exception rather than the rule.
2. It is essential only if it critical for the competitor to compete and no other alternatives are feasible.
3. Legitimate business practices should be an excuse for non-access
4. The intention to exclude rivals is not illegal *per se*. It is illegal only when done through improper means.
5. A court which imposes a duty should have the expertise to reasonably supervise such duty or it should leave it to the regulatory authorities.⁷⁴

The European Commission has reasoned that a positive obligation to share, even for a fair remuneration would reduce the incentive for an undertaking to invest and innovate and this may harm consumers.⁷⁵ It also expresses the fear that, if it is seen as a duty on part of the incumbent, the competitors might not even want to invest in their own facilities and enjoy benefits from the initial investment.⁷⁶ Neither of the two scenarios is conducive to competition in the long run.

The fact remains that this doctrine has never been explicitly accepted or rejected by the courts, either in the United States or Europe. This may be due to the danger of actually interpreting it to

⁷⁴ Areeda, *supra* at 24, at pg 14-15

⁷⁵ See *Guidance* at para. 75

⁷⁶ *Id.*

mean that rather than an exception it is the rule. That reading would not be in keeping with the reasons for the evolution of the doctrine nor would it ultimately serve the purposes of competition. What one has to take into account here is the fact that enforcing

IMPORTANCE OF AN ECONOMIC PERSPECTIVE

In the past the approach, especially in Europe has been a 'form-based' based approach rather than an 'effects-based' approach, as is the case in the United States of America. The basic difference between the two is, "a 'form-based' approach, which is sometimes also referred to as the application of 'per se' rules targets the mechanism and abstract features (for example, sale below cost, supply only subject to exclusivity, tying of two different products) or underlying aims (for example, strategy aimed at eliminating a particular competitor or rebates aimed at ensuring loyalty of a customer) of a commercial conduct, which may typically indicate a risk of anti-competitive effects. By contrast, the effects-based approach advocates an analysis of the potential or even actual effects on competition in the market context of each individual case before finding an infringement."⁷⁷

In other words, the European approach has been to not decide the case on demonstration of the negative effects of an incumbent's pricing policy on the market, but rather on the courts' perception of what a margin squeeze price is likely to be. It has to be noted here that such an approach would not be a problem if the industry in question was sufficiently mature and static with regards to inputs, prices and products. A mature market ensures that pricing policies and actual prices are estimable based on historical data. Thus it is easier for a court to decide what a margin-squeeze inducing price would be.

However, it has to be stated here that the telecommunications industry is anything but homogenous, mature and static. It is, in fact an emerging industry with technologies, prices and products in flux. Thus, it is not easy for a court to base its decision on a form-based approach here. So, it stands to reason that the American approach, that an actual effect has to be shown

⁷⁷ Manuel Kellerbauer, *The Commission's new enforcement priorities in applying Article 82 EC to dominant companies' exclusionary conduct: A shift towards a more economic approach?*, E.C.L.R. 2010, 31(5), 175-186 at pg. 5

before the courts step in, would probably be in order here. The LRIC method has already been discussed above with regards to a market forecast.

In India, the Competition Commission has the necessary human and technical resources to take an effects-based approach to the problem. In view of the fact that even in Europe, enforcement priorities with regards to this kind of abuse are changing, it is only imperative that consumerism be the watchword of the Commission and that efficiency as a mitigating, or even an exculpating factor, be given importance.

IMMUNITY FROM MARGIN-SQUEEZE CLAIMS

The question has been raised in the *Deutsche Telecom* case, as to whether, if a regulatory authority has already set price caps at both wholesale and retail levels, should that give immunity to the incumbent from anti-trust margin squeeze claims. The reasoning given by the CFI and the Commission in that case was the fact that *Deutsche Telecom* still had the autonomy to set prices within that limit and thus it was not free from liability. The CFI did not even *consider* it a factor in deciding culpability of the dominant operator.

In all probability, asking for immunity from anti-competitive claims based on price-cap considerations would not be in order. However, not considering it at all would be the other end of the spectrum. Here the courts and commissions have to decide on how to create a balance between these two methods of solving the problem. While hearing cases, a certain amount of credibility should be given to this as a mitigating factor while deciding on liability. The extent to which such a factor would be critical to the decision would have to depend on facts of each individual case.

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