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Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development **06-Oct-2009**

English - Or. English

DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WP2/WD(2009)25
For Official Use

Working Party No. 2 on Competition and Regulation

MARGIN SQUEEZE

-- Poland --

19 October 2009

The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 19 October 2009.

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JT03271131

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1. Margin squeeze is an anti-competitive strategy which can be used by an undertaking active in vertically related markets and dominant in the upstream one. By controlling its upstream and downstream prices it can make it impossible for their downstream competitors, dependent on the upstream incumbent, to cover their costs, by setting the difference between its downstream and upstream prices at a sufficiently small level. Unable to turn to an alternative source of supply, downstream competitors are excluded from the market.

2. Therefore, for margin squeeze to be found, there must be a dominant firm, which supplies an essential input to firms in a downstream market, in which it is active as well. The price charged to competitors for the input must be so high, that the incumbent would suffer losses, if it had to buy the input at this price. In such circumstances equally efficient competitors are excluded from the downstream market, where the incumbent charges prices *de facto* below costs. In practice, the authority gathers data on total costs and revenues in the downstream market as well as on the prices charged for the upstream input to competitors. If downstream revenue minus cost of inputs at prices charged to competitors is lower than downstream costs for a non-negligible period of time, there is a possibility of margin squeeze occurring.

3. Margin squeeze is not a separate, stand-alone form of abuse under Polish competition law. Cases falling into this category are usually dealt with under art. 9.2.5 of the Competition and Consumer Protection Act, which prohibits dominant undertakings form "*acting against the formation of conditions indispensable to creation or development of competition*". The article is a catch-all category for exclusionary practices, from predatory pricing to refusal to supply. Margin squeeze, as appearing in the decisions of the Polish competition authority, is predominantly a method of proving exclusionary effects of the incumbent's pricing behavior.

4. The margin squeeze methodology, understood as testing the relations between upstream and downstream prices and costs has been relatively rarely applied in the Polish competition law, nevertheless there has been a number of cases where the behaviour of a dominant undertaking could be described as a margin squeeze.

1. Cases

5. Typical cases concern two industries: cemetery and waste disposal services, which are characterized by the presence of an upstream incumbent (cemetery manager and owner of a waste dumping site respectively), who may be active in the downstream market (funeral services and waste collection). Incumbents in the upstream market charge their downstream competitors prices, which would not allow the incumbents themselves to make a profit or require various "access fees" with a similar effect of raising competitors' costs.

6. Two cases from the waste collection sector may serve as an illustration. The first one concerned a municipal company in Cracow, an owner of a locally dominant waste dumping ground. It was also an important player in the local waste collection market. It was accused of excluding competitors in the waste collection market by charging high prices for waste deposition. During investigation cost, price and revenue data was collected, concerning the activities of the company in both markets: waste deposition and waste collection. The data showed that the price charged to competitors for waste deposition, if applied by the company to itself, would not allow it to make a profit on its waste collection operations in the downstream market. The company was found to have abused its dominant position by excluding competitors from the waste collection market. As a matter of fact, the exclusion was not complete – there were still other companies active in the local waste collection market, but their collective market share was lower than the share of the municipal company (in proportion of roughly 40 to 60) and they were forced to use other, significantly more distant dumping sites – the municipal dumping site was used almost exclusively by the municipal company.

7. Another case where margin squeeze framework was used concerned local waste collection market in the north-east of Poland. The municipal company active in the waste collection market was also a manager of a local waste dumping ground. The town, a sole owner of the company, at the latter's request, sharply increased prices for storing waste and introduced maximum prices for waste collection services, based on the (unrealistic, as it turned out) calculations presented by the company. Increase in storage prices triggered a complaint from a firm preparing to enter the waste collection market, alleging unfair denial of access to it. As data gathered in the course of proceedings showed, the municipal company's costs associated with transporting waste were much higher than the difference between the prices it charged for waste collection and the rates for storing it – were it to incur costs it charged competitors, the company would suffer heavy losses. Anti-competitive intent of the increase in the waste deposition rates was evident from its timing: the decision to raise prices was taken in the (unusually long) period during which competitor's application for a permit to collect waste in the municipality was processed.

8. As mentioned, several cases in the cemetery markets may also be treated as a variation of margin squeeze, though, due to data problems, a cost test is usually not applied. A typical case involves a company, to which the management of a municipal cemetery is entrusted. The cemetery management company is also active in the funeral sevices market and introduces various fees, which are paid only by rival funeral companies and have the effect of pricing them out of the market and *de facto* reserving the cemetery to only one funeral company. Such cases are usually treated as exclusionary abuses, without explicit reference to margin squeeze.

