Compecon - Competition Economics Newsletter.

Issue No.6 – January 2006.

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Appeals Panel Overturns Second ComReg Decision.

Introduction.

On 14th December, 2005, the communications regulator, ComReg, agreed to the annulment by the Electronic Communications Appeal Panel (ECAP) of a decision that Vodafone and O2 were jointly dominant in the mobile access and call origination market. ComReg also agreed to pay the costs of the appeal.[1] This followed an earlier decision by the ECAP on 26th September, 2005, in which it upheld an appeal by Hutchison 3G Ireland, "3", against a finding by ComReg that 3 enjoyed significant market power (SMP) in the market for terminating calls on its own mobile network.[2]

In the 3 appeal, the ECAP was highly critical of ComReg's failure to conduct a proper economic analysis before coming to its decision. Serious questions also arise regarding the economic analysis in the Vodafone/O2 decision.

The Legal Framework.

On 7th March 2002 the European Parliament and Council adopted a series of new Directives providing for the regulation of electronic communications. These Directives came into force on 24th April 2002 and Member States were required to apply them as and from 25th July 2003.

The new regulatory framework is designed to move away from *ex ante* regulation of electronic communications services to a system where these are regulated by competition law. To that end the Framework Directive provides that NRAs can only impose *ex ante* regulatory controls in markets that are deemed not to be effectively competitive. Recital 27 of the Directive provides that:

> "It is essential that *ex ante* obligations should only be imposed where there is not effective competition, i.e. in market where there are one or more undertakings with significant market power, and where national and Community competition law remedies are not sufficient to address the problem."

SMP is defined as equivalent to dominance by Section 14(2) of the Framework Directive which states:

> "An undertaking shall be deemed to have significant market power if, either individually or jointly with

[1] Compecon was part of Vodafone's advisory team.

[2] Decision No: 02/05 of the Electronic Communications Appeals Panel in respect of Appeal No: ECAP 2004/01.

> others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers."

The 3 Appeal.

This appeal arose out of a decision by ComReg that all four licensed mobile operators enjoyed significant market power (SMP) in respect of call termination on their own respective mobile networks. Only 3 appealed the decision. The parties agreed that the relevant market was the market for call termination on 3's own network. Call termination refers to the fact that when subscribers to other networks wish to call a subscriber to another mobile network, that operator must grant the other operators the right to terminate the call on its network. By definition 3 had a 100% share of the market for call termination on its own network.

3 argued that ComReg failed to take account of the fact that other parties, notably Eircom, enjoyed a degree of countervailing buyer power in negotiating rates for terminating calls on its network and that, as a result, it did not have a dominant position. The ECAP found that ComReg erred in "assuming that market share gave the Appellant significant market power" and had failed to properly analyse whether or not Eircom and other parties had countervailing buyer power, which would prevent 3 from being dominant. It stated:

> "In the Panel's view this analysis is not sufficient. It does not meet the standard required of a regulator and does not sufficiently explore and analyse the possibility that interconnected parties and in particular, *eircom*, might have sufficient countervailing buyer power. There is no evidence of a "thorough" analysis as required by paragraph 78 of the SMP Guidelines and, as was highlighted in section 6, there is a striking absence of analysis in relation to key areas, areas that the Respondent has now accepted to be of relevance."[3]

The Vodafone/O2 Appeal.

This appeal arose out of a decision by ComReg that Vodafone and 02 jointly enjoyed SMP in the market for mobile access and call origination, i.e. the market for making mobile phone calls. This decision was appealed by Vodafone, O2 and Meteor.

ComReg, in its decision, argued that the market was not effectively competitive and that Vodafone and O2 were therefore jointly dominant and stated:

> "In practice, ComReg believes that the evidence supports the view that O2 and Vodafone are tacitly colluding in this market."[4]

Several aspects of the economic arguments put forward by ComReg are open to question.

