Less is more: *Senwes* and the concept of 'Margin Squeeze' in South African Competition Law

Tjarda van der Vijver*

First published by Juta Law in the South African Law Journal (2009, part 2, pp. 246-255).
For further information, please see http://www.jutalaw.co.za/

* *Dit artikel is geschreven op persoonlijke titel en geeft niet noodzakelijkerwijs de opvatting weer van de Nederlandse Mededingingsautoriteit.*

Overdrukkenreeks no. 2010/7

LESS IS MORE: *SENWES* AND THE CONCEPT OF 'MARGIN SQUEEZE' IN SOUTH AFRICAN COMPETITION LAW

LUKE KELLY
Teaching and Research Assistant, Department of Public Law, University of Cape Town

TJARDA VAN DER VIJVER
LLM student, King's College London

INTRODUCTION

On 3 February 2009 the South African Competition Tribunal (CT) handed down a judgment in *Competition Commission v Senwes Ltd* Case No 110/CR/Dec06 (*Senwes*). In its decision the CT recognized the notion of a 'margin squeeze' as a distinct abuse in terms of s 8(*c*) of the Competition Act 89 of 1998 (the Act). By doing so, the CT chose to follow the prevailing academic and judicial opinion in the United Kingdom and Europe with regard to margin squeeze. In contrast to this convergence of opinion, the United States Supreme Court recently delivered judgment in *Pacific Bell v linkLine Communications Inc* No 07-512 [2009] (*linkLine*) in which it unanimously rejected the idea that a margin squeeze is an abuse of a dominant position under s 2 of the Sherman Act (formally known as the Act of July 2, 1890, ch 647, 26 Stat 209, codified as amended at 15 USC § 1 through 15 USC § 7).

Our aim is to explore the controversial concept of a margin squeeze. The initial part of this note will examine the theoretical underpinnings of this abuse. Thereafter, the article will focus on the *Senwes* decision and will compare its findings with the position in the United Kingdom, the European Union and the United States.

THE ECONOMIC CONCEPT OF A 'MARGIN SQUEEZE'

The economic phenomenon of a margin squeeze can be likened to a constructive refusal to deal. It is a gradual commercial strangulation of a downstream competitor by a dominant, vertically integrated undertaking which controls access to an essential input and uses its upstream dominance to extinguish competition at the downstream level (see Richard Whish *Competition Law* 6 ed (2008) at 744–5). A margin squeeze typically arises in the following circumstances:

1. A vertically integrated firm with dominance upstream also operates in a competitive market downstream;
2. The dominant firm controls access to an essential input upon which downstream competitors rely to compete in the downstream market;
3. The dominant firm leverages its dominance upstream by raising the access price charged to downstream competitors.

The cumulative effect of these factors is that downstream competitors are unable to earn a sufficient margin to survive and are gradually squeezed out

of the market. The elimination of downstream competition inevitably leads to higher prices, lower output and the thwarting of any incentive to innovate.

Notwithstanding the above, margin squeeze is a controversial concept. As Wish op cit at 744–5 notes, as a general proposition (dominant) firms are under no obligation to deal with other companies, including their downstream competitors. Furthermore, even if such firms do supply a downstream competitor, why should they be forced to do so on favourable commercial terms? A system of competition law that forces dominant companies to deal favourably with downstream rivals runs the risk of subsidizing inefficient competitors to the detriment of consumer welfare. The doctrine could thus have a chilling effect on competition. Firms may well think twice about investing in a costly input if they may be forced to share it with others on advantageous terms.

The counter argument that is levelled at 'margin squeeze sceptics' is that inefficient entry does not need to occur as long as competition law authorities only consider margin squeeze complaints by downstream competitors that are at least 'as efficient' as the dominant undertaking's downstream business (Roger J van den Bergh and Peter D Camesaca *European Competition Law and Economics* 2 ed (2006) at 277). This would require a thorough analysis of the costs of the incumbent's downstream operations incurred specifically to the particular goods or services provided. The UK Office of Fair Trading (OFT) has published useful guidance on margin squeeze abuses: see 'Guidance on the Assessment of Conduct', OFT 441a (April 2004). The guidance note has been cited in two significant UK rulings: *Genzyme Ltd v Office of Fair Trading* [2004] CAT 4 and *Albion Water Ltd v Director General of Water Services* [2006] CAT 36.