9. An important telecommunications case may be mentioned in his context as well. Even though it was not prosecuted under margin squeeze allegations, it bore strong resemblance to this strategy. The case concerned access charges to the premium telephone services. Normally such services were used by providers of various information (weather forecast, exchange rates) or other services (e.g. chats). The revenue from such services was shared among three parties:

- access provider (for 90% of telephone users it was the incumbent – Telekomunikacja Polska SA [TP SA]) – 20% of the revenue,
- operator of the premium number – 80% of the revenue,
- service provider – paid by the operator of the premium number.

10. Independent telecom operators found it profitable to use the cheapest premium numbers (starting with the numbers 0-708 1, costing 0,29 PLN) to provide international calls, which affected TP SA's market share: the percentage of international calls provided by TP SA fell from ca. 84% in 2003 to 73,5% in 2004. The incumbent reacted with a two-pronged strategy. On the one hand, starting on 1 October 2005 it raised access charge for the cheapest premium number by 100%, on the other, it lowered price for international calls (1 September 2005, announced a month earlier) as well as preparing special plans and promotions (July 2005). It caused the volume of international calls provided via premium numbers to plummet. 10 days after the increase of access charges, upon complaint from an independent operator, Polish competition authority issued an interim decision ordering TP SA to desist from introducing higher charges. The international calls volume handled through premium numbers returned to its former level.

11. The incumbent provided several justifications for the steep increase in access charges, none of them convincing. First, it claimed that the increase was a result of a cost analysis. It also pointed out that the increase in the premium numbers' popularity caused TP SA to incur additional variable costs, associated with billing customers, debt collection and complaints handling. Finally, the incumbent maintained, that it had to raise its price by 100%, as 0,29 PLN was its minimum tariff unit. As the proceedings showed, the charges for initiating international call (let alone its costs) were actually lower

than the amount TP SA received for a 0-708 1 call even before the increase. The costs of billing customers, debt collection complaint handling were not specific to premium number calls – they were incurred also while providing other services, whose price did not rise. Additionally, costs of billing customers were calculated by the authority on the basis of other services and they turned out to be sufficiently low as not to justify the price increase. The cost arguments were suspicious also in light of the fact that since 1995 premium numbers rates were only decreasing (from 1,20 PLN in 1995 to 0,29 PLN in 2002). The incumbent therefore would have to provide services below costs for a long period of time, noticing that fact only after competition from operators using premium numbers made itself felt. Finally, the argument that the price could not have been raised by less than the multiple of 0,29 was particularly specious, as among nine 0-708 premium rates only two were multiples of that amount.

12. The case, even though it was not investigated within the margin squeeze framework, could plausibly be described as squeezing downstream competitors by increasing the price of an essential input by a quasi-monopolist and, at the same time, decreasing its own downstream price. An essential modification in this case was that the incumbent controlled not only upstream, but also downstream price of competitors (access charge).

2. Problems with practical application of the margin squeeze framework

13. There are several problems associated with applying margin squeeze approach in practice. First, there are problems with determining whether margin squeeze actually took place. The task of establishing upstream and downstream costs in case of multiproduct firms may be very complicated, due to existence of common costs. Second, higher price charged to competitors may result from transaction costs associated with making the input available to them or be a consequence of other efficiencies, which may be overlooked in an "automatic" application of the margin squeeze methodology. Third, undertakings faced with possible uncertainties or inefficiencies associated with the margin squeeze application may choose not to deal with downstream competitors at all, leaving consumers worse off. Finally, margin squeeze cases are to a large extent regulatory in nature, as they force competition authorities and/or courts to decide on the "right" level of prices, based on the companies' costs. Arguably, neither competition authorities, nor courts have the requisite expertise for this task.

14. Such issues, though they make the application of margin squeeze framework a difficult task, are not particularly pertinent to the cases that the Polish competition authority faces in practice. Several factors account for this state of affairs. First of all, in waste collection cases it is not difficult to establish downstream costs and revenues, as issues with common costs usually do not arise. Municipal waste deposition sites are also generally not in a position to refuse to deal without objective justification. Furthermore, we have never been presented with an indication of efficiencies which would justify the pricing policy of an incumbent. Had it been provided, it would have been taken into serious consideration. Finally, even though the margin squeeze cases pursued were in fact regulatory or at least quasi-regulatory, they concern situations in which a regulator – usually a municipality – either does not take any action to prevent competition from being distorted (by allowing the manager of an essential facility to act in a discriminatory manner) or actually colludes with an incumbent in order to thwart downstream competition. Interventions in such cases have therefore an effect of preventing public facilities from being misused to the detriment of consumers with tacit or explicit consent of the institutions entrusted with their management.