While the outcome observed in the market was consistent with tacit collusion, it was equally consistent with non-cooperative (competitive) behaviour by two rival oligopolists. In order to identify whether the market outcome was more likely to be due to tacit collusion or competition, ComReg would have had to undertake a detailed

[3] Para 8.9.

[4] ComReg: *Response to Consultation and Notification to European Commission Market Analysis – Wholesale Mobile Access and Call Origination,* Document no 04/118 and 04/118a, 9th December 2004, para 1.18.

quantitative analysis, which it failed to do. The failure to establish whether or not the market was actually competitive raised serious questions about the decision.

According to ComReg mobile phone charges were sufficiently transparent to allow either Vodafone or O2 to detect cheating by the other firm. It also argued that either firm could punish cheating by its rival by reverting to competitive pricing so that a credible retaliatory mechanism existed. As pointed out, however, ComReg failed to establish that prices were above the competitive level in the first place.

Tacit collusion normally requires symmetrical market shares. Vodafone's market share was considerably greater than that of O2.

ComReg also argued that the failure of Vodafone and O2 to conclude wholesale access agreements with mobile virtual network operators (MVNOs) was further evidence of tacit collusion. This argument ignored the fact that concluding such an agreement might not have been unilaterally profitable for either mobile operator. In other words, the failure to conclude such an agreement might equally well have been explained by the fact that it was not in either firm's interests. Again the observed behaviour could be the result of either competitive or collusive behaviour and so was not, of itself, conclusive evidence of tacit collusion.

ComReg argued that mobile phone charges in Ireland were excessive compared with other EU Member States. The evidence on prices was somewhat mixed. International comparisons showed that pre paid prices in Ireland were low by EU standards but that post paid prices for certain user categories were above the EU average.

ComReg also cited evidence that average revenue per user (ARPU) in Ireland was high by EU standards. The operators countered that high ARPUs in Ireland reflected high levels of usage. ComReg failed to show that high ARPUs were due to high prices rather than high usage.

ComReg argued that Meteor and 3 would not be capable of providing a competitive constraint on the ability of Vodafone and O2 to tacitly collude going forward. There was evidence that, following the conclusion of a national roaming agreement with O2, Meteor had increased its market share, at Vodafone's expense, suggesting that it would represent an effective constraint on tacit collusion going forward.

Vodafone also argued that ComReg had failed to apply fair procedures and act in accordance with principles of natural justice in reaching its decision.

After the first day's hearing, ComReg stated that it would agree to the ECAP annulling the decision.

Conclusion.

Serious questions arise regarding the level of economic analysis carried out by ComReg in both the 3 and Vodafone/02 decisions. Poor regulatory decisions impose high costs, not only on regulated firms, but on the wider economy. The outturn of these two appeals highlights the need for an independent body to review regulatory decisions.

Groceries Order to Go.

Introduction.

Shortly before Christmas, Minister for Enterprise, Trade and Employment, Micheal Martin T.D., published a bill to repeal the Groceries Order and amend certain aspects of the Competition Act, 2002.[5] If enacted the Bill will mean an end to the *per se* prohibition on below cost selling in the grocery sector.

Summary of the Bill.

The Bill provides for the revocation of the Groceries Order, 1987. It also proposes to amend the Competition Act, 2002, by prohibiting certain types of behaviour in the grocery sector. Specifically the Bill proposes to prohibit

(a) suppliers from compelling grocery retailers to sell grocery goods at a fixed price or at a price above a minimum price; and

(b) the payment of "hello money" or "slotting allowances" in the grocery sector.

It also provides that a grocery goods undertaking shall not apply dissimilar conditions to equivalent transactions with another grocery goods undertaking. These provisions are subject to the qualification that such behaviour shall not be prohibited unless it has as its object or effect the prevention, restriction or distortion of competition. The Bill provides that aggrieved parties shall have a right of action against any grocery goods undertaking and any director or manager of such undertaking that contravenes the prohibitions. The Competition Authority would also have a right of action.

Analysis of the Proposals.

