Faculty of Law

Competition Law in the Telecoms Sector

Predatory pricing and margin squeeze

Bruxelles March 17, 2017

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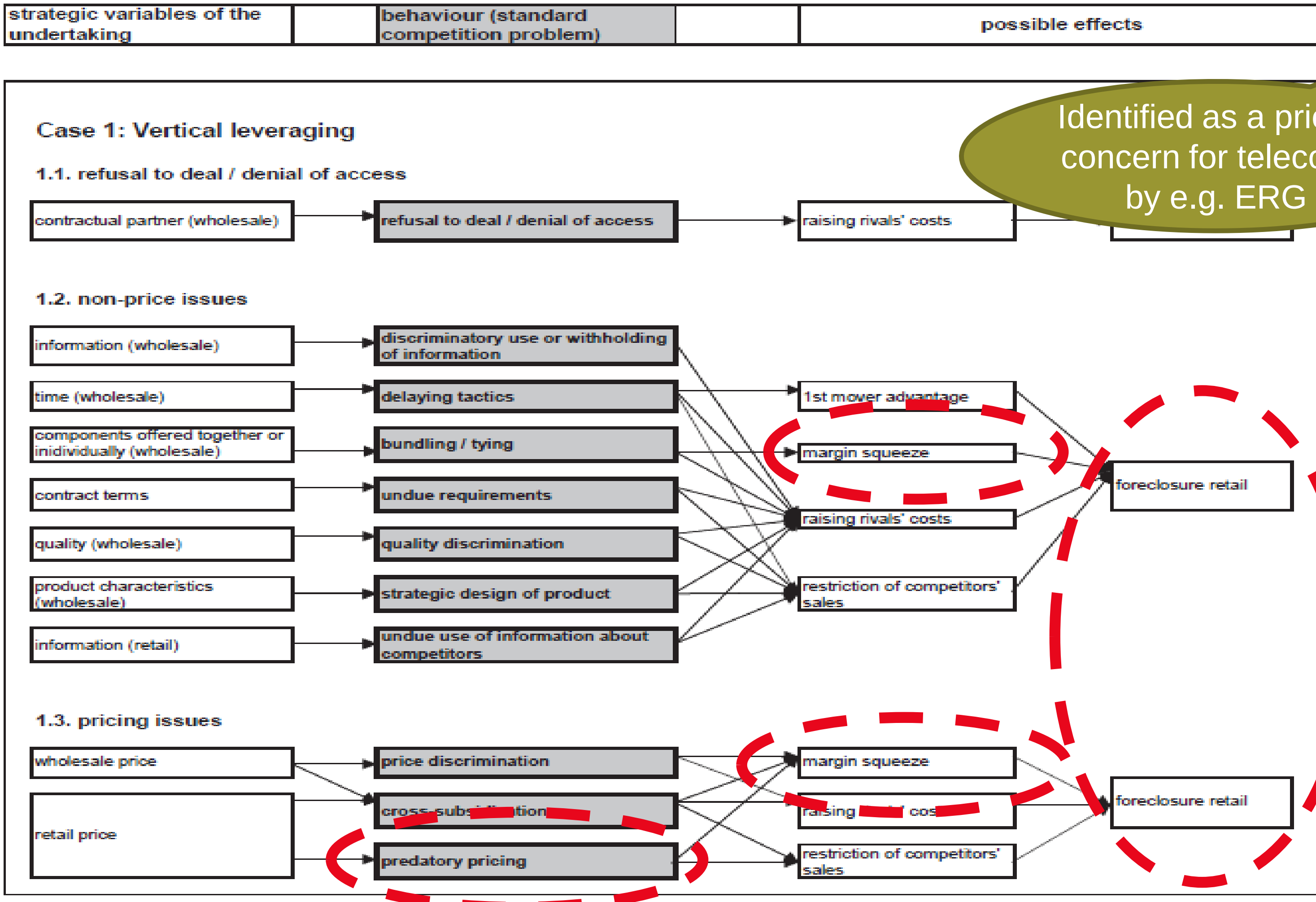
Some initial reservations

