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**Working Party No. 2 on Competition and Regulation**

**ROUNDTABLE ON MARGIN SQUEEZE**

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*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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1. Price squeeze has been addressed in a limited number of decisions by the Competition Board in its enforcement practice since 1997. The issue has been discussed mainly in two decisions in telecommunications sector. First decision (*Turkcell Corporate Tariffs*)<sup>1</sup> concerns the allegations that the dominant GSM operator implemented price squeeze via its tariffs applicable to corporate customers while the second (*TTNet*)<sup>2</sup> deals with the allegations that the vertically integrated dominant fixed line telephone operator abused its dominant position in the downstream market of broadband internet access services. This contribution aims to concentrate on the latter case to highlight the approach of the Competition Board on price squeeze.

## 1. Price squeeze under the Competition Act

2. First of all, Article 6 of the Competition Act entitled “Abuse of Dominant Position” includes a general prohibition of abuse of dominant position with a non-exhaustive list of examples deemed as abuse. Although the list does not cite price squeeze as a separate form of abuse, it can be considered by the Competition Board under the examples of “*preventing, directly or indirectly, another undertaking from entering into the area of commercial activity, or actions aimed at complicating the activities of competitors in the market*” or “*actions which aim at distorting competitive conditions in another market for goods or services by means of exploiting financial, technological and commercial advantages created by dominance in a particular market*” or “*restricting production, marketing or technical development to the prejudice of consumers*”.

## 2. Price squeeze

3. *TTNet* decision provides explanations regarding price squeeze and its assessment under the competition rules. Following is a summary of these explanations.

### 2.1 General remarks

4. Price squeeze emerges when an undertaking, which is vertically integrated and dominant in upstream (wholesale) market, narrows the margin between the wholesale price of the input it controls in the upstream market and the price of the product in the downstream market (retail market) produced via the use of the input by changing the level of both prices. As a result, the profit margin for rivals in the retail market, whose operations are dependent on the use of the input and who have to pay the wholesale price as well as compete with the retail price charged by the vertically integrated dominant undertaking, is squeezed. The vertically integrated dominant undertaking may cause price squeeze either by increasing the wholesale price (fixing it higher compared to retail price) or decreasing the retail price (fixing it lower compared to wholesale price, and the costs in the downstream market) or implementing both at the same time.

5. The practice by the vertically integrated dominant undertaking makes it impossible for the actual and potential rivals in the retail market to compete with it by obtaining a reasonable amount of profit against the decreasing margin. Although the vertically integrated dominant firm charges the same price for the input to its subsidiary/arm in the retail market, it is not affected by the margin between the wholesale and retail prices as the payment will only be transferred on paper.<sup>3</sup> In contrast, the cost of the rivals, who

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<sup>1</sup> Dated 4.7.2007 and numbered 07-56/634-216.

<sup>2</sup> Dated 19.11.2008 and numbered 08-65/1055-411.

<sup>3</sup> Geradin, D. ve R.O'Donoghue (2005), “The Concurrent Application of Competition Law and Regulation: The Case of Margin Squeeze Abuses in Telecommunications Sector”, *Journal of Competition Law and Economics*, Vol:1, No:2, p. 358.

have to pay the price for the input, increases and it becomes possible that the retail market is foreclosed in whole or in part to those rivals.

6. As a result, price squeeze is considered under the Competition Act and especially its provisions prohibiting abuse of dominant position because the vertically integrated dominant undertaking may exclude actual or potential rivals in the retail market, restrain their activities or market shares and prevent competition by transferring its market power on the input in the wholesale market to the retail market.

## 2.2 *Conditions for price squeeze*

7. Certain economic and legal conditions regarding the structure of the market where the vertically integrated dominant firm and its rivals operate should concurrently exist before establishing that competition rules are infringed. The doctrine and the practice concerning price squeeze cite these conditions as follows:

- The relevant undertaking should be vertically integrated in a way to have operations in interrelated upstream and downstream markets (wholesale and retail markets) in a production/service chain and constitute an economic unit.
- The relevant undertaking should be dominant with market power approaching to monopoly in the wholesale market for the production or supply of the input.
- The input in the wholesale market is essential for the relevant undertaking as well as its rivals to produce and compete in order to stay in the market. In other words, there should be no close substitute (alternative) for the input in the upstream market and it should not be possible to produce the input with less cost and in a short period of time.
- The margin between the wholesale and retail price is fixed at such a low level that the relevant undertaking or its equally efficient rival can not profit in the downstream market and stay in the market in the long term. In other words, the relevant undertaking could not operate profitably if it had to pay the same wholesale price like its rivals did.
- Competition is restricted in the retail market as a result of conduct of the relevant undertaking leading to price squeeze.
- The relevant undertaking does not have objective justification for the pricing policy leading to price squeeze.

