Why the Competition Authority needs a Chief Economist.

Introduction.

The version of the memorandum of understanding (MOU) between the Government and the ECB/EU/IMF Troika dated 12th February provided that there should be a review of the Competition Authority's resources to see if they are sufficient to allow effective enforcement of the legislation. It also provides that if additional resources were required, they should be provided by the end of 2012 Q2.

The decision to conduct a review to establish whether the Authority has sufficient resources to do its job properly is welcome. One of the issues which should be addressed by this review is the Authority's need for a Chief Economist who would be responsible for reviewing all aspects of the Authority's economic analysis. This is necessary because of serious shortcomings in the Authority's economic analysis in a number of cases.

It is widely accepted that competition law needs to be based on sound economic analysis. For that reason it is essential that the Authority has adequate resources and proper control mechanisms in place to ensure that it gets its economic analysis right. The present article lists several examples where there are serious questions regarding the Authority's economic analysis. These involve a mixture of court cases, merger decisions and its report on the legal profession. In order to address this problem there is a need to establish a post of Chief Economist within the Competition Authority. The role of the Chief Economist would be to independently review the economic analysis in all cases prior to any decision by the Authority.

The Court Cases.

In the 16 years since the passage of the Competition (Amendment) Act, 1996, there has been only one case of alleged abuse of dominance brought by the Authority which has gone to a full trial. The Authority's claim that the Irish League of Credit Unions (ILCU) had abused a dominant position was ultimately rejected by the Supreme Court.[1] The Authority had repeatedly changed its economic arguments during the course of the case. The case ultimately advanced by the Authority in the High Court differed to that set out in its Statement of Claim.

At the trial the Authority argued that there were two relevant markets when it had previously identified only one. The Supreme Court noted that the idea of a second relevant market first appeared in a report prepared by an expert economist retained by the Authority dated 24th May 2004. The Authority issued proceedings in this case in July 2003. The Court also noted that there was no reference to there being two separate markets in the list of issues to be decided dated 18th June 2004, although the trial commenced on June 22nd.

The Supreme Court Judgment clearly indicated its unease at the repeated shifts in the Authority's position.

> "It is not altogether surprising that the Authority had failed to provide a convincing analysis of ILCU's activities as being anti-competitive. The history shows that it has changed its position in relation to ILCU on several occasions. It was permitted finally to change its stance from that advanced in the statement of claim only because Mr Collins decided not to object, believing that this radical change of position demonstrated the lack of credibility in the Authority's case. It certainly seems to me to undermine confidence in the Authority's consistency."[2]

The repeated shifts in the Authority's position raise serious questions about its economic analysis in this case. The case was reported to have cost the Authority €1.7m in legal costs.[3]

The Authority's economic analysis, or rather the complete lack of it, was strongly criticised following the acquittal of the defendants in the Mayo Waste case.[4] Some of this criticism may have been unfair. Nevertheless, during the trial, defence counsel certainly made much of the fact that the Authority had conducted no economic analysis of the case. This point also featured in the subsequent successful claim for costs by the defendants where it was claimed:

> "Such a manifest failure...leaves open to serious doubt the question whether any prosecution would have occurred had the necessary and appropriate efforts been made."[5]

There are other reasons why having some economics input in such cases may be beneficial. Economists might, for example, identify relevant evidence which would otherwise go unnoticed.

Mergers

Misconstruing the SSNIP Test.

Questions arise concerning the Competition Authority's economic analysis in several merger cases. Several of these involve the Authority's approach to defining the relevant market. In another case the Authority found the relevant products were homogenous when the evidence clearly suggested otherwise while in another instance its analysis of efficiencies was seriously flawed.

The SSNIP test is recognised as the standard test for defining markets and has been accepted by the Irish courts. The test asks whether it would be profitable for a hypothetical monopoly producer of a particular product or group of products to impose a small but significant non-transitory increase in price [SSNIP]. This is usually interpreted as a price increase of 5-10% which can be sustained for at least one year. The issue of whether such a price increase would be profitable depends on whether the extra profit from selling a smaller quantity at a higher price would outweigh profits foregone on sales lost as a result of the price increase.

The key point about the SSNIP test is that it only requires a minority of customers to switch to render a price increase unprofitable. For example, if the price-marginal cost margin is 20% a drop in sales of just over 20% would render a price increase unprofitable. If the price-marginal cost margin is 40% then a drop in sales of more than 11% would render a price increase unprofitable.