- I apologize for any misreadings of cases that you might have been involved in. Please feel free to “enlighten” me
- Case references can be found in a separate paper in my book (Between Regulation and Deregulation)

Predatory pricing and margin squeeze



Identified as a priority concern for telecoms by e.g. ERG

Revised ERG Common Position on the approach to Appropriate remedies in the ECNS regulatory framework, (ERG (06)33), 2006, pp. 39-40

Predatory pricing and margin squeeze

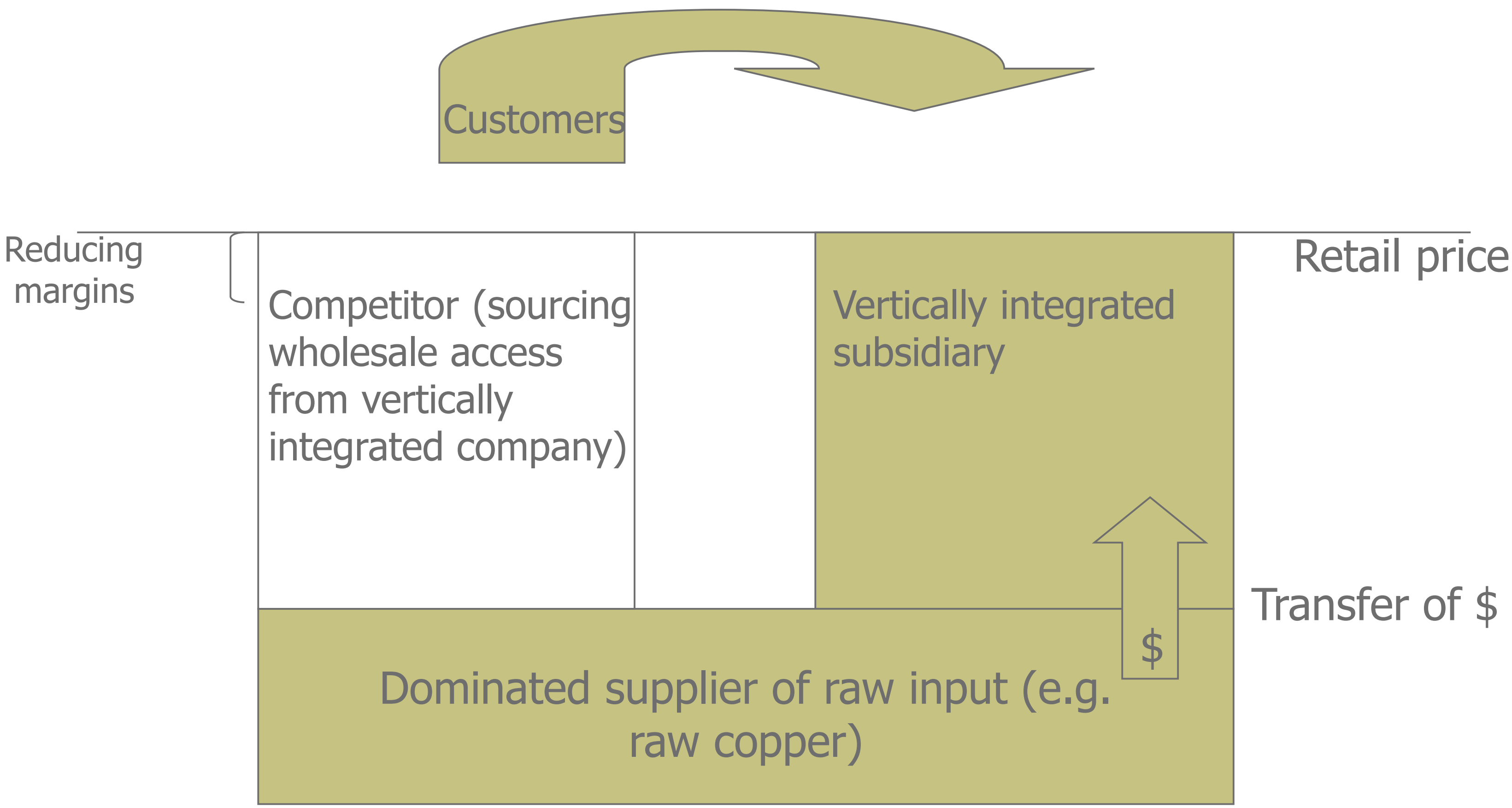
- Both predatory pricing and margin squeeze are **initiated for the purpose of foreclosing** competitors and competition
  - Predatory pricing is the **deliberate** short term **sacrifice of profit.** *Enforcement Paper* recital 63
  - Margin squeeze **increases competitors costs** or denies access to **customers.** *Telefonica* (GC) recital 279
- A shared element is (intentional) **pricing below costs** (or failure to cover these)
  - **own** in the case of predatory pricing,
  - **competitors** in the case of margin squeeze