8. Absence of one or more of those conditions makes it difficult to identify that price squeeze harms competition.

9. *TTNet* decision cites that these conditions have also been mentioned in the Notice on the Application of the Competition Rules to Access Agreements in the Telecommunications Sector - Framework, Relevant Markets and Principles (98/C 265/02) (Access Notice) issued by the European Commission according to which price squeeze could happen and be exclusionary for the rivals in the retail market if “... *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...*”<sup>4</sup> or “... *the margin between the price charged to competitors on the downstream market (including the dominant company's own downstream operations, if any) for access and the price which the*

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<sup>4</sup> Paragraph 117 of the Access Notice.

*network operator charges in the downstream market is insufficient to allow a reasonably efficient service provider in the downstream market to obtain a normal profit (unless the dominant company can show that its downstream operation is exceptionally efficient)”<sup>5</sup>.*

10. Moreover, *TTNet* decision also mentions certain aspects of *Telefónica*<sup>6</sup> decision by the European Commission and the *Deutsche Telekom*<sup>7</sup> decision by the Court of First Instance for their relevance to the case.

### **2.3 Insufficiency of the margin, predatory price & margin squeeze and duration**

11. Based on the explanations on price squeeze, before assessing the conduct in question under competition rules, *TTNet* decision addresses issues on how to calculate insufficiency of the margin, difference between price squeeze and predatory price and finally the duration of the conduct.

12. On insufficiency of the margin, whether the margin between retail and wholesale prices charged by the relevant vertically integrated dominant undertaking is negative and, if not, whether the margin between the two prices covers an equally efficient firm’s increasing retail market cost peculiar to the product in question (the cost caused by production of the product) are taken into account. The vertically integrated dominant undertaking’s (retail arm’s) cost is taken as a benchmark for the equally efficient firm’s own cost. While calculating the downstream costs, the customer acquisition costs can be spread over a certain period of time by considering the customer life and general economic factors prevailing in the market.

13. Regarding predatory price and price squeeze, the latter is different in the sense that retail price need not be predatory in the case of price squeeze. Therefore, price squeeze may happen even in the absence of predatory price. Moreover, although predatory price is hard to establish if the relevant undertaking is not dominant at retail level, there is no need for dominance in the retail market to apply price squeeze. Price squeeze emerges as a result of interaction between prices in two vertically related markets whereas analysis for predatory price concerns prices on a single market.

14. As to duration, short-term sales promotion/campaigns/discounts may be seen as objective justifications against allegations of price squeeze. However, in case such short-term discounts become continuous, price becomes excessively low as a result of such discounts or regular price changes lead to negative margins, then resulting price squeeze may be assessed as conduct having exclusionary effect.

## **3. The decision (*TTNet*)**

### **3.1 Relevant undertakings and dominance**

15. The relevant undertakings in *TTNet* decision are Türk Telekom, the incumbent fixed line telephone operator, which operates in the wholesale broadband internet access market, and *TTNet*, Türk Telekom’s fully owned subsidiary, operating in retail broadband internet access market. Both undertakings are vertically integrated and constitute a single economic unit under competition law. Türk Telekom is dominant in the wholesale market and has a de facto monopoly over local network to which both *TTNet* and other rival Internet Service Providers (ISPs)<sup>8</sup> are obliged to have access in order to provide ADSL

<sup>5</sup> Paragraph 118 of the Access Notice.

<sup>6</sup> Case COMP/38.784 – Wanadoo España vs. Telefónica, 4.7.2007.

<sup>7</sup> Deutsche Telekom AG vs. Commission, Case T-271/03, Court of First Instance, 10.4.2008.

