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FINAL THESIS

EXECUTIVE SUMMARY

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In coherence with the option for three working papers, this executive summary consists in the abstracts of the three articles submitted for the discussion

THE ITALIAN AIRPORT INDUSTRY: PAST UNCERTAINTIES AND FUTURE CHALLENGES¹

GIOVANNI FORMICA

ABSTRACT

This paper provides with an overview of the Italian airport industry from a twofold perspective, which looks at rooms for competition, and also at the regulatory uncertainty currently observed in Italy.

As regards the former, in spite of traditional conclusions about market power, it's argued that airport competition is a special feature of the new context of «Open Skies» and growing demand for air transport services. To be sure, the degree of competition varies largely with the structural and geographical features of airports and depends crucially on the nature of single routes.

The paper also looks at the specific Italian legislation, in order to show the main ambiguities and their direct consequences. A context of regulatory uncertainty - due to temporal inconsistency of public choices, overlapping of rules and regulators and lack of a strategic planning for sector intervention - has *de facto* conditioned the option for regulating, since legitimizing the opportunism of market players, thus not allowing for transparent and cost-oriented tariffs.

The most recent regulation (*e.g.*, delibera CIPE 38/07) partially takes up the challenge of a more certain legal frame. However, some crucial aspects, such as the institutional setting and an incentive-regulation for investments, are still dangerously neglected².

From a policy perspective, the simultaneous acknowledgement of new market trends and of the distortions generated by often inconsistent public choices should be posed as a basis for a large reform effort. We conclude by analyzing the main roadblocks to future

¹ Published paper: Formica G. (2007), "L'industria aeroportuale italiana tra incertezze del passato e sfide del futuro", in Mercato, Concorrenza, Regole, n. 2, agosto 2007.

² To be sure, some very recent, yet fragmentary interventions (showed up after the publication of this paper) have defiantly contributed to complexity and tariff opacity. Moreover, the regulatory frame could soon change radically, due to the implementation of the European Directive 2009/12/CE. All these novelties are briefly discussed in an *addendum* to the article.

efficiency-enhancing policies – first of all, the status and the independence of the Regulator
– and some policy recommendations.

LAW AND ECONOMICS OF BUNDLING BY NON-DOMINANT FIRMS³

GIOVANNI FORMICA

ABSTRACT

This paper discusses the law and economics of bundling in non-monopolistic settings. Notwithstanding uncritically accepted arguments from mainstream theories, it's proved that, under a large set of market circumstances, combined sales may be in the rational interest of multi-product firms facing specialist, yet imperfect competition by single-product suppliers of differentiated components. These conditions vary with the nature of demand interrelation among components, whether they consist in complementary (low differentiation, large bundle size, elastic demand) or independent goods/services (high brand fidelity).

The impact of such a practice on competition, both in a short-run and in a long-run perspective, is discussed in depth. We find that non-dominant bundling may harm social welfare and potentially activate a self-reinforcing process of market power achieving and rivals' foreclosure, even absent original (bundler's) dominance in any involved (component) market. Then, bundling results in limited consumer choice, high transportation costs (*i.e.*, low variety), less than socially desirable innovation, constraints to efficient entry and, eventually, growing concentration of markets over time.

While also taking into account the potential for efficiency defences (added value, quality improvements, cost savings), the paper suggests a case by case approach, to balance pro-competitive explanations against social welfare concerns. Therefore, "one size fits all" conclusions on legal standards, whether in a sense (*per se* prohibition) or another (*per se* legality), appear unadvisable.

³ Published paper: Formica G. (2008), "Law and Economics of Bundling by Non-Dominant Firms" in *German Working Papers in Law and Economics*, volume 2008, n. 16, Berkeley University Press.

These findings contrast the general run in competition law and economics scholarship. In this vein, in the second part of the work, insights from formal economic models are compared with actual legal practices, apparently influenced and stuck with the traditional view about non-profitability and ultimate irrationality of non-dominant bundling.

However, one should carefully distinguish between emphatically settled legal doctrines and *de facto* judicial approaches. Various documented attempts to generously find dominance both in US jurisprudence and in EC competition practice and other systemic inconsistencies authorize a common interpretation: in legal proceedings, dominance is considered as a purely formal, too rigid requirement, more than an economic precondition for exclusionary purposes. In effect, a strict dominance-test has imposed straining and incongruence in the application of competition rules on both sides of the Atlantic, as regards the definition of relevant markets, of dominance (Europe) or sufficient economic power (US), and even with respect to the interpretation of the very notion of market power. This proves a certain intolerance towards too rigid criteria, thus indirectly confirming the soundness of our main (economic) contentions.

Supported by the analysis of underlying economics and by contradictoriness in actual legal practice, the work ends up with some modest proposals for better informed competition policies. In particular, it's invoked for more explicit acknowledgement that the dominance-screening may be unreasonable under certain conditions.

As a matter of legal standards, a modified *per se* legality -whereby non-dominant bundling should be considered lawful unless there is strong evidence of anticompetitive effects outweighing efficiencies- could guarantee against the risk of under-deterrence, while also respecting business freedom. Needless to say, a *feasibility test*, reflecting all conditions proved necessary for bundling rationality, should be preliminary performed, in order to optimize inquiry efforts.

