

The Economics of the UK Legal Market

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Market Structure

- Perfect Competition
- Oligopoly
- Monopoly
 - Patented Drugs
 - Beryllium, Brush Wellman

Perfect Competition

- Many “small” & independent buyers and sellers.
 - Homogeneous product of known quality.
 - Perfect information about price.
- ⇒ Buyers and sellers are price-takers
- ⇒ Good sells for one price

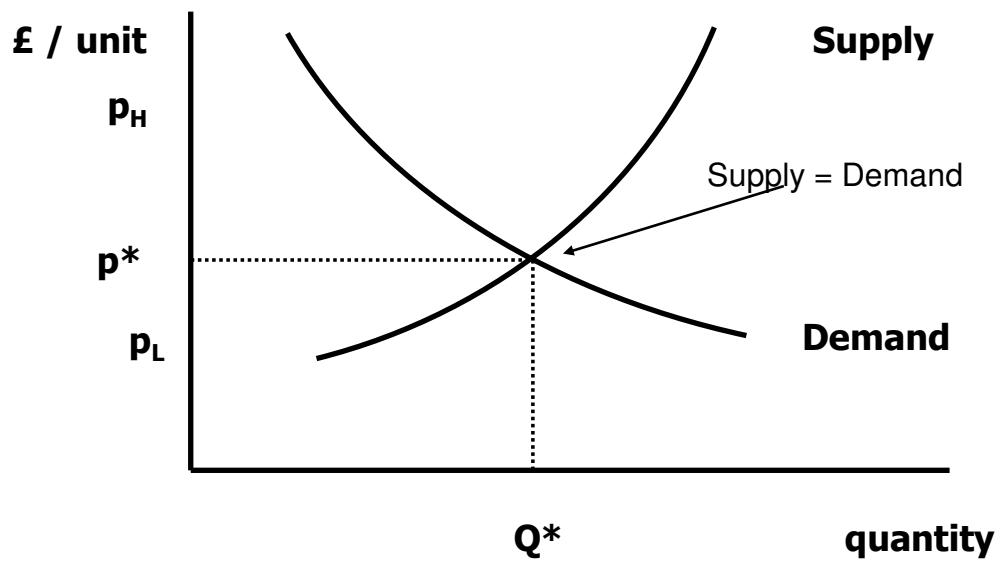
Perfectly Competitive Industries (more or less)

- Agriculture, financial securities, labour, downtown office space (priced per sq foot)

Perfect Competition

- Price Taker: Takes the price as given.
- Buyer: Only question is how much do you want to buy at the price?
- Seller: Only question is how much do you want to sell at the price?
 - Is the price higher than the (marginal) cost?
 - Opportunity cost
 - Allocation of overhead

Equilibrium



Perfect Competition

- Price \approx Marginal Cost
- Very small profit margin

Monopoly

A monopolist sets its price.

Trade-off:

- High Price/Low Quantity
 - A lot of money from each unit sold, but few units sold.
- Low Price/High Quantity
 - Little money on each unit but many units sold.
 - (similar to tendering tradeoff)



Monopoly



- easyJet beer pricing.
- Suppose $P_{\max} = \text{£}7$; easyJet's Cost = $\text{£}2$.
- Suppose most I personally would pay is $\text{£}5$.
- Bargaining.
- “Versioning”.

Perfect Competition

- Many “small” & independent buyers and sellers.
- Homogeneous product of known quality.
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Is the Market Concentrated?