Predatory pricing and margin squeeze

- Consequently, essential to **understanding costs** and cost concepts, and due to multiproduct offerings in telecom to secure correct **distributing of these.** Hence, **inflated** risk of:
  - **under-enforcement** if defined to narrow or too **few costs** are allotted to an activity
  - **over-enforcement** if reviewed under wide concept or if too many costs are allotted

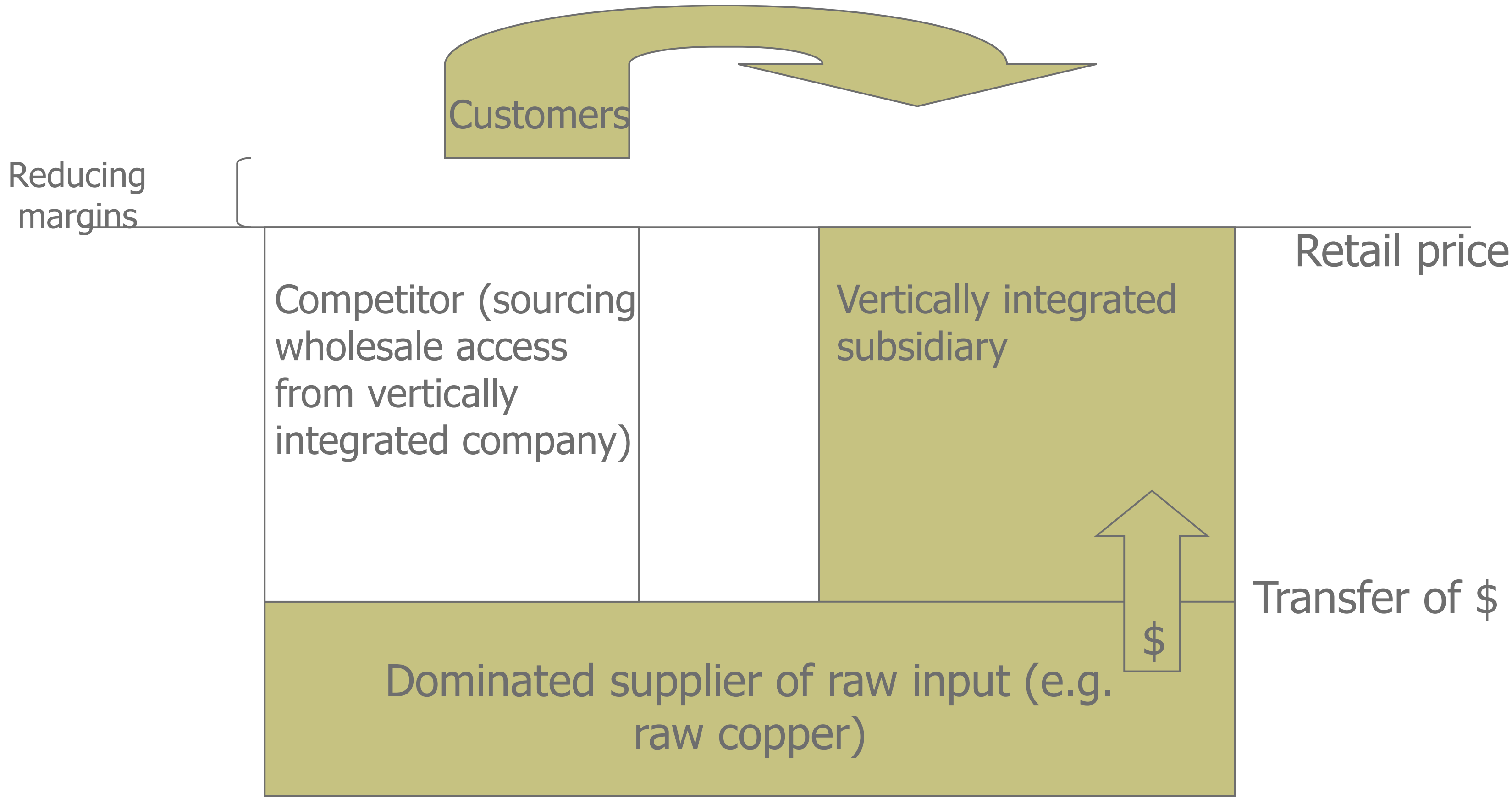
Predatory pricing

(the deliberate short term sacrifice of profit)



Margin squeeze

(increases competitors costs or denies access to customers)



Predatory pricing and margin squeeze

- In theory the concepts differ:
  - Predatory pricing involves an artificially **low retail price** which fails to cover costs. Calculated against a single retail product etc. broadband