At paragraph 6.2 of the guidance note the OFT explains that when testing for an unlawful margin squeeze, one should usually determine 'whether an efficient downstream competitor would earn (at least) a normal profit when paying input prices set by the vertically integrated undertaking'. The guidance note goes on to state that in practice this test entails assessing whether the dominant vertically integrated undertaking's downstream business would be able to earn a normal profit if it were charged the same access price. As a result, the 'as efficient' competitor test reduces the risk of sponsoring inefficient competition.

The greatest challenge for courts in applying the margin squeeze doctrine lies in enforcement. Competition authorities are arguably not well placed to decide what the right margin between wholesale and retail prices should be. This is compounded by the fact that prices are rarely stable. Indeed, the most fundamental principle of a market-based economy (of which competition law is merely a part) is that prices will fluctuate over time. What is a fair price today could be an unfair price next year and vice versa. It seems that sectoral regulators have an advantage here, since their expertise in a particular industry is likely to lead to more accurate approximations of an appropriate price. But even they may have trouble determining an appropriate price, as

this depends on complex and often arbitrary choices concerning cost allocation either to the wholesale or the retail level.

THE *SENWES* JUDGMENT: INTRODUCING MARGIN SQUEEZE INTO SOUTH AFRICAN LAW

In *Senwes* the CT followed prevailing judicial and academic opinion in relation to margin squeeze abuses in the UK and Europe (the position in these jurisdictions will be explained fully below). The CT said (para 117):

> '[T]he concept of a margin squeeze is something relatively new in the literature and case law of abuse of dominance. One of the reasons for its new found utility is that margin squeeze cases frequently arise in the context of recently liberalized markets. As we noted in the introduction this is a feature we see in the grain industry as well.'

The tribunal's remark on the utility of the doctrine in the context of former state monopolies is crucial to understanding its introduction into South African law in this particular matter. The facts of the case demonstrate how it provided the tribunal with an ideal opportunity to articulate the relevance of margin squeeze to South African competition law.

The facts

In December 2004 CTH Trading (Pty) Ltd (CTH), a company trading grain, referred a complaint to the Competition Commission (CC). For the purposes of this note the nub of the complaint was that Senwes Limited, a vertically integrated firm dominant in the market for the storage of grain, abused its dominance in this market (*Senwes* para 45). The alleged effect of this abuse was to exclude rivals downstream in the market for the trading of grain — a market in which Senwes operates, but is not dominant. The margin squeeze allegation was that Senwes's inflated grain storage tariffs rendered its downstream trading rivals unable to compete effectively in the market for trading grain (*Senwes* para 15).

The grain market in South Africa has distinct characteristics that are relevant to the case. The first is that the storage of grain in large silos was previously regulated by the (now repealed) Co-Operatives Act 91 of 1981. The Co-Operatives Act did not allow co-operatives to compete with each other. The effect of this state intervention was that in most provinces in South Africa all grain storage silos in a geographic area were owned by a single co-operative. Following the change of government in the 1990s the agricultural sector began to be liberalized. Senwes was sold to a group of shareholders and, as a result of the historical regulation of the market, found itself in a comfortable position where it controlled the lion's share of silos within prime agricultural territory (*Senwes* para 7). Senwes thus inherited a virtual monopoly position in respect of the storage of grain. The CT notes that, in addition to this, Senwes's position was further entrenched because construction and maintenance of silos is extremely costly, thereby deterring the entry of potential competitors (*Senwes* para 10).

The second important characteristic of the grain market is that grain can now be traded as a commodity on the South African Futures Exchange (Safex), which is now owned by the Johannesburg Stock Exchange (JSE). For grain to be traded on the Safex a 'silo certificate' must be issued by silos registered with the Safex. This certificate is the negotiable instrument for each trade and represents the holder's entitlement to a specified quantity of grain stored at a particular silo. The certificate will also reflect the grain storage costs levied by the silo that is payable by the holder of the certificate. Senwes is registered as a silo with Safex for the storage of grain. In addition to this, Senwes also has a downstream operation that trades grain on the Safex. Thus, the CT noted, Senwes is in a position where it controlled access to an indispensible input for the trading of grain, whilst operating its own trading arm in competition with traders who rely on access to the silos to trade (*Senwes* para 75).

