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Squeezing the margin squeeze abuse into the South African Competition Act

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Summary

The provisions in sections 8 and 9 of the South African Competition Act on the abuse of a dominant position refer to eight named offences plus a catch-all provision on exclusionary acts. Following the successful Senwes appeal to the Supreme Court of Appeal, it is not clear which of these provisions might apply to the next complaint of a margin squeeze. This article considers the alternatives and compares how margin squeeze is treated in both the European Union and the USA.

What is a margin squeeze?

The concept of a margin squeeze refers to the margin of a firm coming under pressure from both sides: from the input cost side and from the retail price side. Margin squeeze is potentially a competition law offence if it is caused by the action of a dominant competitor that supplies an important input to the firm, as expressed by the following definition:

“A margin squeeze occurs when a vertically integrated firm that is dominant in the supply of essential upstream inputs sets prices at the upstream and downstream levels such that the margin between these prices is insufficient for a downstream competitor to cover its costs.”²

Note that if the wholesale price for the input services was higher than the retail price for services to end users, this is sometimes referred to as a “margin crush”.

European Union approach to margin squeeze

In Europe, margin squeeze is now recognised as an independent abuse, in contravention of Article 102. In December 2008, the European Commission released its guidance document on enforcement priorities under Article 102³ (previously Article 82), in which it adopts an economic approach based on an “equally efficient competitor/operator” test, or EEO test. The courts have

¹ Economist, Norton Rose South Africa.

² CRA (Chares River Associates), 2010. *Competition memo: margin squeezes and the inefficient “equally efficient operator”*. November 2010.

³ Guidance on the Commission’s enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings, website reference http://ec.europa.eu/competition/antitrust/art82/guidance_en.pdf

confirmed the approach that margin squeeze allegations, under Article 102 or equivalent provisions in national legislation, should be assessed by applying the EEO standard to determine whether the pricing of the relevant input by the dominant vertically integrated firm would squeeze the margins of equally efficient firms at the downstream level.⁴

Furthermore, the EEO standard is preferred to the “reasonably efficient operator” (REO) standard, which demands that the vertically integrated dominant firm must price its inputs at a level that would allow a less efficient (but still reasonably efficient) downstream operator a margin. This is a subjective standard because it depends on the vertically integrated firm knowing how inefficient its downstream rivals are.⁵

Using the costs and prices of competitors in such tests can be appropriate if for example the cost structure of the dominant undertaking is unclear, or where the input supplied to competitors is simply the use of an infrastructure whose cost has been written off. This can be similar to using a “reasonably efficient competitor” test.

A complication arises if it costs more to supply inputs to downstream competitors than to the downstream arm of the vertically-integrated firm, or if the downstream competitors require additional inputs not needed by the downstream arm of the vertically-integrated firm. Should the vertically-integrated upstream firm be obliged to charge itself these “additional upstream costs” (AUC), thereby increasing the margin it allows its competitors downstream?

Conceptually, it seems that if a downstream competitor is not present upstream at all, then there can be no additional upstream costs that attach to it rather than to the vertically-integrated firm, so that any differences in how the downstream firm takes its inputs must be related to its own downstream inefficiency, but the vertically integrated firm has an incentive to alter its upstream outputs so that they are only compatible with the input requirements of its downstream arm, and not with the input requirements of its downstream competitors.

Recently, however, the European Commission ruled in the Wanadoo case⁶ that the vertically integrated dominant firm must ensure that downstream competitors, using different and more expensive upstream inputs than those used by the downstream arm of the vertically integrated firm, are not subjected to a margin squeeze. This was justified by the “ladder of investment” argument, traditionally applied in *ex ante* regulation rather than in *ex post* competition law cases. The ladder of investment argument is that an entrant on one “rung” of the market should be afforded the ability and incentive to climb up and compete at the next level too.

