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Price Squeeze in Practice: Is it a Profitable Strategy?

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**21st European Regional ITS Conference
Copenhagen, 13-15 September 2010**

“Price Squeeze in Practice: Is it a profitable Strategy?”

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Introduction

Price squeeze has been an important issue in the telecommunications market as many incumbent operators have exercised this strategy in order to foreclose competitive entrants (see Polo (2008), Bravo and Siciliani (2007), Geradin and O'Donoghue (2005) and Crocioni and Veljanovski (2003)). The experience in all European cases considered in these studies shows the difficulty and complexity faced by regulators in implementing the imputation analysis. In the US some Courts have followed a different approach and some authors do not consider margin squeeze as an abuse by a dominant operator (see also Crandall and Singer (2007), Carlton (2008) and Sidak (2008)). The role of the present paper is to examine critically the decision of the Greek regulator on a price squeeze allegedly applied by the Greek incumbent OTE through its subsidiary OTEnet on the market for broadband services. In doing so, a number of important questions arise: Why the regulator used the REO test instead of the EEO test that has been applied in almost all antitrust cases? What is a legitimate or sufficient margin under which a margin squeeze occurs? Can a price squeeze lead to falling market shares for the incumbent and rising market shares for the entrants? Should the NCA intervene just after one year from the opening of the market? In this paper we attempt to answer the above questions and relate our results to the existing literature.

What is a margin squeeze?

In general, a margin squeeze exists when a dominant vertically integrated operator sets its wholesale and/or retail prices at levels that do not give a reasonable margin to its downstream competitors (see Crocioni and Veljanovski (2003)). According to the European Commission "Notice": *"A price squeeze exists if 'the dominant company's own downstream operations could not trade profitably on the basis of the upstream price charged to its competitors by the upstream operating arm of the dominant company'"*(see European Commission (2002b)). The crucial factor is the margin between the wholesale and retail price and not the absolute value of each one price. Below are some definitions of margin squeeze that the European Commission has applied in recent cases.

According to the European Commission Decision (2003b) in the Deutsche Telecom case: *"a margin squeeze exists if the charges to be paid to DT for wholesale access... are so expensive that competitors are forced to charge their end users prices higher than the prices DT charges its own end users for similar services. If wholesale charges are higher than retail charges, DT's competitors, even if they are at least as efficient as DT, can never make a profit..."*. Also according to the CFI (2008) in the same case: *"If the applicant's retail prices are lower than its wholesale charges, or if the spread between the applicant's wholesale and retail charges is **insufficient** to enable an equally efficient operator to cover its product-specific costs of supplying retail access services, a potential competitor who is just as efficient as the applicant would not be able to enter the retail access services market without suffering losses"*.

A similar approach has been taken by the Commission in the Telefonica case: *"... a margin squeeze is an **insufficient margin** between the price of an upstream product A and a price of a downstream product A+B of which A is a component...It is this **difference** and not the specific **level** of the retail and/or wholesale prices which is of importance in margin squeeze cases"*(see Commission Decision (2007)).

Here arises the crucial question. What insufficient means? If we adopt the definition provided by Carlton (2008) then an entrant will exit the downstream market as it will be not be able to compete profitably: *“A price squeeze occurs when a vertically integrated firm supplies an input to its downstream competitors at a price that generates a profit margin so low that the competitors exit the downstream market.”*

However, there remains the issue of timing. Given a margin squeeze, will the entrant continue operating with a loss and for how long? Or will the entrant exit the market once margin squeeze is applied by the incumbent? These questions are important since they are related to the opening of the downstream market to competitors and to whether the NCA should intervene promptly to allegations of margin squeeze or wait until the market matures as we will see below. Furthermore, as Sidak (2008) points out *“...attempting to implement regulatory policy through section 2 of the Sherman Act is ill-advised, both because it makes no sense for courts to re-regulate deregulated or lightly regulated industries, and because courts lack the institutional competence to implement regulation”*. On the other hand a crucial question arises: what should be the remedy? How the regulator should set the **“sufficient”** margin? In this paper we attempt to shed some light on these issues based on a recent margin squeeze case in the Greek telecoms market.

