Calculating the Costs and Profitability of Services in Price Squeeze Investigations

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What is Price Squeeze?

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Situation

- vertically integrated operator
- SMP in downstream market
- supplying essential input to downstream competitors

The price squeeze

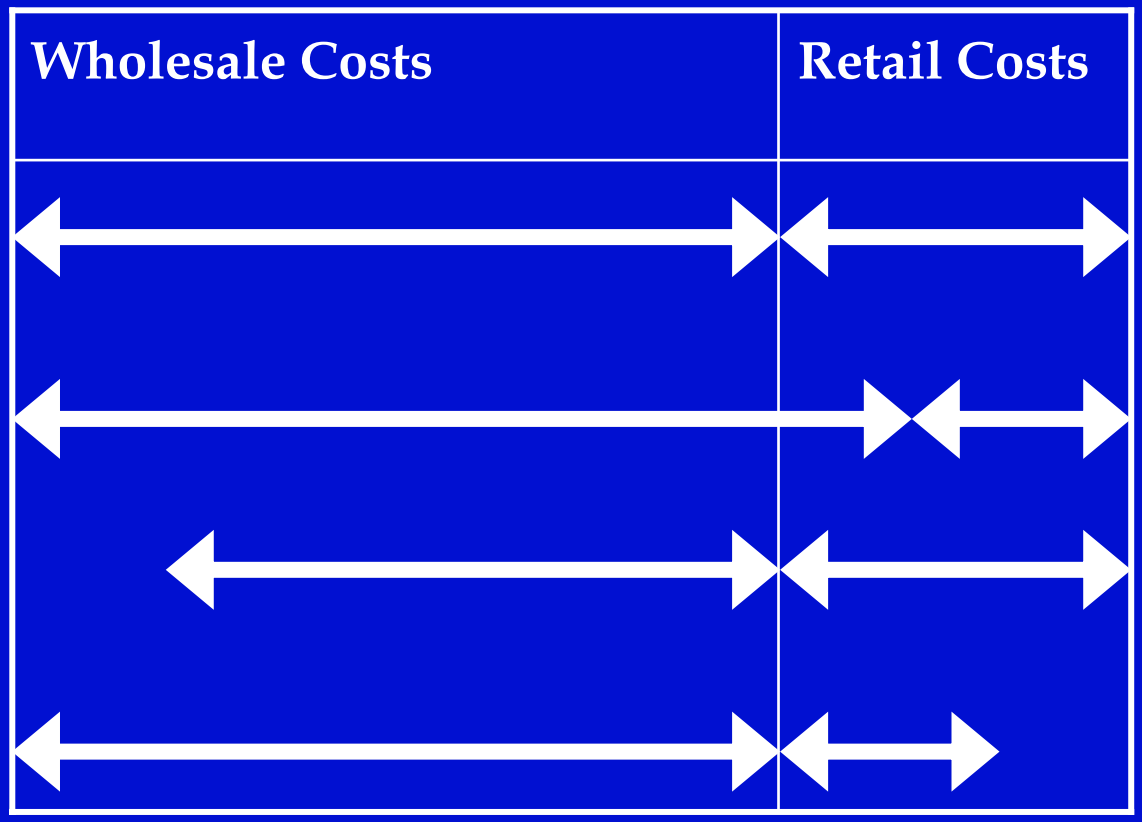
- Raising wholesale price to competitors;

and/or

- Lowering prices for retail customers

Ofcom (2004)

Price squeeze and predation



No margin squeeze or predation

Margin squeeze only

Predation only

Margin squeeze & predation

A simple price squeeze test

$$R_p - W_p \geq R_c$$

OR

$$R_p \geq W_p + R_c$$

Calculating costs

- **Focus on three principal issues:**
  - Whose costs?
  - Economies of scale
  - Treatment of common costs
- **First, what kind of costs?**

Cost Categories – Fixed local residential calls (ARCEP)

"Wholesale Costs"

- Origination
- Transport
- Termination
- Other

65%

"Retail Costs"

- Marketing
- Sales
- Order handling
- Billing/credit management
- Customer service

35%

Whose costs?

