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Margin squeeze and duty to deal

Comparison of US and EU approaches

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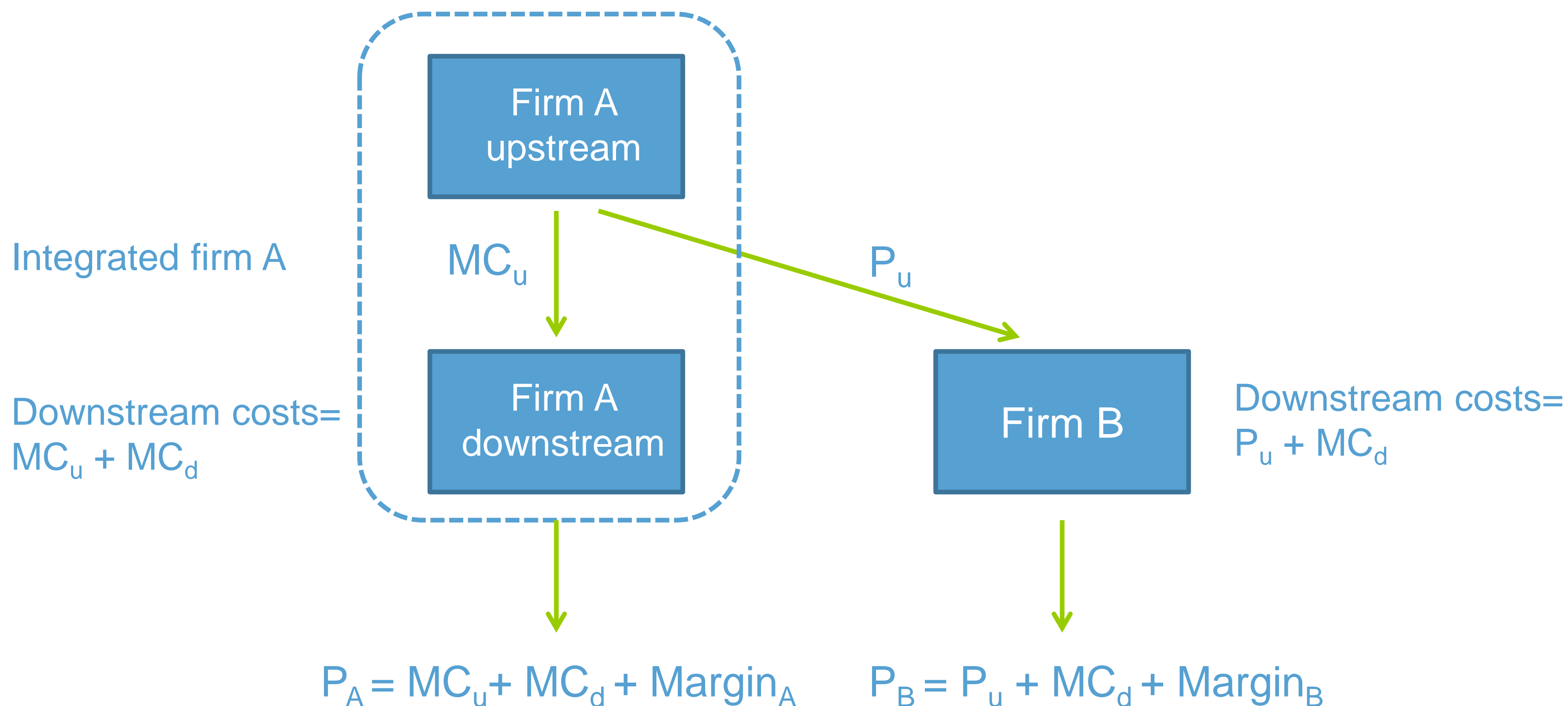
Overview

- US agencies and courts less likely than their counterparts in the EU to define a margin squeeze offense or impose a duty to deal
- Vertical mergers raise similar issues to margin squeezes, but there is more similarity in US and EU approaches to vertical mergers
- Antitrust intervention that imposes conditions on pricing even without a duty to deal can be welfare enhancing
- Courts and agencies must be mindful of maintaining incentives for investment and achieving efficiencies from integration

