

The Proper Measurement of Profitability in Competition Cases: the Dutch Experience

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Art 24 of the Dutch Competition Law (version 2004) reads:

“Undertakings are prohibited from abusing a dominant position”

This is an example of very general formulation, that needs clarification. The competition law gives one clarification. Art 1(i) says:

“Dominant position: a position of one or more undertakings which enables them to prevent effective competition being maintained on the Dutch market or a part thereof, by giving them the power to behave to an appreciable extent independently of their competitors, their suppliers, their customers or end-users”

More clarifications may come from EU laws, supplementary documents, applications of the law and verdicts of courts



- Laws, and especially the supplementary documents, often contain constructs
- A construct is an idea/concept that has no specific meaning without an operationalisation
- Operationalisations make a construct applicable
- Such operationalisations require the definition of the domain of a construct
Example: profitability plays a role in financial analysis, investment in stocks and competition economics
- Examples of constructs in competition laws are: effective competition, fair price, excessive profit, relevant market, satisfied customer, quality of goods, etc etc.
- Constructs can be operationalised in several ways. Each way has to be validated by tests
- Today we look at the construct ‘profitability’ in the domain of competition economics, especially in the sub domain of art. 24 cases (abuse of dominant position)



We do not perform validation tests ourselves, but we take more than 5 decades of operationalisation of the construct ‘profitability’ by economists as the available set of validation tests

This set shows a certain consensus in the sense that:

1. Economic profitability is a superior measure compared to accounting profitability;
2. Economic profitability may deviate substantially from accounting profitability;
3. Forward looking measures are to be preferred over backward looking measures;
4. Ex ante measures are more relevant than ex post measures;
5. Time series of profitability should have some length, rather than consist of a small collection of data, in order to allow a decomposition into a structural, cyclical and incidental part of the time series;
6. Reliable measurement of profits and invested capital is complicated, for example because of the treatment of inflation, risk, intangible assets, depreciation, Ricardian and Schumpeterian rents;
7. Relevant only is the profitability of the product whose price is under investigation; often ABC (activity based costing) type of data are required;



8. Proper benchmarking of profitability between firms requires very strong similarity in terms of product, sector, financing, years in existence, bookkeeping rules, tax system, degree of innovation and working capital;
9. Profitability of firms with a low capital intensity can be better approached by Return on Sales (ROS) than by Return on Invested capital (ROIC);
10. IRR is the best measure of profitability, although proper time series of cash flows are difficult to obtain.

What has NMa done with this set of operationalisations of the construct ‘profitability’?



NMa process in art. 24 infringement (excessive pricing):

1. Delineation of relevant product and geographic market
2. Analysis of supply side and demand side
3. Determination of a dominant position
4. Analysis of actual price setting behaviour
5. Analysis of actual price development, costs and profitability
6. Analysis of excessiveness

We focus on 4), 5) and 6)



N Main characteristics analysis NMa concerning 4):

- Description of facts;
- Simplistic linking of market performance to market structure
- No in-depth analysis of conduct
- No analysis of alternative price setting behaviour
- No attempts to link ex ante price setting behaviour to ex post market results



Main characteristics of analysis by NMa concerning 5):

- Ex post analysis with accounting data
- Limited time period: period of allegation
- Descriptive analysis of costs, profits, revenues
- ROIC as measure of ex post profitability(NOPLAT /invested capital)
- Normative profitability is WACC
- Inter firm benchmarking of actual profitability



Main characteristics of analysis by NMa concerning 6)

- rather rigid: $RIOC/WACC > 1$ is wrong and the more so when benchmarking points to the same direction; (implicit: cost per unit of output is efficient)
- nevertheless some variation in this ratio will be taken into consideration;
- margin of variation not presented in quantitative terms;
- no testing of impact of alternative calculations of underlying variables on conclusions;
- no analysis of alternative market conduct of suppliers;
- no discussion of infringement in broader context of society;
- danger of regulatory conclusions rather than stimulating competition.



INTERPAY case has changed the scene.

Is both art. 24 case as well as art. 6 (cartel) case.
Cartel aspect disregarded here.

Short summary :

April 2003: NMa is alleging Interpay of charging too high prices for network services for pin transactions to merchants. Infringement of art 24. Investigations followed complaint by Retail Organisations. NMa assisted by several external economic experts. NMa delineated relevant market narrowly on the basis of SSNIP test (price elasticity of demand of retailers). Interpay is monopolist and has dominant position. Checking of efficiency of cost. Was OK. Discussion of cost definition. Cost of authorization paid by banks should not be included in Interpay figures. NMa estimated after tax ROIC for allegation period of 4 years (1998-2001) about 80%. WACC (after tax) in same period: 8%. Conclusion: abuse of market power through excessive profitability . Fine: €30 million.



