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Lost in the post: where is the as-efficient competitor test after Royal Mail v Ofcom?

After the Intel judgment, is passing the as-efficient competitor test (AECT) sufficient to establish the absence of an exclusionary pricing abuse? This was a critical question put before the UK Competition Appeal Tribunal (CAT) by Royal Mail, a near monopoly supplier of "final mile" delivery services for bulk mail, appealing a decision that its wholesale delivery terms were exclusionary.[1] The CAT's answer was an emphatic no. It found that the AECT is not required as a matter of law.[2] It also claimed that there were no compelling reasons of economic principle that mandated the use of the test, and said that the test is of very limited or no use as a guide to compliance.[3]

This Brief discusses substantive aspects of the case and their relevance for wider consideration of the applicability of the AECT.[4] We argue that an AEC price-cost test offers helpful guidance, especially when the concern is about low pricing by the dominant firm.[5] As such, it can provide comfort from a compliance perspective, so long as it is mirrored by competition authority enforcement in practice. Moreover, broader consideration of whether as-efficient competitors are likely to be foreclosed – which we denote the "AEC principle" – should have a role in guiding enforcement priorities more generally, even if not as a definitive test of exclusionary abuse.

A brief summary of the case

The case concerned the wholesaling and retail of bulk mail postal services in the UK. Bulk mail constitutes addressed letters sent out in large volumes, such as bank statements, utility bills, and advertising mail. The retail stage involves collection of bulk mail from the customer, sortation, and arrangement for onward delivery. The wholesale stage involves the delivery of bulk mail to final recipients (e.g. households throughout the UK).[6]

Royal Mail operates at both the retail and wholesale levels. As a wholesaler, Royal Mail provides bulk mail delivery services to so-called "access operators", including Whistl and UK Mail. In doing so, it offered the following pricing plans at the time of the alleged abuse:

- NPP1, which provided delivery of bulk mail at a uniform price that did not vary with the delivery location. To qualify, access operators had to send mail to almost every part of the UK and in a similar pattern to Royal Mail.
- APP2 also involved a uniform price. However, unlike NPP1, access operators did not need to send mail throughout the UK. Instead, the proportions of their mail falling into each of four delivery categories or "zones" – rural, urban, suburban and London – had to correspond closely to those of Royal Mail.
- ZPP3 provided delivery of bulk mail at a separate price for each of the four zones identified in the APP2 plan. This price plan did not have any requirement to meet specific mailing profiles.[7]

In 2014, Royal Mail announced that the APP2 and ZPP3 tariffs would become around 1.2% more expensive than the NPP1 tariff (on average, in the case of the zonal ZPP3 tariffs). Prior to that, the tariffs were equivalent.[8] Moreover, in the case of ZPP3, prices for the urban and London zones were to be significantly reduced compared to their 2013-14 levels, while prices for the suburban and rural zones were to be significantly increased.

1 See Royal Mail plc v Office of Communications and Whistl UK Limited, [2019] CAT 27, henceforth "Judgment". Ofcom, which made the original decision, is responsible for regulation of Royal Mail. It also has concurrent powers to apply competition law in the sector, as it did in this case.

2 Judgment, paragraph 487.

3 Judgment, paragraphs 495 and 519.

4 RBB was not involved in the proceedings.

5 See, for example, "Selective price cuts and fidelity rebates" (commissioned from RBB by the Office of Fair Trading in 2005), which sets out a framework for assessing foreclosure, including how the AECT can be applied to targeted price cuts, conditional rebates and mixed bundling. Henceforth (RBB 2005). https://webarchive.nationalarchives.gov.uk/20140402161718/http://www.oft.gov.uk/OFTwork/publications/publication-categories/reports/Economic-research/oft804

6 A peculiarity of postal services is that the market for wholesale delivery inputs is often referred to as the downstream market because it occurs later in the supply chain that runs from sender to recipient.

7 ZPP3 prices were derived from APP2 prices by applying a set of percentage-based adjustments to the uniform APP2 price to produce different prices for each of the four zones, leading to so-called "zonal tilt".

