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Belt and braces

ANALYSING MARGIN SQUEEZE ABUSES UNDER ARTICLE 82

Allegations of margin squeeze abuses by a vertically-integrated, dominant firm have been at the centre of a number of recent investigations by the European Commission (the Commission) and national competition authorities. In this bulletin, we examine the limitations of tests traditionally applied by competition authorities, and explain how wider economic analysis can help to enhance their decisions.

There has been a flurry of margin squeeze cases in recent years – mainly in telecoms – at the national and European level. This reflects enduring concerns that efforts to establish competitive telecoms markets will be undermined by the exclusionary conduct of incumbent operators. In a notable example, last year the Commission found that Telefónica had set its wholesale and retail prices in Spanish broadband markets at a level that foreclosed downstream rivals, and fined the company €152 million.[1] And in early 2008, the European Court of First Instance upheld the Commission's 2003 decision that Deutsche Telekom had engaged in an abusive margin squeeze in Germany's telecoms market.

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In these cases, the Commission used a particular form of profitability test, known as the margin squeeze imputation test. In this bulletin we explain the logic of the imputation test and discuss some of the conceptual and practical issues that arise in its application. We then discuss how economic analysis may provide valuable information that can be used to cross-check the test's reliability.

SQUEAKING PIPS

A margin squeeze arises when a vertically-integrated firm that is dominant in the supply of an important upstream input sets its prices at a level that precludes rival firms from competing profitably against the dominant firm's downstream division. This occurs if the margin between the price set by the dominant firm for its input, and the price obtained by its downstream rivals for their services, is squeezed so low that these rivals cannot recover the downstream costs of supply. Such a squeeze will marginalise them, possibly even forcing them to exit, and deter the entry of others – and such a reduction in downstream competition may expose customers to higher prices, lower quality and a lack of innovation.

In such cases (for example, against Telefónica), the competition authorities seek to determine whether an efficient downstream firm could trade profitably – that is to say, cover its costs of supply and earn a normal rate of return – on the basis of the input price charged by the dominant firm. The application of the traditional imputation test raises a number of important methodological issues.

Firstly, what standard of efficiency should be applied? In the Telefónica decision, as well as in the earlier Deutsche Telekom case, the EC argued that the test should be based on the costs of the dominant firm's own downstream division. This is the so-called "equally efficient competitor test", which effectively asks whether the dominant firm's downstream division would be able to compete profitably if it had to pay the input price charged to rivals. It has the important practical advantage that, since it is based on the dominant firm's own cost information, such a firm should be able to work out for itself whether its pricing policy infringes competition law. Under the alternative "reasonably efficient competitor test", self-assessment is harder.

Secondly, what cost measure should be used? In both the Telefónica and Deutsche Telekom cases, the EC relied on a long-run average incremental cost (LRAIC) measure. The LRAIC is defined to include all of the variable and fixed costs that are directly attributable to the activity concerned, but only those common costs that are incremental to it (i.e., would be avoided if it did not take place). In the Telefónica decision, the Commission explained its rationale by focusing attention on rivals' entry and exit decisions.

But what if the dominant firm benefits from economies of scale or scope, for example in relation to common costs such as customer billing systems? If rivals are unable to replicate these, then their costs are likely to exceed the LRAIC of the dominant firm's downstream division. This problem may, of course, be only temporary (with the gap diminishing as rivals become established) but meanwhile it is arguable that one should make an upward adjustment to the dominant firm's estimated LRAIC to reflect this cost asymmetry. Such an approach has indeed been advocated by the UK telecoms regulator in the past. But there are difficulties with such discretionary adjustments, and not just that they reduce legal certainty. The bigger the adjustment, the greater the chance of stimulating competition, but also the greater the risk of promoting entry by inefficient firms.

