Identifying Market Power in Times of Constant Change

JANICE HAUGE AND MARK A. JAMISON *

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We explain that traditional approaches to defining markets to investigate market power fail in times of constant change because demand and supply are in constant flux. The analyses rely upon historical data, the value of which degrades over time, possibly resulting in harmful regulatory decisions. This points to a need for a different approach to determining when regulation is an appropriate response to market power. We present an approach that relies upon essential factors leading to monopoly (EFMs), such as control of essential facilities, which persist across generations of products. Market power analyses should search for EFMs and policy responses should focus on diffusing the market power without destroying value. We use the telecommunications industry to illustrate our approach.

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* Associate Professor, Department of Economics, Hickory 2201, University of North Texas, Denton, Texas 76203 (janice.hauge@unt.edu); and Director and Gunter Professor, Public Utility Research Center, Warrington College of Business, University of Florida, 205 Matherly, Gainesville, Florida 32611 (mark.jamison@warrington.ufl.edu). The authors would like to thank the organizers of the 20th Anniversary of the National Communications Authority of Ghana for their invitation to present this paper at the symposium. All errors and omissions are the responsibility of the authors. This is a work in progress. Any suggestions and criticisms are welcome.
To determine whether any industry is workably competitive . . . simply have a good graduate student write his dissertation on the industry and render a verdict. It is crucial to this test, of course, that no second graduate student be allowed to study the industry.
- George J. Stigler

Introduction

The justifications for laws regarding competition policy in general, and for economic regulation of utility services more specifically, have long centered on the notion of market power. Traditional economics texts define market power as the ability of a firm to raise price without suffering a significant decline in quantity demanded. (Viscusi, Vernon and Harrington 2000) This definition suffers from the problem that, in equilibrium, a profit-maximizing firm with market power would be unable to profitably raise its price. Perhaps a more effective definition of market power would be that the market demand for the product in question and the demand for the firm’s product are nearly the same, implying a near identity between the firm and the market. With respect to utility services, firms are considered utilities and subjected to economic regulation if

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2 In some contexts market power may be beneficial to customers. For example, in some circumstances firms with market power have a greater incentive to invest in new technologies than do firms in more competitive markets. (Jamison and Hauge 2011) Platform markets – generally two-sided markets that exhibit network effects – tend to tip, resulting in a monopoly or near monopoly, and the tipping creates customer value. (Rohlf 1974) Also a single platform can have multiple diverse market interactions, making the platform monopolistic for some customers but not for others.

3 This in part gives rise the well-known cellophane fallacy, where the market price already reflects the market power of a monopolist, leading the analyst who is trying to define the market to conclude that the monopoly market is not really a market.
they have monopoly power\(^4\) and their services are essential for economic life, meaning that if such firms exploit their monopoly power customers suffer significant economic harm. (Glaeser 1927, Trebing 2001, Jamison and Hauge 2014)

Regulations emanating from concerns over market power include restrictions on single firm conduct (such as exclusive agreements and refusals to deal), limitations on mergers, and utility-style regulation (for example controlling retail and wholesale prices, enforcing service quality, and imposing obligations to serve).\(^5\) (Bonbright, Danielsen and Kamerschen 1988; Brock 1981; Federal Trade Commission 2016) Absent these conditions of essentiality and monopoly, and even with them, government intervention in the marketplace can devolve to rent seeking where the regulations serve the interests of the regulated or the politically powerful rather than the public interest in a well-functioning economy. (Posner 1971, Stigler 1971, Peltzman 1976) Therefore, economic regulation should be used with caution.

The first challenge in knowing whether a market is competitive is defining the market. “Market” in this context means a product space (typically defined by both product features and geography) within which customers are willing to readily substitute between service providers, but beyond which customers do not find suitable substitute products. This analysis is traditionally accomplished using a hypothetical monopolist test. In this approach market boundaries are discovered

\(4\) We define monopoly power as a special case of market power in which the firm’s demand and the market demand are the same.