- EU Access Notice set out two alternatives
  - Incumbent's retail costs
  - Entrant's costs
- **In practice more common to use incumbent's costs:**
  - Usually already procedures in place to collect cost data from SMP operators
  - Avoid problem of hypothetical "efficient" costs
- **Without adjustments, this approach may leave high barriers to entry in place**

Economies of scale

- **Retail costs per customer often decline as the volume of customers increases**
- **These are costs that can be largely "fixed" relative to the size of the customer base, such as:**
  - Advertising and marketing
  - Backhaul [e.g. Cost per Mbit/s is lower for an 8Mbit/s link than for a 2Mbit/s link]
  - Billing
- **<u>Some NRAs have recognised this</u>**

➔ **SMP operators have some cost advantages**

Economies of scale - Implications

Scenario 1

Incumbent cost advantage

↓

Lower retail prices

↓

Entry deterrence

Scenario 2

Incumbent cost advantage

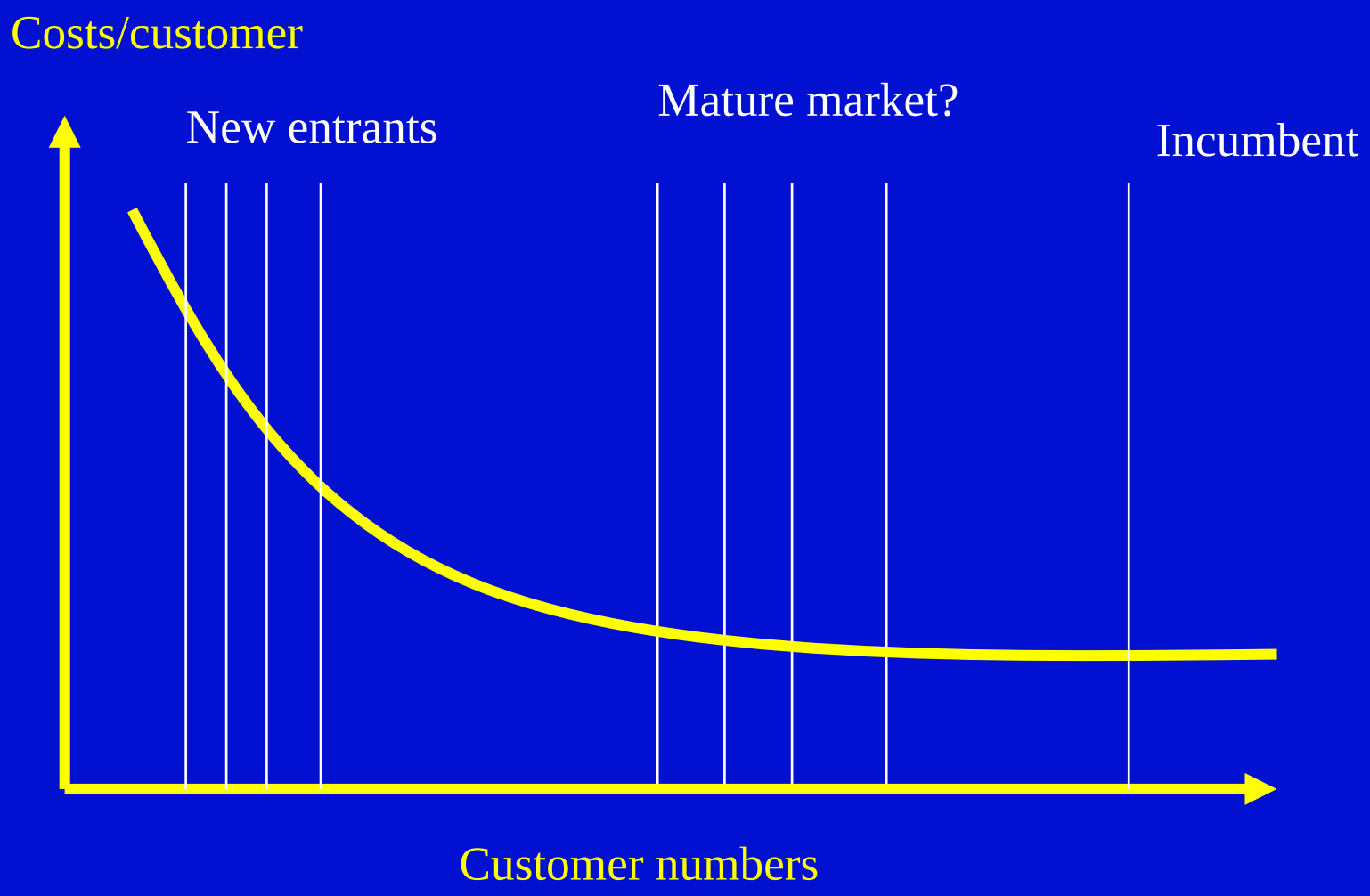
↓

NRA forces higher retail prices

↓

Entry

Costs per customer



Adjusting for EoS

- **Some NRAs do, some don't**
- **Depends on:**
  - Regulatory objectives
  - View on how competition will develop
  - Maturity of market
  - Cost structures in the market

Options for treatment of common costs

1. **Ignore common costs - use incremental costs only**
   - More flexibility for SMP operators to choose the services from which they recover common costs
   - Makes life tougher for entrants offering a more limited product range
2. **Recover contribution to all common costs**
   - Very limited pricing flexibility for SMP operators – may not be beneficial for customers
   - Makes life easier for entrants

Treatment of common costs II

3. **Recover contribution to common costs for services in the same market**

There are 2 variants:

- Require recovery of contribution to common costs from each service in the market
- Allow SMP operator flexibility to decide where to recover common costs – as long as they are all recovered from services within the market
- Latter approach sometimes known as a "combinatorial test"

NRAs and common costs

- NRA treatment of common costs often not clear in the price squeeze context
- IBPT raise issue in their consultation
- OPTA plans to use a "combinatorial test"
  - each service recovers incremental costs; and
  - costs common at the market level must be recovered from services provided in that market.
- ARCEP include a contribution to common costs, though the basis for this is not clear

