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Agenda

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Squeezed and damaged: follow-on damages actions in margin squeeze cases

In recent years, European competition authorities and courts have ruled on a number of margin squeeze cases. In some of these, the victims of abuse (usually competitors in the downstream market) have brought follow-on damages claims. This topic is covered in the European Commission's new practical guide on quantifying damages. What are the economic questions surrounding the quantification of damages from margin squeezes?

Margin squeeze is an exclusionary pricing practice prohibited under the Article 102 TFEU provision on abuse of dominance (and its national equivalents). It involves a vertically integrated firm that is dominant in the supply of an essential upstream input setting the combination of upstream (wholesale) and downstream (retail) prices such that an efficient competitor cannot operate profitably in the downstream market.

Several prominent margin squeeze cases have been assessed under EU competition law in recent years. For example, the European Commission has fined Deutsche Telekom and Telefónica €12.6m and €151.9m, respectively, in Decisions upheld by the European courts.[1] Various other jurisdictions have also dealt with margin squeeze cases in the telecoms, postal and energy sectors. As a result of these cases, there are now relatively well-established principles on how margin squeeze should be assessed under competition law (and, to some extent, in ex ante regulatory contexts).[2]

In particular, the *Telefónica* Decision upheld by the General Court in 2012 established that the 'margin' between wholesale and retail prices—reflective of the downstream costs and a sufficient rate of return—should be based on the downstream costs of an entrant that is 'as efficient' as the dominant firm. The Commission also set out principles for the choice of costs to be included in the 'margin' and for the appropriate range of products to be included in the test. These margin squeeze principles, and the 'as efficient competitor test', applied in abuse of dominance cases are discussed extensively elsewhere.[3]

The focus of this article is on what happens after a competition authority ruling—ie, follow-on damages claims before the national courts by victims of the abuse. The Commission has been actively promoting such follow-on claims, and in June 2013 published further rules and guidance that should facilitate them.[4]

In several Member States such claims have been filed, usually by the downstream competitors, following a finding of abuse by the Commission or a national competition authority. The methodologies used in these cases to estimate the lost profits accruing to the victims are diverse and subject to debate—and the Commission's recently published practical guide on quantifying damages also covers this theme.[5] Case law is relatively scant, in part because many of these cases are settled out of court.

So what are the stages in establishing damages from margin squeeze, and the methodological challenges at each stage? These questions were discussed at an Oxera Economics Council meeting in May 2013.[6]

The right counterfactual?

The Commission's recently published guide notes that:

> Practice of antitrust damages actions shows that foreclosed competitors sometimes choose to claim damages only for part of the harm, for instance the costs incurred in order to respond to an exclusionary practice, the non recoverable costs ('sunk costs') incurred with a view to entering a market from which they have been foreclosed, or the amount judged excessive in cases of margin squeeze or of discriminatory pricing.[7]

The claimants may limit the claim to the costs they incurred as a result of the infringement. However, it is not clear-cut whether the harm in margin squeeze cases is indeed limited to 'the amount judged excessive'.

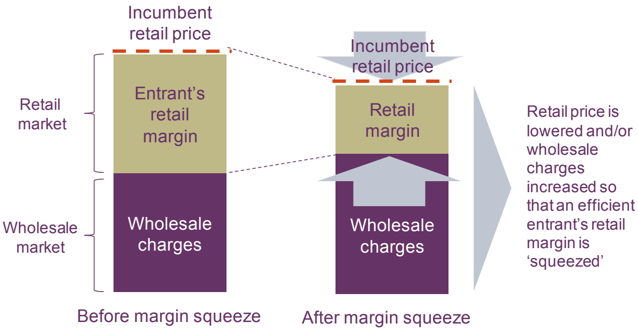
As in any damages quantification exercise, the starting point is to establish what the prices and market outcomes would have been if there had been no infringement—ie, what is the correct counterfactual? In margin squeeze cases, the question is whether the appropriate counterfactual is one in which wholesale prices are lower, one in which retail (downstream) prices are higher, or a combination of the two. This is illustrated in Figure 1 below.

