Feeling the squeeze

A margin squeeze test that is poorly designed, implemented or interpreted can stunt competition, contrary to its objective. This Insight argues that differences between the downstream costs of a vertically integrated company and its rivals should be accounted for in either the design or interpretation of a margin squeeze test.

Enough is enough

The objective of a margin squeeze test is to help identify whether a vertically integrated company could stunt downstream competition by leaving an insufficient margin between the upstream prices it charges its downstream rivals and the downstream prices it charges end customers. Such tests are used by competition authorities to help identify infringements of competition law and by sector regulators to help set price controls (for example, in the United Kingdom Ofcom has recently introduced such a test for some of Royal Mail Group's postal services).

Clearly, how 'an insufficient margin' is defined is critical to whether such tests will help achieve this objective. If the margin is set 'too low,' there is a risk that it will miss anti-competitive margin squeezes. If the margin is set 'too high,' there is a risk that the test will prevent a vertically integrated company from making pro-competitive downstream price cuts; or, equivalently, implementing efficient upstream price increases.

For these reasons, there has been significant debate over the past decade about the right margin to use in such tests.

» In the context of identifying infringements under competition law, the European Commission and others have argued strongly in favour of using the long-run average incremental cost (LRAIC) of a downstream operator that is 'equally efficient' as the vertically integrated company. That is, the test asks whether the downstream operation of the vertically integrated company could, if independent, make a profit given the upstream and downstream prices it charges. Two main arguments are made in favour of this approach.

- First, it makes it easier for a company to comply with competition law. That is, a company can only avoid a margin squeeze if it knows when the gap between its upstream and downstream prices is 'too small'. A company will know its own costs and so has the information necessary to do this.
- Second, it means that competition law only bites in the case of efficient downstream entry and expansion. That is, it does not require the vertically integrated company to support less efficient firms with downstream costs higher than its own.

» In the context of defining price controls under sector regulation, some have argued in favour of using the LRAIC of a downstream operator that is 'reasonably efficient'. One of the arguments is that sector regulators may wish to encourage entry into part of a supply chain. For example, entrants may need to make irrecoverable investments in (say) branding that have already been made by the incumbent. An 'equally-efficient' cost standard could allow the incumbent to set its upstream and downstream prices close enough to each other to make the cost of these investments irrecoverable even if the new entrants could ultimately be more efficient than the incumbent and/or deliver other competitive benefits, such as variety and innovation.

Much of the debate has, implicitly, been concerned with the situation when downstream rivals have the same or higher costs as the downstream operation of the vertically integrated company. This Insight is concerned with a different, but equally plausible situation; that is, when downstream rivals have lower costs than the vertically integrated company. This could happen for a number of reasons, including:

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» ***First, the vertically integrated company may be required by law to offer products and services that its rivals are not.*** These requirements define the shape of its business and so the costs that it incurs overall, including the costs associated with selling products and services that are also supplied by its downstream rivals (a 'universal service obligation' is an example of this).

» ***Second, it may be harder for it to reduce its costs than it is for its rivals.*** For example, it may be (or have been) publicly owned and, as a consequence, have a greater proportion of its workforce represented by a union than its rivals. This could, for political or operational reasons, mean that it is harder for the vertically integrated firm to keep its costs as low as its downstream rivals.

» ***Third, it may have made investments in the past that would not or could not be made today by its rivals.*** For example, technological change means that the price or productiveness of assets purchased today are different to the price or productiveness of assets purchased by the incumbent.

» ***Fourth, it may simply be less efficient than its rivals.***

How should the design, implementation and interpretation of a margin squeeze test differ in this situation? When, if ever, should a competition authority or sector regulator use the downstream LRAIC of the vertically integrated company or its rivals in the margin squeeze test?

Loosening your grip

There is a good reason why the downstream costs of the rivals should feature in the margin squeeze test in some way in this situation: a margin below the vertically integrated company's downstream LRAIC would not make its downstream rivals unprofitable, and so the risk of foreclosure, and the consequent effect on competition, would seem to be limited. Put another way, a test based on the vertically integrated company's downstream LRAIC would unduly restrict the vertically integrated company's ability to increase its upstream prices and/or reduce its downstream prices.

But why is this bad exactly? Why and when would it be 'a good thing' to allow a company to increase its upstream prices or reduce its retail prices below its own downstream costs?

The starting point is that the motivation for such price changes is more likely to be pro-competitive than anti-competitive: indeed, if the downstream rival is more efficient than the downstream operation of the vertically integrated company, it will often be more profitable for it to contract with the downstream rival than foreclose it (effectively sub-contracting is the most efficient production method).

Other pro-competitive reasons for such price changes would include that: (a) the firm might rationally seek to retain downstream market share in the expectation that, over time, it will reduce its downstream costs (because of efficiency improvements or economies of scale); and (b) to the extent that the vertically integrated company cuts its downstream prices, customers would benefit.

There might be three potential concerns with using the costs of downstream rivals.

- First, it might make it harder for the company to comply with competition law, as it might not know the downstream costs of its rivals.
- Second, it might make the downstream market less attractive for entry and expansion than it would have otherwise been, and hence less competitive in the future.
- Third, if building a downstream market presence assists with building an upstream market presence, it might make entry and expansion upstream less attractive too.

The first concern raises numerous legal and policy questions, which we do not revisit here. The second and third concerns highlight the need for an economic assessment of various risks to consumers including:

  - the risk of impairing the competitive position of the vertically integrated company versus its actual or potential rivals;
  - the risk of making entry and expansion artificially attractive or unattractive; and
  - striking the right balance between allowing more efficient downstream rivals to benefit from this versus lower prices for customers.

It is not obvious that using LRAIC of the vertically integrated company in a margin squeeze test minimises the risk to consumers.

Finally, there are other conceptual and practical issues, which point to considering the costs of downstream rivals. Conceptually, the LRAIC in such tests should relate to the specific product and geographic market over which the margin squeeze has or could occur. Where vertically integrated companies offer a wider range of products and services than those included in the markets, and have fixed and common costs, it is necessary to make adjustments so that the right costs are measured. Where it is not clear cut what the ‘right’ adjustment should be (as is often the case), a more accurate proxy for these costs may be found in the LRAIC of the downstream rivals if they supply products and services that align more closely with the relevant market.

Conclusion

This Insight has explained why, in the situation where downstream rivals have lower costs than a vertically integrated company, it makes sense to consider their costs as part of a margin squeeze test. At least, in terms of evaluating the *effect* of a margin squeeze identified by using a test based on the vertically integrated company’s costs, it clearly makes sense to assess the competitive position of the rival versus the company – and their relative cost position is an essential part of that assessment.

Further information

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