Measuring Profitability

- Scope of the test
- Rate of return on capital & Other profitability measures

Scope of the test

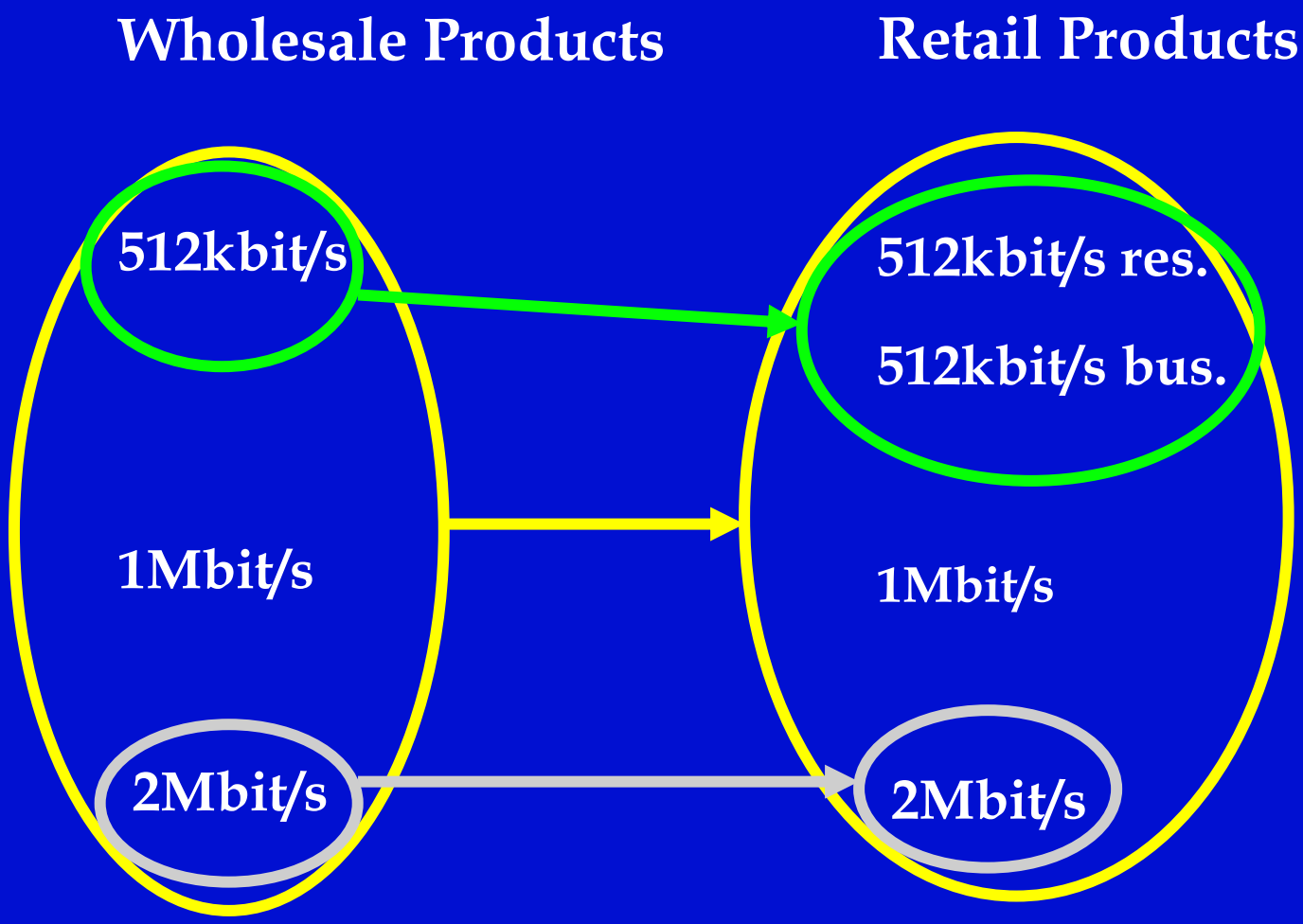
- **Several options, for example:**
  - each call second
  - each call
  - each customer

  } Onerous
  Impractical

  - each product/or service
  - the market
  - each customer class

  } More realistic
  Existing examples

Product Portfolio Issues



Profitability

- **Wholesale prices usually include an element of profitability**
  - Generally measured by WACC
  - Included as a "cost"
- **Should the price squeeze test allow for a measure of retail profitability ?**
  - in addition to wholesale profitability
- **What measure of retail profitability should be used?**

Measures of retail profitability

- **WACC**
  - Well understood concept
  - Accepted benchmark for rate of return
  - In practice often used as discount rate in NPV calculations for price squeeze tests
- **Return on sales**
  - Capital intensity of retail services usually low
  - No widely accepted benchmarks
  - Some precedents (OFT/BSkyB and OPTA)

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Annex

EU Access Notice – Price Squeeze Guidelines

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Option A

Incumbent's own retail arm could not trade profitably on the basis of the wholesale price charged to its competitors.

Option B

The margin between the wholesale price and the incumbent's retail price is insufficient to allow a reasonably efficient retail service provider to obtain a normal profit

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NRAs & economies of scale – some examples

- ARCEP's model assumes that "commercial" costs per minute for large corporates with high volumes are 60% lower.
- IBPT are currently consulting on an adjustment to their price squeeze test to reflect EoS
- OPTA have made it clear that they do not intend to make adjustments to reflect the economies of scale achievable by SMP operators in the fixed calls market
- ComReg have made adjustments for EoS in their retail minus control for the WBA market

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Common costs

- Costs of activities that contribute to more than one product line

  <u>and</u>

  which would still be incurred even if one of the product lines were removed.
- E.g. generic advertising for broadband services

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END