\(5\) Because it is generally accepted that utility services, such as energy and telecommunications are essential for economic life in advanced and advancing economies, the decision of whether to engage in economic regulation is based largely on beliefs about market power. Additionally, because incumbents were, and perhaps still are granted monopoly status by their governments, the traditional practice for considering whether to regulate has been to assume that there is market power absent a specific finding that there is competition. However, the economic regulation of interconnection in telecommunications often remains even if there is competition because there are questions about whether competition can keep interconnection prices at efficient levels. (Laffont, Tirole and Rey 2000; Armstrong 2002)
by examining whether product substitutability and competitive entry are such that above-normal profits could not be sustained if the market were served by a hypothetical monopolist. (Baker 2007, Jamison and Hauge 2015)

The hypothetical monopolist approach has flaws\(^6\) but is workable and constitutes best practice in situations where technologies and markets are stable. But recent developments have made this approach ineffective in many situations. In information and communications (ICT) industries, the growing prominence of new technologies, platform markets, and next generation networks have shortened product lives thereby changing the markets. Also next generation networks enable software apps to replace services traditionally hardwired into voice networks, again generating market changes. In electricity the application of distributed energy resources, new metering technologies, and transactional energy have changed traditional definitions of utility services. In such instances identifying market power by traditional means is futile because the methods are dependent on historical data and market changes occur more rapidly than analyses are completed, making the analyses of limited relevance to future decision making.

This paper addresses the dilemma of assessing market power when markets are constantly changing by suggesting that analyses focus on essential and enduring factors creating monopoly (EFMs). A factor is an endowment leading to monopoly if it is needed by all who might want to produce the relevant service and its limited supply causes competition to fail. A factor is enduring if it is needed across multiple generations of products. We use telecommunications as our sector for discussion, but the analysis could apply to other industries as well.

The remainder of this article is organized as follows. Section II examines the traditional approach for identifying market power. Section III provides a description of our proposed alternative to the traditional approach. Section IV

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\(^6\) For example the cellophane fallacy, as noted by Stocking and Mueller 1955.
applies our framework to a current issue in telecommunications and Section V is the conclusion.

II. Failings of the Traditional Approach to Identifying Market Power

The best practice approach for identifying market power is first to define the relevant market and then to analyze whether there is market power. The process for defining the relevant market has remained essentially the same for several years. It examines markets in two dimensions – product aspects and geographic aspects. In considering product aspects, analysts attempt to determine whether products that customers view as effective substitutes are reasonably available. Regarding geographic aspects, the analyst examines the degree to which customers can expand their search geographically and whether firms can cross geographic boundaries to serve demand.

Boundaries are identified using a hypothetical monopolist test, which considers whether a hypothetical monopolist within the tested product or geographic boundaries would be able to profitably raise and maintain prices above competitive levels. In applying this test, the analyst first chooses a market definition that he believes to be overly small. Then using historical estimates of market demand, including own-price and cross-price elasticities, the analyst tests whether a hypothetical monopolist could profitably raise prices in this market by a small amount and profitably maintain them. If the hypothetical monopolist cannot do so because customers would find alternative sources of supply outside the presumed market boundaries, then the boundaries being tested are deemed too narrow. The analyst then slightly broadens the market definition and again runs the test. Once the analyst finds a market definition where the hypothetical
monopolist can profitably increase its price, then the market boundaries are considered appropriate.\textsuperscript{7} (Jamison and Hauge, 2015)

We address a primary failing in this traditional approach, namely the problem of analysis decay. The decay problem arises because the traditional approach relies upon historical demand and supply data. While this reliance is appropriate under stable market conditions because it grounds the analyses in real experiences, it provides invalid results when demand characteristics are unstable or unknown, such as in rapidly changing markets and emerging products.

Figure 1 illustrates the decay problem. The vertical axis represents $V_t(A, \omega, d_t, z_t)$, where $V_t$ incorporates all economic value created by the regulatory action and all private costs, minus the costs of the regulator (which we later define as $c \geq 0$), and $t$ designates the time period. The economic value of the regulatory action is denoted as $A \in \{0, 1\}$, where 1 represents the regulator choosing to act, and zero represents the choice not to act.\textsuperscript{8} $\omega$ is a vector of exogenously determined weights assigned to the economic interests affected by the regulatory decision. For example the regulator may value net consumer surplus more than industry profits or value one industry player’s profits over another, such as favoring small or minority-owned businesses. The European Union uses competition policy to promote its goal of a European single market.\textsuperscript{9} $z_t$ is a vector of economic parameters at time $t$, and $d_t = [0, 1]$ is the depreciation rate of the regulatory analysis at time $t$. A lower depreciation rate implies a higher

\textsuperscript{7} This is known as the SSNIP test, or “small but significant nontransitory increase in price” test. See Jamison and Hauge, 2015, or The United States Department of Justice, “Operationalizing the Hypothetical Monopolist Test” for additional information.

