

Your Reference

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By email only
Private & Confidential
FAO Dylan Townsend
DCUSA Limited
Northumberland House
303 - 306 High Holborn
London
WC1V 7JZ

Gowling WLG (UK) LLP
4 More London Riverside
London
SE1 2AU

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Dear Dylan

Legal framework and preliminary risk assessment in relation to the concept of a "margin squeeze" under EU and/or UK competition law in the context of the change proposal being considered by the DCP 266 Working Group

By reference to the change proposal in relation to the calculation and application of IDNO discounts being considered by the DCP 266 Working Group (as outlined further within the DCUSA consultation dated 17 April 2019 (the "**CP**")), we set out below an overview of:

- the legal tests that have been applied in recent cases by the Court of Justice of the European Union (the "**CJEU**"), the European Commission (the "**Commission**"), and the courts of England and Wales to assess the circumstances in which a margin squeeze constitutes an abuse of dominance under EU and/or UK competition law (the "**Legal Framework**"); and
- our preliminary assessment of aspects in relation to which the concept of a margin squeeze could raise potential issues under EU and/or UK competition law in the context of the CP, with this preliminary assessment prepared in reliance upon the "arguments presented in response" (as set out within the DCP 266 Working Group request for a legal opinion dated 27 May 2019) (the "**Preliminary Risk Assessment**").

1 EXECUTIVE SUMMARY

Legal framework

1.1 As outlined within **section 2** below, where a vertically-integrated undertaking (e.g. a distribution network operator ("**DNO**")) has:

- (a) a dominant position on an upstream market; and

T +44 (0)370 903 1000
F +44 (0)370 904 1099
gowlingwlg.com

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- (b) competes with its customers on a downstream market (e.g. independent distribution network operators (each, an "IDNO")),

the central issue when assessing the existence of an abusive margin squeeze is determining whether a downstream customer, which is "as efficient" as the dominant undertaking on the downstream market, could operate profitably on the basis of:

- (a) the downstream price charged by the downstream arm of the dominant undertaking to its end customers; and
- (b) the upstream price charged by the dominant undertaking to its downstream competitors,¹ (the "AEC test").

1.2 As such, an abusive margin squeeze may arise where the difference between (i) the downstream price charged by the dominant undertaking; and (ii) the upstream price that the dominant undertaking charges to its downstream competitors is either:

- (a) negative; or
- (b) positive, but insufficient to cover the downstream costs of the downstream arm of the dominant undertaking.

1.3 Accordingly, where the difference is positive (i.e. a margin exists), the question is then whether this margin is sufficient to cover the downstream costs of the downstream arm of the dominant undertaking. This necessarily requires an assessment of such costs to be undertaken in the context of assessing whether an abusive margin squeeze exists.

Regulatory oversight does not preclude the existence of an abusive margin squeeze

1.4 Importantly, as outlined within **section 2** below, on the basis that the relevant approaches differ, an ex-ante margin squeeze test conducted by a sector regulator would not preclude a finding of an abusive margin squeeze in an ex-post analysis under EU and/or UK competition law.

Preliminary risk assessment

1.5 As outlined within **section 3** below, we consider there to be a risk that:

- (a) that each DNO undertaking implementing the CP could be considered to be an undertaking with a dominant position upon (at least) the upstream market for the use of its distribution system; and
- (b) the upstream input provided by each DNO undertaking would be regarded as indispensable to enable downstream competitors to operate on (at least) the downstream market(s) within the DNO's distribution supply area.

1.6 In addition, we are not aware that an analysis has been undertaken which addresses the AEC test in relation to the CP. In the absence of such an analysis, on the basis of the information reviewed at date, we consider there to be a risk that the CP, if implemented, could result in an abusive margin

¹ See, for example, Case AT.39523 *Slovak Telekom*, paragraph 828.

squeeze, giving rise to the risks associated with infringing Article 102 of the Treaty on the Functioning of the European Union ("**TFEU**"), and/or the Chapter II Prohibition, as outlined within **section 2** below.

