

Price Squeezes

Some guidelines to identify an exclusionary abuse

Alleged price squeezes by dominant vertically integrated undertakings, once confined to raw material suppliers, have been given a new lease of life in the network industries, such as communications and electricity, where the EC Commission has recently launched several high profile investigations e.g. KPN, Wannadoo, and Deutsche Telekom. Here some guidelines for identifying an exclusionary price squeeze are discussed.

What is a price squeeze?

A price squeeze takes place when a vertically integrated undertaking, dominant in the provision of an “essential” upstream input, prices it, or the downstream service, to deny a “reasonably efficient” downstream rival a “normal” profit. For example, in *Napier Brown-British Sugar* the dominant supplier of raw brown sugar was alleged to have set a wholesale price for raw sugar at a level which was insufficient for its rivals to cover retail and processing costs given the retail price for processed sugar.

A dominant vertically integrated undertaking can subject its rivals to a price squeeze in one of three ways:

1. charging a higher input price than it charges itself;
2. raising the input price while leaving its retail price unchanged; or
3. reducing its retail price while perhaps also increasing the input price.

While some price squeezes may be discriminatory (1 above), others are not (2 & 3). What differentiates a price squeeze from other exclusionary pricing practices is its focus on the difference between the upstream and downstream price, not whether they are excessive or discriminatory *per se*.

Three necessary, but not sufficient, conditions must exist for a price squeeze to be feasible. First, the vertically integrated undertaking must be dominant in the provision of the upstream input. Second, the upstream input must be “essential” to compete downstream. Third, the inputs must be used in fixed proportions i.e. the downstream provider cannot substitute or vary the amount of the “essential” input in the production process.

Market Definition

As in most areas the assessment of a price squeeze must begin with a definition of the relevant market or market(s). This is necessary to determine whether the input is “essential” to compete downstream. Market definition is likely to give rise to some confusion. This is because there will be a tendency to begin by defining a wholesale or input market. The raw material or network will be seen as the relevant upstream market where the input supplier is dominant. The price squeeze will then be treated as a way to leverage this upstream dominance into the “related” downstream market. This approach is, however, is wrong.

The correct starting point is the downstream market in which the input is used. This is necessary to determine whether access to the input is “essential” to the downstream competitor, in the sense that it is an unavoidable input in order to compete downstream. As a number of Court decisions (*Bronner, Commercial Solvents*) have made clear in order to establish an Article 82 abuse it must be necessary to show that such abuse distorted competition in the downstream market. If the downstream competitor had access to other inputs which are substitutes, or the product it supplies or intends to supply downstream had close substitutes, then the attempted foreclosure through a margin squeeze, even if possible, will have a minimal effect on competition. For example, in *Napier Brown-British Sugar*, the EC Commission defined the downstream market as sugar, making raw brown sugar essential to compete downstream. However, had it defined the downstream market to include saccharin, aspartame and other sweeteners, raw sugar would not have been an essential input, and the basis for the alleged price squeeze would have not been present.

The Price Squeeze Test

Once an input has been determined to be “essential” and the upstream provider dominant, the next step is to assess whether an abuse has taken place. This requires an estimate of the margin between the wholesale and retail price, or prices where there are a number of inputs and/or prices (this is sometimes called an “imputation test”). The EC *Access Notice* suggests two ways of establishing when a margin does not constitute an abuse: (1) where

the downstream division of the dominant vertically integrated undertaking can “*trade profitably*”; or (2) where the difference between the retail and the input prices is sufficient for a “*reasonably efficient*” downstream competitor to make a “*normal*” profit. Test (1) attempts to assess a price squeeze indirectly by looking at whether the vertically integrated firm is cross-subsidising its downstream operations; while Test (2) focuses on the potential margins for a “*reasonably efficient*” provider.

Some Guidelines

To undertake these tests information is required on the inputs prices, downstream price, efficient downstream costs, and some idea of what a “normal” margin for a downstream competitor should be. This looks fairly straightforward, but in practice the calculations can get fairly complicated and confusing. Here are a few guidelines.

The relevant downstream price should be that charged by the vertically integrated undertaking. It is likely that the downstream rival will charge a lower price to give consumers an incentive to switch away from the vertically integrated operator. This price is, however, irrelevant as the margin is that potentially available to an efficient downstream rival.

Second, in many cases calculating the (gross) margin will simply involve subtracting the input price from the output price. In other cases it will not because of the complexity of tariff structures. This is common in many network industries where even homogeneous products (such as voice calls) have complex tariffs based on usage, type of call, time of day, together with fixed charges. Where this arises, representative price indices should be constructed for different customer profiles in order to determine margins. In particular, it will not be appropriate to compare only the wholesale and retail prices of only one or few components of the product (such as peak or off peak calls for a corporate service), since the purpose of the test is to determine whether a downstream rival can earn a sufficient margin taking all input and the retail prices into account.

Third, where a bundle of inputs is used to produce the downstream product(s), the price of the inputs should be the lowest available to a downstream competitor. This may be that of the input supplied by the vertically integrated undertaking. However, where the downstream competitor can compete by making use of cheaper inputs available from other suppliers these should be used.

Often the calculation of a gross margin will be sufficient together with some estimate of what is a reasonable gross margin in the sector or sectors with similar risks. However, it may be necessary (or useful) to estimate downstream costs so that these can be subtracted from the gross margin to determine whether normal profits exist on the downstream market. The estimation of these costs must be related to the purpose of the price squeeze test which is to detect exclusionary behaviour on the downstream market. It therefore should seek to subtract only those downstream costs which would be incurred by a “*reasonably efficient*” downstream firm. These could either be the avoidable costs of the vertically integrated undertaking supplying the input, or the incremental costs of the downstream rival, whichever is the lowest. However, it should be recognised that this may lead to relatively low estimates because the input supplier may benefit from economies of scope and scale not available to its rivals. Thus, while this would be correct, downstream rivals will regard this as unfair given their costs are likely to be unavoidably higher.

Conclusions

The concept of price squeeze is a simple concept gaining popularity, at least among the EC Commission and regulators. However, this disguises the complexities and controversies that will inevitably arise over market definition, and price and cost estimates.

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Case Associates assisted KPN in its response to the EC Commission Article 82 investigation on termination rates which alleged a price squeeze. An expanded version to this Casenote appears in the Journal of Network Industries 2003 (and can be downloaded from our website).

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