

# Lecture 5: Predatory pricing & Margin squeeze

## EC307 Competition Policy

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# Part 1

## Predatory Pricing

# Predatory conduct and competition policy

- A situation where a firm lowers price, possibly below cost, having the effect of driving rivals from the market
- Once rivals are excluded, the firm is able to increase prices and apply market power to recoup earlier losses
- When applied by a dominant firm, predatory conduct has the effect, if successful, of strengthening the position of the firm
- If competitive threats of entry are diminished as a result of predatory conduct, this will likely adversely affect consumer choice and quality
- The challenge for competition authorities is to identify where *desirable* price competition ends and *undesirable* predatory pricing begins
- False positives (wrongfully identifying price competition as predation) and false negatives (wrongly failing to identify predatory conduct)

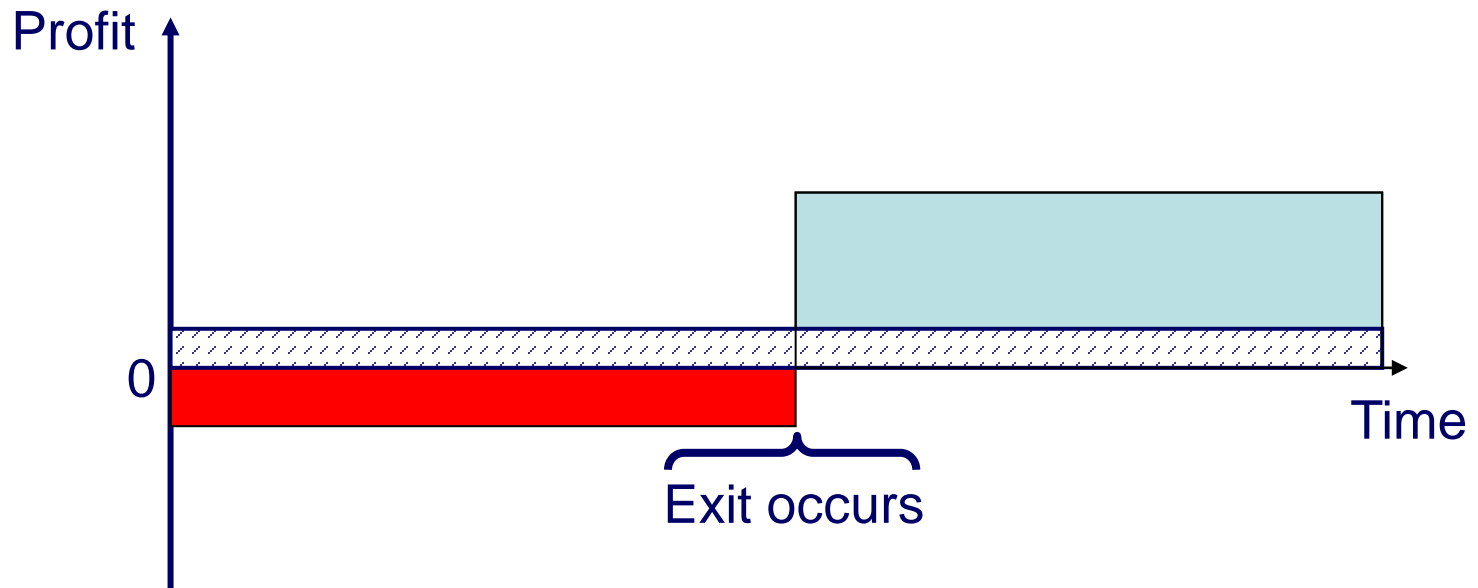
# Economist definition of predation

1. Conduct that sacrifices profits (need not involve an accounting loss) in the short-term (this benefits consumers)
2. Entrants deterred or rivals exit, for example because of the expectation of low profits or insufficient funding due to capital market interpretations regarding the intensity of post-entry competition
3. Post-exit, predator changes conduct (e.g. increases prices) resulting in higher profits (detrimental for consumers) – which is successful because the predatory conduct affects the post-exit market structure (e.g. deters future entry by signalling aggressive behaviour )

