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**COMMISSION DEVELOPS NEW POLICY FOR PREDATORY PRICING IN
NETWORK INDUSTRIES.**

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With the adoption of a number of decisions in the postal and telecommunications services, the Commission has brought back to life an almost forgotten area of article 82: that of predatory pricing.

Since the decisions in AKZO (1985) and Tetrapak II (1991), the Commission had not made a case on predatory pricing as such. In the last two to three years, however, the Commission has sanctioned Deutsche Telekom, Deutsche Post and Wanadoo (subsidiary of France Telecom) for selling below costs; the Commission is currently investigating further cases of predatory pricing.

Although the Commission claims to still apply the traditional average variable cost and average total costs (Areeda/Turner test) as a general framework, it has introduced two very significant developments in relation to:

- Benchmark costs to be used in network industries, by reference to incremental and/or avoidable costs.
- The strategic context in which predatory prices take place.

As argued below, these developments are fully consistent with recent developments in economic thinking, and may announce a long awaited change in policy in the application of Article 82.

RECENT PREDATION CASES.

Deutsche Telekom.

Although the decision of the Commission in this case¹ refers to inequitable prices, it is in fact a case of margin squeeze between the wholesale prices DT charges its competitors for wholesale access to the

¹ COMP/37.451,37.578,37.579 –Deutsche Telekom AG, 21 may 2003.

local loop and the retail prices it charges to its subscribers. According to 9 complainants, the margin between both prices did not allow them to compete effectively against DT for subscribers.

The Commission found that indeed the wholesale price charged for leasing a subscriber line was above the retail price, and fined DT 12,6 million euros. The prices were regulated by RegTP on the basis of Long Run Incremental Costs established according to the analytical cost accounting of DT.

From the point of view of predation, the decision is uninteresting except to the extent that a margin or price squeeze may be assimilated to predatory pricing to prevent entry.

United Parcel Service / Deutsche Post AG.

The Commission found² that Deutsche Post (DP) had abused its dominant position as the incumbent postal service operator by engaging into (i) predatory pricing, (ii) cross subsidization from the profits made in reserved (monopoly) services and (iii) classic loyalty discounts granted to customers in exchange of exclusivity or near exclusivity. Discounts were increased as a function of the increase of business granted by the client to DP. Dominance and the abuse were established in the relevant market for business parcel services.

The combination of predatory pricing for business parcel services, loyalty discounts to the leading mail order customers for contracting with DP most of or all of their requirements in express delivery of packets clearly represents a coherent strategy to prevent the development of competition in a newly liberalized market (the complainant in this case was a potential new entrant).

² COMP/35.141 - United Parcel Service / Deutsche Post AG, 20 march 2001.

Cost test in network industries.

The Commission establishes for the first time detail guidance on how to assess predatory prices in network industries such as postal services³. The Commission took as benchmark the concept of incremental costs related to the development of the activity in the relevant market.

Because of the universal service obligation legally imposed on DP, DP must carry a sufficient network capacity to deliver general types of parcels. The costs arising from carrying such capacity do not have to be computed as relevant costs to establish predation, since even if DP was to decide to abandon the delivery of mail order packets and catalogues, it would nevertheless incur the costs of maintaining a sufficient network capacity.

The approach is then one where incremental costs are measured by reference to avoidable costs once the activity has already started.

The Commission also considers that the allegedly predatory activity should not be required to contribute to network common fixed costs. It is enough that the new line of business covers for its own incremental costs, and in so far as this brings the benchmark cost down, the approach is favourable to the defendant.

Fortunately for the Commission, DP had priced its services below the incremental (avoidable) costs, and allocation of common fixed costs was consequently not an issue here. It remains to be seen how

³ Albeit a special network industry, where the network is not physical, as in energy or telecommunications. This has important implications with respect to entry and the capacity to enforce the monopoly granted in exchange of universal service obligations.

network common costs would be allocated, and whether accounting depreciation periods would be considered appropriate in the context of a predation case when the Commission needs to establish if total costs have been covered or not.