\textsuperscript{8} The regulator may be a sector regulator or a competition regulator. In reality, regulators have a variety of options available to them, some of which are more appropriate than others given the economic conditions; however, we choose to model the regulatory decision as a binary choice to simplify our analysis. This choice does not affect the results of the model.

\textsuperscript{9} High Authority, European Coal and Steel Community, \textit{Memorandum On The Anti-Trust Policy of The High Authority} 1 (1954). The original antitrust rules of Articles 65 and 66 of the ECSC Treaty migrated into what are now Articles 81 and 82 of the EC Treaty.
value for action at time \( t \). We assume that the regulatory action occurs when \( t = 1 \) and that data, which are some subset of \( z_{\ell} + z_{\ell+1} + \cdots + z_0 \), are gathered over the time period \([\ell, 0]\), where \( \ell < 0 \) represents the earliest time period from which data are collected. We also assume based on common practice that the analysis does not weight data with respect to time, i.e., data gathered at any point in the interval \([\ell, 0]\) are given equal weight in the analysis (although values may change) to data gathered at any other point in the time interval.

[INSERT FIGURE 1 ABOUT HERE]

The horizontal dotted line \( V_S \) in Figure 1 represents the situation where economic conditions are stable and regulatory action has created economic value, i.e., \( d_t = 0 \ \forall t \), and \( V_S > 0 \). We normalize \( V_t \) to 0 for \( A = 0 \). The downward sloping dotted line \( V_L \) represents the situation where the depreciation rate is low, but greater than zero, and the steeper line \( V_H \) represents the situation where the depreciation rate is relatively higher. We show \( V_L \) and \( V_H \) as positive when intersecting the \( V \) axis, although this might not be the case for welfare decreasing regulatory actions.

Figure 1 illustrates the value of regulatory action as linear with respect to time, but this also need not be the case. For example an action to deny a merger that had no redeeming welfare effects might become of no consequence once the analysis has decayed so much that \( V_t \) becomes zero. Also the rate of decay at \( t \) might be increasing with respect to time, implying a concave function, or decreasing with respect to time, implying a convex function. \( V_t \) could be below zero if, for example, the regulatory action prevents cost savings, increases industry or customer costs, or limits innovation.

\(^{10}\) It is feasible that \( V_t \) could rise during some time periods \( t > 1 \) if the future economic conditions are more suited to the regulatory action than those during the data collection period \([\ell, 0]\). This would seem to occur by luck since the future state is not reflected in the regulator’s analysis, so we limit our examination to situations where regulatory action improves welfare because of the relevance of the regulator’s analysis.
The decay rate affects the relevance of data from $t = [\hat{t}, 0]$ in two ways. When data value is depreciating during the collection period, the economic significance of the data is decreasing in $|\hat{t}|$, i.e., the economic relevance of the analysis declines as the time period for collecting data grows. However, expanding the time period over which data is collected could increase or decrease statistical significance. More data increases statistical significance all other things being equal. However, if the decay rates are high during the data period, we also would expect greater variances because the true parameters and functional forms are changing with respect to time, which lowers statistical significance.

We now consider the effects of regulatory action using traditional analyses when data relevance might decay. We define a traditional analysis as one that uses data from the time interval $[\bar{t}, 0]$ with no weighting of data with respect to time. Using this approach, a regulator seeking to maximize welfare will regulate if the net value of the regulatory action over time exceeds the regulatory cost; i.e., if

$$\left( \bar{t} - 1 \right) \sum_{t=\bar{t}}^{0} \frac{V_t(A=1, \omega, d_t=0, z_t)}{|\hat{t}|} \geq c,$$

(1)

where $t = \bar{t} > 1$ represents the period it is expected that the regulatory action will end, such as in the case of a sunset provision. We did not find in the literature instances where regulators explicitly considered administrative costs of implementation, so it may be in many situations that regulators effectively act as if $c = 0$.

