Margin Squeezing: The Superfluous "Fancy Phrase" of New Zealand Competition Law

BRADLEY ABURN*

Competition law is often called upon to address anti-competitive pricing, whether the pricing be inexplicably high or low. Those two cases have arisen on countless occasions to produce settled frameworks for analysis. What remains less clear is how to approach margin squeezing: the practice whereby a vertically integrated monopolist increases the cost of the input whilst simultaneously decreasing the downstream price. This margin squeeze makes it difficult, and sometimes impossible, for rivals to compete. New Zealand's only case to address margin squeezing has been Data Tails, in which the High Court ignored United States and European jurisprudence and the Court of Appeal only went one step further by considering it before distinguishing it on less than robust grounds. This article explores the approaches to margin squeezing taken overseas and locally. It concludes with the realisation that the High Court reached the right outcome, albeit through superficial reasoning. Unfortunately, additional glosses that the Court of Appeal superimposed on the High Court test leave one with uncertainty and unease.

I INTRODUCTION

The Rt Hon Jim Bolger once criticised the Commerce Act 1986 for containing many "fancy phrases".[1] Although the phrase "margin squeezing" is noticeably absent from the Commerce Act, it is the latest fancy phrase to infect competition law. Margin squeezing is an unsettling blend of two established — yet nonetheless controversial — anti-competitive trade practices: refusals to deal and predatory pricing.

Unsurprisingly, combining the two already controversial practices does not make the new practice any more palatable. Some courts have therefore attempted to extend competition law to deter or penalise margin squeezing. This article considers the question:[2]

---

* BCom/LLB(Hons), Solicitor, Russell McVeagh, Tutor at The University of Auckland Faculty of Law. The author wishes to thank Sarah Keene, Andrew Peterson, Matt Sumpter and Cushla Dibley for their guidance and support whilst writing the dissertation upon which this article is based. The views expressed are those of the author and not Russell McVeagh.

1   (11 June 1985) 463 NZPD 4683.
2   J Gregory Sidak "Abolishing the Price Squeeze as a Theory of Antitrust Liability" (2008) 4 J Competition L & Econ 279 at 281.

[I]s [margin squeezing] analysis superfluous and unnecessary, or does it add value by extending [the application of] section [36 of the Commerce Act 1986] to conduct that might otherwise escape condemnation?

Margin squeezing is not only an academic concern. Any industry where one firm operates at multiple levels of the supply chain can fall victim to the perils of margin squeezing. However, judicial analysis of a distinct margin squeezing prohibition may well be superfluous.

This article explains margin squeezing. It then canvasses and critiques the judicial approaches towards margin squeezing in New Zealand, the United States and the European Union. These approaches include analysing margin squeezing under existing frameworks as constructive refusals to deal or predatory pricing, and developing new analyses and tests specific to margin squeezing. A final option is regulatory separation.

Overall, this article considers that New Zealand's present approach — to treat margin squeezing as no more than a constructive refusal to deal — is the least troubled and simplest way forward, provided that a safe harbour is established. It is unnecessary for New Zealand courts to develop a distinct judicial analysis of margin squeezing. The existing law on refusals to deal is adequate to capture an anti-competitive wrong committed by margin squeezing.

II WHAT IS MARGIN SQUEEZING?

Margin squeezing may be a strategy used by a dominant, vertically integrated supplier to exclude competitors in a market that it supplies with an essential input. A margin squeeze:[3]

... occurs when a dominant vertically integrated supplier sets prices in the upstream wholesale market in a manner that prevents equally or more efficient competitors from profitably operating in the downstream retail market.

---

3   *Commerce Commission v Telecom Corp of New Zealand Ltd* HC Auckland CIV-2004-404-1333, 9 October 2009 at [3] [*Data Tails* (HC)].
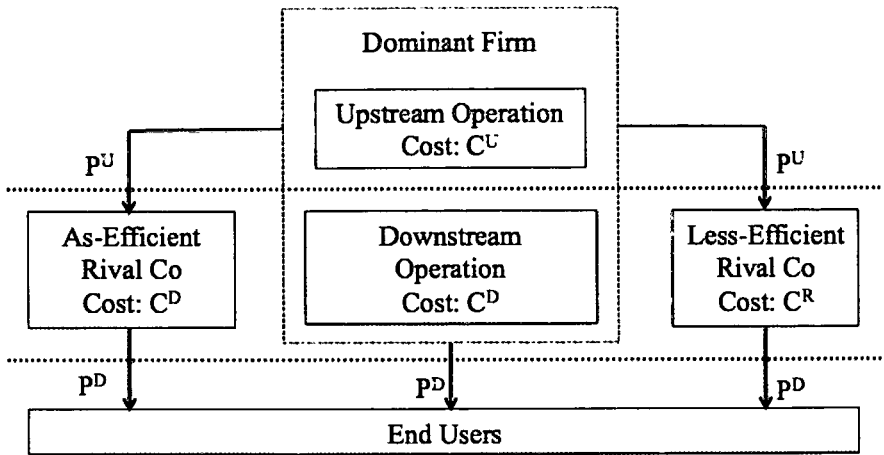
Figure 1 below represents a margin squeeze:

Figure 1

A dominant, vertically integrated supplier achieves a margin squeeze by setting its upstream and downstream prices so that a rival's gross margin ($P^D - P^U$) does not cover that rival's operating costs (C^D or C^R). This forces the rival to exit the market, unable to make a profit.

     As margin squeezing is concerned with relative prices (upstream prices vis-à-vis downstream prices) there are three ways to implement a margin squeeze. The vertically integrated firm may:

(1) increase the upstream price;
(2) decrease the downstream price; or
(3) both.

All three methods may exclude downstream rivals.

     As the proverb goes, "there is nothing new under the sun".[4] Eventually, options (1) and (2) morph into either a constructive refusal to deal or predatory pricing, respectively. When the dominant firm has a duty to supply but does so only at an exorbitant upstream price, it is a constructive refusal to deal.[5] If the dominant firm sets its downstream price below a measure of its variable costs, but is likely to recoup its losses when its rivals exit, it is predatory pricing.[6] A conventional refusal to deal or predatory pricing analysis then becomes appropriate. This article focuses on the treatment of margin squeezing, which

---

4   Ecclesiastes 1:9 (NRSV).

5   *Telecom Corp of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 (PC) at 406 [*Telecom v Clear*].

6   *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* [2004] UKPC 37, [2006] 1 NZLR 145 at [67].

escapes the standard application of these two frameworks: that is, where the upstream price alone is not exorbitant and the downstream price alone is not predatory, but the combined effect is to exclude competition.

III THE NEW ZEALAND APPROACH

This article will now consider New Zealand's approach to margin squeezing. The Commerce Act contains no specific margin squeezing provision. The starting point is the catch-all s 36(2):

> (2) A person[7] that has a substantial degree of power in a market must not take advantage of that power for the purpose of—
>   (a) Restricting the entry of a person into that or any other market; or
>   (b) Preventing or deterring a person from engaging in competitive conduct in that or any other market; or
>   (c) Eliminating a person from that or any other market.

Section 36 is widely drafted. It captures a dominant firm taking advantage of its *upstream* market power for an anti-competitive purpose in the *downstream* market. Were s 36 not drafted in this manner, margin squeezing would fall outside the scope of the Act.[8]

To date, only one New Zealand case has involved margin squeezing: *Commerce Commission v Telecom Corp of New Zealand Ltd (Data Tails)*.[9] In *Data Tails*, the High Court analysed margin squeezing not as a separate offence, but under existing competition law as a constructive refusal to deal. The Court of Appeal in *Telecom Corp of New Zealand Ltd v Commerce Commission (Data Tails* (CA)) agreed with the High Court's analysis.[10]

---

7   "Person" is defined as including "any association of persons whether incorporated or not": Commerce Act 1986, s 2(1), definition of "person".
8   One could argue that margin squeezing could be assessed under s 27 of the Commerce Act 1986 as an agreement with the purpose, effect or likely effect of substantially lessening competition in a market.
9   *Data Tails* (HC), above n 3.
10 *Telecom Corp of New Zealand Ltd v Commerce Commission* [2012] NZCA 278 at [120] [*Data Tails* (CA)].

The *Data Tails* Case

1 Background

In the *Data Tails* case, Telecom was alleged to have overpriced its wholesale "data tail" connections to rival networks. Figure 2 below broadly illustrates how data is transmitted from one customer to another.
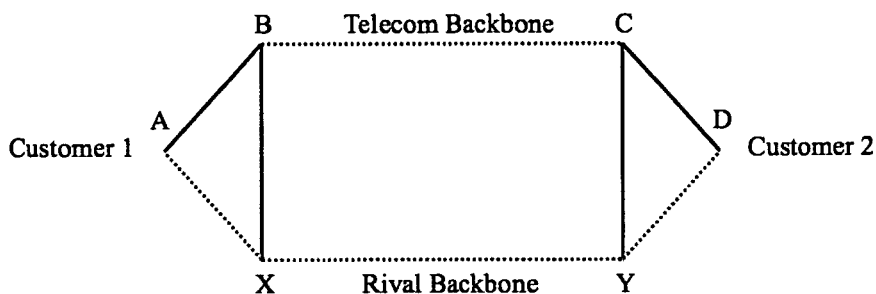

Figure 2

When a person sends data to another person, the data first flows from Customer 1 (at A) to an exchange (B or X). It is then sent across the backbone (BC or XY) to another exchange (C or Y). From there, it finally travels to Customer 2 (at D).[11] A "data tail" is the connection between a customer and the exchange (AB, AX, CD and YD).