Herfindahl-Hirschman index (HHI or HI) is the sum of the squared market shares of all firms in the industry

$$\text{HHI} = \sum_{i=1}^N \text{MS}_i^2$$

Examples:

- Monopoly: $\text{HHI} = (100)^2 = 10,000$
- 10 equally sized firms: $\text{HHI} = 10 \times (10)^2 = 1,000$
- 1 firm with 55% and 9 with 5%: $\text{HHI} = (55)^2 + 9 \times (5)^2 = 3,250$

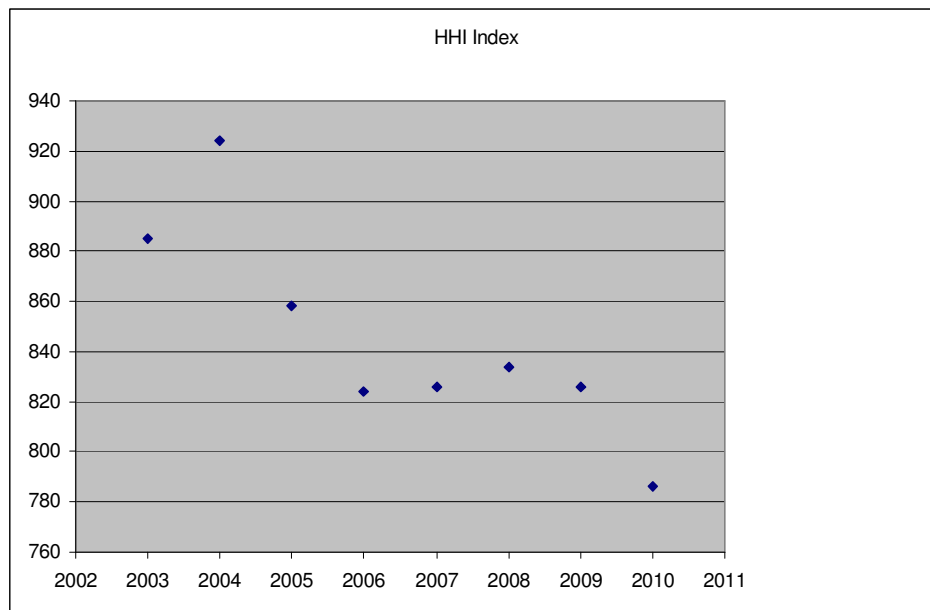
Rule of thumb: The ratio $10,000/\text{HHI}$ can be interpreted as approximately the equivalent number of equal-size firms.

E.g., $10,000/3250 = \text{about } 3.1 \text{ equal-size firms.}$

EU Merger Guidelines

	HHI Index, post-merger	“safe harbor” for merger
Unconcentrated	$HI < 1000$	any merger
Moderately concentrated	$1000 < HI < 2000$	$\Delta HI < 250$
Concentrated	$HI > 2000$	$\Delta HI < 150$

Law Firms: Corporate (top twenty)



Not Many Small...

- 1. Economies of Scale:** More efficient to operate at a large scale.
- 2. Economies of Scope:** More efficient for one firm to do several things, than for several firms to do one thing.
- 3. Learning by Doing:** More efficient the more you have done in the past.

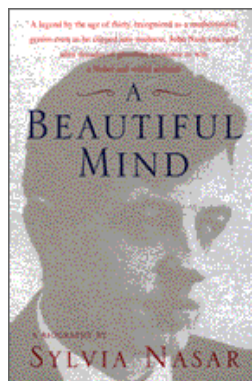
Perfect Competition

- Many, “small” & independent buyers and sellers.
- Homogeneous product of known quality.
- Perfect information about price.

- Differentiated Products
 - You can raise your price and not lose all your customers
- Unknown Quality
 - Lemons
 - Signalling
 - Reputation
- Imperfect Price Information
 - Search Theory

Game Theory

Nash Equilibrium:
A stable outcome



Russell
Crowe

<http://www.nobel.se/economics/laureates/1994/index.html>

Cola Pricing

- Cost = £1
- 1000 customers willing to pay £5
- Monopoly
- $P = 5$, Profits = $1000 \times (5 - 1) = £4000$
- Two firms, Generic cola
- Nash equilibrium?
- $P \approx 1$, Profits very small
 - Unless there is tacit collusion

Coke and Pepsi Pricing

- Cost = £1; 1000 customers.
- Half prefer Coke, Half prefer Pepsi.
- 1/10 would switch to save 10p.
- 2/10 would switch to save 20p.
- 3/10 would switch to save 30p.
- ...
- 10/10 would switch to save £1.