Assuming that the regulator’s choice of $\bar{t}$ is correct, the actual effects of a regulator’s decision to regulate are the sum of the value of the decision from the time the decision is made until the decision expires, if ever:

$$\sum_{t=1}^{\bar{t}} V_t(A = 1, \omega, d_t, z_t) - c.$$

(2)
Comparing actual (2) with presumed (1) and assuming $\bar{t}$ is correct, it is clear that unless $d_t = 0$, the regulator’s decision-making criteria overstates the value of the regulatory decision, resulting in over regulation.\footnote{In other words, $(2) - (1) < 0$ if $V_t(d_t > 0) < V_t(d_t = 0)$.}

Figure 1 illustrates this over estimation in the value of regulatory action. The right-most vertical line represents $t = \bar{t}$. The regulator estimates the value of regulation to be the shaded area minus any costs $c$. The actual value are the triangular outlined areas (I – II), minus any costs $c$, resulting in a significant overestimation. Higher rates of decay of economic validity of the analysis increase this overestimation. In Figure 1, the difference in overestimation with a low rate of decay versus a high rate is the area between $V^{L}$ and $V^{H}$.

When markets are changing ($d_t > 0$), the overestimation of value of regulatory action is strictly positive, which leads us to conclude that overregulation is a normal occurrence. This is not to say that all regulatory actions are inappropriate, but certainly there is a need for a way to address this overestimation of regulatory value. This dilemma can be answered by focusing on what it is that could provide a firm with market power over multiple generations of markets over time. We call such features EFM$\text{s}$ and explain their meaning and use in the next section.

III. The Enduring Factors Creating Monopoly Approach

We suggest that decision makers should focus on identifying and addressing factors that lead markets to be monopolistic, rather than basing regulatory decision-making on rapidly decaying estimates of market power. More specifically, we suggest focusing regulatory concerns on situations where there are either endowed or illicit factors that are likely to lead multiple generations of products to be provided by monopolies, i.e., EFM$\text{s}$. 
Factors leading to monopoly is an understudied area of economics. Smith (1776) and Mill (1848) identify government barriers to competition as a primary source of monopoly. Stigler (1971) extends this view by developing a theory of how industries will seek regulation in order to inhibit competition. Smith and Mill also describe how collusive agreements can allow firms to avoid competition. We call such EMFs illicit since the government or industry actions protect certain industry interests at the expense of sector performance.

There are other situations where the EMFs are endowed or costless to the firm. Mill (1848) describes monopoly arising from situations where essential skills or supply inputs are subject to natural limits. This view evolved into the concept of natural monopoly where inherent factors necessarily limit to one the number of competitors the market can support and remain cost efficient.

In situations of rapid change, regulatory responses should be limited to factors that cause monopoly across generations of products because, in our context, the life of a single product is too brief to warrant regulatory action. Furthermore regulatory responses should be limited to factors either endowed or illicit because they are either costless to the firm (in the case of endowed factors) or destructive to market performance (in the case of illicit factors). All other factors must be built or acquired by a firm, and such innovations will be discouraged by regulatory practices that penalize such developments.

The key question is whether there are factors that will lead to dominant cost subadditivity across generations of products. The most common approach in economics to determining whether a firm is a natural monopoly has been to examine the market from a production technology perspective, i.e., if a single firm represents the least cost arrangement for serving the entire relevant market
demand because its costs are subadditive (Baumol 1977, Sharkey 1982).\footnote{One problem with the natural monopoly concept for our purposes is that it focuses on existing products and markets, which could be too short-lived for proper analysis and regulatory treatment.} Jamison (1999) adds that a firm must have dominant cost subadditivity for its products to ensure that the firm’s supply cannot be more economically provided by any combination of firms, including those outside of these products’ markets.\footnote{Subadditivity is defined as being less costly for a firm to produce a given level of output than for all possible combinations of two or more firms to produce that output (Sharkey 1982). Dominant cost subadditivity extends this concept by requiring that the monopoly in question provides economies of joint production greater than economies that could be provided by all other forms of organization that might produce some portion of the output of the monopoly in conjunction with products and/or markets that the monopoly does not supply. (Jamison 1999)}

As far as we can determine, the economics literature on this point is limited. Baumol et al. (1982) provide the most exhaustive treatment and only identify public and quasipublic inputs. A public input is a factor of production that, once acquired, can be costlessly used for multiple products and quantities of production. A quasipublic input is a factor of production that can be subject to complete congestion, but that is not under current and expected circumstances.