Telecom acquired control of the data tail connections when it purchased the basic telephone system from the New Zealand Government in the 1980s.[12] This meant that rivals needed to lease the data tails from Telecom to operate. Rivals could provide service to their customers in three ways:[13]

(1) lease the entire circuit (ABCD);
(2) establish their own backbone (XY) and access network at one end (AX or DY), and lease the remaining data tail from Telecom (CD or AB); or
(3) establish its own backbone (XY), and lease all data tails from Telecom (ABX and YCD).

In 1999, Telecom introduced its "Streamline" retail pricing policy, which featured significantly reduced retail prices.[14] Telecom did not adjust its wholesale pricing policy to compensate (the wholesale policy provided rivals access at a discount of 15–30 per cent below the old retail price). This

---

11   *Data Tails* (HC), above n 3, at [22].
12   At [2].
13   At [23].
14   At [25].

began the alleged margin squeeze.[15] Eventually, Telecom introduced a new wholesale pricing policy called "Carrier Data Pricing" (CDP). It allowed rivals access at a discount of 6–15 per cent below the new Streamline price. But the Commerce Commission argued that:[16]

> ... under CDP, wholesale prices did not fall commensurately with the large reductions brought about by the introduction of Streamline retail prices; the prices of two data tails in most instances were above the retail end-to-end price charged by Telecom to its customers.

In other words, Telecom was accused of margin squeezing.

2 Margin Squeezing as Refusal to Deal

The High Court did not analyse margin squeezing as a new concept. Although Rodney Hansen J described Telecom's conduct as margin squeezing, he analysed the case as no more than a constructive refusal to deal. The Court concentrated solely on the wholesale (upstream) price, even though the margin squeeze was caused by decreasing the retail (downstream) price.

Consequently, the Court adopted the same counterfactual test that the Privy Council used in *Telecom Corp of New Zealand Ltd v Clear Communications Ltd* (*Telecom v Clear*) for constructive refusals to deal:[17]

> [I]f the terms Telecom were seeking to extract were no higher than those which a hypothetical firm would seek in a perfectly contestable market, Telecom was not using its dominant position.

The Court endorsed a two-stage approach:[18]

> The first is to enquire whether there was an obligation to supply data tails at all. The second is whether supply in the counterfactual by a non-dominant incumbent would be at prices in excess of [the Efficient Component Pricing Rule].

(a) Obligation to Supply

The Court's analysis of the first limb was brief. The Court accepted that Telecom "was not under an express statutory obligation to supply data tails".[19] The Court then acknowledged that an "essential facilities doctrine" has no application in New Zealand besides providing an insight into how s 36 operates.[20] The Commission based its case on *Queensland Wire Industries*

---

15 At [26]–[27].

16 At [28].

17 At [43]. See also *Telecom v Clear*, above n 5, at 403.

18 At [126].

19 At [127].

20 At [127].

Pty Ltd v The Broken Hill Pty Co Ltd,[21] which held that a vertically integrated supplier has a duty to supply an "essential wholesale input" to a downstream rival.[22] The Court accepted the Commission's submission without examining how *Queensland Wire* applies or what relevance it has under New Zealand law. Telecom, on its appeal, argued that the High Court had assumed a general duty to supply, divorced from any counterfactual analysis as to whether a non-dominant Telecom would in fact supply data tails to competitors.[23] The Court of Appeal agreed that the High Court's judgment could be interpreted in that light, but considered that the implicit reasoning of the High Court nonetheless involved counterfactual analysis.[24]

(b) Efficient Component Pricing Rule

The second limb involved: (a) calculating the wholesale (upstream) price according to what is known as the "Efficient Component Pricing Rule" (ECPR); and (b) assessing whether Telecom would price above the ECPR price in the counterfactual market, in which Telecom would be one of two equal-sized competitors.[25]

    The ECPR prices access to networks that are controlled by a vertically integrated monopolist.[26] It does so by finding a wholesale price that compensates the monopolist for properly incurred costs including foregone profits whilst ensuring that the price remains sufficiently low to avoid creating a barrier to entry.[27]

    Two pricing methods for applying the ECPR were advanced: the Gabel approach and the Kahn–Taylor approach.[28] Both derived the same ECPR price and used the same assumptions:[29]

(1) The prevailing retail price of data circuit ABCD is $14.00.
(2) The direct incremental network cost of using data tails AB and CD is $2.00 (that is, $1.00 for each tail).
(3) The direct incremental network cost of using backbone BC is $2.00.
(4) The direct incremental retail cost of serving the customer is $3.00.

The Gabel method first assesses the level of profit that the vertically integrated monopolist would earn if it sold one unit to an end-user — the retail price ($14.00) minus the cost ($7.00) — a profit of $7.00.[30] The ECPR price, according to Professor Gabel, is the direct incremental costs of providing the rival with the data tails ($2.00) plus the foregone profit ($7.00) — resulting in

21 *Queensland Wire Industries Pty Ltd v The Broken Hill Pty Co Ltd* (1989) 167 CLR 177.
22 *Data Tails* (HC), above n 3, at [127].
23 *Data Tails* (CA), above n 10, at [130].
24 At [131]–[132].
25 *Data Tails* (HC), above n 3, at [44]. See also *Telecom v Clear*, above n 5.
26 At [45].
27 At [45].
28 At [48]–[49].
29 At [48].
30 At [48]. This cost is found by adding together the last three costs listed in the assumptions above.

an ECPR price of $9.00.[31]

The Kahn–Taylor methodology is simpler. It does not depend upon the direct incremental cost of using the data tails. It asks what costs the vertically integrated monopolist avoids when it sells the essential input to a competitor. It then subtracts these avoided costs from the retail price. The avoided costs in this case were $5.00,[32] resulting in an ECPR price of $9.00.[33]

The Court noted that the "ECPR alone may not encourage efficient entry but it [would] certainly discourage inefficient entry".[34] Consequently, only as-efficient rivals would enter, and remain in, the market. Those rivals are the ones that can provide the backbone network and service consumers at an equal or lower cost than Telecom.

When the input is priced at the ECPR price, a rival would make zero profit if it were as efficient as Telecom in supplying the backbone and serving the customer. Rivals would only earn positive profits if they were more efficient than Telecom.[35]

Once the ECPR price is established (by either method), a court would consider whether the dominant firm *would* price above the ECPR price *but for* its market power. In *Data Tails*, the Court adopted a counterfactual where Telecom was one of two vertically integrated firms, each with a market share of 50 per cent.[36] The Court held that in this hypothetical market, the level of competition would drive Telecom not only to set a price equal to the ECPR price, but more likely closer to the marginal cost of providing the service. However, the High Court accepted that the ECPR should provide a safe harbour, meaning that s 36 is not breached if the input price is equal to, or less than, the ECPR price.[37]

3 Finding

Ultimately, the Court found Telecom to have breached s 36 in relation to Telecom's pricing where it supplied two data tails.[38] Telecom was fined a record $12 million.[39] The Court reiterated that deterrence is the purpose of pecuniary penalties under the Act.[40]

Rational businesses should now be wary of decreasing downstream prices. The author suggests that the penalty will have the unintended effect of maintaining high retail (downstream) prices that allow rivals to compete.

---

31   At [48].
32   That is, the direct incremental network cost of using the backbone plus the direct incremental retail cost of serving the customer.
33   At [50].
34   At [63].
35   At [62].
36   At [129].
37   At [130].
38   At [188]. The High Court held that where Telecom provided only one data tail and the competitor self-provided the other, its pricing was consistent with the ECPR and consequently did not breach s 36.
39   *Commerce Commission v Telecom Corp of New Zealand Ltd* HC Auckland CIV-2004-404-1333, 19 April 2011 at [60].
40   At [3]–[4].

This result harms consumers, the very group competition law is designed to benefit, over time.

4 Conclusion

Data Tails left many questions unanswered. Remarkably, the Court did not consider what elements needed to be established before a refusal to deal breached s 36. The High Court in *Commerce Commission v Bay of Plenty Electricity Ltd* had required that:[41]

(1) the input provided by the dominant firm must not be practically duplicable or economically viable to replicate;
(2) there be no substitutes to the downstream product that the input produces;
(3) the dominant firm controls the input; and
(4) there be no business rationale for the refusal.

Instead, by adopting the ECPR, the Court endorsed the reasoning of the Privy Council in *Telecom v Clear*.[42] In that case, the Privy Council accepted that an outright refusal to supply an essential input might be anti-competitive. Nevertheless, their Lordships held that supplying the input at a price that covers the dominant firm's foregone downstream profit, as well as any other incremental costs entailed in supplying the input, is not anti-competitive.[43]

Furthermore, the key difference between earlier constructive refusal to deal cases (such as *Telecom v Clear*) and *Data Tails* was not discussed. Decreasing downstream prices created the squeeze in *Data Tails*. A more thorough treatment would necessitate a discussion of the implications, if any, of this distinction. Although the Court of Appeal discussed whether *Data Tails* could be distinguished from *Telecom v Clear*, the issue of where the margin squeeze originated is noticeably absent.[44]

Even more peculiar, the Court failed to consider a number of persuasive overseas authorities. Instead, these authorities were relegated to mere footnotes, seemingly unworthy of treatment in the substantive judgment.[45]

Nonetheless, the Court reached a defensible position. According to the High Court, a margin squeeze is only abusive when a vertically integrated dominant firm is obliged to deal[46] and inexplicably prices above the ECPR price.[47]

---

41 *Commerce Commission v Bay of Plenty Electricity Ltd* HC Wellington CIV-2001-485-917, 13 December 2007 at [376] and [388]. There was also only cursory treatment of *Union Shipping NZ Ltd v Port Nelson Ltd* [1990] 2 NZLR 662 (HC) and *Queensland Wire*, above n 21: *Data Tails* (HC), above n 3, at [127].