One of the CC's principal allegations was that Senwes was abusing its dominant position by preventing rival traders from earning a viable margin on the trading of grain, given the price charged for long-term storage in Senwes's silos (*Senwes* para 118). The evidence led by the CC indicated that prospective traders face a necessary cost of storage. The longer the grain is stored, the higher the daily rate for storage becomes. The market price for grain traded on the Safex does not fully reflect these storage costs — a fact conceded by Senwes. Until 2003 Senwes had offered a capped storage tariff to traders and farmers who stored grain beyond a fixed number of days. In 2003, however, Senwes removed the benefit of this capped tariff from traders alone. The crux of the argument put forward by the CC, and accepted by the CT, was that the new price Senwes charged to rival downstream traders was such that if they had to store their grain beyond a hundred days, without the benefit of a capped storage price, they could not earn a viable margin on trades to compete in the market. In essence, Senwes's downstream trading division had the benefit of lower storage costs that were capped, meaning they could earn sufficient margin on trades to compete profitably. The CC put forward evidence from a Safex trader (Brisen (Pty) Ltd) that clearly established that rival downstream traders faced an unsustainable price-cost margin when faced with the storage costs levied by Senwes (*Senwes* para 129).

Application of the law

In applying the facts of the case to the law pertaining to margin squeeze abuses, the CT chose to accept the test articulated by Robert O'Donoghue and Jorge Atilano Padilla (*The Law and Economics of Article 82 EC* (2006) at 303). The United Kingdom Competition Appeal Tribunal (CAT) has adopted the same test in the *Genzyme* case (supra). The test is as follows:

1. The supplier of the input must be vertically integrated and dominant upstream;
2. Access to the input must be in some sense essential for downstream competition;

3. The prices charged by the dominant vertically integrated firm must render the activities of an efficient rival uneconomic;
4. There is no objective justification for the prices charged.

In the *Genzyme* case (supra) the CAT held that the first requirement did not mean that the vertically integrated firm must be dominant downstream as well. A finding of dominance upstream is sufficient (*Genzyme* at 534). The CT accepted this point at para 141 of the *Senwes* judgment. The CT notes that the first requirement of dominance had been unequivocally met — Senwes had even conceded its dominance in the grain storage market. Nor did Senwes contest the requirement that the input must be essential. The CT stated that it was established that the storage of grain in silos is an absolute must for traders to operate on the Safex (*Senwes* para 141). Lastly, the CT seemed to have been persuaded by the argument that traders were financially incapable of duplicating this costly input. The CT therefore concluded that access to the silos must be deemed 'essential' for the downstream market (ibid).

It is in respect of the third requirement that Senwes challenged the Commission. Senwes alleged that downstream traders were unable to make a profit not because of the access price being charged, but because they were inefficient (*Senwes* para 147). The CC however led the evidence of two of the largest global grain traders — Cargill and Dreyfus — that they were being squeezed as a result of Senwes's pricing behaviour. The CT found that on the balance of probability these firms were efficient. The global standing of these firms, in combination with the fact that they pursued innovation projects, persuaded the CT that they were at least as efficient as Senwes's downstream trading arm (*Senwes* para 148). Notwithstanding these submissions by the CC as to the efficiency of Senwes's competitors, Senwes also proposed an alternative formulation of the third requirement of the margin squeeze test. The alternative formulation was to assess whether Senwes's trading arm could profitably operate with the same input costs as rival traders. (*Senwes* para 149). The CT was unimpressed by Senwes's failure to adduce any evidence in this regard. Their failure meant that CT was left to presume that Senwes did not pass on the same costs to its own trading division (ibid).

The final leg of the test involves assessing whether the firm in question has an objective justification for its exclusionary conduct. The CT noted that this equated to the 'efficiency defence', which is contained in s 8(*c*) and (*d*) of the Act (*Senwes* para 150). In accordance with the construction of these subsections it was necessary for the CT first to find that the conduct amounts to an unlawful margin squeeze before then considering any efficiency defences. The CT found that Senwes had engaged in unlawful exclusionary behaviour that took the form of a margin squeeze (*Senwes* para 151). The CT then affirmed the principle that it is incumbent on the respondent to raise the defence of objective necessity. The CT stated that Senwes had not articulated a clear objective justification in the pleadings. Although counsel for Senwes had made reference to Ramsey pricing as one possible rationale for the

discriminatory pricing, counsel failed to argue how it would have a welfare enhancing effect. The CT refused to entertain this unsubstantiated justification (*Senwes* para 179).