<sup>8</sup> The basic sales model used by ISPs is purchase of the service offered by Türk Telekom at wholesale price and resale of it at retail price (resale model). In this model, the ISPs including *TTNet* involve in marketing

services. Moreover, TTNNet is also dominant in the retail broadband internet access service market. It should again be mentioned that it is not necessary that TTNNet is dominant in this retail market in order for its price and discount policies in its campaigns to constitute price squeeze and abuse of dominant position under competition law. It is sufficient that Türk Telekom, which is within the same economic unit with TTNNet, is dominant in the wholesale market for existence of price squeeze. However, existence of dominant position in the retail market was established by the Competition Board to indicate the position of TTNNet in the market and that the effects of the infringement in the market would be more serious compared to a situation where it was not dominant. In line with the basic allegation against these undertakings, the decision concentrates on whether there is price squeeze, which violates the relevant provision of the Competition Act on abuse of dominant position, as a result of Türk Telekom's setting the margin between its wholesale tariffs and retail tariffs (it applied through TTNNet) in a way that it does not cover the costs of TTNNet at retail level.

### 3.2 *Profitability analysis*

16. In the profitability analysis, incomes and costs of TTNNet were averaged on monthly basis. Three sets of costs were taken into account.

17. The first group of costs consists of service payments to Türk Telekom for wholesale ADSL access under resale model. The second group includes operating costs. The second group of costs was calculated on average terms, i.e. total accounting costs were divided by average number of subscribers. The last group of costs was subscriber acquisition costs. These costs consisted of costs of free internet access, free modems, subscription fee that were not collected, discounts on the monthly fees and advertisements specific to the campaigns. Since these costs were incurred in order to get new subscribers and TTNNet would enjoy the benefits over a long period, they were spread through a period of 36 months.

18. The profitability calculation method conducted by the Competition Board can be categorized as fully distributed costs. This method may not seem to be compatible with the European Commission's practice of using incremental costs (or avoidable costs as proposed by the DG Competition Discussion Paper on the Application of Article 82 of the Treaty to Exclusionary Abuses). However, considering the fact that TTNNet's only business was limited to the resale model and this model does not require fixed investments, all costs incurred by TTNNet can be categorized as incremental or avoidable.

19. It should be said that although the profitability analysis is based on costs incurred by TTNNet, the decision also examined costs of other ISPs operating in retail broadband internet access services market. Although number of subscribers of other ISPs was too few to compare with that of TTNNet in terms of economies of scale, it was thought that examining what cost items some other ISPs faced, determining whether they operated profitably and establishing the similarities and differences between their cost items and those of TTNNet would contribute to the assessments regarding operations and profitability of TTNNet. Although there were twelve ISPs having active subscribers in the market, only costs of four of them were selected based on certain criteria such as number of subscribers, duration of their presence in the market, recognition level by customers. The evaluations proved that rival ISPs incurred similar cost items compared to those of TTNNet in a market where homogenous services were offered and the ISPs, who had to follow the price charged by TTNNet and who operated on the same business model and whose subscriber base and history enabled to conduct profitability analysis, could not profit.

20. *TTNet* decision mentions that the profitability analysis concerning TTNNet and its rivals indicated that an equally efficient rival would also incur losses. It should be said that there was no analysis in the

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of ADSL service bought as a package from Türk Telekom for resale. Therefore, the ISPs operate like dealers of Türk Telekom rather than as operators.

decision to determine whether rival ISPs were as efficient as TTNNet. However, assuming that they were not and therefore had faced higher costs, they would have incurred losses even if they had been equally efficient rivals.

21. As indicated above, the vertically integrated dominant undertaking's (retail arm's) cost is taken as a benchmark for the equally efficient firm's own cost, which is the cost of TTNNet in this case. When Türk Telekom and TTNNet argued that the cost of a hypothetically efficient firm should be used, the Competition Board mentioned existence of two methods in the doctrine and practice in calculating costs. First method, known as "reasonably efficient rival test", takes into account hypothetically efficient rival's costs. However, because it is hard to calculate costs of such a firm in practice, cost of undertakings other than the one subject to investigation (rival's cost) is used. Nevertheless, use of rival's cost is criticized as it would not be fair to expect the undertaking subject to investigation to know the costs of its rivals and arrange its price accordingly and otherwise be the subject of possible proceedings under competition law. This is also seen as incompatible with the aim of protection of competition rather than competitors under competition law. Therefore, it is seen that the method known as "equally efficient rival test" is preferred in the literature and practice which is also followed by the Competition Board in this case. The most important rationale for this test is the fact that liability may only occur when an equally efficient rival is excluded as a result of the pricing by the vertically integrated dominant firm.<sup>9</sup>