42 *Data Tails* (HC), above n 3, at [44].

43 *Telecom v Clear*, above n 5, at 390.

44 See *Data Tails* (CA), above n 10, at [133]–[136].

45 *Data Tails* (HC), above n 3, at [127], n 3.

46 Presumably under the test espoused in *Bay of Plenty Electricity*, above n 41, at [388].

47 The only defences available will be those accepted in refusal to deal claims — primarily a business rationale for the conduct.

5 Data Tails *on Appeal*

Telecom appealed both the liability finding and penalty to the Court of Appeal.[48] The Court of Appeal's analysis went one step further and at least considered the United States and European cases on margin squeezing.[49] Yet, the Court of Appeal did not take the opportunity to examine fully the overseas approaches and their application. Rather, the Court chose to distinguish them on the basis that they only consider the interplay between regulation and competition law, which was not at issue given data tails were not regulated during the period in question.[50] Although there was a regulatory flavour to the overseas judgments, the methodologies applied can be used in regulated and unregulated industries alike. The Court of Appeal settled on a constructive refusal to deal framework.[51]

The Court of Appeal modified the High Court's methodology. First, the downstream price used in the ECPR calculation must be the actual downstream price if that market is competitive or regulated; otherwise, it must be the downstream price that would exist in a competitive downstream market.[52] This development seems redundant given that a vertically integrated firm only has an incentive to create an abusive margin squeeze where the downstream market is competitive. A vertically integrated firm who has market power in both segments has little need to margin squeeze.

It is the Court of Appeal's second modification that is a serious cause for concern. The Court of Appeal eliminated the safe harbour that the ECPR once afforded dominant firms.[53] It was accepted in both the High Court and Court of Appeal that Telecom's pricing in the scenario where they only provided one data tail and the competitor self-provided the other was ECPR-compliant. However, the courts diverged as to whether this provided Telecom with any protection.

The Court of Appeal introduced an additional step in the analysis and asked whether a competitor could compete if it paid Telecom an ECPR price for the input.[54] This development is unsettling. Dominant firms need to know *ex ante* whether their pricing would violate s 36. It is settled that provided a price is set above variable cost, it would not amount to predatory pricing.[55] The High Court approach in *Data Tails* set the maximum price at the ECPR price. Firms knew where they stood. In contrast, the Court of Appeal's judgment requires firms to assess a rival's ability to compete at that price. With respect, this is straying into the dangerous territory of encouraging —

---

48 *Data Tails* (CA), above n 10; and *Telecom Corp of New Zealand Ltd v Commerce Commission* [2012] NZCA 344 [*Data Tails* (CA Penalty)].

49 *Data Tails* (CA), above n 10, at [105]–[112] and [113]–[119] respectively.

50 At [120].

51 At [123]–[124].

52 At [84].

53 At [84].

54 At [236]–[237].

55 *Carter Holt Harvey*, above n 6, at [67].

and perhaps legitimising — dominant firms obtaining sensitive information from competitors.[56] Helpfully, the Court of Appeal does acknowledge that ECPR analysis and the additional calculations required under their approach are not easy, and that the court would not lightly depart from a dominant firm's pricing where "a genuine attempt to apply ECPR prices" had been made.[57]

The Court of Appeal upheld the $12 million penalty imposed by the High Court despite finding an additional breach.[58] While recognising that the penalty imposed may appear light given the additional liability finding, the Commission did not seek an increased penalty.[59]

For now, New Zealand treats margin squeezing as a constructive refusal to deal. This article now examines two alternative approaches. The United States also does not recognise margin squeezing as a separate offence. Instead, margin squeezing is addressed under a predatory pricing framework. The European Union adopts a fresh stance and recognises margin squeezing as an independent offence.

IV THE UNITED STATES OF AMERICA

Like New Zealand, the United States does not expressly address margin squeezing in any statute. Instead, margin squeezing falls to the general anti-monopolisation provision contained in § 2 of the Sherman Act:[60]

> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.

The United States' approach towards margin squeezing has been refined through five cases.[61] The judicial approach to margin squeezing in the United States has shifted, from analysing margin squeezing as an independent violation of the Sherman Act, to analysing it as a form of predatory pricing.

ALCOA: Fair Price and Living Profit

The first case, *United States v Aluminum Co of America* (*ALCOA*), concerned an aluminium company. The defendant, the Aluminum Company of America (ALCOA), manufactured and supplied aluminium ingot in the wholesale (upstream) market. It also competed in the retail (downstream) market as a

---

56   See *Data Tails* (CA), above n 10, at [98]–[99].

57   At [101]. The Court added the proviso that such an attempt must be reasonable under public law standards and referred to *Associated Provincial Picture Houses Ltd v Wednesbury Corp* [1948] 1 KB 223 (CA).

58   *Data Tails* (CA Penalty), above n 48, at [73].

59   At [23].

60   Sherman Antitrust Act 15 USC § 2.

61   *United States v Aluminum Co of America* 148 F 2d 416 (2nd Cir 1945) [*ALCOA*]; *Town of Concord, Massachusetts v Boston Edison Co* 915 F 2d 17 (1st Cir 1990); *Verizon Communications Inc v Law Offices of Curtis V Trinko, LLP* 540 US 398 (2004); *Covad Communications Co v Bell Atlantic Corp* 398 F 3d 666 (DC Cir 2005); and *Pacific Bell Telephone Co v Linkline Communications Inc* 172 L Ed 2d 836 (2009).

fabricator.[62] ALCOA was accused of setting an excessively high price for ingot.[63]

In this case, the Court treated margin squeezing as an independent violation of the Sherman Act, generating an analysis unique to margin squeezing. Judge Learned Hand held that a margin squeeze would violate § 2 of the Sherman Act when:

(1) the firm has market power in the upstream market;
(2) its upstream prices are "higher than a 'fair price'";[64] and
(3) its downstream prices are so low that its downstream rivals cannot match that price and still make a "living profit".[65]

The Court, in essence, employed an imputation test to ascertain the fair price that the dominant firm needed to charge for the input and the living profit that a downstream competitor would be entitled to make.[66] This test assessed whether ALCOA's downstream operation would have been profitable if it had bought the ingot from itself at its upstream price. If it would not have been profitable, then the price could not have been fair.

Unfortunately, the Court gave little guidance on how to apply the test in future cases. The Court stipulated that ALCOA's own costs were to be used for the purpose of the test, but gave no guidance on what a "fair price" or a "living profit" was.[67] The test formulated has been criticised as a result, including in the next case considered below.

The assessment of a "fair price" appears to shift the focus of § 2 from economic objectives to moral objectives. Competition law is directed at economic objectives and should be blind to the winners and losers of the competitive process.[68] The concept of a "fair price" is foreign to economics and should accordingly be viewed with a degree of scepticism.

Boston Edison: Criticisms of *ALCOA* and Price Regulation in Both Markets

The second case was the *Town of Concord, Massachusetts v Boston Edison Co*.[69] The Court doubted the test formulated in *ALCOA* and considered margin squeezing where the dominant firm's prices were regulated in both the upstream and downstream markets.

The dominant firm was Boston Edison, a power company. It operated

---

62 *ALCOA*, above n 61, at 422.

63 At [24].

64 At [25].

65 At [24].

66 Caroline Cavaleri Rudaz "Did *Trinko* Really Kill Antitrust Price Squeeze Claims? A Critical Approach to the *Linkline* Decision Through a Comparison of EU and US Case Law" (2010) 43 Vand J Transnat'l L 1077 at 1088. See also *ALCOA*, above n 61, at [25].

67 Rudaz, above n 66, at 1088.

68 *Queensland Wire*, above n 21, at 194.

69 *Boston Edison*, above n 61.

in both the transmission (upstream) and distribution (downstream) markets.[70] One downstream competitor, the Town of Concord, used its own distribution system but received all its electricity over Boston Edison's transmission lines.[71]

Unlike ALCOA, Boston Edison's prices were regulated in both market segments: the Federal Energy Regulatory Commission (FERC) regulated the transmission price and the Massachusetts Department of Public Utilities (MDPU) regulated the distribution price.[72] Between 1904 and 1987, the FERC granted Boston Edison a series of upstream price increases. The downstream price remained unchanged. As a result, the margins available to competitors were squeezed.[73] The Town of Concord argued that Boston Edison's prices were anti-competitive and brought proceedings under the Sherman Act.

1 Difficulty in Calculating When Margin Becomes Abusive

The most poignant passage of the judgment is Judge Breyer's critique of *ALCOA*. Judge Breyer doubted whether it was even possible to ascertain what a "fair price" was with any degree of certainty or predictably:[74]

> 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? Further, how is the court to decide the proper size of the price "gap?" Must it be large enough for all independent competing firms to make a "living profit," no matter how inefficient they may be? If not, how does one identify the "inefficient" firms? And how should the court respond when costs or demands change over time, as they inevitably will?

In the passage above, Judge Breyer identified a number of key concerns. These concerns require further consideration and comment.