So much for the standard against which an allegation of margin squeeze is tested in the EU: but which of the named offences in Article 102, if any, relates to margin squeeze? Article 102 reads as follows:

“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 in so far 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;

⁴ See Commission Decision of 4 July 2007, Case COMP/38.784 – Wanadoo España v Telefónica, ¶315

⁵ See Deutsche Telekom AG v Commission, ECJ Case C-280/08 P, 14 October 2010, ¶196-204, website page <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62008J0280:EN:HTML>

⁶ Ibid, at ¶392.

(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.”

In Deutsche Telekom, the Commission stated in its decision⁷ that margin squeeze conduct was a contravention of Article 102(a):

“Such abuse consists in charging unfair prices for wholesale access services to competitors and retail access services in the local network, and is thus caught by Article 82(a) of the EC Treaty.”

This would tend to indicate that the margin squeeze abuse is located in Article 102(a) of the EC Treaty; but that would capture only one side of the squeeze, unless the “unfairness” of the conduct also relates to selling prices at the downstream (retail) level of the market, as well as to purchase prices at the upstream level. The wording of Article 102(a) does indeed accommodate such an interpretation.

US approach to margin squeeze (“price squeezes”)

In the USA, there is no statute that relates to unilateral conduct / abuse of dominance, and so it is left to the courts to set precedent in this regard.

The linkLine case⁸ was heard by a District Court, the Court of Appeals and finally the Supreme Court of Appeal, which held that margin squeeze (or “price squeeze”) claims should be assessed as a combination of refusal to deal and predatory pricing, rather than as a distinct type of antitrust harm.

The Supreme Court found that AT&T had no anti-trust duty to deal with its ISP customers, and as such it could price DSL transport services to the plaintiffs at whatever level it wished. And even if AT&T were obliged to deal with the plaintiffs, its pricing would be assessed under the normal US standard as set out in the Brooke Group⁹ case: that the alleged predatory prices must be below an appropriate measure of costs, and that recoupment of the investment in predation was likely. But the Supreme Court ruled that a predatory pricing assessment was not relevant, because AT&T was not even obliged to deal with its ISP customers:

“If AT&T can bankrupt the plaintiffs by refusing to deal altogether, the plaintiffs must demonstrate why the law prevents AT&T from putting them out of business by pricing them out of the market.”¹⁰

Therefore in the USA, margin squeeze is not recognised as an independent abuse, but must rather be challenged either as a refusal to deal that pushes input prices up, or as an episode of predatory pricing that pushes retail prices down.

The EU case of TeliaSonera¹¹ is somewhat similar to the linkLine case, because unlike Deutsche Telekom, TeliaSonera was not obliged by regulation to deal with its downstream competitors, but the recent decision of the European Court of Justice (ECJ) held that it is irrelevant that, unlike Deutsche Telekom and Telefonica, TeliaSonera was not subject to any regulatory duty to deal with its competitors.

⁷ Deutsche Telekom AG v Commission of the European Communities, April 2008. Case T-271/03, at ¶44. Website page <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62003A0271:EN:HTML>

⁸ Pacific Bell Telephone Co. v. linkLine Communications, Inc., 129 S. Ct. 1109 (2009).

⁹ Brooke Group v Brown & Williams Tobacco, 509 US 209, 222-224. 1993.

¹⁰ Ibid, at 16-17.

¹¹ Case C-52/09 - Konkurrensverket v TeliaSonera Sverige AB, judgment of 17 February 2011.

South Africa: the aftermath of the Senwes case

The Senwes case

The only concluded case of margin squeeze so far in South Africa is the Senwes case. The facts of the Senwes case as heard at the Competition Tribunal, and at the appeals of Senwes to the Competition Appeal Court (CAC) and then the Supreme Court of Appeal (SCA) are set out below.¹²

Senwes is a silo-owner that is vertically integrated into grain trading. It is dominant in the storage of grain (mostly white maize) for farmers close to its silos, which are located mainly in the Free State. There are other grain traders that need to store grain in the Senwes silos. Senwes competes with these traders to buy maize from farmers and sell it to millers. Therefore these traders are both customers of Senwes in the upstream market for storage, and competitors of Senwes in the downstream market for trading.