8 This meant that if a provider qualified for NPP1, it would be charged the same average price under that plan, APP2 and (broadly) ZPP3.

Whistl complained to Ofcom about these proposed price changes.[9] At the time, Whistl was a nascent entrant at the wholesale level, planning to expand primarily into the urban, suburban and London zones (but rarely into rural zones). Where Whistl could not self-deliver, it would need to continue to procure wholesale services from Royal Mail. Its self-delivery operations meant that it could not obtain such services on the basis of NPP1. It would therefore be subject to a wholesale price rise in those areas (especially rural zones) where it relied on Royal Mail for delivery.[10]

Notably, Royal Mail did not actually implement these price changes. To the contrary, it suspended the introduction of the higher prices while Ofcom investigated whether such prices would be deemed exclusionary. Nonetheless, Ofcom found that, if implemented, Whistl would have suffered a competitive disadvantage: in order to offer retail services to customers requiring deliveries throughout the UK, Whistl would have to procure delivery services from Royal Mail on worse terms than access operators with no desire to enter the delivery market.[11] Ofcom also considered that the announced price differential, at least in part, caused Whistl to abandon its bulk mail delivery operations, and hence weakened competition.[12]

Royal Mail responded, inter alia, that even if the proposed differential (if applied) would have rendered Whistl's expansion plans unprofitable, this could not be anti-competitive if an as-efficient competitor could profitably operate under the same tariff structure. Royal Mail presented evidence which it said showed that an as-efficient competitor could indeed operate profitably under the disputed pricing plans. Further, it argued that Ofcom had erred by not conducting a similar price-cost test or engaging sufficiently with Royal Mail's evidence.

Ultimately, the CAT sided with Ofcom. Drawing heavily on documentary evidence (and stating that "the existence or otherwise of a strategic intention to exclude competitors is a very relevant factor in law in assessing the conduct of a dominant undertaking"[13]) the CAT found that the announced price differential was abusive, having the intention and effect of stifling Whistl's planned expansion. It concluded that Ofcom had no obligation to conduct an AECT and rejected Royal Mail's claim that competition law should only protect as-efficient rivals.[14] The CAT also rejected Royal Mail's claimed objective justifications.[15]

The AECT as a price-cost test

The AECT is usually implemented as a price-cost test that is used to distinguish between harmful and beneficial (or at least benign) pricing by a dominant firm. According to this test, a pricing strategy is unlikely to harm competition if the relevant price exceeds the appropriate measure of cost. The cost benchmark adopted is the dominant firm's own cost (hence the term "as-efficient"). The AECT is an established way to help distinguish between legitimate and exclusionary behaviour when assessing predatory pricing, conditional rebates and margin squeeze scenarios.[16]

On the face of it, the matter in question did not fit neatly into the latter scenarios. Ofcom's theory of harm was one of a (proposed) discriminatory price increase, i.e. that Royal Mail sought to penalise Whistl for seeking to expand its own delivery operations by charging higher prices for the wholesale delivery services that Whistl would still need to obtain from Royal Mail.

Royal Mail advocated a broader interpretation of the AECT. It argued that, even if conduct involved a price increase that raised rivals' costs (as opposed to a price reduction targeted on direct customers), this did not matter if it passed the AECT. Indeed, Royal Mail argued that, even if the announced wholesale price changes had induced Whistl to abandon its expansion plans, this was not anti-competitive, because an as-efficient competitor could still have profitably operated at the delivery level under the increased APP2 and ZPP3 prices. Royal Mail presented a price-cost test to support its claims.

The CAT rejected the view that competition law should only protect as-efficient rivals.[17] It also warned against using the AECT as an ex post justification of behaviour, noting that Royal Mail had not adopted an AECT in the compliance work it had undertaken when developing its pricing proposals.[18] In addition, the CAT expressed a number of concerns with Royal Mail's version of the AECT.[19]

9 Ofcom's main concern appeared to be the overall price differential rather than the change to the zonal tilt (Judgment, paragraph 153(5)). Nevertheless, when Royal Mail sought to reissue only the less controversial parts of its proposed changes on 4 March 2014, the zonal tilt change was removed (Judgment, paragraph 101).