First, Judge Breyer doubted whether it was possible to ascertain a fair price. Tax authorities have long encountered a similar issue with transfer pricing regimes. The New Zealand Parliament has responded with the "arm's length" price concept whereby all transactions between related parties are priced, for tax purposes, at an arm's length price.[75] In order to ascertain this price, the taxpayer is afforded a choice of five methods.[76] One is the comparable uncontrolled price method, where the taxpayer would adopt

---

70 At 19.
71 At 20.
72 At 20.
73 At 20.
74 At 25.
75 Income Tax Act 2007, s GC 6.
76 Section GC 13(2). The five methods are: comparable uncontrolled price; resale price method; cost plus method; profit split method; and comparable profit method.

the price charged by a comparable seller to an independent customer. Judge Breyer contended that this test of margin squeezing would fail because no comparable uncontrolled price would exist. That is likely to be true. However, there are other methods available to ascertain a price and some guidance can be heeded from transfer pricing cases.

Secondly, Judge Breyer suggested that courts require information about costs and demand to analyse margin squeezing. This is misconceived. Courts frequently enquire extensively into a firm's cost structure in assessing predatory pricing allegations. Furthermore, the level of demand in either market is irrelevant. A margin squeeze can be found to exist, or not, without ascertaining the level of demand.

Thirdly, Judge Breyer argued that it was unclear which rivals are entitled to a "living profit". Such an argument is without merit. Only as-efficient rivals should be entitled to a living profit. The threat of less-efficient rivals entering the market may cause dominant firms to price more competitively.[77] However, competition law is designed to promote competition: a Darwinian environment where only the most efficient should survive. Protecting the weak and preserving the ability of less-efficient firms to enter the market is not a concern for competition law. It is the exclusive domain of regulation.[78]

Finally, Judge Breyer claimed that over time, markets and prices adjust and thus courts would need to monitor the market continuously. Competition authorities should ignore these isolated short-term margin squeezes. Their effects are short-lived and thus unlikely to be exclusionary.[79] It is wholly possible that a firm's pricing policy prevents margin squeezing on most occasions, but due to an erratic or unstable market creates a short-term margin squeeze. Thus, the law should concentrate on a firm's pricing policy and not discrete applications of it over time.

2 Interplay between Competition Law and Regulation

The Court accepted that the difficulty in calculating a margin squeeze was an unsatisfactory argument to dispose of the case. Ultimately, the Court decided the case on the basis of the interplay between regulation and competition law, refusing to hold that Boston Edison breached § 2.

The starting point was that price regulation would not provide a firm with "blanket immunity from the antitrust laws".[80] However, Boston Edison was in the unusual position of being regulated in both markets. This multi-layered regulation meant that Boston Edison could not control its own prices.

---

77 Note that it is not the *actual* presence of the rival that has this effect but the *potential* presence that forces the monopolist to price at least below the marginal cost of the potential entrant. See Barry E Hawk "The current debate about section 2 of the Sherman Act: judicial certainty versus rule of reason" in Abel M Mateus and Teresa Moreira (eds) *Competition Law and Economics: Advances in Competition Policy Enforcement in the EU and North America* (Edward Elgar Publishing, Cheltenham, 2010) 199 at 209.

78 *Telecom v Clear*, above n 5, at 407.

79 Pietro Crocioni and Cento Veljanovski "Price Squeezes, Foreclosure and Competition Law: Principles and Guidelines" (2003) 4 JNI 28 at 41.

80 *Boston Edison*, above n 61, at 21. See also *Otter Tail Power Co v United States* 410 US 366 (1973) at 372–375.

FERC-approved price increases were responsible for the margin squeeze.

Because of that unusual position, the Court considered that an alternative remedy was available to the downstream rivals: petitioning the FERC or MDPU to reassess upstream or downstream prices respectively. The fault for this particular margin squeeze lay with the FERC, which approved upstream price increases without contemplating their effect on the downstream market.

The reasoning in this case — as far as margin squeezing goes — is of limited precedential value. The ratio just described should be confined to cases where regulation occurs at both levels in the supply chain. Still, the case remains relevant for its criticisms of *ALCOA*. It is also relevant for the comments made which suggest margin squeezing may benefit consumers.

3 Margin Squeezing May Benefit Consumers

Whereas *ALCOA* focused on harm to competitors,[81] *Boston Edison* redirected scrutiny towards the competitive process, suggesting that margin squeezing may be pro-competitive if it ultimately benefits consumers.[82]

The Court resurrected the Chicago critique: that margin squeezing does not give a dominant firm any more power than it already has. Regardless of its presence downstream, a dominant upstream firm could raise its upstream price and extract all the monopoly profits upstream.[83]

Such analysis appears to be factually incompatible with this case. The dominant firm, Boston Edison, faced price regulation that prevented it from extracting monopoly rents upstream. It was the margin squeeze that allowed Boston Edison to foreclose the downstream market and extract the additional profit through increased downstream sales once its rivals exited the market.

The Court also recognised that there were two limitations to the claim of possible benefits. First, a dominant firm may increase barriers to entry in the downstream market by fortifying its dominant position upstream.[84] Secondly, the mere existence or threat of downstream rivals can provide a competitive constraint on the dominant firm, inducing it to become more efficient.[85]

Despite these criticisms and limitations, the Court showed pro-competitive aspects of margin squeezing. Margin squeezing is beneficial if a dominant firm is more efficient than its downstream rivals.[86] Furthermore, when a downstream rival is a monopolist, margin squeezing benefits consumers by eliminating double marginalisation — that is, the risk of two or more monopolists in the supply chain each adding their margin to the cost

---

81 By concentrating on the fuzzy concepts of "living profit" and "fair price".

82 *Boston Edison*, above n 61, at 21.

83 At 23.

84 At 23.

85 At 24.

86 At 24.

of the good.[87] However, the judgment failed to show the relevance of such factors to the case.

Trinko: **Refusal to Deal Doctrine**

The third case was *Verizon Communications Inc v Law Offices of Curtis V Trinko, LLP*.[88] It concerned a class action brought by consumers of AT&T (a new entrant in the telecommunication market) against Verizon. The incumbent Verizon refused to grant AT&T reasonable access to its network.

    Trinko is instructive in its treatment of the related refusal to deal doctrine. The case is also important due to how subsequent courts have regarded its reasoning in analysing margin squeezing.[89]

    Scalia J's opinion began with the oft-cited principle that a person operating a private business retains "discretion as to the parties with whom he will deal".[90] This proposition is subject to a carefully guarded list of exceptions.[91]

    Aspen Skiing Co v Aspen Highlands Skiing Corp recognised a duty to deal where a firm had profitably supplied its rival in the past and subsequently terminated the relationship.[92] However, Scalia J held that the *Aspen Skiing* duty did not apply to the facts in *Trinko* as the Telecommunications Act 1996 required Verizon to supply AT&T:[93] there was no *voluntary* provision of access. In obiter, the Court accepted that *Aspen Skiing* would apply if Verizon *would have* provided AT&T access even in the absence of a statutory obligation.[94]

    Scalia J also took the opportunity to comment on the "essential facilities doctrine". He noted that even if the United States accepted the doctrine, it would not assist the plaintiffs because it requires the "unavailability of access to an essential facility, an element missing in this case in light of the Telecom Act's imposition of access obligations".[95]

    This reasoning suggests that either the legislature or the judiciary can grant access to essential facilities, but not both at the same time. Scalia J's holding therefore transforms regulation into a shield that prevents the application of competition law. Scalia J was perhaps concerned that a court's retrospective judgment could conflict with the prospective assessment by a regulator.[96] This view is irreconcilable with the position taken in *Boston Edison* where it was held that price regulation would not provide blanket

---

87   At 24.
88   *Trinko*, above n 61.
89   See generally *Linkline*, above n 61.
90   *Trinko*, above n 61, at 408.
91   At 408.
92   *Aspen Skiing Co v Aspen Highlands Skiing Corp* 472 US 585 (1985).
93   *Trinko*, above n 61, at 409–410.
94   At 410.
95   At 411.
96   Einer Elhauge and Damien Geradin *Global Competition Law and Economics* (Hart Publishing, Portland, 2007) at 427.

immunity from the antitrust laws.[97]

Covad: The Retreat from Analysing Margin Squeezing as a Separate Offence

The fourth case, *Covad Communications Co v Bell Atlantic Corp*,[98] began the retreat from assessing margin squeezing under its own test. Covad sued Bell Atlantic for margin squeezing in the digital subscriber line (DSL) services market. Chief Judge Ginsburg held that since a dominant firm retains the power to refuse to deal with its rivals, under *Trinko*, it must naturally retain the lesser power to choose the terms upon which it deals with its rivals — even if it amounts to margin squeezing.[99]

Linkline: Margin Squeezing as Predatory Pricing

While *Covad* began the retreat from assessing margin squeezing under its own test, it took the Supreme Court in *Pacific Bell Telephone Co v Linkline Communications* to eliminate "margin squeezing" from the American antitrust vernacular.

Pacific Bell Telephone (AT&T) was a vertically integrated dominant firm in the DSL internet services market. The company supplied wholesale DSL transport (upstream) and also retail DSL internet service packages to end-users (downstream).[100] Linkline accused AT&T of margin squeezing.[101]

The majority's reasoning is expressed simply: "two wrong claims do not make one that is right".[102] Hence, if a trade practice is neither a refusal to deal nor predatory pricing it cannot be reframed as a hybrid that violates § 2. This conclusion rested upon the *Covad* approach to refusals to deal, and the difficulties involved in calculating and policing margin squeezing that Judge Breyer discussed in *Boston Edison*.

1 The Refusal to Deal Argument

The majority viewed the case as a straightforward application of *Trinko*.[103] AT&T's only duty to deal was derived from regulations imposed by the Federal Communications Commission.[104] There was no evidence that absent those regulations AT&T would have supplied voluntarily. With that, the hopes of the plaintiffs (and all future margin squeezing cases) hinged on the

---

97   *Boston Edison*, above n 61, at 21.
98   *Covad*, above n 61.
99   At 673.
100   *Linkline*, above n 61, at 842.
101   At 842.
102   At 851.
103   At 846.
104   At 846.