In some merger decisions, however, the Authority has wrongly indicated that it would require many customers to change in response to a price increase to render it unprofitable.[6] In others it has argued that the hypothetical price increase would be profitable because only a few customers would switch in response, when in fact this could be sufficient to render the price increase unprofitable.

In *Communicorp/SRH*,[7] for example, the Authority stated: "These results thus suggest that a hypothetical monopoly supplier of radio advertising can profitably raise the price of radio advertising by 5-10% since only a *few* customers are likely to switch *some* of their advertising spend away from radio." (Para 3.32, emphasis added).[8] In a previous decision regarding a local radio merger the Authority argued that price-marginal cost margins in local radio were 50% or more in which case a loss in sales of just over 9% would render a price increase unprofitable.

The Authority's Determination in *Glanbia/Dairygold* stated: "Liquid milk is a mainly homogenous product..."[9] According to the Determination, at the time of transaction, two litres of own label milk sold at around €1.20 versus €1.52 for branded milk, a discount of around 21%. Such a price differential is completely inconsistent with the claim that the products were homogenous. The Determination also noted that there was a degree of regional brand loyalty which again is inconsistent with the view that the product was homogenous.

Mistaken Analysis of Efficiencies.

The Authority's analysis of efficiencies in *Kerry/Breeo* was seriously flawed. During the appeal hearing in this case the High Court heard that the original Assessment issued by the Authority to the merging parties concluded that the parties' estimates of production and distribution efficiencies might be biased upwards because the social benefits or savings would be less than the savings to the merging parties.[10]

The Authority has consistently stated that the standard for establishing whether or not a merger will result in a substantial lessening of competition (SLC) is consumer welfare Social costs and savings are simply not relevant in the context of a consumer welfare or price test. The parties pointed this out both at the oral hearing and in their written responses.

The Court heard, however, that the references to social costs and benefits were retained in a draft of the Determination which was sent to an external economist retained by the Authority to advise on the case. The economist sent an e-mail sent to the Authority the day before it took its final decision stating that these arguments were incorrect. He indicated that he had originally made these points in a report for the Authority but he had done so mistakenly because he had applied an "industry welfare" standard which is contained in Canadian law rather than the consumer welfare standard applied by the Authority.

The e-mail stated that when applying the consumer welfare standard, the issue was whether prices would rise or fall post-merger and social costs and benefits were not relevant to such calculations. The e-mail correctly stated that transferring production from Breeo's suppliers to Kerry's facilities would yield cost savings from Kerry's perspective "and that is what would influence Kerry's price."

The Authority nevertheless revised the relevant parts of the decision and proceeded to prohibit the merger while stating in the Determination:

> "The Authority is not arguing for a wider industry welfare standard. The assessment in discussing certain of the savings did use perhaps infelicitously the terms 'social gains' and 'social savings'" (Para 9.49).

Questions Arising.

This case raises very serious questions which go well beyond the issue of the quality of the Authority's economic analysis and which need to be addressed. This article will, however, confine itself to the economics issues. The first question that arises is how no one in the Authority recognised that the Canadian expert was not applying a consumer welfare standard in his report when they included the relevant section verbatim in the Assessment.

Second, why did no one pick-up on this point when the parties raised it at the oral hearing and in their written response to the assessment. At that stage alarm bells should have been ringing loudly in Parnell House.

Note the Authority did not suggest at any point prior to the publication of its Determination that there had been any misunderstanding regarding the terms "social gains" and "social savings". It was only at the last minute when the external economist spotted the error and informed the Authority that it rewrote its decision, inserting new arguments in the Determination which were also incorrect.[11]

Advocacy Mistake on Mark-up.

The Authority in its report on the legal profession advanced the following argument in support of solicitor-barrister partnerships.

> "As it currently stands, a lay client hires a solicitor and where required a solicitor hires a barrister on the client's behalf. While this is a one-stop shop, it does not eradicate the double mark-up that the client faces. Namely, a client pays a solicitor's fee and a separate barrister's fee. As the solicitor and the barrister are separate economic entities each fee will include their respective mark-ups."[12]

The problem of double mark-ups is widely recognised in the economic literature and is often advanced as an explanation for vertical restraints. However, the issue of a double mark-up does not arise in the case of legal services. The Authority's claim rests on a basic confusion or misunderstanding. The issue of double mark-up arises where there is a vertical relationship between undertakings. For example, assume an upstream manufacturer of a product. The manufacturer adds a mark-up when it sells its products to a downstream retailer. The retailer then adds a second mark-up. The point is that both the manufacturer and the retailer add a mark-up to the same product, hence the "double mark-up".

