

How to Calculate an Alleged Margin Squeeze

Economic analyses in margin squeeze cases



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Agenda

1. Textbook price-cost test
2. Price-cost tests in practice
3. Theories of harm
 - Based primarily on the Commission's telecom cases (Deutsche Telekom, Telefonica, Slovak Telekom) and DCCA's Coloplast case

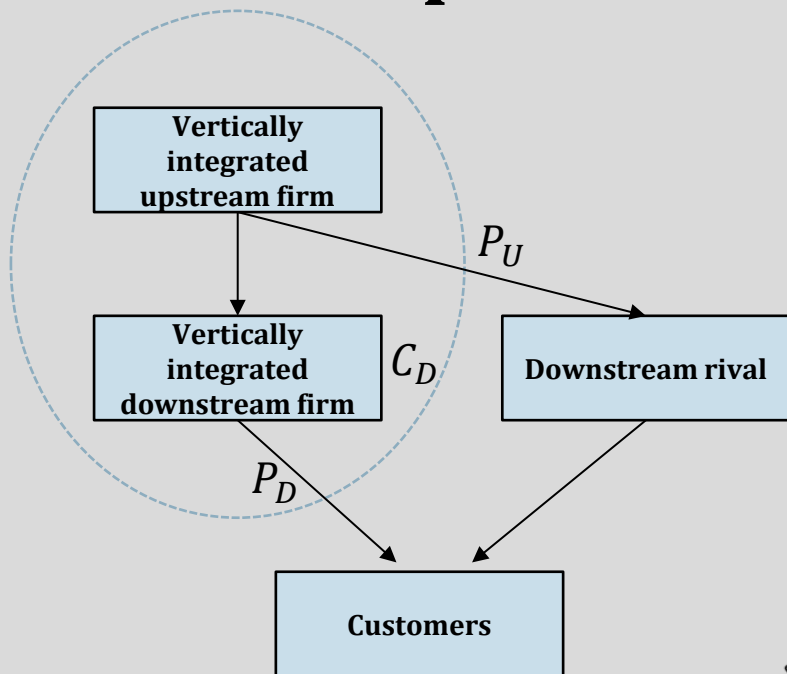
Analysis of abuse

- Two limbs of abuse test:
 1. Price-cost test
 2. Effects analysis (“capability of having exclusionary effects”)

Analysis of abuse

- Two limbs of abuse test:
 1. **Price-cost test**
 2. Effects analysis (“capability of having exclusionary effects”)

Textbook price-cost test



Price-cost test

$P_D < P_U \rightarrow$ Margin squeeze (and "probable" exclusionary effects)

$P_D < C_D + P_U + \pi^* \rightarrow$ Margin squeeze (and "probable" exclusionary effects?)



Interpretation

- Two possible interpretations of the price-cost test:
 1. Shows that an as efficient competitor cannot compete effectively (effects based)
 2. Shows that the dominant firm engages in profit sacrifice (P_U is an opportunity cost for the dominant firm)

Price-cost test in practice

- In practice there are lots of issues related to the price-cost test e.g.:
 - Cost benchmark
 - "Reasonable" margin
 - Periodization of revenues and costs

Relevant cost benchmark

- Costs based on the dominant company (AEC or EEC)
- Based on LRAIC
- Hard to do in practice and will generally rely on accounting costs
- Dealing with common costs

Reasonable margin

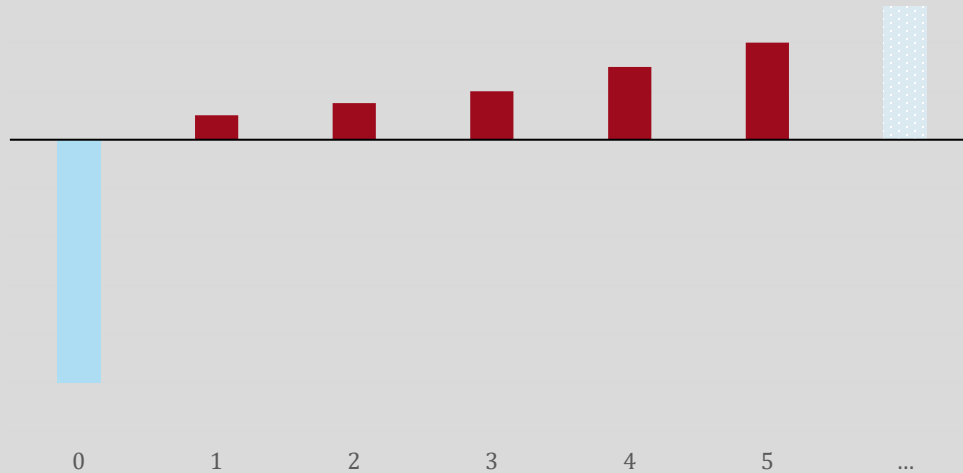
- Should the price just cover costs or should it allow for some profit margin?
- Not a lot of guidance in practice
- Close relation to the definition of "costs":
 - Cost of capital
 - Treatment of common costs