Brooke Group test for predatory pricing.[105] Not only did the majority refrain from overruling *ALCOA*, but also any discussion of *ALCOA* was confined to a solitary footnote:[106]

> Given developments in economic theory and antitrust jurisprudence since *Alcoa*, we find our recent decisions in *Trinko* and *Brooke Group* more pertinent to the question before us.

ALCOA and *Linkline* are so diametrically opposed in their reasoning that the position taken by the Supreme Court is unsatisfactory. It is difficult to read *Linkline* as doing anything but overruling *ALCOA*.[107] Even if the Supreme Court resiled from expressly stating its dissatisfaction with *ALCOA*, the writing is on the wall. It would have been preferable to overrule *ALCOA* and clarify the American position as opposed to leaving the law in a state of theoretical flux. At least in practice, *Linkline* will be the legal position in the United States.

The effect of *Linkline* when considered with *Trinko* is to eliminate the vertical aspect from margin squeezing analysis.[108] By ignoring the dual role that a vertically integrated firm plays as both a supplier and rival, *Linkline* fails to grasp the economic reality of vertical integration.[109] Because *Trinko* renders a refusal to deal action futile, the only available avenue is predatory pricing under the *Brooke Group* test. However, the *Brooke Group* test incorporates a recoupment element. The Court fails to address some of the difficulties of applying a recoupment test, or whether such a test is appropriate in the margin squeezing context. In particular, there is no discussion about whether the recoupment must happen in the downstream entity or whether the recoupment can happen *automatically* through the upstream entity.[110] If margin squeezing is to be assessed under a predatory pricing framework, how the recoupment element is to be applied requires clarification.

2 The Difficulty in Assessing Margin Squeezing

After the majority rejected the theoretical basis of margin squeezing by applying *Trinko*, the Court discussed the inherent difficulties in establishing margin squeezing as an independent offence. Most comments emphasised the difficulty in determining how small the margin must be before it is deemed

---

105 See *Brooke Group Ltd v Brown & Williamson Tobacco Corp* 509 US 209 (1993). Under the *Brooke Group* test, predatory pricing occurs where the dominant firm prices below a measure of variable cost and there is a likelihood of recouping the lost profit by increasing prices once the rival exits the market. This test was applied in New Zealand in *Carter Holt Harvey*, above n 6, at [67].

106 *Linkline*, above n 61, at 848, n 3.

107 Erik N Hovenkamp and Herbert Hovenkamp "The Viability of Antitrust Price Squeeze Claims" (2009) 51 Ariz L Rev 273 at 274.

108 Rudaz, above n 66, at 1083.

109 The flaws of treating a vertically integrated firm as if it were not integrated were discussed in *Telecom v Clear*, above n 5, at 403.

110 See Competition Committee *Margin Squeezing* (Organisation for Economic Co-operation and Development, DAF/COMP(2009)36, 9 September 2010) at 9; and Liam Colley and Sebastian Burnside "Margin Squeeze Abuse" (2006) 2 ECJ 185 at 192.

abusive. One method often mooted is a "transfer price test":[111]

> A price squeeze should be presumed if the upstream monopolist could not have made a profit by selling at its retail rates if it purchased inputs at its own wholesale rates.

Despite recognising the advantages of such a test — mainly its administrative simplicity — the Court quickly distanced itself from this test, claiming "it lacks any grounding in our antitrust jurisprudence".[112] Yet courts consistently separate the financial affairs of two branches of one company for tax purposes. The idea of doing the same, albeit for antitrust purposes, is hardly revolutionary. More troubling still is that the test adopted by Judge Learned Hand in *ALCOA* was a primitive form of the transfer price test espoused here, yet the Supreme Court bench left *ALCOA* on the books as good law.

By rejecting the transfer pricing test, the Court provided no guidance as to how exactly the predatory pricing test should be applied to margin squeezing. Ironically, in order for the predatory pricing approach to be a viable method to assess margin squeezing, a transfer pricing test akin to the one used in taxation, must be used.

Critique of Predatory Pricing Approach

Under the predatory pricing approach, a margin squeeze is abusive when:

(1) the downstream price is less than the average incremental cost of the dominant firm's downstream operations; and
(2) there is a likelihood of recouping the lost profit in the future.

The test is flawed in that it ignores the vertical element of margin squeezing. Furthermore, there is no guidance on how the cost of the essential input is to be imputed, if at all, to the downstream firm, or how the recoupment element is to be applied. This approach also ignores the reality that suppliers rarely try to exclude rivals through downstream predation because it is costly and unsustainable.[113]

So how would Telecom have fared under the predatory pricing approach in *Data Tails*? It can be inferred that Telecom would have succeeded under a predatory pricing assessment. Recall that decreasing downstream retail prices created the margin squeeze in *Data Tails*.

The Commerce Commission even confirmed that it "had no complaint with Telecom's retail pricing as such".[114] If the Commerce Commission had been concerned with Telecom's retail pricing, it would likely have framed the

---

111 *Linkline*, above n 61, at 849.
112 At 849.
113 Ellen Meriwether "Putting the 'Squeeze' On Refusal to Deal Cases: Lessons from *Trinko* and *linkLine*" (2010) 24 Antitrust 65 at 67.
114 *Data Tails* (CA), above n 10, at [123].

case as one of predatory pricing for which the framework is clear, rather than relying on the ill-defined refusal to deal framework.

V THE EUROPEAN UNION

Like New Zealand and the United States, the European Union also does not expressly address margin squeezing in statute.[115] The starting point is the abuse of dominance provision in the Treaty on the Functioning of the European Union found at art 102:[116]

> Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market insofar as it may affect trade between Member States.
>
> Such abuse may, in particular, consist in:
> (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
> (b) limiting production, markets or technical development to the prejudice of consumers;
> (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
> (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

---

115 Although some member states do have specific margin squeezing provisions. See, for example, § 20(4)(3) of the Act Against Restraints of Competition 2005 (Germany) <www.gesetze-im-internet.de>:

> (4) Undertakings with superior market power in relation to small and medium-sized competitors shall not use their market position directly or indirectly to hinder such competitors in an unfair manner. An unfair hindrance ... exists in particular if an undertaking ...
> 3. demands from small or medium-sized undertakings with which it competes on the downstream market ... a price for the delivery of such goods and services which is higher than the price it itself offers on such market, unless there is, in each case, an objective justification for this.

This provision only partially addresses margin squeezing. It only catches margin squeezing where the downstream price is less than the upstream price and where the victims of the margin squeeze are small- and medium-sized competitors.

116 Consolidated Version of the Treaty on the Functioning of the European Union [2010] OJ C83/47 (opened for signature 25 March 1957, entered into force 1 January 1958), art 102 [TFEU]. Note that the Treaty of Lisbon [2007] OJ C306/1 (opened for signature 13 December 2007, entered into force 1 December 2009) amended the TFEU. The old art 82 that addressed abuse of dominance was renamed art 102. The statutory language for the offence was unaltered. The European cases discussed in this section predate the amendment and thus still refer to art 82.

From the outset,[117] the European Union assessed margin squeezing as a distinct antitrust violation. The European cases therefore tell a different story, focused on the appropriate methodology by which to assess margin squeezing.

The European Union has used two main tests: the "hypothetical reasonably efficient operator" test and the "as-efficient competitor" test.[118] The European Union initially adopted the former,[119] before settling on the latter test.[120]

The Hypothetical Reasonably Efficient Operator Test

Under the earlier hypothetical reasonably efficient operator test, a margin squeeze is abusive if:[121]

> The margin between the price charged to [downstream] competitors for access and the price which the dominant operator charges in the [downstream] market is insufficient to allow a hypothetical reasonably efficient [downstream] service provider to make a normal profit.

Thus, a margin squeeze is abusive if the margin $(P^D - P^U)$ is less than a hypothetical reasonably efficient operator's downstream cost.[122]

This test has two advantages. First, it recognises that although a competitor may lack the incumbent's efficiency in the short-run, over time the competitor could become more efficient due to economies of scale, scope and the natural application of the learning curve.[123] Secondly, it is likely to be consistent with the approach taken by regulators.[124] This test is more appropriate in the regulatory setting where it can be used to justify the entry of inefficient operators in the expectation of increased efficiency.[125]

The hypothetical reasonably efficient operator test is not without problems. The first problem is that a dominant firm cannot easily predetermine whether its proposed pricing will be abusive.[126] Since a breach of competition law exposes firms to quasi-criminal penalties, it would be unjust if they could

---

117 See Case 109/75 R *National Carbonising Co Ltd v Commission of the European Communities* [1975] ECR 1193; Case IV/30.178 *Napier Brown & Co Ltd v British Sugar plc* [1990] 4 CMLR 196 (Commission); Case COMP/38.784 *Wanadoo España v Telefónica* (Commission 4 July 2007); and Case C-280/08 P *Deutsche Telekom AG v European Commission* [2010] 5 CMLR 27 (CJEU) [*Deutsche Telekom* (Appeal)].

118 Gunnar Niels, Helen Jenkins and James Kavanagh *Economics for Competition Lawyers* (Oxford University Press, Oxford, 2011) at 241.

119 *National Carbonising*, above n 117.

120 *Napier Brown*, above n 117.

121 Niels, Jenkins and Kavanagh, above n 118, at 241.

122 At 244.

123 Damien Geradin and Robert O'Donoghue "The Concurrent Application of Competition Law and Regulation: The Case of Margin Squeeze Abuses in the Telecommunications Sector" (2005) 1 J Competition L & Econ 355 at 400.