  - Margin squeeze involves an artificially **low margin** caused by high wholesale prices. Calculated against a bundle of retail products etc. broadband, voice and tv.
- However, as wholesale prices are normally regulated the differences are more blurred in practice

Predatory pricing

Predatory pricing – the concept (theory)

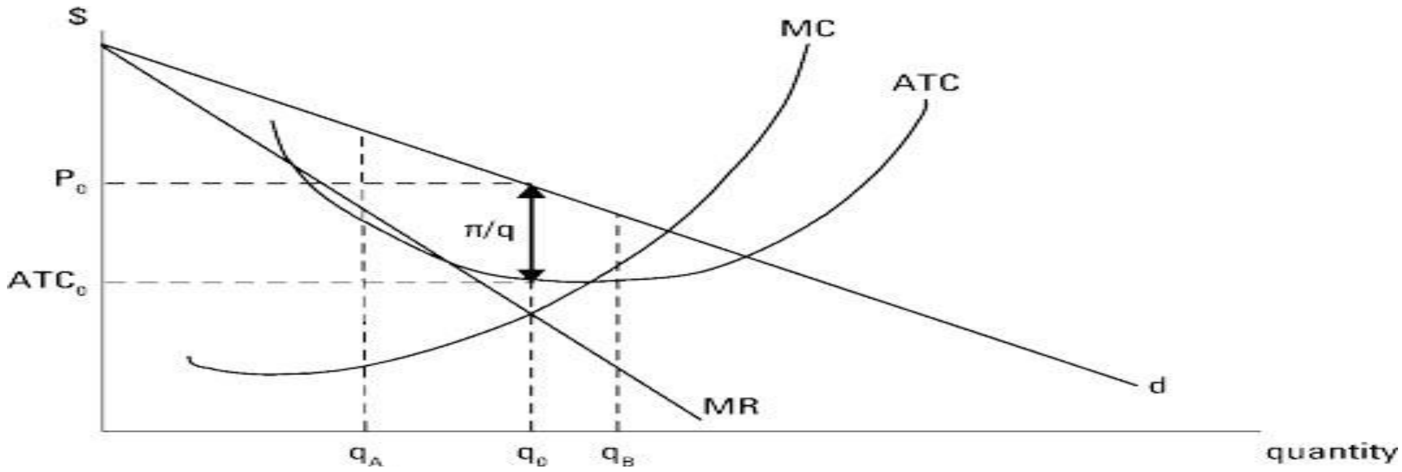
- Conceptually, predatory pricing involves **two phases;** where the retail price in the first fails to cover costs ("**sacrifice phase**") followed by a later phase with higher prices ("**recoupment phase**") most likely of an exploitive nature
- Actual **exclusion is not required. Disciplinary effects** are sufficient to defend the dominant undertaking's position or leverage this into new markets
- Losses are not required. Selective low prices (or threats) and **reduced profit (even failure to seek alternatives)** are sufficient to discipline competitors