Periodization of revenues and costs

- Often companies incur upfront costs when acquiring new customers/entering a market
- Short-term loss, but potentially profitable long-term
- Two overall approaches:
 1. Period-by-period
 2. Multi-period approach (e.g. discounted cash flows)

Periodization of revenues and costs

Hypothetical
cash flows

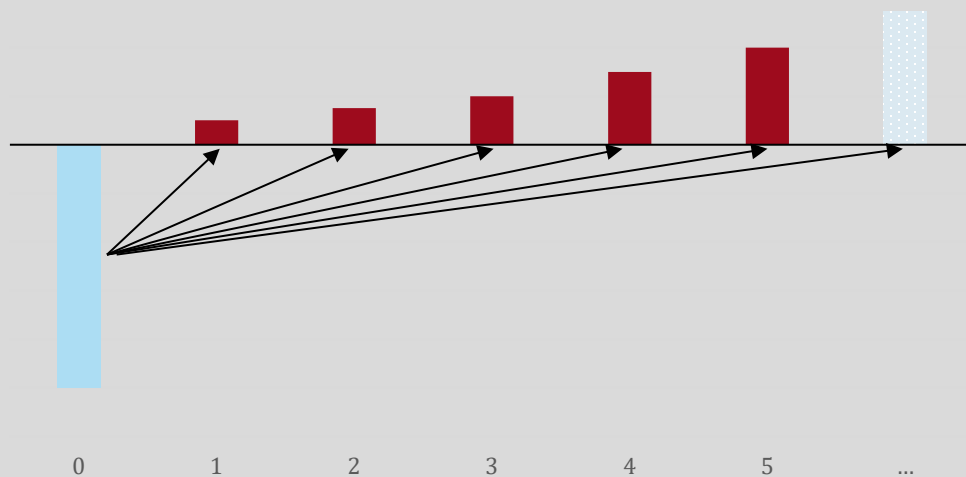


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Period-by-period

- The period-by-period compares revenues and costs for a given period (often a year)
- Costs have to be properly amortized
- Simpler approach requiring fewer assumption
- May lead to false positives, especially in growing industries

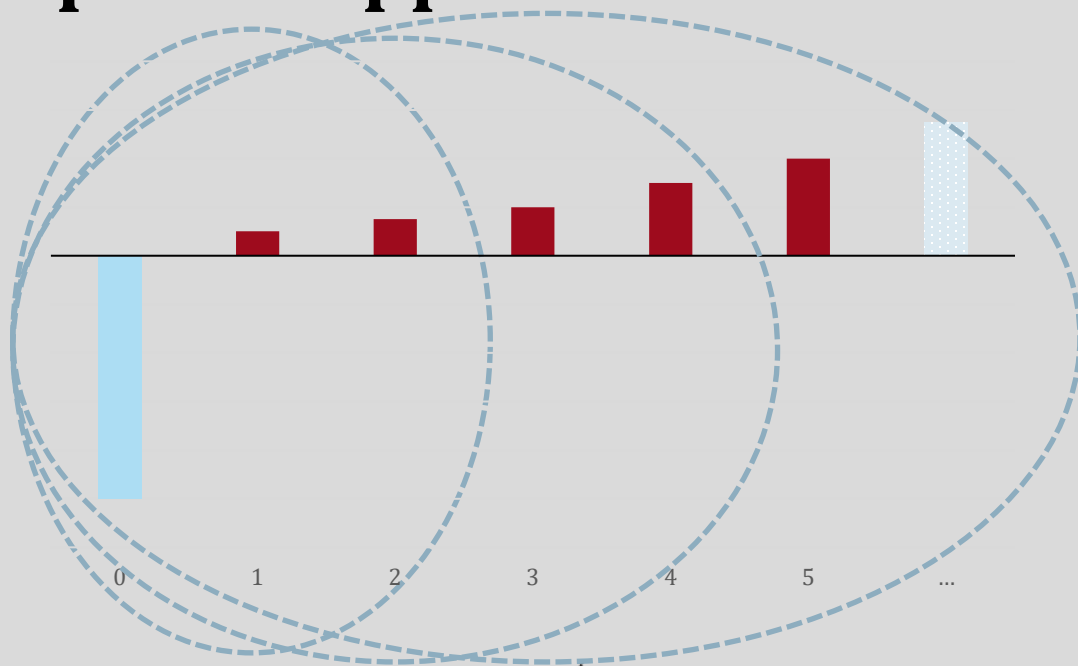
Period-by-period



Multi-period approach

- Evaluates revenues and costs over a longer period – e.g. discounted cash flows
- Allows future profits to cover earlier losses
- More complex and may rely on more assumptions
- Risk of "pricing in" the abuse
- Can be forward- og backward-looking