Thirdly, how should the profitability of the dominant firm's downstream division be measured? The period-by-period approach involves a matching of accounting costs and revenues in each period (for example, over a year) with investment expenditure amortised over time. The discounted cash flow (DCF) method, on the other hand, involves assessing the overall profitability of the downstream division over a period of several years in order to arrive at a net present value (NPV). In principle, of course, both should yield the same result. Competition authorities have tended to favour the period-by-period approach. However, in the Telefónica case the EC used both, and concluded that both indicated that a margin squeeze had taken place during 2001-06.

A RELIABLE TEST?

Even if these methodological questions can be settled satisfactorily, there remain good reasons to be cautious about a mechanical application of the standard imputation test. In particular, it is based on the assumption that rival firms will seek to replicate the dominant firm's downstream service; a highly stylised model of competition that may not be relevant. Rivals will often seek to differentiate themselves by, for example, offering a different mix of price and quality. If a rival is able to command a higher price, then calculations based on the dominant firm's input prices and downstream charges may be misleading.

Moreover, there may be significant uncertainty about the definition and measurement of costs, and the appropriate adjustments to historic accounting data, particularly in new markets, where suppliers must incur significant up-front costs. These difficulties were powerfully illustrated in the 2002 case involving UK broadcaster BSkyB, which alleged a margin squeeze in the supply of pay-TV channels against competing cable and terrestrial TV distributors. BSkyB argued that its own distribution business was profitable – at the wholesale prices charged to rival distributors NTL/Telewest and ITV Digital – and that it was therefore not squeezing its competitors. The case was fraught with difficulties in establishing the costs and revenues of BSkyB's downstream distribution business; in assessing BSkyB's investment in its satellite business; and in estimating BSkyB's future pay-TV (and other) revenues. In the end, the UK Office of Fair Trading found that BSkyB was dominant in the supply of premium pay-TV sports and movie channels, but did not find a margin squeeze.

THE ROLE OF ECONOMIC ANALYSIS

These practical issues are usually a focus of debate in margin squeeze cases. It may be possible to increase confidence in the results of the test by seeing if they remain unchanged across a range of plausible assumptions about the key factors. If, however, the results are sensitive to the ways in which costs and revenues are estimated, it may make sense to consider additional economic evidence. And significantly, in the Telefónica case, the EC did so even though the test results were robust and further analysis was not legally required.

An obvious starting point is to consider whether there is any concrete evidence that an alleged margin squeeze has resulted in market foreclosure, particularly if the abusive conduct is supposed to have continued for a significant period of time. Is there any evidence that downstream rivals have lost (or failed to gain) market share, been forced to exit, or deterred from entry? Was this caused by exclusionary conduct, or by other factors, such as unfavourable market conditions, or a failure to develop attractive offers for customers?

It is also useful to consider whether it would make commercial sense for the dominant firm to foreclose downstream rivals. After all, downstream firms are both rivals of the vertically-integrated firm's downstream division, and customers of its upstream division. Whether the gain from weaker downstream competition outweighs the loss of upstream profits is an empirical question that can be assessed using a similar framework used to assess input foreclosure in the EC non-horizontal merger guidelines.[2] A vertically-integrated dominant firm is more likely to have an incentive to exclude downstream rivals if:

- downstream rivals are unable to switch to alternative suppliers of the upstream input, and cannot readily self-supply;
- the margin earned by the dominant firm's downstream operation is large compared with the margin earned by its upstream operation;
- customers regard the products and services offered by the vertically-integrated firm as close substitutes to those of rivals, so that a significant proportion are willing to switch;
- the vertically-integrated firm has a significant downstream market share, so that a weakening of competition has a sizeable impact on profits;
- the vertically-integrated firm can readily expand downstream output; and
- foreclosed rivals imposed an important competitive constraint.

While the extent to which the Commission will pursue an economics-based approach to Article 82 cases in future remains uncertain, the Telefónica case clearly suggests a greater willingness by the Commission to extend its analysis.

SOURCES

1. *Case COMP/38.784 - Wanadoo España vs. Telefónica, 4 July 2007 (Telefónica has appealed to the Court of First Instance).*
2. *Guidelines on the assessment of non-horizontal mergers (DG Competition).*

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