COMPARATIVE APPROACHES TO MARGIN SQUEEZE

The European position on margin squeeze is roughly parallel to that of the UK. A recent case is *Deutsche Telekom* (Case T-271/03, *Deutsche Telekom AG v Commission*, ECR [2008] II-1747), where the European Court of First Instance (CFI) accepted the European Commission's definition of margin squeeze (para 107):

> '[T]here is an abusive margin squeeze if the difference between the retail prices charged by a dominant undertaking and the wholesale prices it charges its competitors for comparable services is negative, or insufficient to cover the product-specific costs to the dominant operator of providing its own retail services on the downstream market.'

This classification seems to be applied in other margin squeeze cases as well, and has also found its way into sector-specific regulation (see for example Directive 2002/19/EC, which applies to the telecommunications sector). Like the UK authorities, the European Commission clearly uses the 'as efficient' competitor test (see *Deutsche Telekom AG v Commission* (supra) para 199 and the Commission decision, *Deutsche Telekom AG*, OJ [2003] L 263/9 para 102). This approach is followed by the CFI.

Controversy exists, however, given that the margin squeeze formula has been based on form rather than effect. The case law suggests that harm can be inferred from the mere existence of a squeeze — which means that it is not necessary to prove any detrimental economic effects. The CFI in *Deutsche Telekom* (para 235) held that 'the [only] anti-competitive effect which the Commission is required to demonstrate relates to the possible barriers which the applicant's pricing practices could have created for the growth of competition in that market'.

The recent *Telefónica* decision shows, however, that the European Commission does not shy away from conducting a thorough analysis of the effects of the squeeze (see Commission decision, *Telefónica*, OJ [2008] C 83/5 at 543–618). This appears to show a willingness to put the margin squeeze more in line with the mainstream of European dominance cases, which are increasingly effects-based. On the whole it is likely that the margin squeeze concept will play a large role in European dominance cases in the years to come, especially in liberalized regulated network industries.

In the US, by contrast, the notion that a margin squeeze (or, in US terminology, 'price squeeze') is a negative factor has lost a good deal of ground the last few decades. In 1945, Judge Learned Hand accepted the concept of margin squeeze in *Alcoa* (*United States v Aluminum Co of Am* 148 F2d 416, 438, 2d Cir [1945]). This case suggested that conduct of a vertically integrated monopolist could be exclusionary if it left no 'fair' or 'adequate' margin between the wholesale price and the retail price. Times have changed

since then, however, and the current US approach seems markedly different from the ones adopted in the UK and the EU.

The *linkLine* (supra) judgment, delivered on 26 February 2009, shows that the US Supreme Court does not accept margin squeeze as a distinct abuse under s 2 of the Sherman Act. According to the court, the focus should be either on predation under the *Brooke Groupe* standard (see *Brooke Groupe v Brown & Williamson Tobacco* 125 L Ed 2d 168 [1993]), or on a refusal to supply, which falls under the *Aspen Skiing* criteria (see *Aspen Skiing Co v Aspen Highlands Skiing Corp* 472 US 585, 601 [1985]). The *linkLine* judgment seems largely to be inspired by the *Trinko* decision (*Verizon Communications Inc v Law Offices of Curtis v Trinko LLP* 540 US 398 [2004]), which already narrowed down liability based on *Aspen Skiing* (supra). Justice Roberts, who delivered the majority opinion, noted (para 9) that:

> '*Trinko* . . . makes it clear that if a firm has no antitrust duty to deal with its competitors at wholesale, it certainly has no duty to deal under terms and conditions that the rivals find commercially advantageous.'

Since the Sherman Act did not require the integrated firm to deal with their downstream competitors in the first place, there was no requirement to offer access at the wholesale prices the plaintiffs would have preferred (see paragraph 10 of the judgment) In addition, the court warned (para 11) that:

> 'recognizing a price-squeeze claim where the defendant's retail price remains above cost would invite the precise harm we sought to avoid in *Brooke Group*: Firms might raise their retail prices or refrain from aggressive price competition to avoid potential antitrust liability'.