- 1.7 Therefore, so as to seek to confirm insofar as possible that the CP would not result in an abusive margin squeeze, we believe that it would be prudent for consideration to be given to the application of the AEC test, including the extent to which this should be applied in the context of each vertically-integrated undertaking that may be considered to hold a dominant position on an upstream market.
- 1.8 In the event that there were material concerns that the CP could result in an abusive margin squeeze, it would be possible to consider whether the CP could be shown to be objectively necessary or indispensable to achieving efficiency gains, which would give rise to consumer benefits outweighing any adverse effects of the CP (without eliminating effective competition by removing all or most sources of actual or potential competition). However, in practice, this objective justification "defence" presents a high evidential threshold to be overcome.

2 LEGAL FRAMEWORK: MARGIN SQUEEZE AS AN ABUSE OF DOMINANCE UNDER ARTICLE 102 TFEU AND/OR THE CHAPTER II PROHIBITION

- 2.1 Article 102 TFEU prohibits any abuse by one or more undertakings of a dominant position within the internal market or a substantial part of it, insofar as this abuse may affect trade between EU Member States.
- 2.2 In relation to UK competition law, the so-called "**Chapter II Prohibition**"² is modelled closely upon Article 102 TFEU, save that the Chapter II Prohibition applies to any abuse that may affect trade within the UK.
- 2.3 For ease of reading, references within this advice to Article 102 TFEU are intended to include the Chapter II Prohibition, save where otherwise required by the context.
- 2.4 The consequences of infringing Article 102 TFEU are significant, and may include:
- (a) a financial penalty up to 10 per cent of group worldwide turnover being imposed upon the infringing undertaking;
 - (b) infringing arrangements being void and unenforceable;
 - (c) potential actions for injunctions and/or damages by third parties suffering harm or loss as a result of the infringement; and
 - (d) damage to brand and reputation.
- 2.5 In addition, within the UK, director disqualification orders of up to fifteen years may be sought against any directors of an undertaking that has been found to have infringed Article 102 TFEU.

² Competition Act 1998, section 18.

Concept of dominance under Article 102 TFEU

- 2.6 In relation to the issue of dominance, it settled case law that a dominant position under Article 102 TFEU relates to a position of economic strength held by an undertaking,³ which enables it to prevent effective competition from being maintained on the relevant market by giving it the power to "*behave to an appreciable extent independently of its competitors, its customers and, ultimately, consumers*".⁴
- 2.7 While the existence of a dominant position may be established by a combination of several factors, the CJEU has held that where an undertaking holds a market share of more than 50% over a long period, this in itself constitutes proof of a dominant position (save in exceptional circumstances).⁵

Margin squeeze as an abuse of dominance under Article 102 TFEU

- 2.8 In relation to the concept of a margin squeeze as an abuse of dominance, the "classic" example of a margin squeeze is where "*a dominant undertaking ... charge[s] a price for the product on the upstream market which, compared to the price it charges on the downstream market, does not allow even an equally efficient competitor to trade profitably in the downstream market on a lasting basis*".⁶
- 2.9 Having regard to the case law of the CJEU, while each case has been considered on its facts, the following criteria have been established in relation to assessing whether a margin squeeze infringes Article 102 TFEU:
- (a) the undertaking engaging in the margin squeeze must be dominant in the upstream market for the supply of services (the "**dominant undertaking**");⁷
 - (b) the dominant undertaking supplying services on the upstream market must be vertically-integrated (i.e. with the dominant undertaking supplying services to customers on the upstream market, and then competing with those customers on the downstream market) – however, there is no requirement for the undertaking to be dominant on the downstream market;
 - (c) the margin squeeze applied by the dominant undertaking must have an anti-competitive effect - it is sufficient to demonstrate that there is an anti-competitive effect which may potentially exclude or restrict downstream competitors, who are at least as efficient as the dominant undertaking;⁸
 - (d) any anti-competitive effect should be considered by reference to the indispensability of the dominant undertaking's upstream input to the ability to operate on the downstream market, as well as the intensity of the margin squeeze on the downstream competitors' margins, meaning that:

³ EU law provides that an "undertaking" encompasses any entity engaged in economic activities which relate to the offering of goods and/or services on a given market, irrespective of the legal status of the entity, or how it is financed (see, for example, Case C-41/90 *Klaus Höfner and Fritz Elser v Macrotron GmbH* ECLI:EU:C:1991:161, paragraph 21, and Joined cases C-180/98 to C-184/98 *Pavel Pavlov and Others v Stichting Pensioenfonds Medische Specialisten* ECLI:EU:C:2000:428, paragraph 75).

⁴ Case C-457/10 P *AstraZeneca v Commission* ECLI:EU:C:2012:770, paragraph 175.

⁵ *ibid*, paragraph 176.

⁶ Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, 2009 OJ C45/7 (24.2.2009), paragraph 80.

⁷ Case C-457/10 P *AstraZeneca*, paragraph 176.

⁸ See, Case C-52/09 *TeliaSonera Sverige* EU:C:2011:83, paragraph 64.

- (i) where the dominant undertaking's upstream input is indispensable to operating on the downstream market, and downstream competitors who are at least as efficient as the dominant undertaking are unable to operate other than at a loss, then an anti-competitive effect is probable;⁹
- (ii) where there is an indispensable upstream input, and downstream competitors who are at least as efficient as the dominant undertaking are able to operate profitably, an anti-competitive effect may still arise if the margin squeeze is likely to make it more difficult for downstream competitors to operate (e.g. as a result of reducing their profitability);¹⁰ and
- (iii) a margin squeeze may also have an anti-competitive effect in situations where:
 - (A) the upstream input is not indispensable – i.e. there is a dominant undertaking upstream but alternative sources of supply exist for the upstream input;¹¹
 - (B) neither the upstream price nor the downstream price are abusive in and of themselves – i.e. it is the "spread" between the upstream and the downstream prices that falls to be considered in the context of an alleged margin squeeze;¹² and
 - (C) the dominant undertaking has no ability to adjust its upstream price, provided it is able to adjust its downstream pricing.¹³

2.10 However, Article 102 TFEU does not apply to conduct that would otherwise be prohibited if the downstream undertaking can show the conduct in question to be objectively necessary or indispensable to achieving efficiency gains, which give rise to consumer benefits that outweigh the adverse negative effects of the conduct in question (without eliminating effective competition by removing all or most sources of actual or potential competition). In practice, this objective justification "defence" presents a high evidential threshold to overcome.

Assessment of a margin squeeze – the AEC test

- 2.11 The CJEU has held that, as a general rule, reference should be made to the costs of the dominant undertaking when considering the likely effect of a margin squeeze upon a downstream competitor that is at least as efficient as the dominant undertaking.¹⁴
- 2.12 In this context, the "as efficient competitor" test (the "**AEC test**") in essence uses the downstream arm of the dominant undertaking as a proxy for the "as efficient competitor", and seeks to ascertain whether that downstream arm of the dominant undertaking could operate profitably on the basis of:

⁹ See, Case C-52/09 *TeliaSonera Sverige*, paragraph 73.

¹⁰ *ibid*, paragraph 74.

¹¹ *ibid*, paragraph 72.

¹² Case T-336/07 *Telefónica v Commission* ECLI:EU:T:2012:172, paragraph 187.

¹³ Case T-271/03 *Deutsche Telekom v Commission* ECLI:EU:T:2008:101, paragraph 167.

¹⁴ Case C-52/09 *TeliaSonera Sverige*, paragraph 41. However, the AEC test may not be applicable to all cases; for example, the CJEU has indicated that it may be necessary to consider the prices and costs of competitors if the dominant undertaking's cost information is unavailable or unsuitable (see, for example, *ibid*, paragraph 45).

