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Access regulation and strategic transfer pricing

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Abstract

Access price regulation is used in telecommunications to prevent a vertically integrated firm, which controls an essential input, from raising the rivals' costs. When the authorities remove the access price as a strategic tool, it becomes optimal for the regulated firm to use the transfer price as an alternative strategic device. Ironically, the tools authorities use to implement access price regulation, such as accounting separation and transparency, may facilitate the regulated firm's use of the transfer price to reduce competition. Furthermore, the transition from FAC to LRIC-based access pricing makes strategic transfer pricing more relevant and provides a legitimate excuse for it. Consequently, the regulation may protect the rivals (and the regulated firm) from competition to the detriment of consumers.

Keywords: Transfer pricing; Access pricing; Cost-based regulation; Competition; Telecommunications

1. Introduction

When vertically integrated firms control essential inputs, such as in the telecommunications industry, a policy concern is that these firms will abuse their market power and discriminate against downstream competitors. Sector-specific obligations are imposed on firms that are defined to have significant market power (SMP). Both in the USA and in the EU a light regulation with unregulated retail prices combined with *ex ante* regulation of the upstream access component has become dominant. Like previous regulation regimes, the European telecommunications regulation framework that came into force by July 2003, also prescribes cost orientation of access prices on essential inputs (e.g. the local loop).[1]

We argue that when the access price is regulated, the vertically integrated firm may prefer decentralized pricing to obtain an alternative strategic tool—the transfer price. On the assumption of complete vertical integration (centralized pricing), transfer prices have no strategic impact in the theoretical literature. At the other extreme, policy makers implicitly assume that the transfer price a headquarters charges its downstream subsidiary has a direct impact on the downstream competition. This is evident both from the regulation and from regulators' statements.[2]

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[1] Access price is what downstream rivals pay for access to essential upstream components controlled by the regulated firm. An example would be a mobile company's payment for access to the fixed telephone line network (also known as the local loop).

[2] In the new European framework on electronic communications services The Access Directive (2002, Article 9–13) and the Universal Service Directive (Article 17–19) contain a list of available obligations that may be imposed on SMP-operators in the wholesale and retail markets, respectively. The European Commission stresses the role of transfer prices in The Access Directive (2002).

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Furthermore, the present regulatory regime may facilitate using the transfer price as an observable and credible strategic device that can enable the regulated firm to reduce competition. First, all regulation methods for cost orientation calculate the access price based on some averaging of costs. In the telecommunications industry this means that the regulated access price will be above the true marginal cost. Second, to implement this average cost-based access regulation, complementary obligations like accounting separation and transparent transfer pricing are used.[3] These obligations will to some degree force the headquarters of the regulated firm to consider its retail subsidiary as an independent firm. Moreover, these obligations make it profitable for the regulated firm to use decentralized pricing (i.e. by organizing its retail subsidiary as an independent profit center) by making the transfer price observable and credible.[4] Only then do the transfer prices have strategic impact on retail competition consistent with the common view among policy makers.

While the authorities can expect rivals to bring excessive access prices to their attention, the same is not true for excessive transfer prices. This is a cautionary tale for reactive regulators who only investigate subsequent to receiving complaints, and moreover may be more concerned with too low rather than too high transfer prices. Indeed, their regulation may be too successful in protecting the rival from margin squeeze to the detriment of consumers.[5] Hence, the regulation regime may increase both the regulated firm's *incentive* and *ability* to use strategic transfer pricing.

Indeed, in this case, accounting disclosure may have adverse effects on competition as it can be used to make the transfer price observable. That such disclosure recently seems to have been advocated by the European Regulators Group, makes this caution all the more important (ERG, 2006).[6] Specifically, the obligation on transparency states that the regulator can require "operators to make public specified information, such as accounting information, technical specifications, network characteristics, terms and conditions for supply and use, and prices" (Article 9). Furthermore, "to facilitate the verification of compliance with obligations of transparency and non-discrimination, national regulatory authorities shall have the power to require that accounting records, including data on revenues received from third parties, are provided on request. National regulatory authorities may publish such information as would contribute to an open and competitive market, while respecting national and Community rules on commercial confidentiality" (Article 11). This is also done. BT publishes results of their accounting separation under the oversight of the Director General of Telecommunications. The aim is "to make BT's costs as transparent as possible to competitors and potential new entrants without infringing on competitive confidentiality" (Bromwich and Hong, 2000, p. 138). The regulators' concern regarding publication of transfer prices seems to stem from a wish to protect the competitive confidentiality for the regulated firm. However, our main argument is that the regulated firm might very well welcome such publication rather than object to it. The authorities' apparent lack of attention to strategic transfer pricing may thus leave them more open to facilitate it.

The main concern by the authorities is predatory behavior, and the non-discrimination obligation (Article 10) is used to ensure that the transfer price is not set *below* a given threshold. The aim is to ensure "that third party access seekers are treated no less favorably than the operator's internal divisions" (ERG, 2003, p. 49).[7] The authorities' main tool to indirectly control the regulated firm's transfer price is therefore through margin squeeze tests. These tests may discover predatory behavior by the integrated firm (through margin squeeze). However, if the transfer price is strategically raised above the margin squeeze threshold as suggested by our results, such behavior should not trigger intervention by the authorities. Thus, the conventional wisdom that low transfer prices are anti-competitive because they favor internal divisions over external competitors, does not apply.

[3] The list of remedies in The Access Directive (2002) includes a transparency obligation (Article 9), a non-discrimination obligation (Article 10), an accounting separation obligation (Article 11), an access obligation (Article 12), and a price control and cost accounting obligation (Article 13). See ERG (2003). Although not directly comparable, for certain competitive activities, the US Telecommunications Act of 1996 does have similar obligations on structural (and accounting) separation (Section 272 (b)), non-discrimination (Section 272 (c)) and transparency (Section 272 (b) (5)).

[4] Necessary conditions to ensure that the transfer price is a credible strategic device are that it is irreversible, observable and chosen before the price competition takes place (Katz, 1991; Bagwell, 1995).

[5] A margin squeeze occurs when the integrated firm raises the access price to its downstream rivals (or lowers retail prices) thus reducing the margin of rivals.

[6] The European Regulators Group (ERG) was established by the European Commission in 2002. The ERG is advising and assisting the Commission in the electronic communications field.

[7] A similar concern seems to be reflected in the Telecommunications Act of 1996: "A Bell operating company . . . shall charge the affiliate . . . or impute to itself . . . an amount for access to its telephone exchange service and exchange access that is *no less* than the amount charged to any unaffiliated inter-exchange carriers for such service. . ." (Section 272 (e) (3)) [italics added].