DP was fined € 24 million for the loyalty schemes it had operated, but not for the predatory pricing strategy. The Commission stated that its policy with regard to predatory pricing cases in network industries was not sufficiently clear before the DP decision.

If Wanadoo was counting on this leniency approach to predation cases in network industries, its expectations were deceived, since this second time, the Commission did decide to impose a fine.

Wanadoo.

In Wanadoo ⁴, the Commission imposed a fine of app. 10 million euros on the basis of predatory pricing. Wanadoo is a fully controlled subsidiary of France Telecom, the incumbent dominant telecom operator. Wanadoo markets retail ADSL Internet access in France and in other Member States.

The analysis of the Commission focused on wholesale and retail broadband access in France. The retail ADSL services of Wanadoo accounted for some 90% of ADSL access to Internet in France and for 70% if access via cable modem (including France Telecom's cable activities) is included in the relevant market.

Strategic context.

The details on how the Commission approached calculation of costs in this case has to be put first into the overall strategic context in which the launching of

⁴ COMP 38233, Wanadoo, see press releases IP/01/1899 of 21/12/2001 and IP/03/1025 of 16 July 2003.

ADSL services took place. According to the Commission's press releases, the competition concerns arising from Wanadoo pricing ADSL services below costs were related to:

- Hindrance of competitor's growth; competitors also rely on France Telecom for the supply of the wholesale ADSL services. The competitors for general-public high-speed Internet access, in particular those working with ADSL, must, if they wish to match Wanadoo's prices, accept losses or sacrifice other investments which are strategic for their development in other areas of telecommunications services.
- The Commission further considers that the aim of a strategy of below-cost pricing is to remove competitors or to give the dominant operator increased market power. The dominant operator can then use that stronger market position, once the consumer's choice has been severely restricted or completely removed, to charge high prices, for instance for access to content.
- As a result of the high market shares of 70%-90%, alternative telecommunications operators who, with the move towards unbundling of the local loop, might wish to offer ADSL services comparable to those of France Télécom will find themselves up against an incumbent in a firmly entrenched position, something which will limit their own growth potential.

In conclusion, to the extent that an emerging, high growth market for (ADSL) broadband access to Internet may develop competitors and hence competition not

only in the relevant market but also in other service markets in the context of policy initiatives to unbundled the local loop, the Commission intends to look particularly careful into any type of abusive behaviour, including selling below costs⁵.

This decision, together with the decision to fine Deutsche Telekom, reflect "the Commission's determination to prevent exclusionary practices by incumbent operators on strategic markets."⁶

In its press release announcing the imposition of a fine to Wanadoo, the Commission stated that, up to October 2002, the retail prices charged by Wanadoo were below cost. According to the Commission, this practice restricted market entry and development potential for competitors, to the detriment of consumers, on a market that is key to the development of the information society.

The Commission found that the predatory strategy was designed to pre-empt the strategic market for high-speed Internet access. The Commission qualified the strategy as deliberate, since the company was fully aware of the level of losses which it was suffering and of the legal risks associated with the launch of its ADSL services. According to in-house company documents, the company was still expecting at the beginning of 2002 to continue selling at a loss in 2003 and 2004.

Therefore, the Commission clearly places the analysis of abusive predatory pricing in its full strategic context, and devotes considerable attention to the consequences the conduct at stake may have on competition on the relevant market and on related markets.

⁵ The Commission stated the same policy goals with regard to its decision of 21 May fining Deutsche Telekom.

⁶ Commission's press release IP/03/1025 of 16/07/2003.

With regard to the test of predation, the Commission evokes the traditional CJ case law (Akzo and Tetrapak) ⁷. In addition to looking into the incremental costs incurred to provide broadband Internet access, it carried out certain adjustments to costs and revenue so as to take account of the characteristics of a take off, strongly growing market.

Although the decision has not been made public yet, it appears that the adjustments related to both revenues and costs.

Revenues.

Revenues are counted as effective revenues, net of quotas that subscribers did not pay as compensation when the service was still functioning irregularly. Revenues from distinct but related services, such as e-advertising and e-commerce were attributed as revenues arising from the provision of Internet access.

Recurring and non-recurring variable costs.