124 At 393.

125 At 393.

126 At 392.

not predetermine the legality of their actions.[127] Finally, unlike regulators, it is not the role of competition authorities to maximise social welfare by promoting inefficient entry.[128]

In conclusion, this test merely transfers wealth from the dominant firm to its rivals without any corresponding increase in consumer welfare.

The As-efficient Competitor Test

The as-efficient competitor test has surpassed the hypothetical reasonably efficient competitor test in the European Courts.[129] This test deems a margin squeeze to be abusive if:[130]

> ... 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.

The test is not applied at the micro-level.[131] Under this test, a margin squeeze is abusive if the dominant firm's downstream operation would be unprofitable if it were forced to pay its own upstream price.[132]

The as-efficient competitor test changes the benchmark from a hypothetical firm to the dominant firm itself.[133] The advantage of this test is that it is easy for a dominant firm to apply *ex ante* and it reflects the goal of competition law: the promotion of competition in markets. The as-efficient test does not penalise dominant firms for acquiring economies of scope or scale.[134] Furthermore, like the predatory pricing test,[135] it does not penalise a dominant firm for having lower costs than its rivals.[136]

Barry Hawk describes three problems with the as-efficient test.[137] First, it is questionable that no consumer harm would result from the exclusion of less-efficient rivals.[138] Less-efficient rivals are said to encourage dominant firms to lower their prices. Furthermore, critics say that consumer

---

127 *Carter Holt Harvey*, above n 6, at [23].

128 Geradin and O'Donoghue, above n 123, at 392.

129 See *Telefónica*, above n 117, at [313]; *Deutsche Telekom* (Appeal), above n 117, at [107]; and *Napier Brown*, above n 117, at [66].

130 *Telefónica*, above n 117, at [311].

131 *Decision of the Office of Fair Trading under section 47 relating to decision CA98/20/2002: alleged infringement of the Chapter II prohibition by BSkyB* Office of Fair Trading (UK), 29 July 2003 at [157] [*BSkyB*].

132 *Telefónica*, above n 117, at [311].

133 Case T-271/03 *Deutsche Telekom AG v Commission of the European Communities* [2008] 5 CMLR 9 (CFI) at [188] [*Deutsche Telekom*], which was endorsed by the Court of Justice of the European Union in *Deutsche Telekom* (Appeal), above n 117, at [202].

134 Crocioni and Veljanovski, above n 79, at 55.

135 At least in the United States and New Zealand. The European Union approach to predatory pricing is slightly different: see Case T-83/91 *Tetra Pak International SA v EC Commission* [1997] 5 CMLR 309 (CFI). Predation is assumed if the price is below average variable cost (AVC). If the price is between AVC and average total cost (ATC), and is accompanied by a plan to eliminate rivals, it is predatory. If the price is above ATC, it is not predatory. Even under the European approach, a firm is not penalised for having a lower ATC than its rivals.

136 See Herbert Hovenkamp "Exclusion and the Sherman Act" (2005) 72 U Chi L Rev 147 at 153–154.

137 Hawk, above n 77, at 208–210.

138 At 209.

harm could result if the less-efficient rivals supply differentiated products.[139] Although this may be true, it is not a concern for margin squeezing. Where rivals supply differentiated products, the incentive to engage in margin squeezing diminishes. This first criticism is short-sighted. The as-efficient test encourages potential entrants to plan their entry into the market. In the long run, this additional planning would ensure more firms survive and less resources are wasted by failing enterprises.

The second problem Hawk raises is the difficulty of measuring "comparative efficiency". Hawk argues that the judiciary would need to define "equally efficient rival".[140] This criticism would be valid if one were contemplating a generic as-efficient test for s 36 claims. In the confines of a margin squeezing test, "equally efficient" requires no definition as it merely describes using the dominant firm's own costs for the test. However, there might be problems if the rivals produce differentiated products or if the products were bundled.[141] Assessing the entire bundle for a margin squeeze avoids the need to assess whether one bundled offering is as efficient as another bundled offering.

The final problem identified is that the as-efficient test focuses on the dominant firm's competitors and not the impact of their conduct on prices and output.[142] Yet, focusing on the symptoms (the prices and output) only identifies a problem, which would be the competitive make-up of the market. If the market inefficiencies could be addressed, then the symptoms would cure themselves. Thus, the final critique is also without merit.

The as-efficient test is the appropriate test to use if margin squeezing is to be treated as an independent offence.

Applying the As-efficient Competitor Test: Measures of Profitability

The as-efficient competitor test does not strictly compare the margin with the dominant firm's downstream costs. The test isolates the dominant firm's downstream operations and asks if that isolated operation would be profitable if it paid its own upstream price. If not, the margin squeeze is prima facie abusive.

There are two possible methods to calculating profitability: the period-by-period approach and the discounted cash flow (DCF) method.[143] The European Commission has discretion to choose how to assess profitability[144] and uses the two methods concurrently.[145] The defendant then has the burden of proving that the European Commission's chosen methodology is unlawful.[146]

---

139 At 209.
140 At 210.
141 At 209.
142 At 209.
143 *Telefónica*, above n 117, at [326].
144 Case T-340/03 *France Télécom SA v Commission of the European Communities* [2007] ECR II-117 at [129].
145 *Telefónica*, above n 117, at [349].
146 *France Télécom*, above n 144, at [153].

The period-by-period approach assesses profitability through the standard accounting approach whereby fixed costs are depreciated or amortised over their useful lives.

The DCF method examines whether the net present value (NPV) of the downstream operation is positive. The test is applied to all upstream inputs that the dominant firm provides.[147] The downstream operation's costs are measured using the long-run average incremental cost of production (LRAIC).[148]

Where the dominant firm supplies the product as part of a bundle, it is the bundle, in its entirety, that is tested. However, if it is a new product (the volume of which could increase) and other bundled products are currently subsidising it, then that product is separately tested.[149]

1 Discounted Cash Flow Method

The European Commission raised three problems with the DCF method. The first was the issue of unreasonable forecasts in estimating future cash flows.[150] By merely adjusting cash inflow predictions, an abusive margin squeeze becomes permissible. A related problem is the selection of the interest rate used to discount future cash flows. The higher the interest rate in the calculation, the more future cash flows are discounted and the lower the NPV will be (and vice versa). With both cash flows and the discount rate open to manipulation, the case reduces to a battle of the economists.

The second problem is that under the DCF method the rewards from effecting an exclusionary margin squeeze are incorporated into the calculation to assess whether the margin squeeze was exclusionary.[151] A dominant firm contemplating an exclusionary margin squeeze would expect its revenues to rise after implementing the squeeze. This increased revenue would be factored into the DCF calculation and increase the NPV of the downstream operation. The DCF test is thus fundamentally flawed. The more successful the squeeze is in excluding as-efficient rivals, the less chance the squeeze will be found to be abusive. One way of overcoming this limitation would be to test also whether the forecasted increases in revenue would be possible if the same number of competitors remained in the market for the forecast period.[152]

The final problem is that although the theory behind recovering investments over time is sound, it is subject to the disclaimer that not

---

147 *Telefónica*, above n 117, at [392].
148 At [318]. The LRAIC is used to allocate common costs that are incurred in producing multiple final products to the product subject to the margin squeeze allegation.
149 At [387].
150 *Telefónica*, above n 117, at [333]. An operation's NPV is calculated by estimating all the revenues and expenses incurred during an operation and discounting them by a factor to reflect the time value of money.
151 At [334].
152 At [347].

everybody can wait as long to recover their initial investment.[153] Thus the primary advantage of the DCF model — how it reflects investment decision-making — can be reconceptualised as one of its great defects.

2 Period-by-period Method

The period-by-period approach is likewise riddled with apparent problems. Its first problem is that it ignores how businesses conceptualise investment.[154] Businesses do not expect to recover their investment costs immediately, nor do they necessarily expect to recover the proportion of their investment costs that accounting standards dictate are amortised to the expense account in a given period. Under international accounting standards, businesses are to depreciate their investment expenditure in a manner that reflects the pattern in which the asset's economic benefits are consumed.[155] Businesses expect to recover the operational costs of converting inputs into final products in the period they sell the product. Likewise, businesses expect to recover the loss in capital value associated with the depletion of their fixed asset stock. The alternative would be to recover such losses in the year of purchase, which is an unrealistic proposition. Thus, the period-by-period method withstands this criticism.

The second problem is that it "ignores the impact of uncertainty on the strategies of companies".[156] That is to say, firms may enter, invest and remain in the market irrespective of short-run losses.[157] According to *Wanadoo España v Telefónica*, the fact that investors are prepared to incur short-run losses and remain active in a market displaces the veracity of the period-by-period approach. The author suggests that this criticism merely advocates against a finding of an abusive margin squeezing on the backing of one period's results. A solution would be to require a certain number of abusive margin squeezes according to the period-by-period approach before finding liability.

The third criticism is the most creative: this approach lacks information about the exclusionary impact of a margin squeeze.[158] As described earlier, the DCF method incorporates the potential gains from exclusionary conduct into the test. Telefónica claimed that the period-by-period method was inappropriate, as it lacked an insight into the potential impact of the margin squeeze. A margin squeeze's impact and whether a margin squeeze is abusive are two logically distinct issues that should not be collapsed.