Definition of margin squeeze

- Integrated firm sells both upstream input and downstream final product; charges high price to un-integrated rivals
- Concern that downstream rivals that purchase upstream input are not able to compete against the integrated firm's downstream price, even if equally efficient at transforming the input
  - Downstream firm may be a less effective competitor or even exit as a result of the squeeze
  - Competition downstream may be harmed

Definition of margin squeeze (cont'd)



Concern about margin squeeze arises when $P_A < P_u + MC_d$. In other words, meeting firm A's downstream price implies a negative margin for firm B ($Margin_B < 0$)

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US approach

- General approach of US agencies and courts to pricing strategies has reflected concern to avoid deterring efficient conduct
  - For example, rebates in the first instance lead to lower prices—the very outcome the antitrust laws are supposed to encourage and protect
  - Enforcement against an alleged margin squeeze could reduce incentives of integrated firm to invest to produce the input by forcing it to supply competitors or by regulating upstream price to an inefficiently low level
- US Courts have been reluctant to define a duty to deal or to make a margin squeeze an actionable offense

Should one prohibit a margin squeeze without a duty to deal?

- Areeda and Hovenkamp view
  - Analytically, margin squeeze not very different from refusal to deal
    - Refusal to deal is just a margin squeeze with an infinitely high price
  - "It makes no sense to prohibit a predatory price squeeze in circumstances where the integrated monopolist is free to refuse to deal"[1]
- Within lower courts, there has been disagreement over this view
- In recent decisions Supreme Court has generally agreed that margin squeeze is not actionable without a duty to deal
- Explore whether this logic is complete

[1]Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law, 767c3 (2d ed. 2002)

US courts' interpretations of margin squeezes and duties to deal

- Trinko (2004, Supreme Court): only a few exceptions to a general rule that antitrust does not require a duty to deal
  - Aspen Ski case, which did define such a duty to deal in context of previous dealing, is "at or near the boundary of Section 2 liability"
  - Does this invalidate most or all price squeeze claims as well?
    - Lower courts subsequently were divided on the issue
    - Linkline (2007, 9th Cir Court of Appeals) versus Covad v. Bell South (11 Cir. 2004) and Covad v. Bell Atlantic (2005, DC Circuit)
- Linkline (2009, Supreme Court)
  - Price squeeze claim not viable post-Trinko where antitrust law does not impose duty to deal, except under traditional predatory pricing standard in downstream market
  - In earlier notation, violation only if $P_A < MC_u + MC_d$

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EU guidance

- Margin squeeze can occur without a regulatory obligation to deal
  - Tripartite test outlined in EC Article 102 Guidance Paper
    - Upstream good is “objectively necessary” to be able to compete effectively in downstream market
    - Likely to lead to elimination of effective competition downstream
    - Likely to lead to consumer harm
- Price test for margin squeeze compares the integrated firm’s downstream price to the costs of the un-integrated firm
  - Using the earlier notation, test is whether $P_A < P_u + MC_d$
  - More likely to find a violation compared to *Brooke Group* test in US of $P_A < MC_u + MC_d$

EU court cases

- Deutsche Telekom (2008, European Court of First Instance)
  - Confirmed the validity of margin squeeze theory of harm
  - "In order to assess whether there is a margin squeeze, it is necessary to consider whether the dominant undertaking, or an undertaking that is equally efficient, would have been in a position to offer the derived product otherwise than at a loss if it had first been obliged to pay the charge for the raw material."
    - In other words, violation if $P_A < P_u + MC_d$
- TeliaSonera (2011, European Court of Justice)
  - Supports approach of Deutsche Telekom decision
    - However, unlike Deutsche Telekom, TeliaSonera had no regulatory obligation to supply
  - Follows tripartite test of EC Guidance paper
    - But finds that even if upstream product is not "indispensible," there still might be anticompetitive effects