The proposal is balanced and economics-grounded. Moreover, legal certainty and genuine competition would be preserved and, if any, enhanced against artificial interpretations and strained applications of existing rules, used by Courts just to bypass too rigid, formal standards of proof.

AWARDING PROVISION THROUGH COMPETITIVE TENDERING: LESSONS FOR AND FROM THE ITALIAN EXPERIENCE WITH LOCAL PUBLIC SERVICES

GIOVANNI FORMICA

ABSTRACT

The work starts from the most recent Italian reform for local public services, which will make tenders no longer facultative by 2012 (by 2015, for listed companies)⁴, at least in the event of no last-minute about-turns. In fact, the legislative novelty is just an excellent opportunity to address more general issues about franchise bidding, having no national specificities. Besides, through all pages, Italy is merely taken as emblematic of more general findings.

Firstly, the paper discusses potential benefits from competitive tendering (hereinafter CT), hence its desirability as a policy option. It's shown that, in a context of asymmetric information, competition "for the market" is expected to improve allocative efficiency (*i.e.*, it allows for higher probability to select the most efficient potential provider), to drive down subsidies and tariffs (*i.e.*, it assures better "rent extraction") and incentivize efficiency-enhancing efforts (*e.g.*, by awarding fixed-price contracts).

The working mechanism is not dissimilar from that of ordinary competition "within the market": the risk of being surpassed by rivals (hence, to lose money) has the potential to induce bidders to a truth-revealing attitude, fair price (and subsidy) requests/bids and a continuous commitment to improve oneself. Moreover, franchise bidding is often a first step towards privatization: a wind of beneficial changes and refreshments in sectors - as local services - historically dominated by public patronage and widespread inefficiencies.

A very basic condition for successful tenders is an high number of sellers, bidding *on equal foot* and acting non-collusively. At the limit, as the number of independent bidders becomes

⁴ Article 23bis of the Law 133/08, as modified by article 15 of the Legislative Decree 135/09, requires tenders (either for the whole service or for the selection of private partners) as the ordinary way to award local public services "with economic significance", such as urban transportation, water, refuse collection, etc.

sufficiently high, tenders achieve the first-best and resemble perfect competition “within the market”, as in the Walrasian analogy of competitive markets as auctions.

Unfortunately, real-life circumstances are often foreign to the stylized world depicted in formal models. Consistently, the paper discusses in depth those numerous reasons why tenders may fail, from a twofold perspective, both theoretical and empirical. The economic theory – in particular, insights from auction, public choice and contract theory – are extensively relied upon, in order to reveal most of these implementation risks, then confirmed on the basis of the disposable empirical evidence.

As a matter of synthesis, “bidding parity” (*i.e.* all parties, including the incumbent, are allowed to bid on equal foot) is often a little more than an aspiration. In case of corruption, favouritism or incumbency (information) advantage, it’s illusory to expect actual benefits from competition, as the rules of the game are somewhat *biased* in favour of *special* competitors, saved from disciplining market forces.

Other practical flaws are also relevant. For instance, collusion may be an issue, as it can invalidate the truth-telling mechanism through which tenders achieve their desirable outcomes. Then, contract incompleteness and improper enforcement of tendered schemes may make awarding agencies subjected to risks associated with renegotiation and opportunism (*e.g.*, hold-up and strategic bidding): initial gains may prove only apparent, once taking into account the possibility for ex post generous (for franchisees) adjustments. Finally, tenders may also be prone to quality deterioration and under-investment problems, at least when auction rules do not provide for suitable controlling devices.

All these potential flaws are confirmed empirically, through recent failure stories. In particular, the Italian (and not only) past experience with CT, although limited by a certain political disfavour towards liberalization, is taken as representative of most of such risks. To quote some examples, Italian past tenders for water services have been conditioned by limited participation, due to improper auction design (*e.g.*, too ambitious and poorly remunerative ATO plans). CT for urban transportation has often been led by the desire to perpetuate the incumbency, also through generous allowance for bidding consortia. In gas distribution, franchise fees and local finances have been (in average) the main concerns, with dangerous (*e.g.*, for safety) neglecting of qualitative aspects and dynamic incentives to invest.

In effect, appreciable successes are also not infrequent, as the tender for additional transportation services held in Rome in 2000 or that for the integrated water service in the

ATO-Frosinone. Both are indirect confirmations that franchise bidding is *per se* a powerful disciplining device, yet that an improper use could be flawed and counter-productive.

Overall, the work should suggest that proper tender design is crucial to final success, but also that implementation is a non-trivial challenge, firstly because optimal choices vary with the context and the service nature. In this vein, the paper tries to provide with a toolbox and general guidelines, hopefully useful to both practitioners and theoreticians interested in efficient ways to organize local services.

The main contention is that successful tenders require both suitable framing conditions (independent institutional setting, vertical separation of infrastructures) and proper auction rules. Each specific design feature (*e.g.*, participation prerequisites, object, awarding rule, etc.) is separately analysed in the paper, as to provide the reader with some *prima facie* advices.

Consistently, an important lesson for Italian policy-makers is inferred, namely the need to complete the reform path with institutional changes, in the sense to allow for more independent regulatory and awarding roles in local public industries. The time is ripe for the courage of a radical reform, often promised, yet never actually realized.