A distinction is made between recurring and non-recurring variable costs. Because the ADSL were new services in the process of being launched, suppliers had engaged in substantial advertising and promotional activity to ensure that customers were made aware of the new possibilities and were encouraged to try the new product.

Promotions have typically included free subscription, limited periods of time where the subscriber paid no fee and subsidizing of the modems and other necessary equipment.

The costs of the promotional campaigns are variable in so far as they depend of the number of subscribers or output level, but are incurred only once, i.e. when a

⁷ Case C-62/86 Akzo v Commission [1991] ECR I-3359; Case C-333/94 Tetra Pak II [1996] ECR I-5951.

consumer subscribes the service for the first time. They are therefore non-recurring variable costs. The Commission allowed to capitalise these costs, and to write them off over a number of years (apparently 4). The treatment of expense in advertising campaigns is undoubtedly more complex, but in the absence of a published decision, it is difficult to ascertain how did the Commission approach the issue.

In any case, capitalisation of non-recurring expenses allows computing lower variable costs in the first years, and hence, reduces initially the scope for a finding of predatory pricing. This approach makes sense to the extent that subscribers will usually remain with the same ADSL supplier for a number of years: the costs of capturing that new customer do not necessarily have to be written off as a variable cost in the first year. The economic and business logic requires making a balance of costs and revenues over the full "life" of the individual customer.

But the effect depends (i) on the average time span over which a customer remains subscribed and (ii) on the pattern of subscriptions over the years. The first of these elements can be estimated (the so called "churn rate") from the yearly subscriptions and the customer base at the end of each year.

The second element may play in favour or against the defendant. If subscriptions are slow to take off and the customer base is only built to a significant extent (break even point) after a number of years exceeding the "churn rate", the amortization of non recurring variable costs is favourable to the defendant. But if subscriptions grow initially very quickly, and subsequently flatten, the amounts of non-recurring costs carried forward from previous years may inflate variable costs over retail prices in years say, 3 or 4, and "artificially" place a company under a predatory scenario.

This is the same situation if we take into account uncertainty with regard to the level of demand for a new product. Anticipated demand may be proven by the facts as over optimistic, and the costs and prices foreseen in the business plans may not match with ex-post reality.

A mechanical application of price and costs comparisons, may lead to the paradoxical result that a company breaches article 82 just because it did not properly anticipate the level of demand for a new product.

Conclusions on predation.

The Commission continues to apply the traditional predation test as formulated in Akzo: where variable costs are not covered, an abuse is automatically presumed; where variable costs are covered, but total costs are not, the pricing is deemed to constitute an abuse if it forms part of a plan to eliminate competitors.

Within this broad formulation, the Commission practice has significantly evolved in the instrumental application of the test.

The Commission has introduced in its case law the reference to incremental cost and avoidable cost to assess predation in network industries. So far it has not had to confront a situation where variable incremental/avoidable costs were covered but not total costs. It remains to be seen what criteria would be used in that situation to apportion common network fixed or variable costs to the relevant market where the abusive conduct allegedly takes place.

There have also been new developments to adjust the calculation of variable direct costs in new or emerging, high growth markets.

The Commission carries out an analysis of the strategic behaviour of the defendant (and to a lesser extent, of its competitors) in the context of predation cases in network industries. The Commission has now gone well beyond a mere accountancy exercise, and it devotes considerable effort to assess whether the predatory conduct has had or is likely to have an actual exclusionary effect. This is in sharp contrast with the policy towards the exclusionary effects of loyalty discounts, as reflected in Michelin and BA.

The test of recoupment of losses has not been taken into account in the decisions of the Commission so far.

In the last 3-4 years, the Commission has taken more decisions on predatory pricing than in the last 3-4 decades. The development of analytical cost accounting, and the obligations imposed on incumbent operators in network industries to implement detailed cost accounting plans may have certainly played a role in it.

In any case, predation should now be among the priority concerns for dominant firms in network industries undergoing a liberalization progress and willing to expand into new products or markets. Its business plans and effective realizations in the first years will be subject to detail scrutiny by competition authorities in Europe.

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