Farmers must decide when to sell their stored maize, by weighing their expectations about future maize price movements against their mounting storage costs, and they must also decide whether to sell to Senwes or to an independent trader. Initially, Senwes charged farmers and traders a daily maize storage rate, and gave them the option of an annual rate for storage longer than 100 days, in which case the charge was capped at 100 days. Senwes didn't charge its own trading operation for storage at all.

In May 2003, Senwes withdrew the benefit of the 100-day cap from the independent traders, but not from farmers. Senwes therefore discriminated in respect of storage charges between farmers and its trading competitors. By not charging farmers for storage longer than 100 days, Senwes could offer farmers a better price for their maize than could the other traders for these late-season trades. As such, the storage price discrimination applied by Senwes favoured its own trading operation over its trading competitors, rather than favouring farmers over independent traders, because farmers and traders do not compete with each other.

For maize stored for less than 100 days, there appeared to be a level playing field between Senwes and the other traders. Senwes charged farmers and traders the same daily storage rate, so when the Senwes trading arm purchased maize from farmers, it deducted the daily rate for storage from that purchase price, and other traders would do the same in order to pay Senwes for storage. But for grain stored longer than 100 days, the trading arm of Senwes set storage charges so that it could offer farmers a better deal than other traders could.

The price of white maize is now set on Safex, the South African Futures Exchange, and tends to vary between a minimum of export parity and a maximum of import parity, according to international maize prices, exchange rates and transport costs. But within those global price boundaries the maize price also responds to the aggregate forces of South African supply and demand. There are no silo-specific or trader-specific prices: there is only one national price of white maize set on Safex.

To be successful, any trader must buy low and sell high – so that the margin between its purchase price and its selling price covers its costs and yields a profit. But grain traders could not compete with the trading arm of Senwes for late season trades, for two reasons. First, they could not match the prices Senwes offered to farmers for their maize because they had to pay the extra storage charges to Senwes, and secondly the resale price to millers (as determined on Safex) was not high enough to cover both the purchase price from farmers and these extra storage costs. Their trading margin had been squeezed on both sides.

¹² Adapted and reproduced from my article "Senwes: a marginal case of margin squeeze?" in *Without Prejudice*, August 2011, p18-19.

In 2004, CTH Trading complained about this to the Competition Commission. Following its investigation, the Commission referred the complaint to the Competition Tribunal in 2006, alleging that Senwes had contravened section 9 of the Competition Act, by engaging in prohibited price discrimination between farmers and traders in respect of post-cap storage charges. The Commission also referred the complaint in terms of other provisions in the Act, including the catch-all section 8(c) on exclusionary acts, section 8(d)(i) on requiring or inducing a customer not to deal with a competitor, and section 8(d)(iii) on tying.

The Commission alleged that it was anti-competitive for Senwes to charge different prices to farmers and traders for post cap storage, but Senwes pointed out that traders do not compete with farmers. It is the trading arm of Senwes that competes with other traders, and if anything, it was the price discrimination engaged in by Senwes between its own trading arm and other traders that was potentially anti-competitive.

In 2009 the Tribunal¹³ therefore dismissed the allegation of price discrimination, but concluded that Senwes had implemented a margin squeeze against the independent traders by discriminating in storage charges between traders and its own trading arm and that this constituted an exclusionary act.

A remedy that would have addressed what the Commission had thought was price discrimination against farmers, would not have prevented Senwes from continuing to discriminate against its downstream trading rivals, and squeezing their margins. For example, Senwes could simply have removed the 100 day cap from farmers. On realising that, the Commission drastically amended its proposed remedies, and recommended a structural remedy that would force Senwes to sell off either its grain trading division or its storage division; and the storage division would be obliged to charge everyone the same rates for storage.