Figure 1 contrasts the outcomes before and after the margin squeeze. It shows that, after the squeeze, wholesale charges are higher and retail prices are lower. Both have the effect of squeezing the retail margin.[8] Which scenario is more appropriate as the counterfactual depends on the facts of each case and, in particular, on the competitive environment in both the upstream and downstream markets.

Take the example of a telecoms operator that is dominant in the relevant wholesale input market (eg, interconnection or other access services), which is found guilty of squeezing downstream operators out of the market. What would have happened in the counterfactual? Counterfactual wholesale charges might have been lower if the dominant firm's factual charges were not cost-reflective. Alternatively, counterfactual retail prices might have been higher, although this is less likely where retail markets are competitive.

When it comes to quantifying damages, the key economic question often relates to the difference in factual/counterfactual margins, regardless of whether this difference is due to counterfactual wholesale charges that are lower or retail prices that are higher. In a static homogeneous goods setting, for example, the quantification of damages can be as simple as the volumes multiplied by the difference between the factual and counterfactual margins (although this would provide only a lower-bound estimate under these circumstances).

Figure 1 Margin squeeze mechanics



Source: Oxera.

The outcome might be different, however, if the main assumptions of this simple setting were relaxed.

- First, the dominant telecoms operator referred to above might offer a service at the retail level that is differentiated from that of its downstream competitor(s). The effects of the squeeze therefore depend on the specific circumstances in the retail market. If, for example, there were several downstream competitors and they all offered homogeneous goods, they would be expected to make zero profits. In this case, the harm to the downstream competitors from a margin squeeze would be somewhat diluted because most or all of the profits would be competed away. There might still be harm to consumers, however, given that the potentially inflated wholesale charges could lead to higher price levels across competitors.

- Second, margin squeeze can affect firms' entry and expansion behaviour in a dynamic sense. It can be argued that an entrant might have invested in expanding its share of the total market had there been no margin squeeze. At the extreme, there may be cases where a competitor was completely foreclosed. Hence, the *actual* volumes—which are zero in such a case—are hardly an appropriate basis for estimating what the profits would have been in the absence of the squeeze.

In summary, the simple damages calculation based on actual volumes and differences in factual and counterfactual margins provides a reasonable starting point for damages estimation, and might produce an informative estimate. Nevertheless, there may be good reasons to deviate (in either direction) from the baseline scenario. These reasons would need to be supported by an explanation of the mechanisms through which a different outcome could be reached, and evidence on the extent to which these mechanisms are indeed present in a given case. Having these economic assumptions clearly laid out can be helpful in informing the court on the factors that drive the damages estimate.

The right margin?

Regardless of whether the margin squeeze occurred because retail prices were 'too low' or wholesale prices were 'too high' (or a combination of the two), one important factor in defining the appropriate counterfactual is to establish the size of the margin that would have prevailed had there been no infringement. The size of the margin depends on the assumptions embedded in the margin squeeze assessment—ie, what a competition law-compliant combination of wholesale and retail prices would have been. While not discussed in detail here, margin squeeze assessments build on a number of economic assumptions about the costs and volumes on the basis of which the 'appropriate' margin is calculated (notably, the assumption about whether the entrant is equally efficient as the dominant firm or 'reasonably efficient', and what is included in the downstream costs).

Furthermore, a somewhat contentious question is whether the appropriate margin in the counterfactual is one that would only just have avoided the squeeze, or one that was larger. This is illustrated in Figure 2 below.

Figure 2 illustrates the range of potential outcomes for counterfactual margins, all of which have implications for the size of the margin and therefore the damages caused by the squeeze.

- The counterfactual where the margin just about complies with competition law ($m_{compliant}$ in Figure 1) results in the smallest possible damage. In the figure, this is the margin that enables the incumbent's downstream arm to recover its LRAIC, which was the cost basis established as competition law-compliant in, for example, the *Telefónica* ruling (the exact basis of the smallest lawful margin may depend on case-specific circumstances).