- (a) the downstream price charged by the downstream arm of the dominant undertaking to its end customers; and
- (b) the upstream price charged by the dominant undertaking to its downstream competitors.¹⁵

2.13 As such, an abusive margin squeeze may arise where the difference between (i) the downstream price charged by the dominant undertaking; and (ii) the upstream price that the dominant undertaking charges to its downstream competitors is either:

- (a) negative; or
- (b) positive, but insufficient to cover the downstream costs of the downstream arm of the dominant undertaking.

Assessment of downstream costs

- 2.14 Where a margin exists (i.e. the difference between the downstream and upstream prices is positive), the issue is whether the margin is sufficient to cover the dominant undertaking's downstream costs.
- 2.15 Necessarily, this assessment is highly fact-specific, and the CJEU has confirmed that "*all of the circumstances of each individual case should be taken into consideration*" when assessing whether a practice is abusive.¹⁶
- 2.16 However, by way of example, in cases in the telecommunications sector, the Commission has tended to consider the long run average incremental costs (the "**LRAIC**") of the downstream arm of the dominant undertaking for the purposes of assessing whether the "as efficient competitor" could operate profitably.
- 2.17 The Commission's guidance on its enforcement priorities in applying Article 102 TFEU to abusive exclusionary conduct also provides that the Commission will generally rely on the LRAIC of the downstream arm of the dominant undertaking as an appropriate benchmark for the costs of an "as efficient competitor".¹⁷
- 2.18 The Commission has previously defined the LRAIC as "*the average of all the variable and fixed costs that an undertaking incurs to produce a particular product or service*".¹⁸ The LRAIC includes all volume sensitive and fixed costs directly attributable to the production of the total volume of output of the product or service in question, and the increase in the common costs attributable to that production.
- 2.19 In the UK, Ofgem has previously adopted a similar approach to the assessment of costs for the purposes of assessing whether an "as efficient competitor" was able to operate profitably (albeit without expressly referring to LRAIC).

¹⁵ See, for example, Case AT.39523 *Slovak Telekom*, paragraph 828.

¹⁶ Case C-52/09 *TeliaSonera Sverige*, paragraph 113.

¹⁷ Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, OJ C 45, 24.2.2009, paragraph 80.

¹⁸ See, Case AT.39523 *Slovak Telekom*, paragraph 861.

2.20 In its assessment of connection charges to an electricity distribution network¹⁹ (the "**ENW connection charges decision**"), Ofgem considered "as efficient" costs in assessing whether there had been a margin squeeze.²⁰ Ofgem estimated these "as efficient" costs by:

- (a) estimating the total cost (including reasonably allocated fixed costs) of operating the downstream part of the relevant DNO which approximated to the business of the complainant IDNO;
- (b) dividing that total cost between customer types (e.g. domestic and non-domestic); and
- (c) calculating the average cost of providing downstream network services to customer types based on average electricity consumption characteristics.

2.21 In this context, the DNO's low voltage network was considered to be a reasonable proxy for the business of the complainant IDNO.

Regulatory oversight does not preclude a margin squeeze infringing Article 102 TFEU

2.22 For completeness, we note that the CJEU and the Commission have both acknowledged that regulatory bodies may consider issues of margin squeeze in the context of promoting competition on a given market, but have indicated that this analysis typically differs from the assessment of a margin squeeze under Article 102 TFEU.

2.23 For example, the Commission has stated that: "*while regulatory authorities usually take an ex-ante approach in order to promote competition on a given market, competition authorities intervene ex-post in case of an abuse of a dominant position*".²¹

2.24 As such, "*an ex-ante margin squeeze test carried out by a regulator would, in no circumstances, prejudice a finding in proceedings under [EU] competition law*",²² and the CJEU has held that, even if an ex-ante assessment has been carried out, a dominant undertaking would still be able to foresee its pricing policy would be anti-competitive under Article 102 TFEU, given that it has access to its actual costs.