Senwes appealed to the Competition Appeal Court (CAC) that the Commission hadn't even alleged a margin squeeze in its section 8(c) referral, but the CAC disagreed¹⁴, and confirmed the Tribunal's decision later in 2009. Senwes then appealed to the Supreme Court of Appeal (SCA), and in June 2011 its appeal was upheld, and the orders of the CAC and Tribunal were set aside. The SCA found¹⁵ that not only was the Commission's price discrimination allegation ill-founded, but that it had not properly pleaded a case of margin squeeze as an exclusionary act.

Perhaps the Commission's case would have succeeded if it had correctly identified its referral of price discrimination as being between the trading arm of Senwes and the independent traders. And perhaps its case would have succeeded if it had correctly identified and elaborated on its referral of an exclusionary act as a margin squeeze. But Senwes, as the SCA stated, "...steadfastly refused to engage with a charge of a margin squeeze. Whether or not it has a defence to that charge we simply do not know."

Senwes did raise some defence of its conduct, including that the effect was *de minimis*: Senwes had only 16% of the white maize trading market, and the exclusionary effect of its storage charges was only in respect of post 100 day trades.

Margin squeeze: the relevant provisions of the Competition Act

We now turn to the question of where the margin squeeze offence fits in to the South African Competition Act. First, it is likely to be considered under the provisions in the Act relating to the abuse of a dominant position. A firm is a dominant firm in terms of the Act if it fulfils the conditions set out in section 7:

¹³ Competition Commission v Senwes Limited. Competition Tribunal, Case No. 110/CR/Dec06.

¹⁴ Senwes Limited v Competition Commission. Competition Appeal Court, Case No. 87/CAC/Feb09.

¹⁵ Senwes Limited v Competition Commission. Supreme Court of Appeal, Case No. 118/2010.

“7. Dominant firms

A firm is dominant in a market if –

- (a) it has at least 45% of that market;*
- (b) it has at least 35%, but less than 45%, of that market, unless it can show that it does not have market power; or*
- (c) it has less than 35% of that market, but has market power.”*

It is clear from the wording of section 7 above that dominance is equated with market power in the Act. market power is defined in section 1 of the Act as follows:

“1(xiv) ‘market power’ means the power of a firm to control prices, or to exclude competition or to behave to an appreciable extent independently of its competitors, customers or suppliers”

Next, sections 8 and 9 set out the provisions that regulate the conduct of dominant firms. First, section 8 reads as follows:

“8. Abuse of dominance prohibited

It is prohibited for a dominant firm to –

- (a) charge an excessive price to the detriment of consumers;*
 - (b) refuse to give a competitor access to an essential facility when it is economically feasible to do so;*
 - (c) engage in an exclusionary act, other than an act listed in paragraph (d), if the anti-competitive effect of that act outweighs its technological, efficiency or other pro-competitive gain; or*
 - (d) engage in any of the following exclusionary acts, unless the firm concerned can show technological, efficiency or other pro-competitive gains which outweigh the anti-competitive effect of its act –*
 - (i) requiring or inducing a supplier or customer to not deal with a competitor;*
 - (ii) refusing to supply scarce goods to a competitor when supplying those goods is economically feasible;*
 - (iii) selling goods or services on condition that the buyer purchases separate goods or services unrelated to the object of a contract, or forcing a buyer to accept a condition unrelated to the object of a contract;*
 - (iv) selling goods or services below their marginal or average variable cost;*
- or*
- (v) buying-up a scarce supply of intermediate goods or resources required by a competitor.”*

Note that in respect of section 8(a), excessive pricing is defined in section 1 as follows:

“1(ix) ‘excessive price’ means a price for a good or service which –

(aa) bears no reasonable relation to the economic value of that good or service; and

(bb) is higher than the value referred to in subparagraph (a)”

Also note that in respect of the portmanteau category of exclusionary acts covered by section 8(c), an exclusionary act is defined in section 1 as follows:

“1(x) ‘exclusionary act’ means an act that impedes or prevents a firm entering into, or expanding within, a market”

Then, section 9 regulates the practice of price discrimination by a dominant firm as follows:

“9. Price discrimination by dominant firm prohibited

(1) An action by a dominant firm, as the seller of goods or services is prohibited price discrimination, if –

(a) it is likely to have the effect of substantially preventing or lessening competition;

(b) it relates to the sale, in equivalent transactions, of goods or services of like grade and quality to different purchasers; and

(c) it involves discriminating between those purchasers in terms of –

(i) the price charged for the goods or services;

(ii) any discount, allowance, rebate or credit given or allowed in relation to the supply of goods or services;

(iii) the provision of services in respect of the goods or services; or

(iv) payment for services provided in respect of the goods or services.”

(2) Despite subsection (1), conduct involving differential treatment of purchasers in terms of any matter listed in paragraph (c) of that subsection is not prohibited price discrimination if the dominant firm establishes that the differential treatment –

(a) makes only reasonable allowance for differences in cost or likely cost of manufacture, distribution, sale, promotion or delivery resulting from the differing places to which, methods by which, or quantities in which, goods or services are supplied to different purchasers;

(b) is constituted by doing acts in good faith to meet a price or benefit offered by a competitor; or

(c) is in response to changing conditions affecting the market for the goods or services concerned, including –

(i) any action in response to the actual or imminent deterioration of perishable goods;

(ii) any action in response to the obsolescence of goods;

(iii) a sale pursuant to a liquidation or sequestration procedure; or

(iv) a sale in good faith in discontinuance of business in the goods or services concerned.”

Evaluation

One might consider certain subsections of the Act together in deciding whether a case of margin squeeze fits or not. Therefore, we consider first whether margin squeeze can be thought of as some combination of excessive pricing, and/or predatory pricing, and/or refusal to grant access to an essential facility, and/or a refusal to supply. This resembles in certain respects the US approach to price squeeze / margin squeeze, although there is no concept of excessive pricing in the US statutes, nor is there any case precedent on excessive pricing in the USA.

Next, we ask whether margin squeeze constitutes either a requirement/inducement not to deal with a competitor; tying; or buying up a scarce supply of an intermediate good.

Thirdly, if margin squeeze does not fit into any of the named offences in section 8, is it relegated to section 8(c) (as the Tribunal held in its *Senwes* decision)?

Finally, does margin squeeze amount to price discrimination?

(1) Is margin squeeze addressed by section 8(a), 8(b), 8(d)(ii) and / or section 8(d)(iv)?

Is margin squeeze an example of excessive pricing in terms of section 8(a)? Certainly, one side of the squeezing is done by a wholesale input price that is too high for the downstream competitor to afford. But excessive pricing is usually thought of as an exploitative practice, rather than one that excludes a downstream customer firm.

The usual difficulties of establishing that a price is excessive would however apply here – what exactly would be the “economic value” of the wholesale input? Is economic value to be assessed by a process of benchmarking or other comparative methods relating to price or profitability, or by means of examining price/cost mark-ups, or demand-side factors? And once that is established, what exactly would be a “reasonable relation” between the price of the wholesale input and the “economic value” of the wholesale input?

Even if these problems are overcome, the fact is that an excessive pricing inquiry will evaluate only one side of the squeeze, and leave the other side unattended to – the level of the retail price. On the other hand, the wholesale price may be the only relevant price, if the vertically-integrated dominant firm does not have market power in the downstream market, which was arguably the case in *Senwes*.

But if the firm does have market power downstream and is depressing prices there, then it might be natural to supplement a complaint of excessive pricing with a complaint of predatory pricing, per section 8(d)(iv). Predatory pricing in terms of section 8(d)(iv) is assessed according to a rule of reason, so that the vertically-integrated firm would be able to counter any anti-competitive effect of its pricing by raising arguments about any technological, efficiency or other pro-competitive gains associated with its conduct.