The Competition Act already prohibits dominant firms from applying dissimilar conditions to equivalent transactions with other parties thereby placing them at a competitive disadvantage. The Bill proposes that all undertakings would be prohibited from applying dissimilar conditions to equivalent transactions irrespective of whether the undertaking is dominant and whether or not it places the other party at a competitive disadvantage. The rationale for such a provision is difficult to fathom.

The prohibition on "hello money" is a carry over from the Groceries Order. Whereas the Order absolutely prohibited such behaviour, the Bill provides that it will be prohibited only if it has the object or effect of preventing, restricting or distorting competition. There has been some debate in the economics literature over whether such payments are anti-competitive.

The Bill proposes to expand the definition of resale price maintenance (RPM) by prohibiting suppliers from coercing or compelling retailers to sell goods at a particular price. EU and US competition law only prohibit RPM where there is an agreement between the supplier and the retailer. There has also been a considerable debate in the economics literature regarding the competitive effects of RPM.

Conclusion.

The new Bill proposes to outlaw specific practices in the grocery sector. Whether or not such practices are anti-competitive is open to debate and may have to be thrashed out in the courts if the Bill is enacted in its current form.

[5] Competition (Amendment) Bill, 2005.

NOT PROVEN – Verdict on the Competition Authority Report on the Legal Profession.

Introduction.[6]

The Competition Authority's Preliminary Report on the Legal Profession concluded that "the legal profession is permeated with serious and disproportionate restrictions on competition." According to the report these restrictions emanated primarily from the rules of the professional bodies that represent barristers and solicitors. The report contained 41 proposals for reform of the Irish legal profession. The Authority's report, however, fails to provide any strong evidence in support of its conclusions.

The Authority's Main Conclusions.

In essence the Authority's conclusions may be summarised as follows. Lawyers in Ireland enjoy relatively high incomes which are due to monopoly rents resulting from restrictions on competition. These restrictions on competition are primarily the result of regulatory restrictions imposed by the relevant professional bodies, which have the effect of limiting entry to the legal profession. The areas highlighted in the Authority report include:

1. Monopoly supply of legal education.
2. Restrictions on business structures.
3. Restriction on supply of conveyancing services
4. Restrictions on advertising.
5. Restrictions on holding dual titles.
6. Restrictions on recognition of foreign legal qualifications.
7. Restrictions on senior counsel.
8. Legal fees and the taxation of costs.
9. Miscellaneous restrictions on competition.

The report argues, however, that removing all of the identified restrictions will not suffice to introduce competition, as the professional bodies, which currently regulate the profession, would simply introduce new restrictions on competition. The Authority therefore proposes that a new State regulatory body, to be known as the Legal Services Commission (LSC), should be established to regulate solicitors and barristers.

Lack of Evidence.

The report points out that the growth in expenditure on legal services between 1992 and 2003 was in line with overall [nominal] GDP growth. It states:

> "This increase is surprising given that a service sector would not typically expand at the same rate as an economy experiencing very rapid growth fuelled predominantly by growth in hi-tech sectors."[7]

The Authority fails to advance any evidence in support of this assertion. This finding ignores the existence of a number of factors that would have led to increased demand for legal services including:

- A rapid increase in house building and a buoyant in the housing market;

[6] This article is based on a paper by Patrick Massey of Compecon and Professor Frank Stephen of the University of Manchester which was presented to Dublin Economics Workshop Annual Economic Policy Conference in Kenmare on 15th October 2005.

[7] Para 2.48

- Strong economic growth – presumably increased commercial activity generates extra demand for legal services;
- Increased litigiousness.