3 PRELIMINARY RISK ASSESSMENT

3.1 Having regard to the Legal Framework, and the "arguments presented in response" (as set out within the DCP 266 Working Group request for a legal opinion dated 27 May 2019), we set out below an overview of our preliminary risk assessment in relation to the CP.

Dominance

3.2 We consider there is a risk that each ex-public electricity supply distribution network operator in implementing the CP would be considered to be an undertaking with (at least) a dominant position upon the upstream market for the use of its distribution system.

¹⁹ See, 76/12 *Decision to accept binding commitments from Electricity North West Limited over connection charges*, 24 May 2012, available at: <https://www.ofgem.gov.uk/ofgem-publications/114389>.

²⁰ ENW connection charges decision, paragraph 3.66.

²¹ Case AT.39523 *Slovak Telekom*, paragraph 855.

²² *ibid*, paragraph 856.

- 3.3 In this context, we note Ofgem's previously expressed view that, on the facts of the case, the DNO undertaking held a dominant position in the upstream market for connections of newly constructed electricity networks in its distribution supply area to the national grid, via its distribution system, and for the use of its distribution system in this respect (whereby the DNO's market share was effectively 100%).²³
- 3.4 In addition, while outside of the scope of our current assessment, we consider there to be a risk that the decisions of the DCP 266 Working Group in relation to the CP could:
- (a) be deemed to confer collective dominance upon the DNO undertakings; and/or
 - (b) be caught by Article 101(1) TFEU, which prohibits agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market.²⁴ This would give rise to the risks of infringement outlined within **section 2** above. However, insofar as this is outside of the scope of our current assessment, we have not sought to address this further at this time.

Margin squeeze as an abuse

- 3.5 We also consider that there is a risk that the upstream input provided by each DNO undertaking would be regarded as indispensable to enable downstream competitors to operate on the downstream market(s) within the DNO's distribution supply area, meaning that an anti-competitive effect is likely where downstream competitors (who are at least as efficient as the dominant undertaking) are unable to operate other than at a loss, or with reduced profitability.²⁵
- 3.6 From the information reviewed to date, we are not aware that an analysis has been undertaken which addresses the AEC test in relation to the CP. In the absence of such an analysis, we consider there to be a risk that the CP, if implemented, could result in an abusive margin squeeze, giving rise to the risks associated with infringing Article 102 TFEU, and/or the Chapter II Prohibition, as outlined within **section 2** above.
- 3.7 Therefore, so as to seek to confirm insofar as possible that the CP would not result in an abusive margin squeeze, we believe that it would be prudent for consideration to be given to the application of the AEC test, including the extent to which this should be applied in the context of each vertically-integrated undertaking that may be considered to hold a dominant position on an upstream market.

Objective justification

- 3.8 On the basis of the information reviewed to date, we are not aware of the extent to which the CP could be shown to be objectively necessary or indispensable to achieving efficiency gains, which would give rise to consumer benefits outweighing any adverse effects of the CP (without eliminating effective competition by removing all or most sources of actual or potential competition).

²³ See, by analogy, the ENW connection charges decision, paragraph 3.44

²⁴ In relation to UK competition law, the so-called "**Chapter I Prohibition**" set out within Chapter I of the Competition Act 1998 is modelled closely upon Article 101 TFEU, save that the Chapter I Prohibition applies to arrangements that may affect trade within the UK.

²⁵ Case C-52/09 *TeliaSonera Sverige*, paragraph 73.

3.9 In the event that there were material concerns that the CP could result in an abusive margin squeeze, it would be prudent to consider whether it may be possible to objectively justify the implementation of the CP by reference to the achievement of such efficiency gains. However, as noted above, in practice, this objective justification "defence" presents a high evidential threshold to be overcome.

We hope that this overview is of assistance, but please do let us know if there are you any questions or comments in relation to this.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Beighton', with a stylized flourish at the end.

Samuel Beighton

Partner

+44 (0)203 636 7972

samuel.beighton@gowlingwlg.com