Recent margin squeeze cases in Telecommunications

Wanadoo Interactive has been fined for predatory pricing. France Telecom's Internet access subsidiary, Wanadoo, had charged predatory prices for its consumer broadband internet access services. The company was not vertically integrated so the case was one of predation instead of a margin squeeze (see Commission Decision (2003a). In 2003 Telecom Italia, the incumbent telecom operator, abused its dominant position in the market of fixed line telecom services. The practices involved a price squeeze in the procurement for the provision of telecom services to the Public Administration and the use of restrictive vertical contracts with the top business clients. The wholesale interconnection services were regulated, while retail prices to the Public Administration were unregulated and were determined through a procurement auction. Telecom Italia accused for bidding below costs (see Polo (2007)). The European Commission found that between September 2001 and December 2006, the margin between Telefonica's retail prices and the prices for wholesale broadband access at the regional and national level was insufficient to cover the costs of an operator as efficient as Telefonica (see European Commission (2007)). Furthermore, according to the European Commission, Deutsche Telekom from 1998 to 2001 has infringed Article 82 EC by operating abusive pricing in the market for direct access to its fixed telephone network in the form of a margin squeeze. DT was charging its competitors prices for regulated wholesale access that were higher than its prices for retail access to the local network (see European Commission (2003) and CFI (2008)).

In the present paper we are going to present a recent margin squeeze case applied by OTE, the Greek incumbent operator. OTE was fined €20m for abusing its dominant position by applying margin squeeze in the market for retail broadband access to the internet for a period of 14 months (December 2004 to March 2006). OTE buys from its subsidiary ISP OTEnet a fast internet product called Conn-X that sells to the final consumers. Margin squeeze was non-discriminatory (see ERG 2009).

In its decision, the Greek National Regulatory Authority (EETT) which also serves as the NCA for the telecoms market, examined three markets: 1) Market for wholesale broadband access through the DSL network of the incumbent, 2) Market for retail broadband access through xDSL and 3) Market for retail broadband access to the Internet through xDSL. The NRA decided that the squeeze took place in the second and third market which it considered as one market. The reason provided by the NRA is that all ISPs supply their services bundled i.e. access to retail broadband plus Internet services. The NRA didn't consider the LLU as a substitute for wholesale access through xDSL following the Commission's decision in Telefonica. The NRA has tried to establish dominance in this market even though views are conflicting on this issue as Crocioni and Veljanovsky (2003) and Motta and Streel (2003) regard that dominance is not necessary in the downstream market since the incumbent can leverage its power in the wholesale market to the market for fast internet, whereas Faull and Nikpay (1999) and Bellamy and Child (2001) regard that dominance is necessary in the downstream market. It must be noted that in all European cases referred above the incumbent was dominant in the downstream market.

In the 1st market the incumbent has a 100% market share as it is the incumbent operator that offers wholesale broadband access. In the second market the share of the incumbent falls in 2006 to 54.3% from 81.5% in 2006. On the other hand, for the same period the share of the alternative providers increases to 36.3% from 18.2%. In the second and third markets considered as one, the market share of the incumbent falls in the same period from 70.2% to 59.1% and those of the alternative providers increase from 29.8% to 40.87%. In the third market for internet services the incumbent through its subsidiary OTEnet has the second largest market share.

It is well known (see ERG (2009)) that there are two imputation tests that can be applied to test for a margin squeeze. The first test known as the Equally Efficient Operator (EEO) test is based on the costs of the incumbent: If $P_i - r \geq d_i$ then there is no margin squeeze, where r = wholesale price of essential input, P_i = downstream retail price of incumbent and d_i = downstream costs of incumbent. The second test known as the Reasonably Efficient Operator (REO) test is based on the costs of the entrant: If $P_i - r \geq d_e$ then there is no margin squeeze where r = wholesale price of essential input, P_i = downstream retail price of incumbent and d_e = downstream costs of entrant. In the present case the NRA used the second test, as the data provided by the incumbent were incomplete. However, it is known that (see ERG (2009)) the second test is used in mature markets where the aim of the regulator is to promote competition. That wasn't the case as the market was operating for 14 months and therefore, it wasn't mature.

The net present value calculated for a period of 5 years was -4.4m € or the cost of REO per customer is almost double its respective revenue per customer. Therefore, the NRA concluded that the incumbent had a set a margin squeeze that would put barriers to entry for alternative competitors. However, there are certain limitations to the REO approach:

- 1) It does not provide a clear way of calculating the downstream costs of a hypothetical "reasonably efficient" entrant.
- 2) It may attract a non-efficient entrant and may provide proof of margin squeeze when the non-efficient entrant has very high costs.
- 3) It is inconsistent with the first test, which in fact has always been used by the European Commission and the Community Courts.
- 4) It does not assist in cases where the incumbent operator is more efficient than the entrants or some of the entrants are more efficient than others.