In the court's view, recognizing the claim would be to 'amalgamate' a meritless wholesale pricing claim with a meritless retail pricing claim into a viable claim based on the relationship between the wholesale and retail prices (*linkLine* para 11). It is important to be aware that the Supreme Court believed that there was no antitrust duty to deal in *linkLine*, which makes it different from the *Senwes* case.

Central to the court's reasoning were a number of institutional concerns (*linkLine* paras 12–13). The court observed that rules in antitrust law must be clear and capable of being administered. The decision is also underpinned by the belief that courts in general are ill-suited to decide, let alone monitor, these types of cases. This argument seems to have been inspired by the fact that the dominant firm's conduct, including its pricing behaviour, was in fact regulated by the Federal Communications Commission (FCC). To be more specific, the incumbent (AT&T) was bound to a number of mandatory interconnection requirements as a condition resulting from a recent merger. The court appeared to suggest that the claimants should have asserted their rights at the FCC instead of the ordinary courts. Lastly, the courts believed that a rule mandating on 'fair' and 'reasonable' margins for competitors would be objectionable, since it left vertically integrated firms 'no safe harbor for their pricing practices' (*linkLine* paras 13–14).

The *linkLine* judgment is a thought-provoking perspective on margin squeeze, particularly when one considers the contrasting UK and EU

positions. We concede that there are unquestionably many differences in fact and law that would explain the variation in approaches. Nevertheless, the court's strong wording in *linkLine* has forcefully brought to an end the concept of margin squeeze in US antitrust law.

COMMENT

It is evident that there is much debate about the concept of margin squeeze. Although there seems to be a convergence of the UK, European, and now also the South African approaches, the US Supreme Court's position indicates that the discussion is far from settled.

Overall, we welcome the approach of the CT in *Senwes*. A margin squeeze can indeed lead to a significant lessening of competition. This will be the case especially where a dominant position was not achieved by superior skill and industry, but arose from a monopoly granted by government. Such (former) state intervention is often the source of these cases, which can be discerned in the UK, European and South African experiences to date. In these types of cases one should be careful about making the assumption that the incumbent firm has achieved its position by being more efficient than others. Critics may argue that the margin squeeze concept risks having a competition dampening effect. Why would we take up antitrust action against a firm that actually charges low prices? Such a stance ignores the fact that there is no such thing as a 'low price' in abstracto. Prices can only be deemed low with reference to a certain benchmark; for instance the costs incurred to produce the specific goods or services. The fact that the retail prices are only marginally above wholesale prices may indicate that there is fierce downstream competition, but may equally be a sign that the wholesale price is artificially inflated. Equally, we do not share the belief of some critics that the rule entails a great risk of sponsoring inefficient competitors. Competition authorities and courts should simply abide strictly by the 'as efficient' competitor test.

Apart from these general comments, there are a few other aspects worthy of note in the *Senwes* ruling. It is a positive development that the CT chose to deal with the foreclosure effect of the margin squeeze in great detail. It summed up the evidence of the CC and traders, noting in particular that the effect was clearly established in that one of the traders had ceased trading in the Senwes area of influence. This summation of the exclusionary effect in reaching a finding, in combination with the prior analysis of economic evidence of foreclosure of the 'as efficient' competitor, is significant. By doing so the CT chose to adopt a rigorous approach to the effects-based analysis in the context of a margin squeeze, eschewing the controversial European jurisprudence that allows for exclusionary effects to be inferred without a thorough economic analysis. It is hoped that, post-*Telefónica*, not only the European Commission but also the Community courts will fully endorse the effects-based approach.

Nevertheless, aspects of the *Senwes* ruling are controversial. The fact that the CT found Senwes's downstream competitors to be efficient by referring

to their 'global standing' and the fact that they have pursued innovation projects, does not represent sound economic reasoning. Such factors are often poor indications of efficiency. For instance, the fact that the big Detroit motor vehicle manufacturers all have considerable global standing (and undoubtedly have also engaged in many innovative projects) does not necessarily mean that those firms are efficient — as recent events have shown. It might have been better if the CT had kept its analysis 'pure', and merely focused on cost allocation matters and the actual effects of the alleged squeeze. It did so by raising the issue whether Senwes's trading arm could profitably operate with the same input costs as rival traders, in effect using an 'as efficient competitor' benchmark. Future litigants would be well advised to pay particular attention when compiling evidence to support the claim that its competitor is not 'as efficient' as its own downstream operations. Incumbents will prefer to use this standard, as it is more difficult for new entrants to meet than the 'reasonably efficient' benchmark.