Predatory pricing – somewhat risky

- Requires **deep pockets** unless confined to separate customers/markets. **Discrimination, cross subsidy and two** (closely linked) **markets** are therefore observed in cases
- Requires **entry barriers to provide for** recoupment and end-users are that are willing to pay the higher price in later phases
- True predation is thus **rare,** requiring a **monopoly** prone to overcharging. In telecom the infrastructure might provide for this

Early theory – *Areeda Turner* (1975)

- **US theory** identified the issue of predatory pricing **early on** (1975) including the need to separate ***pro-competitive* low prices** from those being *anti-competitive* in the longer perspective
- As prices **below MC** per se would be **loss-incurring** it was suggested to use MC to isolate true anti-competitive pricing and in the **absence** of reliable data on MC, the use of **AVC** instead.
- Hence, predatory pricing was coined as **non-recovery of costs** and a **US practice emerged** requiring **below MC pricing** and a **prospect of recoupment**



Early EU practice – *AKZO* (1985)

- *AKZO* translated **predatory pricing** into EU practice making it abusive to price **below AVC** and even when there is **intent** to price below ATC
- However *AKZO* **left some open issues**:
  - What to **include in AVC**? Lengthy discussions on the matter including the risk of an arbitrary allocation of shared and common costs
  - How to prove **predatory intent** and why should it matter?
  - Is recoupment a requirement in EU law (as in US)?
  - What to do with substantial **economic of scale and scope** providing for incumbent advantages making **AEC favorable** to these?
  - What if the incumbent possess an **established and written off infrastructure** benefitting from low AVC?
- Issue of relevance for telecom with **multiple products** offered over the same local loop; **cost structure** (perceived) **unusual** and an infrastructure less susceptive to competition

Mature EU practice – *Deutsche Post I* (2001)

- *Deutsche Post (I)* involved **two areas of activity;** one reserved area (letters) was available to **subsidies** at artificial low prices, and the other (parcels) through an **arbitrary** allocation of **costs**
  - Cost to be covered were the extra costs of providing a particular service, introducing the concept of IC to Article 102
  - Failing to cover these for a period of 5 years and in the absence of a reasonable explanation amounted to an abuse
- In *Discussion Paper* (2005) a **modified AKZO test** was tabled replacing AVC with LRAIC in sectors with special rights. Also suggested (in modified version) in the *Access Notice* (1998)
- *Enforcement Paper* (2009) suggest **AAC** to which *opportunity costs* can be added if profits are forfeited or sacrificed by not re-directing capital to other activities. Further, if involving new activities or production of **multiple** products **LRAIC** should be used

Mature EU practice – *Wanadoo* (2003)