- 5) It is in contrast with the rule of competition law. Margin squeeze is based on ex ante assumptions and forecasts rather than on ex post facts.

Furthermore, the incumbent states that there are several flaws in the analysis conducted by the NRA which alter significantly the NPV (see PwC (2007)):

- 1) The estimation of terminal or residual value of REO after 5 years, based on its liquidation value underestimates the NPV instead of using other methods for an ongoing firm (multiple approach or stable growth model approach).
- 2) If the estimation of terminal value is based on a perpetual stable growth model even at 0% growth rate, then the NPV becomes positive at 45m € (PwC).
- 3) Estimation of WACC based on pre-tax instead of after-tax revenues.
- 4) Higher wholesale broadband access prices than the ones proposed by the incumbent.
- 5) Other flaws of minor importance that produce a positive NPV of 5.8m €.

Apart from the limitations of the REO test, there remains the question of what is an insufficient margin. In the provision of wholesale broadband access the incumbent has set quantity discounts for the entrants as follows:

Initial margin = 15% between wholesale and retail prices of the incumbent, plus:

- 4% up to 985 ADSL lines
- 6% up to 3700 ADSL lines
- 8% up to 7500 ADSL lines
- 10% up to 15000 ADSL lines
- 12% up to 30000 ADSL lines
- 15% up to 100000 ADSL lines

The average estimated profit margin for the entrant is 27% in the 3rd year of operation. The largest ISP Forthnet has reached 103,000 customers in mid 2007 from 2,328 customers in February 2004, so that it could enjoy a margin of 30%. Is this margin insufficient? Certainly, the NRA should have waited before acting given the margins set by the incumbent. Furthermore, the NRA did not examine the dynamics of the market structure nor did it examine the evolution of market shares. According to the Commission's Guidance in applying Article 82 of the EC Treaty "*Competition is a dynamic process and an assessment of the competitive constraints on an undertaking cannot be based solely on the existing market situation....The market performance of the dominant undertaking and its competitors may provide direct evidence of anti-competitive foreclosure. For reasons attributable to the allegedly abusive conduct, the market share of the dominant undertaking may have risen or a decline in market share may have been slowed*".

Figure 1 shows the evolution of market shares of the ISP's for the relevant period. It is clear that the incumbent through its subsidiary OTEnet wasn't dominant in the market for internet services. Also, the market shares of the three largest operators were increasing in the investigating period, i.e. from 2004 until March 2006. Also, the retail price of the incumbent was higher than that of entrants for the relevant period. This implies that there was always room for the entrants to cut prices even further and get a higher market share.