History (continued):

October 2003 Interpay, also using external economic experts, presents many arguments similar to those presented earlier. It argues that SSNIP test is performed incorrectly. Presents alternative pointing to broader market definition including other counter payments as well. It is wrong to use ROIC. Period of 4 years is much too short. Descriptive analysis of price, cost and profitability of NMa is incorrect. Presents IRR calculation over period 1989 -2002, because the pin network started in 1989. IRR (before tax) is estimated to be 17%. WACC (before tax) should be preferred and estimated in a forward looking way. Result: 15%. Allegation of NMa concerning abuse of dominant position by Interpay is ridiculous.

April 2004 NMa takes Decision. We stay where we are and don't change anything. NMa claims generally not to be rigid in its judgement of RIIOC/WACC ratio, but discrepancy is disproportional in this case. Hardly any in-depth discussion of alternatives presented by Interpay. NMa says that SSNIP test is not a good instrument for market delineation in this case because of cellophane fallacy (existing price is far above competitive level and this distorts measurement of price sensitivity).



April 2004 –December 2005 Interpay starts an Appeal against the decision. Additional exchange of arguments between Interpay and NMa takes place. NMa announces new research on market delineation. Interpay puts emphasis on lack of attention by NMa for network character of its activities. It is considered wrong that NMa is looking at four years, implicitly assuming that the usual losses occurring when a risky network with low penetration starts functioning, were already compensated by profits at the beginning of the infringement period. It was claimed that indicating a “break even year” does not justify the need of earning ‘normal’ profits thereafter.

During a long period of silence informal meetings between direct and indirectly involved persons took place. Also the National Forum on the Payments System took action.

Members of the National Forum are: Retail Organisations, Banking Association, Consumer Organisation and Central bank. They emphasize the national interest of having an efficient, safe and reliable national payment system, in which cash transactions could be better replaced by pin transactions.



In November 2005 there was announcement of, what was called, a historical agreement between banks (Interpay) and retailers. It included: 1) re-payment by Interpay of 1 eurocent per pin transaction to merchants from 1 January 2005; 2) developing joint initiatives to improve the efficiency, safety and reliability of the Dutch payment system; 3) financing of research to reach that goal.

December 2005 two documents are finally published. One document was prepared by the so called “Advisory Committee for Appeals in Competition Law”. According to Ch. 12 of Dutch Competition Law, called Legal Protection, “A Commission (...) shall advise on any administrative appeals against a decision as referred to (in the Competition Law).

In the present case 2 law experts and 1 economic expert studied the Interpay dossier and organised hearings. The conclusions of the Advisory Committee were remarkable.



1. NMa has never fulfilled its plan to present new research that could help in delineating the relevant product market. For that reason the Advisory Commission concluded that NMa had failed in denying the critical arguments of Interpay showing that this market was not as narrow as suggested by NMa. Moreover NMa has taken distance from the SSNIP test and not produced an alternative. Therefore it is impossible to conclude that Interpay has a dominant position, let alone has abused such a position.
2. NMa has failed to combat the argumentation of Interpay that the operationalisation of its profitability by NMa was inadequate, especially when the network character of its activities are taken into account. Interpay is right in its argument on the need to earn normal profit after losses from the past were compensated.

How did NMa finally react?



NMa, in its Decision in Appeal, concludes as follows:

Interpay is correct in its argument that after a break even year Interpay may earn normal profit. It takes new research to determine in what year losses in the past were just compensated by profits. This is too much work for NMa and too costly. NMa therefore accepts that it is not justified to draw conclusions on abuse of market power by Interpay. However this does not mean that we accept broader delineation of the relevant product market. New research is also needed here. Last, but not least, the agreement in the National Forum gives us a good feeling on the functioning of the market of network services for pin transactions.



Conclusion:

NMa has explicitly and implicitly accepted that its limited operationalisation of the construct ‘profitability’ is no longer sustainable. More attention should be given to many aspects that were known to economists after more than 50 years of experience with this problem.

Moreover it is acknowledged that certain national interests, such as a safe, reliable and efficient payments system, can play a role in decisions in competition cases.

In our view the decision of NMa in Appeal will also have consequences for the profitability analysis of other industries than network industries. The Interpay case will change the discussion on the measurement of profitability is all future art. 24 cases in the Netherlands.