Finally, the approach is vulnerable to accounting distortions.[159] Firms retain a limited discretion to choose the method and rate by which they

---

153 At [335].
154 At [337].
155 International Accounting Standards Board *International Accounting Standard 16: Property, Plant and Equipment* (December 2003) at [60].
156 *Telefónica*, above n 117, at [338].
157 At [338].
158 At [339].
159 At [346].

depreciate their investment costs. This criticism would be valid if and only if it was applied to a unique asset where no comparable assets existed to gauge the appropriate rate and method of amortisation. But these assets are likely to be rare in margin squeezing cases because rivals are likely to own similar assets. Further, any manipulation is easily avoided by adopting the rates stipulated in tax legislation.[160]

3 Which Method Is Best?

In *Telefónica*, the Court assessed profitability under both methods.[161] Fortunately, both methods reached the same result — that the margin squeeze was abusive.[162] Using both approaches is helpful only if they concur, as it makes the decision less susceptible to being overturned on appeal. However, there will come a case where the two tests conflict and a decision as to which is preferable will need to be made.

The preferable approach is to use the period-by-period method but over a longer time period than a single financial year and discount the profits to reflect the time value of money as per the DCF methodology. This compromise dilutes the problems of the two methods when used in isolation. Essentially, the methodology would be to take the three years after the implementation of the alleged squeeze and see if a cumulative profit is established.

4 Costs

The next issue concerns the costs to be used. Under the as-efficient test, the costs used are the dominant firm's own downstream costs.[163] Any other approach to costs would infringe upon legal certainty.[164] The complicated costs are the common costs, which arise where multiple products are produced together when they could be produced separately.[165] How these common costs are treated dramatically affects the ultimate test. To allocate all of the common costs to the downstream operation is unfair to the dominant firm — likewise, to allocate them all to the upstream operation would not reflect economic reality. The LRAIC approach resolves this difficulty:[166]

> The long run incremental cost of an individual product refers to the product-specific costs associated with the total volume of output of the relevant product. It is the difference between the total costs incurred by the firm when producing all products, including the individual product under analysis, and the total costs of the firm when the output of the individual product is set equal to zero, holding the output of all

---

160 See Income Tax Act 2007, s EE 26.
161 *Telefónica*, above n 117, at [349].
162 At [525].
163 *Deutsche Telekom*, above n 133; and *Deutsche Telekom* (Appeal), above n 117, at [202].
164 *Deutsche Telekom* (Appeal), above n 117, at [202].
165 At [316].
166 At [319].

other products fixed.

The LRAIC assesses the increase in common costs attributable to the downstream operation. However, this test needs refining. Consider the case of the Warehouse Extra concept: some stores were specifically fitted to sell both the Warehouse's standard lines and the new grocery lines. The cost of leasing the building was a common cost. A strict application of LRIAC would result in a LRIAC of zero for the grocery lines. This would understate the reality. To correct it, one must ask whether the Warehouse would have leased the same amount of floor space if it only sold its standard lines. If the answer is in the affirmative, then the LRIAC will be zero, otherwise it will be the market value of the floor space that the Warehouse needed to extend the lease by to accommodate the new grocery lines.[167] The modified LRIAC is a vital component of the margin squeezing analysis — without it the test would not reflect economic reality.

5 Prices

A related concern is which prices to use. It is clear for the as-efficient test that the dominant firm's own downstream price is used.[168] What is less clear is which upstream price to use when multiple upstream prices exist. This issue arose in the Australian Competition and Consumer Commission's (ACCC) investigation of Telstra for margin squeezing.[169] Telstra offered its downstream rivals a volume-based discount, meaning that the more units a rival purchased, the lower the upstream unit price would have been. The options open to the ACCC were to use the highest upstream price that Telstra charged or use a hypothetical price that Telstra would charge its own downstream operation. This would reflect the quantity it purchased.[170]

The ACCC's solution allowed Telstra a comparative discount if it could demonstrate that the discounts reflected actual cost savings.[171] In other words, Telstra needed to prove that it was cheaper to supply larger retailers than smaller retailers. If it was cheaper, Telstra could take advantage of a hypothetical discount for the purposes of the margin squeezing test.

6 The Problem of Bundling

A related problem is when the dominant firm bundles multiple products into a single downstream offering.[172] Bundling creates two additional issues: first, whether to test the bundle for margin squeezing, or merely an individual

---

167 See *Telefónica*, above n 117, at [320].

168 Crocioni and Veljanovski, above n 79, at 52.

169 See Australian Competition & Consumer Commission "Assessing vertical price squeezes for ADSL services: An ACCC information paper" (May 2005) <www.accc.gov.au>.

170 At 12.

171 At 12.

172 Matt Sumpter *Competition Law and Policy* (CCH New Zealand, Auckland, 2010) at 302.

product; and secondly, how to allocate costs between bundled products.

In the investigation of BSkyB, the issue was whether the basic and premium channels should be considered separately or as a horizontal bundle.[173] Rivals (who were principally concerned with the premium sports and movie channels) argued that the higher margins that BSkyB obtained from its basic channels were subsidising the low margins from the premium channels. The rivals sought to have the margin squeeze test applied solely to the premium channels. The Office of Fair Trading rejected this approach and tested the entire bundle because "[t]o separate the revenues derived by DisCo[174] from the distribution of basic channels ... would involve arbitrary allocations".[175] In avoiding arbitrary allocations, the OFT's approach still allows rivals the chance to compete with the incumbent by offering the same bundle.

Vertical bundling raises other issues. Pure vertical bundling, where upstream and downstream products are only sold together,[176] does not concern margin squeezing and is best left to be assessed under the standard s 36 test. In contrast, mixed vertical bundling, where upstream and downstream products can be purchased separately but where an attractive discount is offered if purchased together,[177] raises margin squeezing issues. A case of mixed-vertical bundling could be assessed under the bundling test set out in *Port Nelson*,[178] or under a margin squeezing test.

This issue came before the Competition Appeal Tribunal in *Genzyme Ltd v The Office of Fair Trading*.[179] Genzyme Ltd manufactured the drug Cerezyme, a treatment for Gaucher disease, and provided in-home care services treating out-patients using Cerezyme.[180] Gaucher patients receive Cerezyme through a professionally-administered infusion. To begin with, third parties provided the in-home care service. Genzyme restructured its business and offered its own in-home care service through its subsidiary Genzyme Homecare Ltd (GHL). Genzyme continued to sell Cerezyme to its rivals. The main purchaser of Cerezyme and in-home care services was the National Health Service (NHS). GHL charged the NHS £2.975 per unit for the drug and in-home care services. GHL also charged its rivals £2.975 per unit but *just* for Cerezyme.[181] Irrespective of how efficient GHL might have been, it would have been incapable of remaining profitable if it also had to pay £2.975 for Cerezyme.[182] The margin squeeze was abusive and violated s 18 of the Competition Act 1998 (UK).[183]

The problem with *Genzyme* is not the result on the facts of the case. It was clear that the restructuring did have, and was intended to have, an

---

173 *BSkyB investigation: alleged infringement of the Chapter II prohibition* Office of Fair Trading (UK) CA98/20/2002, 17 December 2002 [*BSkyB investigation*].

174 DisCo was BSkyB's downstream distribution subsidiary.

175 *BSkyB investigation*, above n 173, at 106.

176 Sumpter, above n 172, at 301.

177 At 302.

178 *Port Nelson Ltd*, above n 41, at 700–711.

179 *Genzyme Ltd v The Office of Fair Trading* [2004] CAT 4.

180 At [40]–[46].

181 At [17].

182 At [549]–[575].

183 At [549]–[575].

exclusionary effect.[184] Although factually speaking, all decisions to internalise an operation may appear identical to *Genzyme*, it is only in cases where the business surpasses the market power threshold that liability could attach.

Even in cases that appear factually identical to *Genzyme*, a distinction would be made between cases where a function has always been performed in-house, and cases like *Genzyme* where the business deliberately stopped outsourcing to eliminate competitors.[185] With these two safeguards in place, most businesses can continue to decide, on economic grounds, which operations to run in-house without fear of breaching competition law.

7 Defences

It is unsettled whether merely failing the margin squeeze test would constitute an offence or whether a defendant could argue that its pricing policy is actually pro-competitive or efficient. *Deutsche Telekom*, and the New Zealand Court of Appeal in *Data Tails* (CA) by inference,[186] refused to countenance the availability of a defence.[187] In contrast, *Genzyme* and *Telefónica* discussed possible defences before deciding that they did not apply on the facts.[188] A key element of both New Zealand's s 36 and the European Union's art 82 is the causal element of "taking advantage of" or "abuse ... of" market power. In order to distinguish between abusive margin squeezing and a squeeze that any vertically integrated firm *would* implement, more is required than the failure of a mathematical test. In other words, the standard counterfactual test should be used to see whether but for the market power the dominant firm would have engaged in a margin squeeze.

In *Telefónica*, three defences were raised:[189]

(1) Telefónica's downstream losses were, in the context of a non-mature market, investments with a view to achieve future profits;

(2) Telefónica was forced to align itself on the retail prices charged by its downstream competitors ("meeting the competition" defence); and

(3) Telefónica's conduct has resulted in efficiencies which have benefited consumers.

(a) Non-mature Markets

Two aspects of the first defence warrant discussion. First, the role of investment has already been factored into the margin squeezing test by adopting both the

---

184 At [549]–[555].

185 See *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* [2001] HCA 13, [2001] 205 CLR 1. The fact that Melway had used the same distribution structure both before and after gaining market power militated against a finding of taking advantage of market power.

186 *Data Tails* (CA), above n 10, at [262]: "In our view, the finding of pricing above ECPR in the two-tail scenario was sufficient to support the inference that Telecom had an anti-competitive purpose."