ISP'S MARKET SHARES

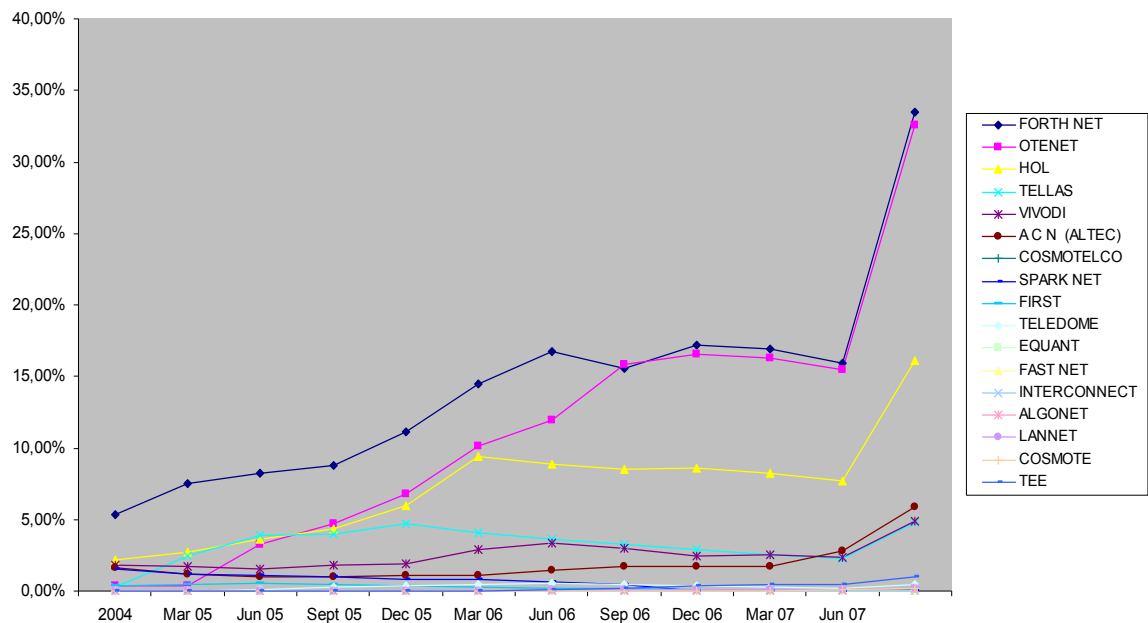


Figure 1

The Dutch Competition Authority (2001) has rejected margin squeeze allegations by a mobile service provider Talkline Benelux B.V. against the incumbent operator, KPN. Talkline argued that the prices applied by KPN make it impossible for an independent service provider to operate in a profitable manner). The Dutch Competition Authority rejected Talkline's complaint by reasoning that there was evidence that several independent service providers who relied on access to KPN's network, including Talkline, were able to operate on the market profitably. Unfortunately, in the present case, such a reasoning didn't apply despite the fact that alternative providers were steadily increasing their customer base as is evident from Figure 2.

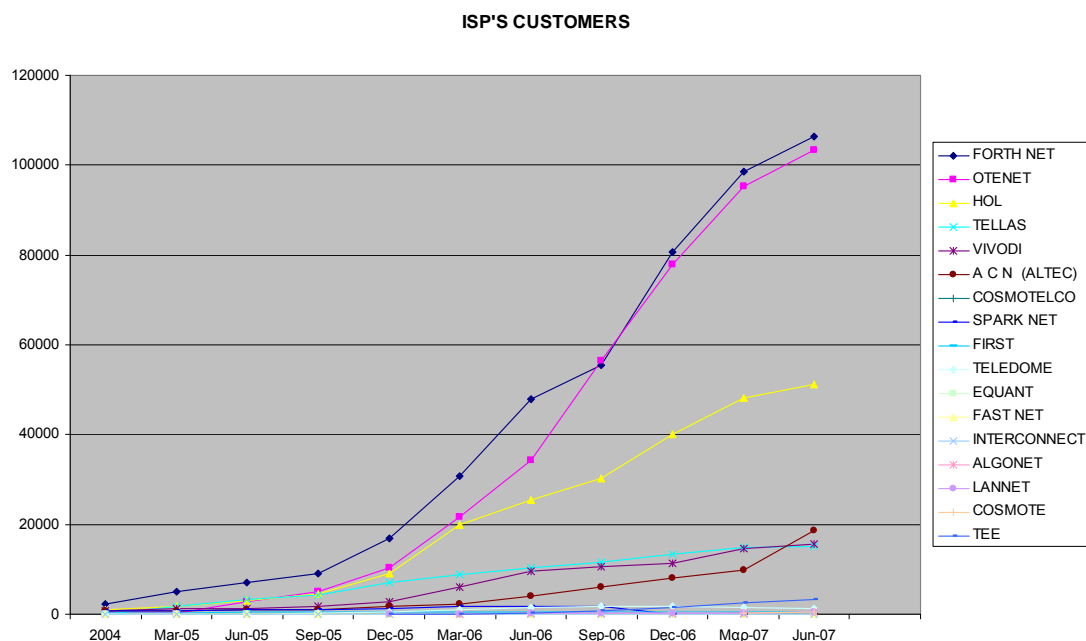


Figure 2

To intervene or to wait in an emerging market?

If the NCA waits until the market has matured and stabilised and meanwhile an abuse is being practiced, there is a danger of weakening or destroying of competition. On the other hand if the NCA intervenes at an early stage when the market has not yet developed it may not have sufficiently available accounting data upon which to base a finding using the EEO test. Furthermore, it may deter investment in the market and invite inefficient entry. The EC has chosen to act early in the Wanadoo case as “...nothing in Article 82 of the Treaty or in the Community case law provides for an exception to the application of the competition rules to sectors which are not yet fully mature or which are considered to be emerging markets” (see Commission Decision (2003a) paragraph 301).

However, the action was justified by the fact that the market shares of Wanadoo had reached 70%-80% in less than two years and were also steadily increasing. In the present case, in the market for fast internet services, the incumbent was not a dominant operator nor did it possess the largest market share as it was the second largest with a market share of 32.5%. Therefore, the investigation was conducted in a market where unlike other European cases, the incumbent wasn't dominant and the alleged margin squeeze didn't seem to affect the market as the number of subscribers and market shares of the four largest operators were steadily increasing.

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