Bulletin

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The Invisible Handout

SANTA'S ECONOMICS

Every Christmas, children receive free goods via a supply chain that winds through their chimney and ends up under a tree. It seems simple and efficient: few customers question the quality of service; seek alternative suppliers; or challenge the price charged in accumulated 'good behaviour'. But in these tough times Frontier's economists thought it was time to take a cold, hard look at the quality of the service provided by Santa Claus.

Father Christmas is coming to town, and if previous years are anything to go by, he'll be providing unrivalled service in the Christmas Eve present delivery sector. To do so, he has to operate a complex supply chain with some unusual market dynamics. Upstream, the Elves of Lapland manufacturers have been working day and night to ready products. The Sleigh & Reindeer distribution chain is raring to go, offering Santa unrivalled just-in-time delivery solutions. In the retail market, Father Christmas demands a minimum level of "good behaviour" in exchange for a present. And across this whole supply chain, Father Christmas owns and operates a monolithic vertically integrated business.

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In many ways, therefore, Santa's market is unique. But different economists will analyse its peculiarities from different angles. This bulletin describes the probing questions that four of Frontier's leading practices would put to Santa plc.

COMPETITION

Santa wasn't always the only provider in the Christmas Eve delivery market. A literature review reveals that in times past he faced competition from providers such as Kris Kringle, Father Christmas and (in Finland) the Yule Goat, to name but a few. Over time, however, these brands appear to have merged.

To competition economists, this begs an important question: does Santa now have a dominant position in the Christmas Eve Delivery sector, and if so might he be abusing this position? An important question here is whether Christmas Eve really forms a separate market, or is in fact only part of a wider winter present market. What about 6th December, for example, when St Nicholas does the rounds in many countries? Or New Year's Eve, when Ded Moroz ("Father Frost") and the Snow Maiden deliver gifts to children in Slavic countries? And then, of course, there's Twelfth Night, where the at least three kings are renowned for offering a high-quality gift delivery service.

Notwithstanding these questions, our competition economists fear that if the authorities were to investigate Santa, he might have a fight on his hands:

- **Predatory pricing.** Talking about "peace and good will" is all very well, but running a huge production facility in Lapland can't be cheap. The available evidence, however, suggests that Santa has not been charging for his services for centuries (beyond a nominal "good behaviour" requirement). Could Santa be deliberately pricing his products at a loss as part of a systematic and illegal campaign to drive his remaining competitors out of the market?

- **Refusal to supply.** When investigating vertically integrated firms, competition authorities often keep an eye out for so-called "essential facilities". These are elements of the distribution system to which manufacturers must have access if they are to compete on a level footing. And when it comes to distributing toys to millions of children in a single night, a magic sleigh is about as essential as an essential facility can get. An investigating authority might demand that Santa provides so-called Fair, Reasonable and Non-Discriminatory ("FRAND") access to his sleigh to prevent him from locking competitors out of the market. The available evidence, however, suggests that Santa locks up his sleigh 364 days a year.

REGULATION

The first question for a regulatory economist approaching this market is to consider whether the manufacture, distribution and retail of Christmas Eve presents constitutes a natural monopoly. These typically arise in industries with significant fixed costs, creating high barriers to entry. In such cases, economists tend to agree that it is socially optimal for a single firm to supply the market.

Santa's distribution business could constitute a natural monopoly, since other firms would have to sink considerable investment sums to develop a magic sleigh. However, competition could still function efficiently in the upstream manufacturing market. Santa has had the Elves of Lapland manufacture his gifts for a long time, but a new, lean competitor could also lay claim to some of Santa's demand. Santa's business could, therefore, be unbundled, with competition taking place upstream and the downstream monopoly distribution business being held to account by a new regulatory authority ("OFMAS").

Arguably there is inefficiency or "fat" in the distribution business, and not just around Santa's waist. For example, Santa likes to maintain an expensive polished red nose on one of the reindeer, but it is not clear how this benefits his customers. And when the car in front of Santa's office is a magical, turbo-charged flying sleigh, it could be argued the boss is getting paid too much.

However, regulatory theory tell us that it is not the regulators' job to determine the monopolists' input choices, since it can be hard to overcome the information asymmetry between regulator and monopolist. Instead, monopolies have been given incentives to identify and reveal cost-reduction opportunities. Often regulatory regimes allow the monopolist to retain additional profit if it can bring costs down below target levels, which are determined at periodic reviews.

There is, though, one risk with this type of regime. If Santa has a strong incentive to cut costs, he may do so at the expense of the quality of his service. Removing Rudolph's red nose from the cost base is one thing, but Santa could also shed a few reindeer altogether, leaving children in remote destinations at risk of late-delivery. The regulatory framework must also, therefore, pay attention to Santa's quality of service. A "presents delivered" target might be a good place to start.

STRATEGY

Santa should be worried. Niceness is on the wane, and "depression" is taking over. To compound Santa's concerns, fizzy-drinks monoliths and small-time copycats are piggy-backing on a brand he has created and carefully crafted over centuries. Santa needs strategic help.

- **Branding.** Santa is one of the world's most recognisable brands, but the evidence suggests that he is not making the most of this asset. To start with, he should demand royalties from those firms that make use of his image in the visual media. But he should also give thought to what this means for his optimal pricing strategy. Should he, for example, view his present distribution service as a "loss leader" that helps boost his advertising revenues? And if so, should he waive his good behaviour requirements in order to help further boost these revenues? Or would this simply damage his brand as a purveyor of peace and good will?

- **Behavioural economic insights** could also help Santa. For example consumers sometimes heavily discount the future, preferring a bit of "jam today" instead of a lot of "jam tomorrow". Maybe Santa should therefore deliver small presents on a monthly basis, rather than delivering a whole sack of gifts once a year. Loss aversion is also a concept that Santa should be thinking about. This theory suggests that customers feel the pain of losing something they own more than they enjoy gaining something new. If Santa really wants to get his customers to maximise their good behaviour, perhaps he should give them their presents in September and then confiscate them if their good behaviour drops below a certain threshold?

PUBLIC POLICY

Regulatory and competition economists may not be Santa's only headache. Delivering toys to every household in the world on a supersonic sleigh cannot be good for his carbon footprint. And the picture looks worse still when Santa considers the millions of "toy miles" he clocks up as a result of shipping raw materials across the world to his Lapland production facility. Economists have been thinking about these sorts of problems for years and have come up with some innovative policy solutions that could incentivise Santa to clean up his act.

- Policymakers could introduce a quota system that sets an upper limit on the number of miles that his fleet of ships and trucks is permitted to travel in sourcing his raw materials and unfinished goods. Santa would be free to use these credits as he saw fit, but would face tough penalties for exceeding his quota. Policymakers would, however, need to think about what impact the need to source inputs more locally would have on Santa's cost base and the knock on effect this could have on the quality and variety of his presents.

- More radically, policymakers could consider replacing Santa's service with a new government-led programme that provides children with Christmas tokens which are redeemable in local toy shops. This could help provide a much-needed boost to high street stores, which have recently been feeling the effects of both the global economic downturn and the rise of internet retailing. However, an expansionary fiscal stimulus on this scale could prove inflationary. And it would load further pressure on government spending, which is already under strain across much of the developed world.

COMING TO A TOWN NEAR YOU…

This brief survey of the challenges facing Santa suggests that he is in need of advice from experts with skills across the microeconomic spectrum. But perhaps that can wait until next year. A Happy Christmas to our friends, clients and collaborators from all of us at Frontier Economics. Here's hoping that Santa Claus is coming to town and that his service is up to scratch.

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