187 *Deutsche Telekom* (Appeal), above n 117.

188 *Telefónica*, above n 117.

189 At [620].

DCF and period-by-period methods to assess profitability. Both these methods, to varying degrees, allow upfront losses in return for long-run profitability. The second and more interesting aspect is the distinction between mature and non-mature markets. The European Commission rightly recognised that to allow non-mature markets a leniency period whilst the market stabilised was undesirable. It would render competition law no more than the proverbial "ambulance at the bottom of the cliff" and deny it the ability to address competition concerns proactively.[190] Furthermore, the statutory language in both art 82 and New Zealand's s 36 makes no distinction between mature and non-mature markets. Hence the first "defence" should not be, and is not, a defence.

(b) "Meeting the Competition" Defence

The "meeting the competition" defence is premised on the notion that a firm with lawfully acquired monopoly power is permitted to defend itself from the actions of its competitors.[191] However, this is not a carte blanche permission to engage in anti-competitive behaviour under the guise of meeting the competition. A parallel can be drawn with the claim of self-defence in criminal law, whereby:[192]

> ... one is justified in using, in the defence of himself or another, such force as, in the circumstances as he believes them to be, it is reasonable to use.

Two key matters in assessing the reasonableness of the force are whether the force was necessary and how proportionate the force was to the imminent threat repelled.[193] A similar test is used to restrict the meeting the competition defence:[194]

> The meeting the competition defence will only apply if it is shown that the response is suitable, indispensable and proportionate. This requires that there are no other economically practicable and less anti-competitive alternatives, which is unlikely to be the case in a margin squeeze case.

Unlike in criminal law, the notion of self-defence in competition law has an added layer of complexity. The law must be careful not to permit self-defence downstream that, in truth, is an abuse of upstream market power.[195] This

---

190 At [623].
191 Case T-65/89 *BPB Industries v Commission of the European Communities* [1993] ECR II-389 at [69].
192 Crimes Act 1961, s 48.
193 AP Simester and WJ Brookbanks *Principles of Criminal Law* (3rd ed, Brookers, Wellingon, 2007) at 471.
194 *Telefónica*, above n 117, at [639].
195 At [638].

notion is reflected in the requirement that the response must be "suitable", meaning right or appropriate for a particular situation. As the infliction on rivals of costs not borne by the dominant firm would be an inappropriate response, the defence would not be available.

     In terms of margin squeezing, the defence is likely to be restricted to extreme cases. The primary problem would be convincing the court that the squeeze was indispensable and that no alternatives were available. The defence would only be available if the dominant firm already prices at cost upstream. In that case, the dominant firm should be able to match its rivals' downstream price without fear of liability.

(c) Efficiency

A third possible defence is the efficiency defence. Essentially, it is the argument that the margin squeeze was more competitive than anti-competitive. This defence is likely to be highly fact-specific and determined on a case-by-case basis.

(d) Why Such Defences Are Unsuitable for Margin Squeezing

The seeming failure of all the defences when applied to margin squeezing is explicable by the ability of dominant firms to avoid margin squeezing by adjusting either the downstream price or upstream price, or both. With this inherent flexibility, margin squeezing would only ever be excused when the dominant firm has no economically viable way to avoid margin squeezing. The cases where this is likely to be true are in regulated markets where both segments are regulated. Still, in these cases, competition law is unlikely to apply due to the principles in *Deutsche Telekom* and *Boston Edison*.

(e) Other Possible Defences

A number of other defences not advanced in *Telefónica* might be available. A firm might plausibly argue that it reduced the downstream price to:[196]

    (1) stimulate demand in economic downturns;
    (2) introduce a new product, recipe or formula;
    (3) sell excess stock before it deteriorates; or
    (4) recover costs in a declining market.

These four defences are likely to be successful as the rationale behind them is common to all firms, not just those with market power.

---

196 Geradin and O'Donoghue, above n 123, at 360.

The Mathematical Equivalence of the Margin Squeezing Test and New Zealand's Constructive Refusal to Deal (ECPR) Test

How would Telecom have fared under a separate margin squeezing test? The author argues that the result would have been identical, at least under the High Court's analysis. For the most part, the constructive refusal to deal approach using the ECPR and the margin squeezing approach using the as-efficient test are effectively identical.[197]

If the actual upstream price exceeds the ECPR price then it is said to be abusive in the absence of a justification. Thus, mathematically the pricing policy is abusive if $P^D - C^D < P^U$.[198]

Correspondingly, the margin squeezing test simply asks if the dominant firm could make a profit if it were forced to pay its own upstream price. Thus, mathematically the pricing policy is abusive if: $P^D - C^D - P^U < 0$, which can be rearranged to $P^D - C^D < P^U$. The two tests are equivalent.

The Court of Appeal's approach, particularly the removal of the ECPR safe harbour, could be viewed as a departure from this equivalence theory. The author suggests that the supplementary DCF assessment undertaken in *Telefónica* (or the author's preferred modified period-by-period approach) should satisfy the Court of Appeal's additional requirement that a competitor be able to compete at the ECPR price. The mathematical equivalence would remain intact if either of these assessments were conducted.

VI POSSIBILITY OF REGULATORY SEPARATION

Regulatory separation is the last option for dealing with margin squeezing. It is the only method that can guarantee the elimination of abusive margin squeezing. In essence, it requires the upstream and downstream operations of the dominant vertically integrated firm to be owned and operated by different legal entities.[199] This approach is not without precedent in New Zealand.[200] Nonetheless, this approach is drastic and is a last resort. Separate upstream and downstream operations may cause higher prices due to increased transaction costs throughout the supply chain and the loss of economies of scope.[201] However, in most cases, margin squeezing can be prevented by the normal operation of competition law.

---

197 Crocioni and Veljanovski, above n 79, at 59.

198 Where P^D is the downstream price, C^D the downstream cost and P^U the upstream price.

199 See Geradin and O'Donoghue, above n 123, at 370; and Carlos Lapuerta and Boaz Moselle "Network Industries, Third Party Access and Competition Law in the European Union" (1999) 19 Nw J Int'l L & Bus 454.

200 See pt 2A of the Telecommunications Act 2001, which structurally separated the wholesale and retail operations of Telecom.

201 Geradin and O'Donoghue, above n 123, at 370.

VII WHERE TO FROM HERE?

There are four recognised approaches to addressing margin squeezing. Three rely on the "taking advantage of market power" prohibition under the Commerce Act. These assess margin squeezing through three different frameworks:

(1) A constructive refusal to deal framework;
(2) A margin squeezing framework; and
(3) A predatory pricing framework.

The final recognised approach bypasses competition law and removes any possible incentive to margin squeeze by requiring the separation of the upstream and downstream entities into independent entities.

In the end, there is only one test in s 36: whether the trade practice takes advantage of market power for an exclusionary purpose. The different approaches discussed in this article are merely lenses through which to examine potentially abusive trade practices.

The predatory pricing framework is problematic as it fails to grasp how recoupment may occur in a vertically integrated firm. However, where an upstream market faces price regulation, predatory pricing should be the sole test in assessing margin squeezing. Predatory pricing in this context would be indistinguishable from standard predatory pricing behaviour. Besides this one exception, the predatory pricing test is ill-suited to analysing margin squeezing.

As the article has discussed, the constructive refusal to deal and margin squeezing tests are mathematically equivalent. Either one of these two tests would be appropriate to assess margin squeezing. The author argues that margin squeezing should only be assessed through a constructive refusal to deal test.

There is no point in creating a *new* approach when an adequate methodology already exists. Furthermore, a separate margin squeezing test is likely to take on a doctrinal life of its own, similar to other trade practices caught by s 36.[202] The constructive refusal to deal framework neatly distinguishes between abusive and pro-competitive margin squeezes. It also ensures that the law treats economically equivalent actions equally. The beauty of the constructive refusal to deal test is that it can also be used to assess predatory pricing in vertically integrated firms and makes the recoupment element redundant.

This conclusion does not render the European jurisprudence on margin squeezing superfluous. The problems encountered in applying the margin squeezing test still exist: primarily, which prices and costs to use and how

---

202 Sumpter, above n 172, at 306, n 135. In discussing the refusal to deal doctrine, Sumpter comments that: "[f]ancy phrases ... can be staging posts in the analysis, but they should never determine the result."

to treat bundled offerings. The European margin squeezing cases provide answers to these difficult questions and should be applied in New Zealand through the constructive refusal to deal framework. The Court of Appeal said as much in *Data Tails* (CA).[203]

Firms with market power looking to mitigate their exposure to competition law liability should conduct a thorough self-assessment based on the DCF method employed in *Telefónica*. This approach should satisfy the Court of Appeal's requirements of ECPR pricing plus the added ability-to-compete threshold.

Despite the author's criticism of *Data Tails* for failing to consider foreign approaches and *Data Tails* (CA) for prematurely dismissing them, these decisions should be applauded. They have consolidated s 36 analysis by resisting the urge to invent yet another lens through which to view abusive trade practices. However, firms require certainty and so the ECPR should provide a safe harbour. Unfortunately, for now, the position will remain as stated by the Court of Appeal. Whether the Supreme Court will get the chance to refine New Zealand's approach will have to await another margin squeezing case.

In essence, this article considers that margin squeezing is simply a constructive refusal to deal by another name. Margin squeezing is the latest superfluous "fancy phrase" of New Zealand competition law and should be permanently removed from the competition law vernacular.

.

---

203 *Data Tails* (CA), above n 10, at [124]: "However, we do not consider that this means that the European cases cannot provide some assistance in highlighting the anti-competitive effect of a price squeeze."