For conduct to be predatory it must meet all of the above conditions

# Identifying predatory conduct

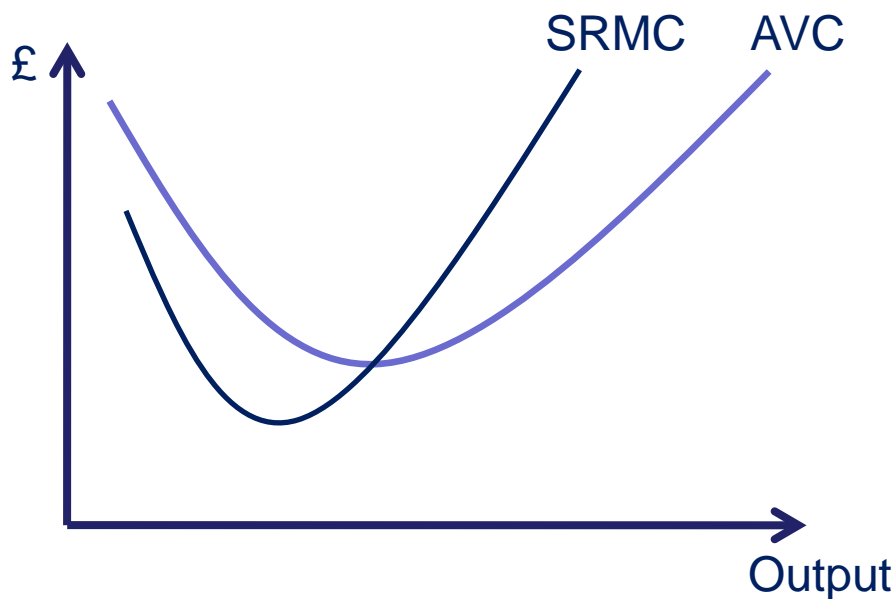
A firm engaged in predatory conduct is likely to be able to change the conditions of competition in a market (i.e. is more likely to be dominant) and must sacrifice profit in the short-term



# Testing for predation

- Areeda and Turner (1975, *Harvard Law Review*) proposed a test based on comparing observable price with *short-run marginal cost* (SRMC)
- A price lower than reasonably anticipated SRMC is not predatory
- But because SRMC is not easy to measure, the test uses average variable cost (AVC) as a surrogate
- Test: If price is below AVC it should be presumed unlawful

# Areeda-Turner Test: Issues



- SRMC is the wrong reference point as predatory conduct can occur above SRMC
  - Especially in the case of influencing behaviour of new entrants
- Gives too much room for manoeuvre
- Difficult to draw distinction between fixed and variable cost elements in practice
- In some markets (e.g. digital downloads) AVC may be small

# The AKZO Case

- The EC considered predatory pricing in the AKZO case (1985, 1986 and appeal 1991)
- Case involved Engineering and Chemical Supplies (ECS) a small firm based in the UK that produced benzoyl peroxide used to bleach flour
- Also used as a catalyst in plastics production, where AKZO was a major player
- ECS entered the market served by AKZO who issued threats against ECS and subsequently targeted customers of ECS with generous discounts
- EC found AKZO had abused a position of dominance
- The EC did not apply an Areeda-Turner test and stated that the behaviour was clearly intended to eliminate competition – intent alone was sufficient to convince the EC of predation
- EC acknowledged price above AVC could be predatory

# AKZO Appeal: ECJ set out test for predation

- AKZO disputed the EC reliance on the intent argument and wanted instead an Areeda-Turner like test (a test based on objective criteria)

The ECJ in its judgment stated:

*“Prices below average variable costs by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive.”* Para 71

*“Moreover, prices below average total costs, but above average variable costs, must be regarded as a abusive if they are determined as part of a plan for eliminating a competitor.”* Para 72

- The test for predation set out by the ECJ in AKZO rules that pricing below AVC is abusive if practised by a dominant firm and relies on intent for the case where price exceeds AVC but is below ATC

# Multiproduct Network Industries

- Applying the AKZO test in an industry like telecommunications is difficult because of considerable common costs
- The EC has advocated using *Long Run Average Incremental Cost* (LRIC) as the cost floor
- In Deutsche Post AG (2001) the EC applied the incremental cost standard
- UPS complained that DPAG was cross-subsidising competitive mail-order parcel services from revenues in the statutory monopoly DPAG had over basic post (letters below the weight 200g)
- How was the EC to measure DPAG's cost of providing the mail-order parcel services business?
- The EC measured DPAG's incremental costs and did not attribute any of the common costs to the incremental mail-order parcel service business

