CASE ASSOCIATES

Initial response to NMa's comments on the proposed KPN/Reggefiber's incentive to engage in a price squeeze

Prepared on behalf of

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I. INTRODUCTION

We have been asked by KPN to comment on the NMa's analysis of the '*theoretical possibility'* that KPN may persuade the proposed joint venture (JV) between KPN and Reggefiber to engage in an anticompetitive price squeeze. This suggestion is contained in Drs. Ivo Nobel's e-mail of 25 September 2008 to KPN under the title *6397/standpunt ten aanzien van de voortgang en inhoud van de voorgestelde remedies*.

II. NMa's ANALYSIS

We have specifically been asked to respond to the NMa's numerical example which we reproduce in the original Dutch language version for reference.

"Rekenvoorbeeld
Kabel biedt het product aan tegen een tarief van EUR 100. De kosten van ODF-toegang zijn 50 en de kosten van retaildiensten zijn 40. De GO biedt ODF-toegang aan tegen kosten, dat wil dus zeggen EUR 50. Stel tevens dat er 100 eenheden ODF worden verkocht en het ODF - marktaandeel van KPN 50% is.

De winst van KPN is dan	*50 x 10 + 41% x 0 x 100*	*= EUR 500*
De winst van derden is dan	*50 x 10*	*= EUR 500*
Indien de tarieven van ODF-toegang nu verhoogd worden met EUR 15		
De winst van KPN is dan	*50 x -5 + 41% x 15 x 100*	*= EUR 365*
De verlies van derden is dan	*50 x -5*	*= EUR -250*

Doordat derden vanwege het verlies de markt zal verlaten verkrijgt KPN een marktaandeel van 100%."

III. OUR ASSESSMENT

The possibility of an anti-competitive price squeeze arises if at least four conditions are satisfied:

1. vertical integration

2. ODF access is '*essential'* to downstream rivals and to downstream competition

3. there is a consumer welfare loss

4. ODF access prices are unregulated

The NMa has only identified one of these conditions i.e. partial vertical integration via the joint venture (JV). The other three conditions are not, in our view, satisfied.

Not withstanding this, we have been asked to focus on the NMa's example. This we find is an incomplete analysis of the impact of the alleged price squeeze.

1. Competitive and efficiency constraints

A major flaw of the NMa's example is that there are no competitive and/or cost responses to the proposed price squeeze. Namely that all other prices, costs, margins and quantities remain unaltered by a large increase (30%) in the ODF access tariff.

The NMa sees the outcome as a win:win situation for KPN as it is assumed to successfully wipe out all other active operators, and thereafter persuade the JV Board to lower the access tariff so that KPN's active operations can return from deep losses to excessive profitability.

These may be acceptable assumptions if the JV was a monopoly providing an essential input to the entire industry offering the same retail services, but it is not. If, as the example assumes, other active operators have 50% of all fibre retail customers and

KPN's actions wipes these operators out, then it is unlikely that all the customers will go to KPN or that the growth of fibre take-up, and hence costs, will be unaffected.

A more realistic assumption given the extinction of other active operators and consequent disruption of the service to their customers, is that cable and KPN's active operations would target these customers with the net effect that cable would gain market share and less ODF access would be sold. Thus the action is likely to reduce Fibre to the Home (FTTH) network penetration and the gains to KPN of from the JV's attempt to foreclose the market to other active operators.

In order to illustrate this we use what in our view are more plausible assumptions on prices, costs, margins and market shares of ODF access and cable to assess the profitability of a proposed illegal price squeeze.

Assume that the retail tariff for the cable and fibre products is €55. The costs of ODF access is a more realistic €15 (not the very high figure of €50 used in the NMa's example) and the retail costs of active operators €30. The JV initially offers ODF access at €15.

Unlike the NMa we do not see ODF access and fibre operating in isolation from high speed cable (see *Case Report*[1]).[2] They are both in the same relevant retail market. Thus the competitive response of cable must be taken into account. With this broader market definition, of the 100 units assumed by the NMa, KPN has 50 (as the NMa assumes), other active operators 15 units, and cable 35 units (like the NMa we assume there is a one-to-one correspondence between an 'access unit' and a retail unit).

The table below shows the outcomes for the three entities (KPN as a whole[3], the JV and the other active operators) under four situations – the initial position (column 2), when

[1] Case Associates, *New Generation Network Development in the Netherlands – Market definitions*, Report prepared for KPN submitted to OPTA and NMa, 5 September 2008, pp. 26-28.

[2] We have, like the NMa, ignored copper access. While copper may coexist in areas with a FTTH network, it is generally agreed that this will only be for a limited transitional period.

[3] This aggregation of KPN's losses and gains is artificial as upstream and downstream gains accrue to different legal and economic entities (the JV and KPN's solely owned active operators respectively). There will thus be tensions and conflicts over the proposed price squeeze strategy

the ODF access tariff is raised (column 3), when the other active operators have all been eliminated (column 4), and in the post-price squeeze situation when the ODF access tariff has been reduced (column 5) back to the cost oriented price.

Assume that the JV engages in a price squeeze which increases the ODF access tariff from €15 to €30. Both KPN and the other active operators incur a per unit loss of €5. Given KPN's 41% share in the JV, its overall profits (from the JV and its active operation) fall to €150[4], the JV partner gains €575, and the other active operators bear a collective loss of €75 (column 3 below). As the other active operators are eliminated by the price squeeze KPN's losses increase (column 4).