- *Wanadoo* (France Telecom) involved a **pre-emptive foreclosure** of the French broadband market and offered four different tests
  1. recovery of the *full instantaneous costs* as recorded in the undertaking's accounts (traditional *AKZO*),
  2. recovery of *adjusted costs* by spreading certain costs over 48 months, identical to an average subscription; and
  3. recovery of the costs which the undertaking would have foreseen
  4. A discounted cash flow (DCF) test suggested by Wanadoo but rebutted by the Commission and not substantially applied
- In particular, the **recovery of *adjusted costs*** was favored by the Commission viewing initial **startup costs** as acquisition costs to be **written off** over the expected duration of the subscription
- Regarding recoupment it was **rebutted** as **irrelevant**. However, the Commission had noted how **later privatization** could secure this
- On intent, the use of **indirect evidence** were accepted including an internal memo' on "a strategy to become the preferred supplier"

Concluding on predatory pricing

- While defined as short term sacrifice of profit predatory pricing is tested against non-recovery of costs
- *Enforcement Paper* suggests **AAC/LRAIC**. *Wanadoo* suggests spreading **startup costs** over longer than one year. Unclear if this differs from *Enforcement Paper.* Both **improves** *AKZO* by allocating direct/indirect costs including common/shared costs
- Both *Wanadoo* and *Enforcement Paper* remain "**generous**" when it comes to **companies** offering **multiple products** and thus able to allocate common and shared costs somewhat arbitrarily
- Condemning **above ATC pricing** as suggested in *Discussion Paper* **would not be prudent** despite reducing the risk of under-enforcement. Nor would further use of **indirect evidence** of intent as in *Wanadoo*
- The risk of **under-enforcement** is more **prominent** than **over-enforcement**

Margin squeeze

Early EU practice – no separate infringement

Early practice viewed margin squeeze as **variations** of other forms of **abuse** (*NCC, British Sugar / Napier Brown* and *IPS)*:

•Dominance (most likely) required upstream and downstream

•Infringement required **a**) excessive wholesale prices **b**) predatory retail prices, or **c**) a refusal to supply; indicating margin squeeze as a *variation* rather than a separate abuse

•*IPS*: (most likely) irrelevant competitor has disadvantages of inferior cost structure; economies of scale and scope; or special requirements caused by production methods or business model

•Abuse to be assessed against the dominant undertaking's own costs, indicating an early AEC test without precluding the use of a *Reasonably Efficient Competitor (REC)* test as an alternative

Early practice is **aligned with theory** but might be prone to under-enforcement when rebutted as separate infringement

The first mature case - *Deutsche Telekom* (2003)

- *Deutsche Telekom* identified margin squeeze as a **separate** abuse involving an **insufficient margin** between upstream and downstream products. However, the Commission framed it as a form of excessive pricing
- **Irrelevant** that the **NRA** had **approved wholesale** prices. As these had exceeded retail prices, the abuse was obvious (to all but DT) making the issue of costs and income less imperative
  - DT's own cost was used (accepting the AEC test) including the regulated wholesale price with a surplus levied for opening a line divided with the average lifetime of subscription. Moreover, downstream cost was LRAIC based
  - Income, and product-specific costs, were more complex as several products were supplied over the same copper lines. However, dial up charges were not included despite the generated cash flow as sector regulation did not provide for this
  - These methods were decided *"…based on the principle that the established operator's tariff structure must enable competitors to compete with that operator effectively, and at least to replicate the established operator's customer pattern"*
- However, the Courts (in contrast to the Commission) required at least a **potential foreclosure risk**

The next mature case – *Telefonica* (2007)

- *Telefonica* also involved a **failure by the NRA** to secure a reasonabe margin raising competitors costs and restricting access to customers
- Applying the AEC test without precluding alternatives, it was accepted that Telefonica could **benefit** from any **economic of scale and scope**
    - Cost was calculated as LRAIC including variable, fixed and a portion of joint and common costs and initial one-time costs allotted over 3 years. Perhaps even elements of opportunity costs
    - The retail price was calculated as an average as broadband products came in different versions, while two different models were used for the purpose of estimating the generated profits (including the DCF method)
- **Separate testing** for each wholesale product to secure a reasonable margin for new entrants **regardless** of their **requested access level** and business model (not offering the full spectrums of products available from Local Loop) (the ladder of investment approach?)