10 Royal Mail's delivery charges accounted for around 90% of the retail price (Judgment, paragraph 177). Therefore, while the overall percentage price rise may appear relatively small, its impact on an access operator's retail margin would be much more substantial.

11 Whistl's main rival, UK Mail, would be able to procure under NPP1. UK Mail apparently used unspecified market leaks of a pending price change as the basis for a campaign to capture retail business from Whistl (Judgment, paragraph 379).

12 Whistl continues to provide retail bulk mail services (following a management buyout) and relies on Royal Mail for delivery services.

13 Judgment, paragraph 278.

14 "Intel does not provide authority for the proposition that conduct will always be compatible with Article 102 provided that the only undertakings affected by the conduct are less efficient than the dominant undertaking". Judgment, paragraph 485.

15 Royal Mail argued that the lower price of NPP1 was justified by cost savings (due to customers providing volume forecasts under this plan) and that the higher prices for APP2 and ZPP3 were necessary to fund its universal service obligation (USO). The CAT did not find these arguments convincing.

16 See, for example, Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, published 24 February 2009 ("Commission's Guidance Paper"). See, inter alia, paragraphs 23-25, 27, 43-45, 60, 67 and 80.

17 Judgment, paragraph 485.

18 Judgment, paragraphs 280 and 589.

19 Judgment, paragraphs 549-578.

Should less efficient competitors be protected by competition law?

In relation to the issue of whether the AECT should be a necessary component in assessing abuse, the CAT found "no compelling reasons of economic principle that mandate such a test".[20]

A number of factors may have influenced the CAT's reasoning on this point. In the context of this case, the CAT seemed to take the view that competition had been clearly harmed (inter alia because the dominant firm intended to oust its only rival) and that this was sufficient to find an abuse irrespective of the long term impact on consumers or whether an as-efficient competitor would have been excluded by the conduct in question.[21]

The CAT also highlighted that entry and competition from a less efficient rival can lead to lower prices and better outcomes for consumers, notably where an unconstrained monopoly would otherwise prevail.[22] Further, where scale economies are significant, firms that could grow to be as-efficient as dominant incumbents may need competition law protection while they are still small.

However, while the preceding arguments may apply in special cases, there are good reasons why competition authorities should be careful not to intervene to protect less efficient rivals.

First, to say that clear evidence of harm to competition trumps "passing" an AECT may sound indisputable but, in practice, harm to competition and consumers is rarely obvious: the value of the AECT is that it can be an important, and sometimes critical, indicator of whether such harm has arisen (or is likely to arise). Indeed, the CAT acknowledged that the AECT may be "particularly useful" as a practical tool (as opposed to a legal requirement) for distinguishing between legitimate and anti-competitive low prices.[23]

Second, while inefficient entry can lead to better short-term outcomes for consumers, protecting inefficient entrants can also be harmful over the longer term. For example, a firm would be expected to respond to vigorous competitive pressure from rivals by cutting its prices and the AECT guides dominant firms in respect of the price level below which scrutiny is likely to arise. But if less efficient competitors are protected, what should the dominant firm do? Such a framework would imply that the dominant firm should price at a level that accommodates a higher cost entrant. Not only would this make compliance difficult (how much accommodation is required?), the rival would also have a weakened incentive to invest in lowering its own costs. The overall effect could be higher prices, less innovation and consumer harm.

It is notable too that the CAT reaffirmed the CJEU's view in Post Danmark II that (at least in the postal sector) the AECT is not meaningful if there is no possibility of an as-efficient competitor arising.[24] This, in essence, was an argument that (i) the incumbent may benefit from sources of advantage, notably in respect of costs, that are not available to even the most efficient (bulk addressed mail) entrant, and (ii) some competition is better than none. While such precedent may protect consumers in some special cases (e.g. in respect of behaviour by former state-owned monopolies), signalling that dominant firms may infringe Article 102 by failing to leave sufficient headroom for inefficient rivals risks chilling legitimate competition (and harming consumers) outside of these rare circumstances.[25]

20 Judgment, paragraph 495.

21 Judgment, paragraph 367.

22 The CAT noted that even if entry led to some duplication of costs and caused the dominant firm to operate on a smaller, less-efficient scale, it may still benefit consumers through lower prices.