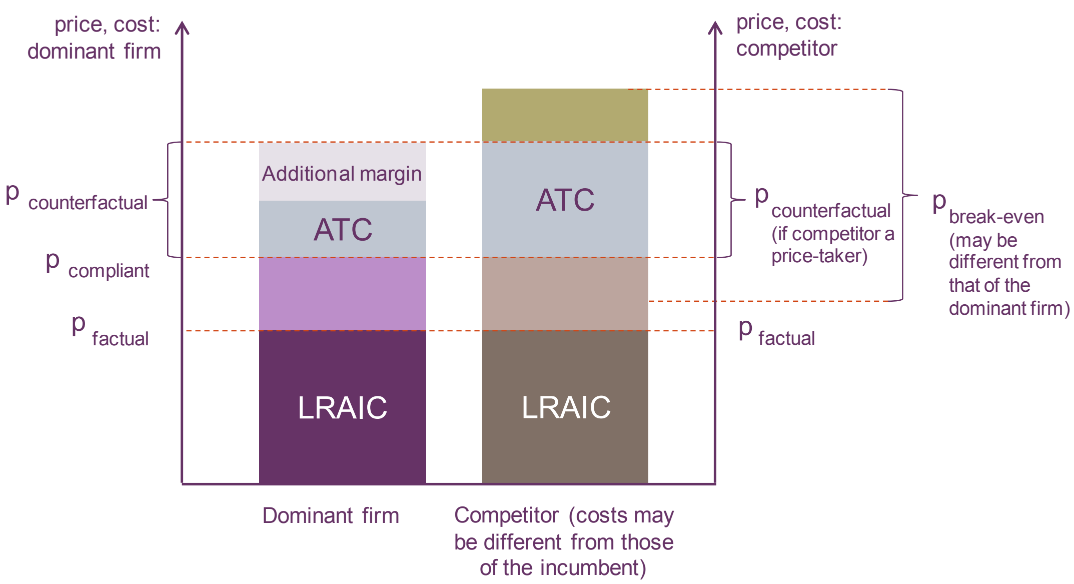
- However, it could be (and has been) argued that, if there had been no intent to foreclose competition, the 'reasonable' level of prices would have allowed an even wider margin than that which just passes the competition law test. For example, if the wholesale prices had stayed constant over time, and there was evidence that the retail prices were reduced to a level that resulted in a margin squeeze (akin to predatory conduct) with a clear intent to foreclose the market, the claimant(s) could argue that the relevant counterfactual margin is that which prevailed before the infringement, regardless of whether it is wider than the 'equally efficient' LRAIC-based estimate. In the figure, this could be a margin that covers ATC—ie, one that incorporates a greater share of common costs.

The 2013 *Albion Water* judgment by the UK Competition Appeal Tribunal followed an approach where the court used the mean of different lawful cost benchmarks to find the wholesale price that would have prevailed 'in the counterfactual world, on the balance of probabilities':

> There is a range of lawful access prices that Dŵr Cymru could have offered and we should take the figure in the middle of that range. The counterfactual must be based on an assumption that Dŵr Cymru would have offered a reasonable access price, rather than an access price which is the highest it could lawfully have charged.[9]

This is not clear-cut from an economic perspective. The cost standard applied in margin squeeze assessments should allow the incumbent's own downstream arm to stay in the market and to break even. Basing the damages claim on some additional margin (over and above the compliant margin) would mean that the claim might incorporate elements that are, first, not reflective of anti-competitive pricing and, second, not necessary from the perspective of the 'as efficient' competitor's cost recovery. There may

Figure 2 Cost basis and counterfactual prices—stylised illustration



Note: ATC, average total cost. LRAIC, long-run average incremental cost.
Source: Oxera.

be a case to consider an alternative to the smallest margin that complies with competition law where there is genuine uncertainty about the cost estimates underlying the margin analysis (due, for example, to the quality of the data) or about the precise cost basis that would be considered lawful.

Furthermore, as Figure 1 illustrates, what matters for defining the counterfactual margin are the dominant firm's costs, which may be different from those of the competitor(s). From an economic perspective, the actual effects of the squeeze depend on what the competitor's prices and consequent volumes would have been in response to the counterfactual wholesale and retail prices, given its cost structure and pricing strategies. Put another way, while the counterfactual competition law-compliant margin can be established by using the incumbent's costs as a basis, the effects may not be those that would have been felt by a competitor that was 'as efficient' as the incumbent.