➢ The applied principle appears **strongly inspired by sector regulation** (the ladder of investment approach), even ignoring earlier cases and rendered principles (e.g. how *IPS* ignored competitors extra costs)

And then came - *TeliaSonera*

- *TeliaSonera* confirmed **separate abuses** making it irrelevant that there was no obligation to supply in the first place. Moreover, neither upstream requirement of super dominance nor downstream dominance
- Assessment should be made against the dominant undertaking's own costs, (**AEC test**) unless practically impossible, providing for a *Reasonable Efficient Competitor* test as an secondary alternative
- Elements suggesting the **less efficient competitors' right** to enter and remain in the market and even that positive margins could be abusive (inconsistent with later *Post Denmark I*)

And – *KPN*, *Slovak Telekom* and *Deutsche Bahn I/II*

- *KPN* is most **notable for what** it's **not**. Opened as an excessive pricing case, changed into a margin squeeze case due to the vertical link to the parent company and closed without a decision
- *Slovak Telekom*, utilize *Telefonica*, but offers some novelties
  - The Commission feels compelled to **explain why NRA fails** to remedy margin squeeze noting different datasets and a more forward-looking perspective on market development with NRA
  - Different *voice products* are included in calculating competitors' potential revenue **had they** opted for a more **advanced access product** (full local loop unbundling) allowing further sales. Looks like reverting to *IPS* overturning *Telefonica* on extra due to different business models
  - References are made to an overall foreclosure plan and one-time costs allotted over 3 years
- *Deutsche Bahn I/II* is a settlement, but refers to a **malicious foreclosure plan**. Moreover, its noted how *Telefonica* differs from previous cases on the issues of allotting one-time costs

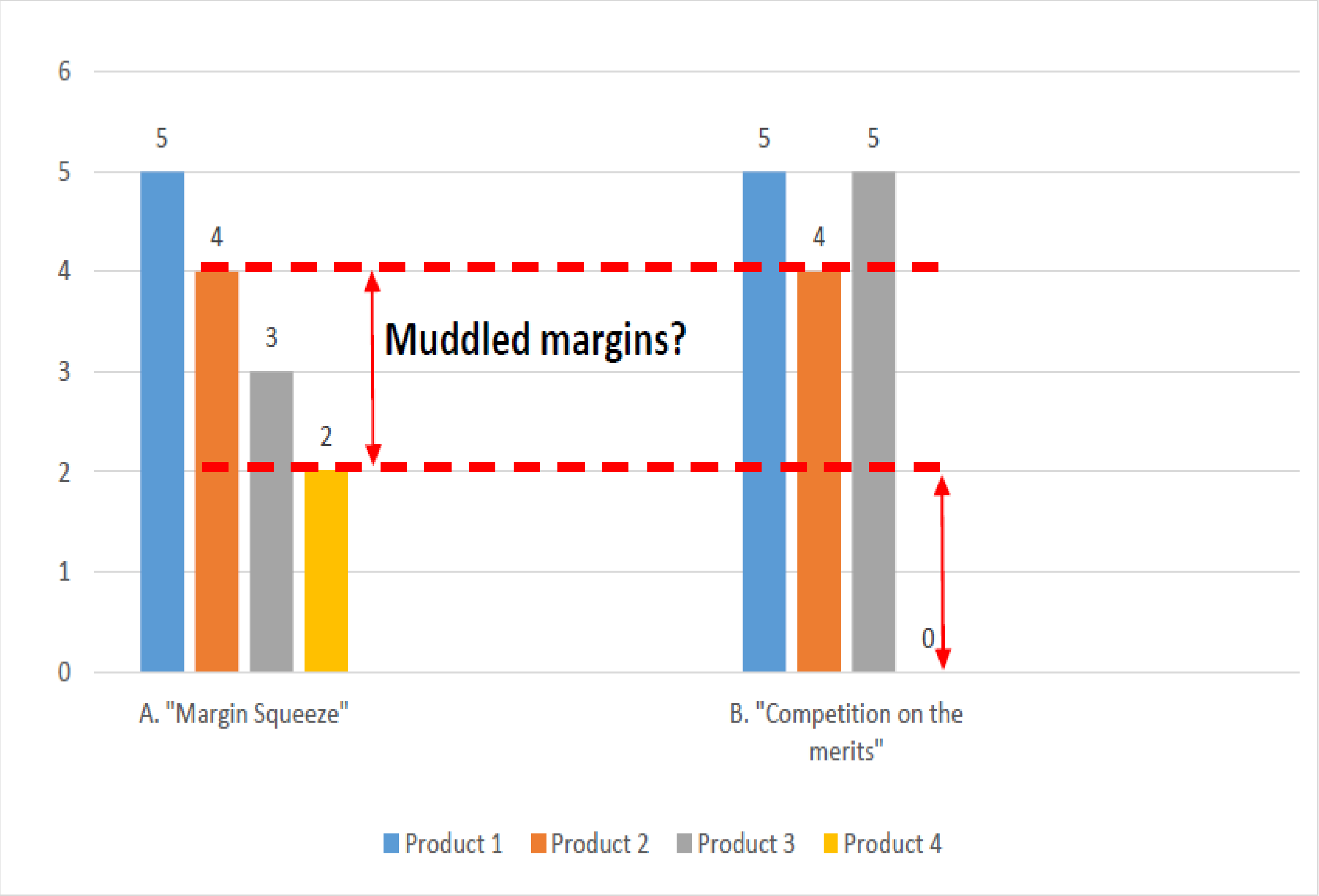
Mature EU practice – the good, the bad and the ugly