# Recoupment

- Economics regards recoupment to be key in demonstrating predation
- In the US predation cases rarely succeed because the courts have expressly required recoupment to be shown (Supreme Court ruling in the *Brown Group Ltd v Brown & Williamson Tobacco Corp*, 1993)
- The position in EC law is not so strict, with recoupment being considered in the Tetra Pak II case (1997)
- Tetra Pak II case look at predation enabled by cross subsidy
  - Tetra Pak has over a 90% share of the relevant market (aseptic cartons – long life)
  - The market where predation was alleged was that for non-aseptic cartons
- Tetra Pak argued that the EC could not have shown predation because it did not demonstrate recoupment
- ECJ emphasised in para 44 of its ruling that the key factor was the risk of competitors being eliminated

# Network externalities and predation

- In markets for new products prices may lie below AVC, which may be rational if seeking to exploit economies of scale/learning
- Wanadoo (2003) an ISP in France was 72% owned by France Telecom which had a near 100% share of the wholesale DSL market
- Wanadoo was pricing its services below cost in 2001 (below AVC for a period and below ATC otherwise)
- Wanadoo claimed its pricing was perfectly rational and a way to attract more customers who would become profitable in due course (as a result of unit costs falling and customer revenues rising)
- The EC saw the reasoning as demonstrating that the pricing was predatory
- The case was appealed and the CFI in 2007 upheld the decision

# Conclusion

- Economic analysis suggests that predation has three elements: (i) sacrifice (ii) elimination and (iii) recoupment
- The approach in the EU has focussed on the *form* of pricing by emphasising (i) and to some extent (ii) rather than looking at the *effects* of the pricing
  - e.g. comparing welfare gains enjoyed by customers today versus lower surplus in the future
- Policy on predation in the US emphasises all three components and as a consequence it is more difficult for competition authorities to demonstrate predation