The report also argues that lawyers' average incomes are high by comparison with certain other professions. It then goes on:

> "Relatively high incomes are consistent with the increase in demand for legal services not being met by an equal increase in supply. This does not prove that competition is restricted, but is consistent with the existence of restrictions."[8]

Information included in the report, however, reveals that there is a wide disparity in lawyers' incomes, particularly in the case of barristers with a relatively small number of individuals enjoying very high incomes. Such relatively high earnings by a small number of individuals may simply reflect their high skill levels and expertise and the fact that there is a very high demand for a small number of top lawyers. People may be able to hire someone whose fees are lower, but they choose not to do so. The Authority's view contrasts with that of a 2001 OECD report on regulatory reform in Ireland, which triggered the Authority investigation of the legal profession. It found that:

> "there is little reason for concern that barristers fees are above the competitive level, at least on average".

Another issue ignored in the Authority's report is the oft observed phenomenon that increasing lawyer number may actually increase the demand for legal services thereby resulting in higher incomes for lawyers due to supplier induced increase in demand. The decision to reintroduce some restrictions on solicitor advertising to restrict so called "ambulance chasing" can be regarded as an attempt to limit solicitors' ability to generate an increase in demand for their services.

The report argues that the existing monopolies on education and professional training of solicitors and barristers may limit entry to both professions and thus restrict competition. This is true from a theoretical viewpoint but the report provides no evidence of this. The numbers of both solicitors and barristers have increased considerably over the past number of years. In addition there is evidence of a significant attrition rate, particularly for barristers. The report notes that 15% of newly qualified barristers exit the market within five years of qualification. In other words there is evidence of high levels of entry and exit which is inconsistent with restrictions on entry, a point made in the OECD report which observed that:

> "High turnover and low income of many practitioners both suggest that entry controls are not restricting competition among barristers."

The Economics of Regulation.

Economists generally begin from the premise that any economic activity should be free of regulation (or at least regulated only by the market) unless it can be shown that it is subject to *market failure*: left unregulated the market will not generate socially efficient levels of output. Market failure can arise for a number of reasons. The economics literature indicates that the usual source of market failure in professional service markets is incomplete information.

[8] Para 2.57

In the case of legal services potential consumers do not have the technical or expert knowledge to make judgements about the quality of what is being offered to them or, in some cases, whether what they are being offered will satisfy their requirements. Indeed, in the extreme, a situation can exist where even after the service has been provided the consumer is unable to judge whether what was supplied was appropriate. The consumer of a professional service needs the professional's services precisely because s/he does not have the specialist knowledge of the professional. There is an information asymmetry between professional and client. This asymmetry can have two consequences: adverse selection and moral hazard.

Adverse selection affects the client's choice of professional. If clients are unable to distinguish between high quality and low quality providers before engaging one, the price they are willing to pay for the services will be lower than they would be willing to pay to a high quality provider if they could identify one. If the cost of providing a high quality service is greater than for a low quality service, the price consumers will be willing to pay may be insufficient to keep high quality providers in the market. Consequently, high quality providers will exit the market reducing the average quality of the remaining suppliers. This will lead to consumers revising downwards the price they are willing to pay, possibly generating a race to the bottom or a 'lemons market'.

The typical solution to this problem has been to regulate entry to professional markets. In most European and North American jurisdictions this has taken the form of giving monopoly rights over some legal services to those who are members of a professional body requiring an educational qualification and a period of professional training. The professional body reduces the adverse selection problem by setting and policing a minimum quality standard.

Moral hazard arises after a client has selected a supplier. The client is often not in a position to judge whether the service being provided by the professional is necessary or adequate. Most professional services involve two separate functions. First, there is the diagnosis of the problem and the identification of the services necessary to deal with it. Secondly, there is the supply of these services. In some fields these are separate activities e.g. architects are employed to design buildings to satisfy a client's specified needs but they do not provide construction services. On the other hand, when a party to a dispute consults a solicitor, the latter will usually diagnose the legal problem, suggest a remedy and implement it. In such circumstances, a solicitor motivated solely in terms of financial gain may be tempted to suggest an expensive solution. By definition the client is not in a position to judge whether that remedy is the only one possible or even if it is likely to be successful. In the economic literature this is described as 'supplier-induced demand'. In the absence of regulation the market is likely to generate a level of services which is above the optimal (or efficient) level. This suggests that regulation is required to ensure that suppliers do not exploit their informational advantage.