More convergence on vertical mergers, which raise similar issues

- Vertical mergers raise similar issues to margin squeeze
  - Central question is whether merged firm has an incentive to withhold a critical input or raise the price of the input after the merger
  - US authorities more willing to intervene in such a case compared to a case involving unilateral pricing by an already integrated firm
- Incentives to engage in post-merger refusal to deal sometimes calculated via “vertical arithmetic”
  - “Vertical arithmetic” compares upstream sacrifice from refusing to sell inputs to competitors with downstream benefits of additional sales
    - Post-merger withholding is profitable if additional profits gained from downstream sales exceed lost profits from upstream sales to competitor
    - Depends on upstream and downstream margins and downstream cross-elasticity of demand, or diversion ratio
    - Versions of this arithmetic explored by US FCC and DOJ in NBC/Comcast
  - This represents an extreme strategy and may be less profitable than a strategy of raising input prices short of complete withholding

"Margin squeeze" from vertical merger

- Post-merger, merged firm may have unilateral incentive to raise price to downstream competitor because it now internalizes impact on its downstream sales. Higher prices may not be enough to drive downstream firm out of business, but may still soften competition downstream and affect prices.
  - Pre-merger, firm will set upstream price such that

$$\frac{d\Pi}{dp_u} = \frac{dq_u}{dp_u}\left(p_u - mc_u\right) + q_u = 0$$

  - Post-merger, gain from additional downstream sales diverted from rival

$$\frac{d\Pi}{dp_u} = \frac{dq_u}{dp_u}\left(p_u - mc_u\right) + q_u + \frac{dq_d}{dp_u}(p_d - mc_d - mc_u) = 0$$

- Because the last term is positive, the first-order effect of the merger is to increase the merged firm's upstream price to its downstream competitor; firm faces opportunity cost from selling input (possible lost margin downstream)

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Implications for margin squeeze analysis

- Even if integrated firm has no duty to deal, it may choose to deal at a higher price than it would if it were not integrated
  - Possible anticompetitive effects of vertical merger are not limited to withdrawal from upstream market
- Antitrust intervention could require an upstream firm to charge a lower price for the input without an explicit duty to deal
- For instance, if integrated firm would set $p_u^I > p_u^{NI}$, it could be the case that $\Pi_{p_u^{NI}} < \Pi_{WH} < \Pi_{p_u^I}$
  - In other words, the firm would prefer to deal but at a higher price
- But there could also be a $\bar{p}_u < p_u^I$ such that $\Pi_{\bar{p}_u} > \Pi_{WH}$
- The fact that there is no duty to deal therefore does not mean that limiting the input price would be futile

Analogy to aftermarket analysis

- Possible concern if an equipment manufacturer withholds spare parts from aftermarket competitors
- Raises similar issues to margin squeeze or vertical merger
  - In some cases, firm may want to provide spare parts to large customers the do self-service, but not to aftermarket competitors
  - A remedy sometimes sought in these cases is not to require the firm to deal, but simply to prohibit the firm from discriminating (e.g., DOJ judgment against GE, 1999)
  - As in a margin squeeze, this type of intervention, which limits price without imposing a duty to deal, could theoretically increase welfare
    - The firm may find it more profitable to sell spare parts on a non-discriminatory basis than to withdraw from the market altogether

In all cases, need to be mindful of efficiencies

- EU guidance notes that “the Commission starts from the position that any undertaking, dominant or not, should have the right to choose its trading partners and to dispose freely of its property”
  - Notes that imposing such an obligation may reduce incentives to invest and promote free-riding
- Similar concern for investment incentives and free riding in US
- “Double marginalization” effect causes a vertically merged firm to charge itself a lower internal price than it charges to other firms. This efficiency can lead to lower prices downstream on net
- More generally, outside the merger context, there is a natural, non-strategic incentive for a firm to charge itself a lower price than a non-affiliated firm. This would happen even if there were no downstream competition. Should be careful about labeling this type of behavior a “margin squeeze” or “foreclosure.”