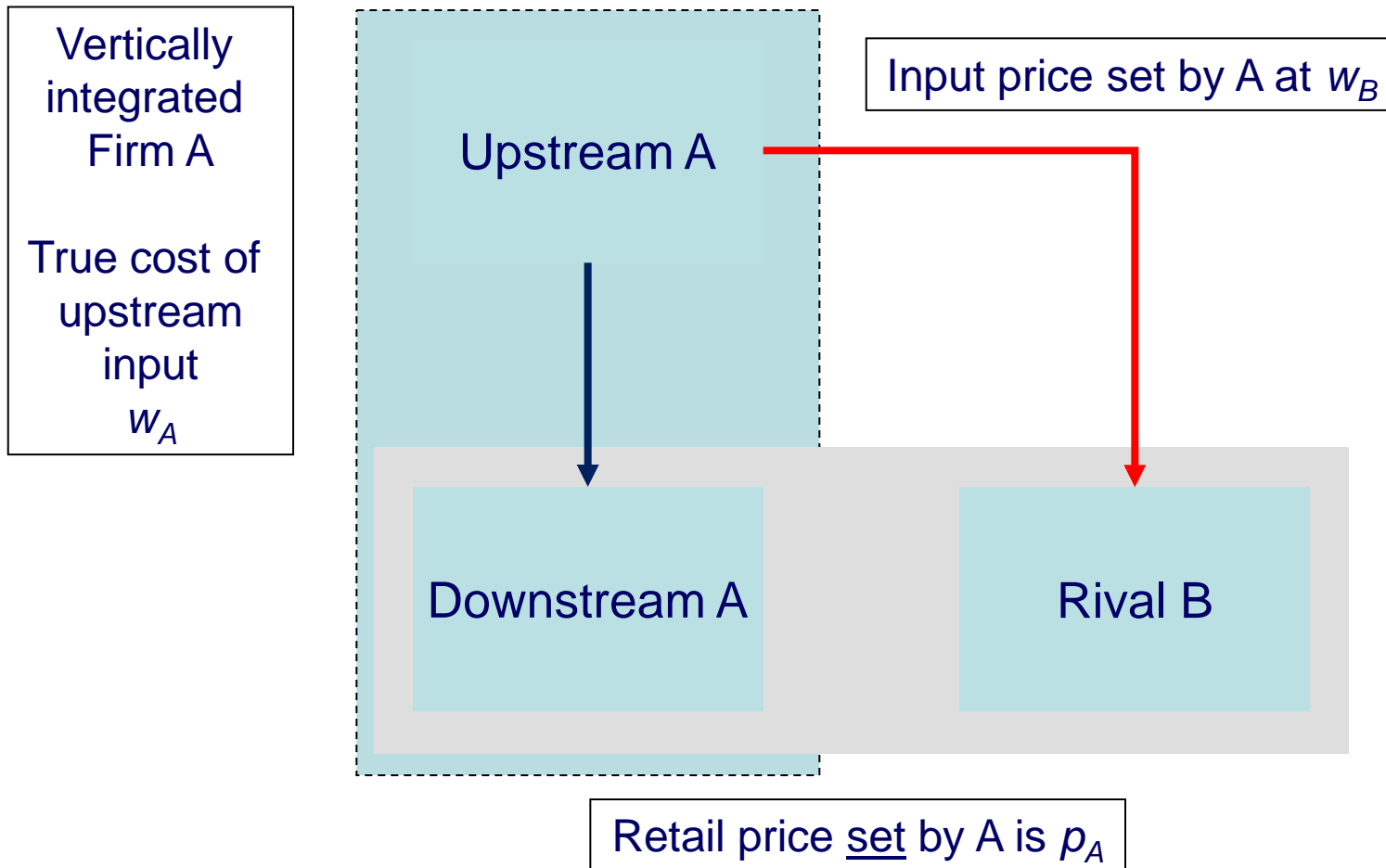
# Part 2

## Margin Squeeze

# What is a margin squeeze?

- A vertically integrated firm sells wholesale inputs (e.g. access to a platform) to firms it competes against in a downstream market
- A vertically integrated firm may ‘squeeze’ the margin available to rivals by:
  - Setting the input price high relative to cost (e.g. by discriminating against its rivals)
  - Setting a retail price too low
- If a firm operating in the downstream market were as efficient as the integrated firm’s own downstream affiliate, a margin squeeze would have the effect of making entry unprofitable
- A margin squeeze may therefore be applied by a dominant firm to foreclose markets
- We shall look at testing for the alleged application of a price squeeze and examine whether it is the same as predation

# Margin squeeze



# Margin squeeze

- Firm A's upstream unit cost is  $w_A$  and the wholesale charge levied on firm B is  $w_B$
- In a competitive market for the wholesale product we would expect  $w_B = w_A$ 
  - Where  $w_B > w_A$  this indicates possible exploitative behaviour
- Assume firm B's unit downstream costs  $r_B$
- Assume firm A's unit downstream costs  $r_A$
- Effective competition and efficiency is when the market price is:  
$$p = \min[r_A, r_B] + w_A$$
- What if  $r_B + w_A < p$ ? The market is not delivering efficiency
  - The wholesale price  $w_B$  is too high relative to the downstream retail price  $p$  – is this an abuse?
- One solution that achieves efficiency is setting  $w_B = p - r_A$

# Solving the margin squeeze problem

- The solution of setting  $w_B = p - r_A$  is known as 'retail minus' (more generally the efficient component rule 'ECPR')
  - The wholesale price is related to the retail price minus the cost incurred by the vertically integrated in supplying the good which is avoided by admitting entry (opportunity cost)
- Efficiency is consistent with the case where  $r_B \leq r_A$ 
  - In words we want competition to take place when the entrant has lower costs in the competitive segment, i.e. is more efficient
- The entrant's cost is  $w_B + r_B = p - r_A + r_B$
- Where  $p - r_A + r_B > p$  entry is unprofitable and implies:
  - $r_B > r_A$

# Margin squeeze and predation

- Predation involves the predatory firm incurring a loss (opportunity cost i.e. foregone profits – need not be an accounting loss) with the intention of driving out a rival
  - If successful the predator changes conduct (increases price) to recover lost profits in the future
- A margin squeeze is intended to disadvantage or drive out a potential rival but unlike predation can in some circumstances stimulate profit
  - e.g. by setting high wholesale prices, profits can be made on these sales
- A margin squeeze may involve foregone profits – but as with predation we can ask: Is it a better strategy for a firm to sell an input to rivals and extract greater profits?

# EU Case law

- National Carbonising (1976)
- National Carbonising Company (NCC) bought coal from the National Coal Board (NCB), whose subsidiary (NSF) produced coke in competition with NCC. NCB held a virtual monopoly in coal production and through NSF held almost 90% of the downstream market
- The EC found NSF was a price leader downstream and there was no possibility for NCC to increase its prices above NSF's
- As a result of successive increases in the cost of NCC's raw material sourced from NCB, NCB's costs of production rose by £10.39 per ton, whereas its subsidiary's downstream price for the finished product was only £6.70. NCC was unable to operate economically and sought interim relief
- The EC rejected NCC's complaint but it recognised the possibility of abuse