Clients who are repeat purchasers of legal services, such as companies, may

have sufficient information to make proper choices. Alternatively, the frequent purchaser may be in a position to generate competition between suppliers resulting in a more efficient specification of service and price. Nevertheless, individuals and households require legal services less frequently. For them purchasing a house, writing a will or disputing a contract are relatively infrequent occurrences. These are the clients who suffer from an informational disadvantage with respect to the professional. Thus there is a *prima facie* case for regulation of the market for such legal services.

Why Self-Regulation?

In most jurisdictions regulation of the legal profession takes the form of self-regulation by the profession itself. Some economists argue that self-regulation is tantamount to creating a cartel. A contrary view is that self-regulation is the most cost effective form of regulation. A common problem facing regulators is that it can be very costly to acquire sufficient information to enable them to make good decisions, which means that regulation can frequently be very costly. Self regulation may reduce the cost of acquiring information and makes adjustments of regulations easier. The efficiency gains due to self-regulation need to be compared to the potential costs due to the potential for cartel-like behaviour.

A more philosophical approach is to view the right to professional self-regulation as implying a social contract between society and the profession which mitigates the moral hazard problem. However, the terms of the social contract may need to be reviewed from time to time to ensure that cartel-like behaviour has not evolved.

The Scope for Regulatory Failure.

Much of the economics literature on regulation over the past thirty years has highlighted the problem of "regulatory failure". This literature has identified the fact that regulation is a far from perfect solution to problems of market failure and that, even where market failure exists, regulation may not be capable of making things better.

The Authority completely ignores the issue of regulatory failure in its proposal to replace self-regulation of the legal profession with State regulation. According to the Authority:

> "Such a regulatory body, provided that its reforms are based on the principles of good regulation, would retain the strengths of the current structure while avoiding its weaknesses."

In other words, if the proposed regulator does its job perfectly, then things will be better. Such reasoning is fundamentally flawed. In the real world the choice is not between imperfect self regulation and a perfect State regulator, as the Authority seems to suggest. Regulators suffer from a lack of information and are prone to be misled by those they regulate. Regulators are not disinterested agents who act only in the public interest; regulators pursue their own interests too. The historical record shows that State regulatory bodies are highly susceptible to capture by the undertakings that they regulate and just as likely to introduce anti-competitive regulations.

The Authority's arguments that such a reform would be cost effective appear rather weak. It argues that:

> "A Legal Services Commission would not necessarily be more costly than the present system."

It then goes on to state, however, that:

> "Even if there were higher costs, they would likely be associated with a higher degree of transparency and accountability, with attendant benefits."[9]

No evidence is adduced to support such assertions.

The Authority case for ending self-regulation is that professional bodies representing solicitors and barristers could, in the future, introduce anti-competitive restrictions. As a general rule competition law only interferes with the activities of businesses and representative bodies where there is clear evidence that the law has been broken. There are circumstances where *ex ante* regulatory intervention may be justified in order to prevent an abuse of market power; the case of deregulated utility industries comes to mind. It is not clear that such intervention is appropriate in this instance.

This is not to say that the existing regime of self-regulation cannot be improved upon. This could be achieved far more effectively by a more limited range of reforms. The risk that self-regulatory bodies would in the future impose anti-competitive restrictions could be greatly reduced by a requirement that the Law Society and Bar Council obtain the views of the Competition Authority regarding any proposed rule changes before they could be implemented.

The Verdict.

The Authority's report contains a number of worthwhile recommendations. For example, there may be very good reasons for ending solicitors' monopoly on conveyancing, although experience in England and Wales suggests that the impact of such measures may be limited. Overall, however, it would appear that the most appropriate verdict on the Authority's case against the legal profession is one that is available to juries in Scottish criminal trials:
"NOT PROVEN".

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[9] Para 3.53.