Multi-period approach



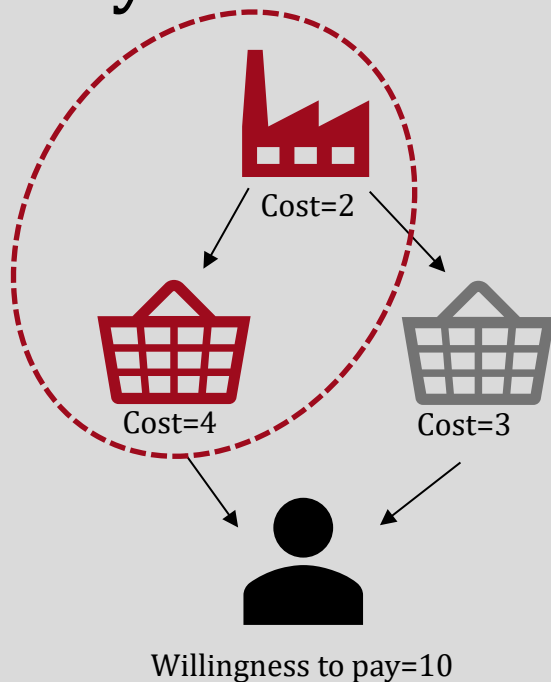
In case law

- Period-by-period generally used and accepted (telecom cases, Coloplast)
- Supplementary multi-period analysis in Telefonica, Slovak Telekom (growing markets, infrastructure costs)
- Generally looking at 3-5 years

Theory of harm – Chicago School critique

- At first glance, theory of harm may seem obvious
- Exploit upstream market power to increase market power in downstream market and make "double monopoly profits"
- However, this conflicts with the "one monopoly profit theorem" – if already monopolist in upstream market, there is no way of increasing profits further
- So any margin squeeze must have other explanations (e.g. efficiencies)

Theory of harm – Chicago School critique



No margin squeeze

Downstream rival will charge 10 to consumer. DomCo can sell the input at a price of 7:

$$\text{Total profit} = 7 - 2 = 5$$

With margin squeeze

DomCo monopolizes downstream market, but can still only charge a price of 10:

$$\text{Total profit} = 10 - 2 - 4 = 4$$

Theory of harm

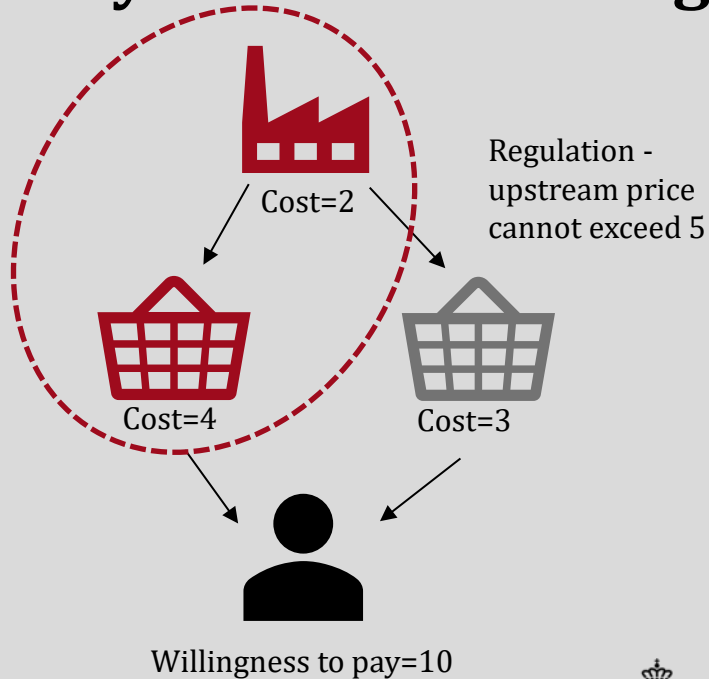
- Several papers find economically consistent theories of harm
- One commonality is *imperfect rent extraction* – the monopolist cannot fully exploit its upstream monopoly power
- Examples include:
 - Regulation
 - Competition in the upstream market (actual or potential)
 - Double marginalization or bargaining power downstream

*See e.g. Jullien, Rey & Saavedra (2014)
Gaudin & Mantzari (2016)

Regulated upstream prices

- If upstream prices are regulated, the dominant company cannot fully exploit its market power
- May have incentive to foreclose the downstream (unregulated) market
- Similar to classic predation
- Often the case with Telecoms (Deutsche Telekom, Telefonica, Slovak Telekom etc.)

Theory of harm – Chicago School critique



No margin squeeze

Downstream rival will charge 10 to consumer. DomCo can sell the input at a price of no more than 5:

$$\text{Total profit} = 5 - 2 = 3$$

With margin squeeze

DomCo monopolizes downstream market and charges a downstream price of 10:

$$\text{Total profit} = 10 - 2 - 4 = 4$$

Upstream competition

- Dominance in the upstream market does not necessarily mean monopoly
- Upstream competition, even fringe, erodes monopoly profits
- Downstream foreclosure can entrench upstream market power (i.e. Coloplast)
- Can also apply to potential competition – ladder of investment (i.e. Microsoft tying cases, potentially telecom cases)

Double marginalization/bargaining power

- Upstream firm wants high upstream prices and low downstream prices (and vice versa for downstream rival)
- May lead to double marginalization and/or downstream rival may have bargaining power
- DomCo can use downstream arm to push down downstream margins
- Not interested in actual foreclosure of AEC – exclusionary or exploitative?
- Risk of “umbrella effect”, but a margin squeeze may also deter entry and investments downstream





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