Party	**Original tariff**	**€15 euro ODF tariff increase**	**Other active operators are eliminated**	**€17 euro ODF tariff**
KPN (net position)	€500	€150	€20	€480
JV Partner	0	€575	€460	0
Other active operators	€150	-€75	No longer in market	No longer in market

The NMa assumes that all the customers of the other active operators switch to KPN. However, given the availability of cable in FTTH networked areas this is neither a realistic assumption nor a likely outcome. Some of the eliminate other active operators' customers will migrate to cable. For illustrative purposes assume that of the 15 units previously purchased by other active operators, one-third switch to cable and two-thirds

especially where KPN's active operators are required to be separate profit centres and conduct their businesses at arm's length from the JV.

[4] For presentation purposes we have rounded the figures to the nearest Euro.

to KPN. This gives a post-squeeze market share of 60 units to KPN and 40 units to cable.

Although the increase in the ODF access price benefits the JV it is unsustainable for KPN as its active operations will make huge losses. KPN will therefore want to reduce the ODF access tariff once its downstream competitors have been eliminated. Assume that it is able to persuade its JV partner and the JV Board to reduce the ODF tariff to costs.

The decline in ODF access take-up will not enable the JV to reduce the ODF access tariff to its pre-price squeeze level. Given the cost structure of FTTH networks, a lower take-up of ODF access will increase costs (due to economies of density). Assume that the ODF access costs increase to €17. After the price squeeze has been successful the ODF access tariff will fall back to €17 and not €15. At this higher tariff KPN's overall gains from the price squeeze will be lower than those generated before the price squeeze.

The post-squeeze outcome will have higher ODF access costs, the JV partner will be in the same negligible profit position as initially but far worse off than under the price squeeze, and KPN will be worse off than before the price squeeze with a profit of €480 rather than €500.

Under these assumptions KPN has no incentive to engage in a price squeeze. It is a loser in both the short and long run.

KPN appreciating both its loss and the opposition of its JV partner would not engage in an illegal price squeeze.

Even if one disputes the figures, the calculations above illustrate two important aspects of the competitive dynamics ignored in the NMa's example:

- First, in practice a price squeeze is likely to lead to a loss of market share by KPN and the JV.

- Secondly, this will have the knock-on effect of raising ODF costs and cost-oriented tariffs, or in a growth situation see tariffs not falling as fast as take-up is retarded.

3. Other considerations

There will be other considerations which need to be taken into account in any assessment of the feasibility and sustainability of an illegal price squeeze.

The NMa's example ignores the constraints imposed by the JV partner which has a controlling interest. There are several considerations here:

First, and critically, it is not KPN but the JV Board which must decide on and authorise the proposed price squeeze. KPN as minority partner has to persuade the JV board to engage in an illegal act in order to benefit it, and facilitate KPN becoming the JV's only customer.

Secondly, the JV dampens the financial incentive of KPN (assuming that it has the ability to persuade the JV) to engage in an illegal price squeeze compared to a situation where KPN is the sole (vertically integrated) owner. This is because it only receives 41% of the gain from the increase in the access price rather than 100%, and therefore its losses are greater than if it were sole owner. The leakage of the short-term gains to the 59% JV partner reduces KPN's incentive to engage in margin squeeze.

The price squeeze if successful would mean that KPN was the only customer of the JV. This strengthening of KPN's position as both a significant shareholder and only customer creates conflict of interests and weakens the bargaining power of the JV partner. It would be a consideration factored into the willingness of the JV partner to agree to a price squeeze strategy.

The JV, KPN and its JV partner would also face the prospect of legal actions, damage claims, and the disruption of their commercial relationships with the industry. Today, the threat of a legal action would be real. Any realistic analysis would have to factor in the damage claims which would reduce the expected gains to KPN and the JV i.e. it affects the financial payoffs from a price squeeze. To illustrate, if the probability of KPN/JV being sued is 50%, then the total expected damage claim would be around €113 (50% of the other active operators €150 lost profits plus out of pocket loss of €75).[5] This would

[5] The claim would in fact be higher as the other active operators forced out of business would have a claim for lost future profits of €150 each period.

have to be deducted from KPN's gain to arrive at the expected profits to KPN from an illegal price squeeze (€367 = €480-€113). If legal costs are added the expected gains are further reduced. Since it would be the JV that imposed the price squeeze, it would initially be liable for damages, which would significantly reduce the JV's willingness to go along with KPN.

There is another consideration which is an implicit assumption of the NMa's example. The NMa's assumes that ODF access has no effect on retail and access prices, and therefore does not enhance consumer welfare. In our report submitted to the NMa on behalf of KPN we stressed (as assumed by the NMa example) that the competitive pressure on retail prices come from cable. We also referred to supporting empirical research which casts doubt on the pro-competitive impact of access (see *Case Report*[6]). The NMa's analysis fails to show any consumer welfare loss arising from the alleged price squeeze.

[6] Case Associates, *New Generation Network Development in the Netherlands – Market definitions*, Report prepared for KPN submitted to OPTA and NMa, 5 September 2008, pp. 48-49.