Any of these forgoing factors leading to monopoly could be enduring across generations of products. For example, a government barrier to competition or a collusive agreement might be adapted to allow the favored businesses to collect monopoly rents. We are unable to find a clear rule of thumb for knowing when factors are enduring, so as far as we are able to determine they must be identified on a case-by-case basis.

Once an enduring factor is identified, the next step is to determine whether a regulatory response is appropriate. We believe that some enduring factors should be encouraged because, if regulatory practice makes developing them less economical, then customers will be denied some future innovations.

One recent example of an essential and enduring factor leading to monopoly is the development of a customer base in platform industries. An embedded
customer base results in market power for the firm. Additionally, platform industries have the characteristic of holding an elementary part of a product ripe for future investment and innovation. Some economic analyses that find market power in platform markets observe that a firm has a customer base that the firm is able to leverage across multiple generations of products. For example, Cremer, Rey, and Tirole (2000) examine market power in the Internet backbone and conclude that embedded customer bases are a source of market power leading to discrimination in connectivity.

Missing from their analysis, however, is any consideration of how public policies addressing market power (mergers in their case) affect the economics of building a customer base. If policies extract that value, then service providers are likely to limit the amount of value that they create for customers. Similarly, Carlton and Waldman (2002) examine generations of software and conclude that an embedded customer base provides a software provider with a competitive advantage that can lead to market power. Akin to Cremer, Rey and Tirole (2000), Carlton and Waldman (2002) assume that the customer base is endowed and so omit from their analysis any consideration of how regulation might affect business incentives to create such a valuable product space in the first place.

We would discourage treating a customer base as a factor that should trigger regulation. As Jamison (2001) demonstrates, the opportunity to leverage complementarities across markets stimulates investment in existing markets. A regulatory practice of limiting opportunities for firms that have built their base of customers by developing valuable products would necessarily limit the amount of capital that investors would make available in the future.
IV. Implications for a Current Issue

A current issue where our analysis is relevant is the case of over the top (OTT) services in telecommunications. These are situations where an application provider, such as Skype, enables customers to communicate using voice or video in real time. The app is provided over the public Internet, which is designed for data, and so the service is sometimes low quality relative to that provided by specialized networks.

Three issues tend to arise with OTT providers. One prominent issue is whether the OTT provider should be considered a telecommunications provider. Per our analysis in Section II, the OTT provider is not a provider of a physical communications channel and so is not a telecommunications carrier but rather a software interface for customers. The OTT provider does not compete with telecommunications channels and is indeed dependent on them.

Another prominent issue is whether an OTT provider is competition for a telecommunications provider. In our analysis this is the wrong question. It is futile to base policy or regulation on a product rivalry when product definition evolves rapidly: Even if one could conduct a valid analysis, its relevance would quickly decay. Instead decisions on whether to regulate should be based on analyzing whether any operator possesses EFMs. Any service operators that do not should not be subjected to economic regulation, except to address consumer protection issues and perhaps network interconnection. Operators that do possess EFMs, such as government protections, will possess market power over time and over generations of products. How this market power should be addressed would depend upon the specifics of the situation.

An issue that is less often addressed is the regulator’s role in the evolution of traditional telecommunications providers’ business models. Sometimes telecommunications providers seek to have regulations imposed on OTT
providers. In our analysis this is an issue of how traditional operators will evolve their business models to an NGN world. They certainly need regulatory space to experiment and adapt, for example, by trying different service provisioning and pricing arrangements for providing communication channels. Limiting OTT providers would likely be a mistake in this context, as the restrictions would keep the network providers from learning how customers will value and use networks in a world rich with apps.

V. Conclusion

In this article we examine how to consider market power in a world of constant change. We find that traditional approaches fail because they depend on stable markets. We suggest that a more productive approach is to identify those factors that lead to market power, that endure over generations of products, and that are endowed or illicit.

We have left many questions unanswered. For example we have not identified a systematic approach to finding EFMs. Nor have we developed rules of thumb or classes of EFMs that could guide regulators in knowing how to respond when an EFM is present. These and other questions are left for future work.
FIGURES

Figure 1. Economic effects of decay
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