From counterfactual margins to damages

If the right counterfactual is one where the claimant's sales volumes would have remained unchanged, the damages from a margin squeeze can be estimated on the basis of actual volumes multiplied by the difference between the actual and counterfactual margins. This is often a useful starting point.

As discussed above, in more complex settings there may be a case for analysing the retail market implications of a squeeze—in particular, what the claimant's sales volumes would have been in the absence of the margin squeeze. In general, there are two ways to approach this problem.

- **Comparator-based techniques**. Counterfactual market shares can be based on historical (time-series) evidence to establish how the market would have developed in the absence of the squeeze. Furthermore, the counterfactual analysis can be informed by comparator markets. It is usually challenging, however, to find suitable comparators that share key characteristics—such as number of competitors; competitor characteristics, in terms of vertical integration and lifetime in the industry; and maturity of the market as a whole. Comparator-based approaches can be (and have been) applied with different degrees of complexity, depending on how well the other factors affecting comparators' performance are controlled for.

- **'Market-structure-based' simulation techniques**. Alternatively, an economic simulation model could be constructed and calibrated to reflect the market structure that prevailed with and without the infringement, and compared against the actual market outcomes. This type of approach would need to recognise what exactly caused the squeeze and what the circumstances in the downstream market were in terms of product differentiation and the dynamics of the market.

Both types of approach have been applied in damages cases relating to exclusionary conduct and margin squeeze. They can be complemented with financial analysis-based techniques—for example, to assess profit margins and business and financial forecasts that feed into the overall assessment of lost volumes and profits.

Concluding remarks

The Commission's practical guide on quantifying damages, and other economic contributions, have helped to establish some best-practice principles for quantifying damages from exclusionary practices in general. The techniques to calculate margin squeeze damages in particular are still in development. This article has pointed out some of the specific questions that arise in these cases. There are circumstances under which simple approaches suffice, while some cases may require more complex techniques.

In particular, establishing the damages from margin squeeze requires an understanding of the circumstances in the upstream and downstream markets. Put another way, before jumping into detailed economic modelling of damages, it is necessary to understand the mechanisms through which the claimants were, in fact, affected.

[1] *Deutsche Telekom AG v Commission of the European Communities*, Case T-271/03, Judgment of April 10th 2008; *Wanadoo España v. Telefónica*, COMP/38.784, Commission Decision of July 4th 2007; General Court of the European Union (2012), 'Case T-336/07', Judgment of the General Court, March 29th.
[2] There is a separate debate on how, and whether, the competition law approach to margin squeeze should differ from that followed in ex ante sector regulation.
[3] See, for example, Oxera (2009), 'No Margin for Error: the Challenges of Assessing Margin Squeeze in Practice', *Agenda*, November; and Oxera (2009), 'The New Guidance on Article 82—Does it Do what it Says on the Tin?', *Agenda*, January.
[4] A new proposed Directive on damages actions, and related documents, can be found on DG Competition's dedicated website: http://ec.europa.eu/competition/antitrust/actionsdamages/.
[5] European Commission (2013), 'Practical Guide on Quantifying Harm for Damages based on Breaches of Article 101 or 102 of the Treaty on the Functioning of the European Union', staff working document, June 11th, para 193.
[6] The Oxera Economics Council is a forum of prominent European economic academics, chaired by Professor Sir John Vickers, All Souls College, University of Oxford, which meets twice a year to discuss current economic policy topics. The recent Council meeting on margin squeeze was also attended by the Chief Economist of DG Competition. Oxera is solely responsible for the contents of this article.
[7] European Commission (2013), op. cit., para 192.
[8] For further discussion on the economics of margin squeeze, see Vickers, J. (2010), 'Competition Policy and Property Rights', *The Economic Journal*, **120**, May, pp. 375–92.
[9] Competition Appeal Tribunal (2013), 'Case No. 1166/5/7/10', March 28th, para 71.