23 Judgment, paragraph 487.

24 In such circumstances, the CAT stated, "some other means must be used to ensure that the conduct complained of was not competition on the merits". Judgment, paragraph 491.

25 If public policy considerations dictate that intervention is desirable in specific industries to promote competition from less efficient rivals, then narrowly specified regulation might be a better answer to "ringfence" precedent within the regulatory regime.

An AEC principle as an administrable guide to enforcement priorities and compliance

How might we administer a policy based on the AECT? At the outset we note that there is no single test (or simple approach) that will perfectly distinguish benign or pro-competitive behaviour from anti-competitive conduct. Nonetheless, a clear principle is important to assist dominant firms to comply with the law (and notably their "special responsibility" not to allow their conduct to impair genuine, undistorted competition). The principle should be administrable (from both enforcement and compliance perspectives) and seek to balance error costs – i.e. the risk of erroneously punishing firms for benign or beneficial behaviour versus failing to intervene against harmful conduct.

The AEC principle provides a sensible way to balance these objectives and guide competition enforcement priorities in line with the European Commission's 2009 Guidance. There, the Commission says that it "will normally only intervene where the conduct concerned has already been or is capable of hampering competition from competitors which are considered to be as efficient as the dominant undertaking".[26] It should also be noted that an AECT leaves scope to flex enforcement somewhat through the choice of cost measure. If the dominant firm's price is benchmarked against a long run measure of cost, this will leave greater room for entry than if price is compared with a short run measure of cost.

When implementing the AEC principle, it is helpful to be mindful of a difference between the AECT as a price-cost test and a more general test for anti-competitive foreclosure. Importantly, it is possible for pricing schemes to fail the price-cost test yet not foreclose an as-efficient competitor (e.g. when the test is failed on units that cover only a small part of the relevant market).[27] So while passing the price-cost test should (in our view) weigh heavily in favour of the dominant firm's behaviour being legitimate, the results of the test must be viewed in conjunction with other evidence on the feasibility of foreclosure and likely consumer harm.

It is notable that the CAT starkly dismissed the use of an AECT as a self-assessment tool on the basis that it "provides at best a very limited degree of legal certainty and, at worst, none at all".[28] We are less inclined to dismiss the value of the AECT. We note, for example, that the CAT helpfully indicated that the AECT may be "particularly useful" as a practical tool (as opposed to a legal requirement) for distinguishing between legitimate and anti-competitive low prices.[29] This suggests that, even on the CAT's view, an important role should remain for the AECT in the assessment, and self-assessment, of these types of cases.[30]

Finally, while the CAT noted that conducting an AECT can be complex (and so a dominant firm's self-assessment may differ from the approach adopted by a competition authority), this is not a compelling reason to doubt its usefulness: conservative assumptions and sensitivity testing, allied with good guidance from competition authorities, can mitigate compliance risk.

Conclusion

The AECT provides a valuable guide for sensible competition policy. When used as a price-cost test for the assessment of alleged low-price abuses, it is both administrable and a reasonable way to balance the error costs of over- versus under-enforcement. More generally, an AEC principle (that authorities should be reluctant to intervene against behaviour which would not exclude as-efficient competitors) is a good way to prioritise competition authorities' caseloads. Indeed, this is in line with the European Commission's Guidance Paper on enforcement priorities for exclusionary abuses.[31] In our view, it would be unfortunate to lose sight of this as, post-Brexit, the UK moves to plough its own competition law furrow.

26 Commission Guidance Paper, paragraph 23.

27 See, for example, RBB (2005) for a discussion of the relevant evidence.

28 Judgment, paragraph 519.

29 Judgment, paragraph 487.

30 An interesting point is whether the emphasis by the CAT on low prices may suggest that, in the assessment of alleged margin squeeze, the CAT would be more willing to place weight on the results of an AECT where the alleged margin squeeze arises from a retail price reduction as opposed to a wholesale price increase.

31 Op. cit, paragraph 23.