# Margin squeeze may be an abuse of dominance

*“An undertaking which is in a dominant position as regards the production of a raw material (in this case coking coal) and therefore able to control its price to independent manufactures of derivatives (in this case coke), and which is itself producing the same derivatives in competition with those manufactures, may abuse a dominant position if it acts in such a way as to eliminate competition from these manufactures in the market for derivatives. From this general principle the services of the Commission deduced that the enterprise in a dominant position may have an obligation to arrange its prices so as to allow a reasonably efficient manufacturer of the derivative a margin sufficient to enable it to survive in the long term.”*

EC hints very strongly about a margin squeeze test, but in the case focused more on refusal to deal

# EU Case Law

Napier Brown/British Sugar (1988) the European Commission stated:

*'The maintaining by a dominant company, which is dominant in the markets for both a raw material and a corresponding derived product, of a margin between the price it charges for a raw material to the companies which compete with the dominant company in the production of the derived product and the price which it charges for the derived product, which is insufficient to reflect that dominant company's own costs of transformation (in this case the margin maintained by Napier Brown between its industrial and retail sugar prices compared to its own repackaging costs) with the result that competition in the derived product is restricted, is an abuse of a dominant position.'*

Case IV/30.178 [1988] OJ L-284/41, paragraph 66

# Margin squeeze: Deutsche Telekom

- COMP/C-1/37.451, Decision May 2003 and CFI Case T-271/03 - *Deutsche Telekom AG v. Commission* (2008)
- Dispute about wholesale costs of access to the local loop
- Unbundled loop can be used for voice telephony and DSL (broadband)
- DT found to be applying a margin squeeze and was fined €12.6m
- The EC stated:
  - *“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...”* Para 102

# Imputation tests for a margin squeeze

## Test 1 (Napier Brown/British Sugar, endorsed in DT case)

- Can the vertically integrated firm operate profitably if confronted with the same prices as the rival downstream firms?
  - Integrated firm's data – imputation test: integrated firm's price no lower than sum of wholesale charges plus actual incremental costs of providing retail service
  - Principles suggest that we should rely on the costs of an efficient firm and not those of a possibly inefficient firm

## Test 2

- Can an equivalently efficient operator downstream obtain a normal profit? (entrant's data)

The CFI stated that the Commission's use of Test 1 in the case of DT was appropriate (known as the "equally efficient" or "just as efficient" standard)

# OFT BSkyB case - CA98/20/2002

- In December 2002 the DG of FT found that BSkyB was dominant on two markets:
  - The wholesale provision of TV channels carrying sports content that will only appear on premium pay TV sports channels (currently identified as live Football Association Premier League football) and
  - Premium pay TV film channels
- The DG of FT stated that there were insufficient grounds to find that BSkyB had abused its dominant position by exercising a margin squeeze on its premium channel distributors, or by practising anticompetitive mixed bundling in the wholesale provision of such channels
- The OFT, which succeeded the DG of FT on 1 April 2003, rejected two applications to vary the decision

# OFT BSkyB case - CA98/20/2002

- Each of the principal distributors (ntl and OnDigital) of BSkyB's premium channels alleged that BSkyB had exercised a margin squeeze
- In other words the wholesale price at which BSkyB supplied the distributors was so high that, in order to match BSkyB's own retail prices (as they must to be competitive with BSkyB), they would necessarily incur losses in distributing those channels
- Para 356: *“The Director considers that the correct test, consistent with these precedents, should determine whether an undertaking as efficient in distributing as BSkyB can earn a normal profit when paying the wholesale prices charged by BSkyB to its distributors, and that this should be tested by reference to BSkyB's own costs of transformation.”* Test 2 proxied by Test 1 data

# Genzyme (CAT, 2004)

*“A further particular example of the same general principle may occur where an undertaking that is dominant in an upstream market supplies an essential input to its competitors in a downstream market, on which the dominant company is also active, at a price which does not enable its competitors on the downstream market to remain competitive. Such a practice is called a “margin squeeze” or “price squeeze”.”*

Para 7, Genzyme [2004] CAT 4, 11 March 2004

# Conclusion

- Margin squeeze tests look at the *form* of conduct and are not directed to towards examining the *effects* of the conduct (it is not an *effects based method* of competition policy) applied
- The application of imputation tests is sometimes difficult
  - Multi-product firms (scale and scope economies)
  - New products (e.g. broadband)
  - *Ex ante* versus *Ex post*
- Test has been applied differently by different authorities and in different cases
- The *ex post* approach using entrant costs seems closest to underlying economic principle of efficiency