22. As a result of the profitability analysis, the Competition Board concluded that Türk Telekom/TTNet economic unit followed a pricing policy that did not cover its costs in the retail broadband internet access services market and implemented price squeeze aiming to complicate the activities of rivals and competition was restricted in the market. Therefore, it was decided that Türk Telekom/TTNet economic unit abused the dominant position it held in the wholesale broadband internet access services market in the retail broadband internet access services market.

### 3.3 *Presence of intent and anti-competitive effects*

23. Although general prohibition of abuse of dominant position by Article 6 of the Competition Act does not mention that intent of the conduct may be adequate to prohibit it as an abuse of dominant position, the example of "*actions which aim at distorting competitive conditions in another market for goods or services by means of exploiting financial, technological and commercial advantages created by dominance in a particular market*" among the list of abusive practices under Article 6 overtly indicates that a conduct may be prohibited if its intent alone is anti-competitive. Moreover, the reasoning of Article 6 of the Competition Act also mentions that intent or effect may be adequate to establish abuse.<sup>10</sup> Therefore, there is no need to demonstrate anti-competitive effects of the price squeeze to prohibit it as abuse. However, it should be said that although *TTNet* decision mentions some internal business plans, correspondence and presentations among high level officials of Türk Telekom and TTNNet indicating that they incurred losses and campaigns could not compensate themselves within reasonable time, such evidence was used to prove that the price squeeze, which resulted in anti-competitive effects in the market, was intentional. Therefore, the decision demonstrated that price squeeze lasted over a certain period of time and resulted in anti-competitive effects in the market in addition to intent to complicate activities of rivals or exclude them from the market.

<sup>9</sup> O'DONOGHUE, R. ve A. J. PADILLA (2006), *The Law and Economics of Article 82 EC*, Hart Publishing, Oxford & Portland, 2006, Oregon, p. 361.

<sup>10</sup> "...On the other hand, it is prohibited for the undertakings that obtain dominant position in the market to abuse their position with an aim to restrict, prevent or distort competition in our country or in a way to cause such effects. ..."

24. As to anti-competitive effects of the price squeeze in this case, the decision cites that although no rival exited the market as a result of price squeeze, it prevented them from expanding in the market and gaining market share as shown by analysis of the market shares and number of subscribers in the relevant period. In this context, the decision refers to literature<sup>11</sup> which says that apart from excluding rivals from the market, price squeeze also aims to control rivals.

### **3.4 Objective justification**

25. The Competition Board did not accept the defence by Türk Telekom/TTNet economic unit that the investments it made, its contribution to development of broadband internet via alleged anti-competitive conduct, increasing penetration rate in recent years were objective justifications as there was documentation such as correspondence among high level officials found during on-the-spot inspections indicating the anti-competitive intent and strategy behind the relevant conduct. For instance, such correspondence proved that foreclosure of the market in favour of TTNet by ensuring rapid subscription of many users was adopted as a strategic target. According to the decision, although the dominant undertaking has the right to respond to competition in a proportionate manner, the price squeeze implemented by Türk Telekom and TTNet was not a competitive behavior when its duration and effects in the market were taken into account.

### **3.5 Outcome**

26. The Competition Board imposed a fine of approximately 6 million Euros and required Türk Telekom/TTNet to refrain from practices that might lead to price squeeze. Before the final decision was taken, the Competition Board had to take interim measure<sup>12</sup> to terminate price squeeze practices increasingly used by the Türk Telekom/TTNet during the investigation stage. Türk Telekom/TTNet terminated the relevant practices in compliance with the interim measure and documented this before the Competition Board.

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<sup>11</sup> See footnote 9, p.306.

<sup>12</sup> See Decision by the Competition Board, dated 11.7.2007 and numbered 07-59/676-235.