In the case of legal services solicitors and barristers supply different services. It will make no difference to the overall mark-up whether the solicitor and barrister are separate undertakings or part of the same undertaking. Suppose two products A and B are produced by two separate undertakings, that each costs €1,000 to produce and that each undertaking adds a 20% mark-up. The total price of the two products to the customer is €2,400 and this includes a total mark-up of €400. Now suppose a single undertaking provides both products. As before the cost of producing each product is €1,000 and the undertaking applies a 20% mark-up. The price for the two products will be the same as before, €2,400, and will include a total mark-up of €400. Simple maths states that 20% A + 20% B = 20% (A+B). The Authority's double mark-up claim confuses the situation where two separate undertakings sell two different products with one where two different undertakings at different stages in the supply chain are involved in the production and resale of the same product.

Some Conclusions.

At times economic evidence in competition cases may be open to different interpretations. The High Court noted in its judgment in the *Kerry/Breeo* appeal, for example, that a reasonable case could be made for cooked meats to be considered one market or two separate markets. These are judgment calls on which experts may disagree. The examples described above do not fall into this category, however. These cases raise serious questions regarding the quality of the Authority's economic analysis.

In fairness, any organisation will get decisions wrong from time to time. Errors may arise because of the tight time constraints in merger cases. In other instances errors, may go unnoticed by individuals who have been closely involved in a matter over a period of time. Such errors can prove costly both to the Authority, as demonstrated by the ILCU and Mayo Waste cases, and society generally, which bears the cost when anti-competitive behaviour is not detected or when competitive behaviour is wrongly held to be anti-competitive.

The arguments in these cases may also redound against the Authority as they may be used against it in future cases. They may also be advanced and accepted in private court actions.

The question is whether there are adequate quality control checks in place to ensure that such errors are kept to a minimum. The number of cases highlighted here indicates that there is room for improvement. The EU Commission established a post of Chief Economist following a series of reversals in merger appeals before the EU General Court which was strongly critical of the Commission's economic analysis. There is a need to establish a similar position within the Competition Authority with a Chief Economist heading up a division of 2-3 economists. This division would be responsible for reviewing the Authority's economic analysis not just in merger cases but in enforcement actions and advocacy reports. Economists in this division would not be involved in the handling of cases or preparation of reports as the whole point is to have a fresh pair of eyes review the economics in each case before a final decision is arrived at. While the Authority's membership includes an economist it would not be appropriate for such an individual to combine the suggested Chief Economist role with heading up one of the Authority's other divisions.

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[1] *Competition Authority v John O'Regan & Ors* [2007] IESC 22. The author was an expert witness for ILCU.
[2] Para 52.
[3] *Competition* 16(8), p.183.
[4] See Competition News Alert 24th September 2009, *Authority's Loss of Waste Case Hammered by Economics Consultancy.*
[5] Six Arguments Against Authority's Conduct in Mayo Waste Prosecutions, *Competition*, 17(3), p.64.
[6] In *IBM/Schlumberger* (M/04/32) the Authority stated that "a majority of high-end users" would not switch in response to a price increase. Similarly in *Metro/Herald AM* (M/09/013) the Authority stated "it is not possible to conclude whether *a majority* of advertising agencies would... divert their advertising spend to other media." (para 3.61, emphasis added).
[7] M07/040.
[8] Similarly the Authority Determination in *Grafton/Heiton* (M/05/051) stated: "In response to a 5% price rise, it seems clear that *very few* customers would switch to DIY superstores or other retail stores." (Para 7.4, emphasis added)
[9] M/05/006, para 14.
[10] The Assessment is sent to the merging parties and outlines the reasons why the Authority believes the merger would result in an SLC. It is akin to a statement of objections. The author advised Kerry in this case.
[11] The Determination claimed that only reductions in variable costs should be counted as efficiencies and that the price paid by Breeo to its suppliers might have included a contribution toward their fixed costs. Breeo's variable cost was the price it paid to its suppliers. The issue was whether Kerry's variable costs were lower than that price. Whether or not the price included a contribution to the suppliers' fixed costs was wholly irrelevant.
[12] Competition Authority, *Competition in Professional Services Solicitors and Barristers*, December 2006, para 5.130.