As for the refusal to grant access to an essential facility (section 8(b)), if a vertically-integrated dominant firm charges high wholesale prices to its downstream competitors that would squeeze or even crush their margins, that could be regarded as a constructive refusal to grant access to an essential facility.

Equally, charging a price for essential inputs that squeezes the margin of a downstream competitor could be regarded as a constructive refusal to supply scarce goods to a competitor, in contravention of section 8(d)(ii).

(2) Requiring/inducing a consumer not to deal with a competitor; tying; buying up a scarce supply of intermediate goods or resources required by a competitor

Requiring or inducing a customer not to deal with a competitor (section 8(d)(i)) would not seem to be a typical feature of margin squeeze conduct. Rather, this would tend to be associated with offering rebates, for example to fulfil a customer's total annual requirements, or to induce a customer to disregard competitive offerings. The Competition Commission alleged inducement in the Senwes case, but the Competition Tribunal did not give much weight to this complaint, because it held that customers were not even aware of what traders' terms with Senwes were. Nevertheless in different circumstances it is certainly conceivable that a vertically integrated dominant firm might implement a margin squeeze by way of requiring or inducing customers not to deal with a downstream competitor.

Likewise, in terms of section 8(d)(iii), margin squeeze cases might involve mixed bundling or pure bundling (tying) that could make it impossible for a downstream competitor of the vertically-integrated firm to replicate its bundled offering.

Buying up a scarce supply of intermediate goods or resources required by a competitor would appear to be a distinct type of conduct to margin squeeze, or at best a complementary strategy in advance of a margin squeeze, but again it is difficult to rule it out altogether as a type of margin squeeze, in the right set of circumstances.

(3) Exclusionary act

Section 8(c) of the Act is a catch-all provision that is designed to catch those exclusionary acts that do not necessarily fit into any of the named offences in section 8(d). At first sight it appears to be the best home for the margin squeeze abuse, because the margin squeeze abuse has come to be known as such and yet it is not amongst the named offences of section 8 of the Act.

In Senwes, the Competition Tribunal found that the margin squeeze amounted to an exclusionary act, and that was confirmed by the Competition Appeal Court, and not denied by the Supreme Court of Appeal (SCA). All that the SCA disputed was that the Commission had not properly brought a section 8(c) case against Senwes, and so it could not succeed.

The disadvantage of margin squeeze being examined in terms of section 8(c), from a complainant's point of view, is that the onus is on the complainant to show that anti-competitive effect of the margin squeeze outweighs any efficiencies thereof.

This is in sharp contrast to the position in the EC, where the margin squeeze abuse is akin to a *per se* offence, because the presumption is that a margin squeeze will be anti-competitive, rather than having to wait for anti-competitive effects to come about (e.g. with loyalty rebates).

(4) Price discrimination

Here again the Competition Commission referred the case against Senwes in terms of price discrimination: the Competition Tribunal however picked up that the Commission had not correctly identified the discrimination as being between independent traders and the trading arm of Senwes.

The Tribunal therefore rejected that part of the Commission's case. It does seem that but for the Commission's error, a valid case of margin squeeze could have been brought against Senwes. Senwes certainly was discriminating against traders by continuing to charge them for storage post 100 days, whereas it did not charge its own trading arm for storage in the post-cap period. In other cases too, margin squeeze might be due to price discrimination, and as a consequence, for example, non-discrimination undertakings/obligations are sometimes imposed on incumbent telcos.

Conclusion

As it turns out, there is no shortage of space in the South African Competition Act to accommodate a margin squeeze abuse. This is because arguably, a case of margin squeeze can be brought successfully under the provisions of almost any of the named offences in sections 8 and 9 of the South African Competition Act, as well as under the provisions of the catch-all section 8(c). This seems strange at first, but perhaps less so if one considers the widely divergent treatment of margin squeeze in the USA compared to the EU.