In mature practice, a separate category of exclusionary abuse emerges

- Competition law can serve to correct under-enforcement under sector regulation limiting the risk of regulatory capture and mistakes by NRA
- Assessment should be made against the dominant undertaking's own costs, (AEC test) unless practically impossible, providing for a REC test as a secondary alternative. Moreover, even positive margins could be abusive
- Costs to be calculated using LRAIC including a reasonable profit while income follows principles adopted under sector regulation. Embedded in this is a large number of decisions vesting the enforcer with a high level of discretion
- Testing at different (wholesale) access levels to secure beneficial market access for entrants (under regulatory objective). Moreover, the used principles (e.g. allotting one-time costs over a period of 3 years rather than the normal "lifetime span") differs from normally accepted standards
- Against *TeliaSonera* and *Telefonica,* a constructive refusal to supply doctrine has been identified subject to reduced protection. That renders less advantageous legal positions available to the "good" company, granting access void of any obligations compared to a "bad" company denying all

Mistakes might still be lurking

- If a company bundles products (quad play) giving some of them away for free (retail price 0), it might elude condemnation as margin squeeze, but still foreclose competitors
- Could be appraised as predatory pricing
- In *Telefonica* the Commission reserved the right to review margin on a product by product basis indicating that issue has not eluded observation



Concluding - Predatory pricing and margin squeeze

- ✓ Margin squeeze **legally** requires two separate markets vertically linked. Predatory pricing **de-facto** requires two (horizontal) markets of which one is susceptible to overcharging
- ✓ Both predatory pricing and margin squeeze are **initiated for the purpose of foreclosing** competitors and competition and involve an element of cross-subsidizing and malicious intent. However, there is only a legal requirement for the former
- ✓ Both **reviewed** under the **AEC test** allowing the dominant undertaking to benefit from economic of scale and scope
- ✓ Both **separate infringements** but margin squeeze might warrant prudent considerations and be prone to over-enforcement while predatory pricing would be more prone to under-enforcement
- ✓ Both involve **retail prices below costs**. Either the dominant undertaking's direct costs or the costs had the dominant undertaking been charged it's own wholesale prices

Questions

Feel free to contact me on cbe@jur.ku.dk