Margin Squeeze

Lecture 7

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Section 1

Definition

Definition

Basic conditions for a margin squeeze

Definition (margin squeeze)

Firm I applies a margin squeeze on firm C if the following conditions are simultaneously fulfilled:

- I is a vertically integrated firm.
- I has significant market power on its upstream market.
- I provides the upstream (wholesale) product to C.
- I and C are rivals in the downstream (retail) market.
- I keeps C from achieving an economically viable price-cost margin.

Definition

Imputation tests: Determination of a viable price-cost margin

Test 1 – refers to retail costs of vertically integrated firm I	Test 2 – refers to retail costs of rival firm C
I's retail price	I's retail price
$<$ I's wholesale price	$<$ I's wholesale price
$+$ I's retail-specific costs	$+$ C's retail-specific costs

Definition

Imputation tests: Determination of a viable price-cost margin

Test 1 – refers to retail costs of vertically integrated firm I	Test 2 – refers to retail costs of rival firm C
synonym: 'equally efficient operator test'	
Retail branch of I could not earn a viable profit if it had to buy the wholesale product at the price charged to C.	C cannot earn a viable profit.

Definition

Imputation tests: Determination of a viable price-cost margin

Arguments in favour of 'equally efficient operator test' (test 1)

Consumer welfare: Under the EEOT, C will be only able to compete with I if

$$\begin{aligned} &C\text{'s retail-specific costs} \\ \leq\ &I\text{'s retail-specific costs} \end{aligned}$$

Practicability: C's retail-specific costs are not known to I

Definition

Difference between margin squeezing and predatory pricing

Predatory pricing	Margin squeeze
Suspected firm's retail price is always below costs.	Suspected firm's retail price might be above costs.
Suspected firm has SMP on retail market.	Suspected firm has SMP on wholesale market.

Definition

Difference between margin squeezing and predatory pricing

Predatory pricing	Margin squeeze
Suspected firm's optimization calculus is always dynamic – as firm suffers a loss while engaging in predatory pricing, it has to recoup that loss later once it got rid of rivals.	Suspected firm's optimization calculus might be static – firm might be profitable while engaging in a margin squeeze.

Definition

Difference between margin squeezing and predatory pricing

Predatory pricing	Margin squeeze
To prevent rivals from entering the market, the threat of predatory pricing has to be credible ('chain store paradox').	Credibility is no issue.

Section 2

'Innocent' margin squeezes

'Innocent' margin squeezes

Does a margin squeeze aim aim at deterring competition?

- To be checked: Has the vertically integrated firm the opportunity to raise retail rates?
- Typical for CEE-countries: Rates for unbundled access to the local loop (ULL) $>$ retail access line rentals
- But: Incumbent might not be able to increase retail rates due to fixed-to-mobile substitution and decline of demand
- Provision of retail services below costs makes economic sense:
  - Most costs are sunk
  - Retail access is cash flow-positive

Section 3

Regulatory remedies

Regulatory remedies

Pre-requisites for regulatory action (EU Commission)

1. No competition on the downstream market without the upstream product.
2. Risk of elimination of effective competition on the downstream market.
3. Harm to consumers is likely.

Regulatory remedies

How can the regulator remove a margin squeeze?

- Reduction of wholesale rates.
  - This does not necessarily require the regulator to prove that wholesale rates lack cost-orientation.
- Adjustment of wholesale rate structures
  - Historic example: Retail flat-rate internet dial-in, but wholesale call origination charged on a per-minute basis.