In any margin squeeze case, possible alternatives must also be carefully analysed. If there is a reasonable alternative to access (meaning that the facility upstream is not essential), there can be no margin squeeze. Therefore the CT was right to consider the very high cost of constructing and maintaining new silos, leading to its conclusion that the existing silos were essential. However, it is submitted that there should have been some additional analysis by the tribunal. In particular, the CT should have analysed whether these costs were sunk (i e not retrievable if a firm decides to exit the market and sell its assets). If there is a lively market for the sale of such assets, the investment's size in absolute terms may not be overly relevant.

Lastly, one should be careful in attaching too much weight to the fact that Senwes removed the benefit of the capped tariff 'only' from downstream traders. Although this targeted behaviour could indeed be used as an addition proxy for the abusiveness of Senwes's conduct, such reasoning should not be taken too far. It would be perverse if dominant firms, in order to minimize the risk of antitrust liability, were given an incentive to raise prices across the board.

CONCLUSION

The *Senwes* judgment introduces the concept of margin squeeze in South African competition law. It is noteworthy that the CT seemed to have been particularly inspired by the UK and European approaches, while paying no attention to the differing US perspective. This schism seems to have been widened since the US Supreme Court's ruling in *linkLine* just two weeks after *Senwes*. In particular, the focus the CT gave to the economic effects of the conduct is welcomed. Rigorous economic analysis lies at the heart of sound competition law policy.

Interpreting a margin squeeze as a distinct abuse in terms of s 8(*c*) of the Act is a welcome development. It enables challenges to behaviour which may severely disrupt competition, and which would otherwise not be dealt

with. The doctrine's Achilles heel is the practical difficulties associated with enforcement. Courts and competition authorities are poorly placed to determine what a 'reasonable' margin for a downstream competitor ought to be. The risk of incorrectly calibrating the doctrine may lead to over-inclusive enforcement, which could have the effect of stifling investment.

However, the doctrine could be useful in the context of former state monopolies. Lowering the wholesale price to a level that reflects actual costs incurred could mean fiercer competition in the downstream level, and may ultimately increase consumer welfare. In that sense, less can truly be more.

PRE-INCORPORATION CONTRACTS: STATUTORY REFORM*

CAROLINE B NCUBE
Lecturer, University of Cape Town

INTRODUCTION

South African company law is undergoing a major two-stage overhaul that will culminate in the coming into force of the Companies Act 71 of 2008. The first stage was completed with the coming into force of the Corporate Laws Amendment Act 24 of 2006 on 14 December 2007 (Proc 47 GG 30594 of 14 December 2007) and the second stage will be completed with the coming into force of the Companies Act, 2008. This Act has been assented to by the President and was published for information on 9 April 2009 (GN 421 *GG* 32121 of 9 April 2009). Section 225 of this Act provides that it will come into force on a dated fixed by the President by proclamation in the Gazette, which may not be earlier than one year following the date of presidential assent. The earliest that the Act can come into force is therefore 9 April 2010. This note examines certain aspects of the regulation of pre-incorporation contracts contained in s 21 of the Companies Act, 2008, read with the definition of the term 'pre-incorporation contract' contained in s 1. The policy considerations underlying the current provision regulating this issue (s 35 of the Companies Act 61 of 1973) and some of the difficulties of interpretation that section has presented will be considered, with a view to evaluating whether there is any policy shift evident in s 21, and whether its provisions represent an improvement on its predecessor. The formulation of s 21 draws on the provisions of its counterpart in the recently amended New Zealand Companies Act, 1993, and so consideration will also be given to those provisions.

This note finds that although the imported provisions relating to pre-incorporation contracts are based on a more balanced and nuanced

* I am indebted to Professor Richard Jooste, the late Professor Michael Larkin and Graham Bradfield for their invaluable comments on earlier drafts of this note. The usual disclaimer applies.