Coke and Pepsi Pricing

- Both charge 5
 - Split market equally, profits = $500 \times (5 - 1) = \text{£}2000$
 - Coke undercuts to 4.80,
 - profits = $600 \times (4.80) = \text{£}2,880$
- Not a Nash equilibrium
- But incentive to undercut has decreased!

Coke and Pepsi Pricing

	1.60	1.80	2.00	2.20	2.40
1.60	300, 300	360, 320	420, 300	480, 240	540, 140
1.80	320, 360	400, 400	480, 400	560, 360	640, 280
2.00	300, 420	400, 480	500, 500	600,480	700, 420
2.20	240, 480	360, 560	480, 600	600, 600	720, 560
2.40	140, 540	280, 640	420, 700	560, 720	700,700

Coke and Pepsi Pricing

	1.60	1.80	2.00	2.20	2.40
1.60	300, 300	360, 320	420, 300	480, 240	540, 140
1.80	320, 360	400, 400	480, 400	560, 360	640, 280
2.00	300, 420	400, 480	500, 500	600, 480	700, 420
2.20	240, 480	360, 560	480, 600	600, 600	720, 560
2.40	140, 540	280, 640	420, 700	560, 720	700, 700

- Product differentiation increases your profits.
 - Can be good for consumers too.
- Switching costs increase your profits.
- Search costs increase your profits.

Perspectives on the Magic Circle...

Samantha Fairclough

“...I clearly see that those five firms as the leading firms... I think it’s about...the breadth and depth of service of the different practice areas that those five firms can offer more depth, more breadth of experience in the leading areas of commercial practice”

– Partner, Magic Circle firm

Perspectives on the Magic Circle...

Samantha Fairclough

“In terms of what it means to me is a section of high quality, slightly snobby, very expensive, hugely profitable, law practices that would claim, or would be perceived as having, some degree of intellectual firepower, city connections and capability of getting things done...it’s those sorts of positives and negatives that come together to define what I see as the Magic Circle”

– Former Head of Marketing at a non-Magic Circle firm

Panel Games...

Samantha Fairclough

The Magic Circle firms have an expensive oligopoly on complex, high risk legal matters, but are not always an attentive servant:

“*Clifford Chance* have been probably our biggest earner because they do our securitization and some of the tax work, but we don't see them for a bar of soap, and they're next door”.

“...*McDermott Will & Emery* will get some pretty talented partner who'll do a good job for us, whereas if we took it to *Clifford Chance* they'd get some lowly guy to do it and you wouldn't get the same...”

Panel Games...

Samantha Fairclough

In-house counsel often include a small cadre of national, regional, and/or mid-tier London firms on their panels, to deal with day-to-day legal affairs and low to medium risk/value litigation and transactional matters. The attentive service and cost-effectiveness of some of these firms was widely praised:

Panel Games...

Samantha Fairclough

“So we have *DLA* on, I believe we are their biggest client...We pay them a lot of money every year. We like them, we think they’re a great firm, they’re not in the Magic Circle, we use them for different things we don’t use the Magic Circle for, it works very well.”

“And the regional firms, one or two of them, you know, sort of the *Addleshaws*, a firm like *Dibb Lupton*...they have somehow picked up their game because they both sort of, you know, seem to say thank you I’ve got the mandate I’m really going to go out, and they’re all out!”

Panel Games...

Samantha Fairclough

Some clients place a great deal of significance on the quality of advice and the reputation of their Magic Circle advisers, above any cost implications:

“...I’d try and do what? Save fifty thousand quid on a bill that’s going to be three million? Frankly I’m not interested. I’d rather have advice from people I know and trust and they’ll bring the deal in. It’s the core reputation I’m worried about here, not fifty thousand quid.”

Reputation, search...

Panel Games...

Samantha Fairclough

- “...it’s a little bit like the IBM defence, I mean, your decision will be beyond reproach if you choose a Magic Circle firm...but if you take that to it’s logical extreme in every case you would instruct a Magic Circle firm and that would be lunacy because the cost simply does not justify it.”

Principal agent problems