

## Testing for Price Squeezes

### A critical review of recent competition law decisions

To determine whether a price squeeze is anti-competitive, competition authorities use an imputation test. This calculates whether, using appropriate cost estimates and prices, a reasonable profit can be earned by an efficient downstream firm. Such a test was key to rejecting price squeeze allegations in *Freeserve* (Ofel), *BSkyB* and *Companies House* (OFT), while upholding them in *Deutsche Telekom* (EC Commission) and *Genzyme* (OFT/Competition Appeal Tribunal). Here the recent differences among these competition authorities are examined.

#### What is an imputation test?

An anticompetitive 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 (see previous *Casnote* on necessary conditions). An imputation test quantifies whether the downstream retail margin is reasonable.

The EC *Access Notice* sets out two imputation tests. A price squeeze exists if:

- Test 1: the downstream division of the vertically integrated firm could not trade profitably if it were to buy the upstream input at the price charged to downstream competitors; or
- Test 2: a reasonably efficient downstream operator paying the wholesale input price cannot earn a normal profit.

Both tests have four main elements: 1) the upstream (wholesale) price charged by the dominant upstream supplier for the essential input, 2) other costs of the downstream activity, 3) the downstream (retail) price, and 4) the 'normal' return to the downstream activity.

#### Test 1 or Test 2?

The critical difference between Tests 1 and 2 is whose downstream costs to use i.e. element 2) above. Test 1 uses the costs of the vertically integrated firm; Test 2 those of a 'reasonably efficient' downstream rival. In most cases the former's costs are known whereas those of the efficient downstream rival are not. For this reason competition authorities have usually opted for Test 1 (*Deutsche Telekom* and *BSkyB*). Furthermore and

critically, the OFT has stated that Test 1 is 'correct' because it allows the more efficient downstream rivals to benefit from their superior efficiency. If Test 2 was used, the efficiency differential would effectively be 'taxed' away by the dominant upstream firm. Or put differently, the more efficient the downstream rival, the more difficult it would be to establish a price squeeze.

In *Freeserve* Ofel also endorsed Test 1 and that the appropriate downstream costs were those of British Telecom (BT). It claimed that these were likely to be lower than those of its downstream rivals, although no evidence was given. It further claimed that the use of the rival's higher costs (Test 2) would only be appropriate if it was under a regulatory duty to promote competition, but not under competition law. However, Ofel did not use BT's existing downstream costs but estimates of its Long Run Average Incremental Costs (LRAIC). That is forward-looking estimates of the costs that would have been incurred by an 'efficient' or 'reasonably efficient' operator in BT's position. In doing this it purportedly used the lowest efficient downstream costs irrespective of whether these were the entrant's or that of the vertically integrated firm. The use of 'efficient' downstream costs removes the principal distinction between Tests 1 and 2. *Freeserve* has appealed Ofel's decision for using the (lower) LRAIC estimates rather than BT's actual costs.

Test 1 will, however, be inappropriate in some cases. For example, where the vertically integrated firm incurs additional costs in supplying its competitors. In this case the additional costs should be included. Furthermore, the rival's downstream price should be used for Tests 1 and 2 where the downstream rival faces a less elastic demand because of product differentiation, and can charge a higher price than the vertically integrated firm. In this case, the rival's downstream price should be used.

#### Incremental costs or FAC?

In principle an imputation test should use incremental or avoidable costs, and exclude all common and joint (whether fixed or variable) downstream costs. Under Test 1 avoidable costs refer to those costs that would be avoided if the vertically integrated firm withdraws from the downstream market, while continuing to supply the essential input. Conversely, incremental costs are the costs that it has to incur to supply the downstream market. The two are often identical, unless there are costs that are specific to exit rather than entry decisions

or vice versa. The use of incremental or avoidable costs ensures that a vertically integrated firm is not penalised if it is more efficient, say because of economies of scope and vertical integration.

While Oftel (*Freeserve*) and the EC Commission (*Deutsche Telekom*) have used incremental costs, the OFT in *BSkyB* and *Companies House* did not. In *BSkyB* the OFT allocated all costs across all activities (pay TV, PPV etc) and along the vertical supply chain using a Fully Allocated Costs (FAC) model. The allocation of these costs is both arbitrary, as is any cost allocation based on assumption about 'cost drivers'. The inclusion of these common and joint costs to *BSkyB*'s downstream activity increases its downstream costs, and with this the likelihood of incorrectly identifying a price squeeze.

### Emerging Markets

A number of recent price squeeze cases have concerned products/services in the early phases of the product cycle, or in dynamic markets where there is continuous product innovation, e.g. pay TV and broadband Internet access. Emerging markets pose two difficulties for imputation tests - 1) how to deal with the uncertainty of a forward-looking assessment; and 2) how to deal with the fixed (investment) costs. We focus on the second of these difficulties.

Emerging markets have initial heavy investment, marketing, and launch costs. These generate losses in the early years of the product cycle, which if the product is successful are recouped in later years. Clearly these early losses are not alone evidence of a price squeeze attributable to anti-competitive actions.

Competition authorities have adopted different approaches to the treatment of these fixed costs. In *BSkyB* a FAC model was used to amortise these fixed costs over the (accounting) life of the product. The OFT claimed this allowed it to identify if, and in which years, *BSkyB*'s downstream division earned negative margins. In contrast, Oftel adopted a Discounted Cash Flow (DCF) approach using the projected revenues and incremental costs of *BT*'s downstream division in its original business plan. A negative Net Present Value (NPV) provided evidence of a price squeeze.

Neither method is satisfactory since both include downstream fixed costs. Notwithstanding this, Oftel's DCF incremental costs approach makes more sense. Oftel's approach only includes fixed costs specific to the

downstream activity, thereby excluding all fixed costs that are common to other products or the upstream division. Since the former are likely to be small, this approach will not introduce a significant bias into the imputation test.

### Is the Imputation Test Enough?

An imputation test alone cannot identify whether a price squeeze is anticompetitive. It is the final step in an overall competition assessment which includes identifying whether the necessary conditions for leveraging market power exist. However, in some cases it has been used as the basis for the finding that there has been a price squeeze.

The pitfalls of the sole use of an imputation test to identify a price squeeze are shown by *Deutsche Telekom*. There the EC Commission relied solely on the results of an imputation test to hold that *DT* had operated a predatory price squeeze by reducing its retail price allegedly designed to squeeze its rivals out of the German market for local network access. This conclusion appears implausible since *DT*'s unbundled local loop (ULL) prices were set at cost by the German telecoms regulator (RegTP), and its retail prices regulated within a broad price cap. The existence of such wholesale and retail price regulation should have alerted the EC Commission that a price squeeze was unlikely in the circumstances especially since *DT* would find it very difficult to recoup its initial losses later by raising its retail prices.

### Conclusion

The purpose of an imputation test is straightforward – to provide empirical evidence that the retail margin of an efficient downstream rival is unreasonably low. However, its proper application is more complicated, as has been shown by the different approaches which competition authorities have recently adopted.

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*Case Associates has provided assistance in a number of recent competition cases alleging a price squeeze, and has advised on imputation tests. Past publications by Case on price squeezes and related topics can be downloaded at [www.casecon.com](http://www.casecon.com)*

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