

Market investigation references

A consultation paper

July 2002

Part of a series of consultation papers about how the provisions of
the Enterprise Bill will work in practice

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ENTERPRISE BILL: Public consultation on guidance for market investigation references

The Office of Fair Trading (OFT) is conducting a public consultation on the guidance it is required to publish about the making of market investigation references once the Enterprise Bill becomes law. A copy of the proposed guidance, including a summary, is enclosed. These can also be found on the OFT's website, www.oft.gov.uk. The introduction to the consultation draft is available in Welsh – on the OFT's website or by calling 020-7211 8970.

Details about the Enterprise Bill, including an explanatory note can be found on the Department of Trade and Industry's website, www.dti.gov.uk/enterprisebill.

The Enterprise Bill remains subject to parliamentary debate and approval. This draft guidance reflects the content and clause numbering of the bill as at 20 June. The OFT will publish the finalised guidance after the Bill receives Royal Assent and becomes the Enterprise Act 2002.

The Enterprise Act 2002 will introduce provisions for a system of market investigation references to replace the existing monopoly enquiries under the Fair Trading Act 1973. Where features of a market may be having an adverse effect on competition, the OFT may refer that market to the Competition Commission for a market-wide investigation. The proposed guidance sets out the circumstances in which the OFT has power to make a reference, various procedural points and how the OFT will apply the reference test.

Law firms representing business and other representatives of business as well as consumer bodies are being invited to comment on the proposed guidance in order to improve its clarity. Consultees responding to this consultation are asked to supply a brief summary of the people and organisations they represent, where appropriate. We are open to suggestions of other individuals or organisations about who should be consulted.

Please turn over



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We will be taking queries by phone, but any suggested changes or comments should be submitted in writing (by letter or email as indicated below). We will reply to all written submissions or queries. The OFT can only consider suggested changes to the guidance, not the underpinning legislation, as the latter is a matter for Parliament and not covered by the consultation exercise.

Responses may be made public unless confidentiality is specifically requested. This consultation exercise will last for 12 weeks. We therefore ask that your comments on the proposed guidance are submitted to us no later than 2 October 2002. It may not be possible to take into account any suggested changes or comments after the deadline for receipt.

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I hope that you will be able to assist in this invaluable procedure.



Stephan R Pukas
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SUMMARY

The purpose of the guidance is to indicate how OFT and the sector regulators who have concurrent jurisdiction with OFT intend to apply the provisions relating to market investigation references in the Enterprise Bill. The relevant sectoral regulators are the Office of Telecommunications, the Office of Gas and Electricity Markets, the Office of Water Services, the Office for the Regulation of Electricity and Gas (Northern Ireland), the Office of the Rail Regulator and the Civil Aviation Authority. References to OFT should be interpreted as applying to these regulators.

Part I of guidance deals with the reference process and Part II with how the reference test will be applied.

Part I provides an overview of the power to make a reference in the introduction and sets out the criteria for making references which are additional to the basic test that there are reasonable grounds for suspecting that any feature, or combination of features, of a market prevents, restricts or distorts competition. In particular, Part I discusses when references will be used instead of the powers under the Competition Act 1998, when undertakings may be accepted instead of references and when references may be inappropriate because of insignificant customer detriments or the unavailability of remedies.

Part I also discusses the use of powers of investigation before making a reference, how persons on whose interest a reference is likely to have a substantial impact will be consulted, the content of a reference and the roles of OFT and the relevant sectoral regulators who have concurrent jurisdiction.

Part II describes how, in making the case for a reference, structural features and the conduct of both firms and customers in the market will be looked at in the assessment of the prevention, restriction or distortion of competition. It also describes how market definition, where appropriate, will be used to help analyse market structure and market power.

Part II discusses the effect upon competition of market structure features such as market concentration, vertical integration, conditions of entry, exit and expansion, regulations, information asymmetries, customer switching costs and countervailing buyer power. It also discusses the conduct of firms, particularly in oligopolistic markets and how certain practices can facilitate muted rivalry and how custom and practice and networks of vertical agreements can have an adverse effect upon competition. Finally, the market feature of customer search costs and its impact on competition are discussed.

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PART I: THE REFERENCE PROCESS

1 INTRODUCTION

- 1.1 UK competition law was strengthened by the Competition Act 1998 (CA98) which came into force on 1 March 2000. CA98 prohibits anti-competitive agreements and concerted practices, and conduct amounting to the abuse of a dominant position, where UK trade is affected. However, the Government retained the monopoly reference provisions of the Fair Trading Act (FTA) on the grounds that these powers, particularly complex monopoly references, allowed market-wide investigations by the Competition Commission (CC).¹
- 1.2 The market investigation reference provisions of the Enterprise Bill (the Bill) replace these FTA provisions. It will primarily be for the Office of Fair Trading (OFT) to make market investigation references, but, as with CA98 and the monopoly reference provisions of the FTA, certain sectoral regulators have concurrent jurisdiction with the OFT to make references within the regulated sectors. In specified circumstances the appropriate Minister will also be able to make a market investigation reference.
- 1.3 The purpose of this guidance is to indicate how the OFT and the sectoral regulators² intend to apply the provisions of the Bill relating to the making of market investigation references. It does not deal with Ministerial references.
- 1.4 The guidance is not binding but will help business and its advisers, and consumers to understand the grounds on which the OFT may decide that a market investigation reference is justified. It is not intended to provide a prescriptive framework for analysis nor do the various issues discussed constitute an

¹ Since 1994 there have been 20 reports on monopoly references of which 14 were concerned with complex monopolies.

² References to the OFT in this guidance are to be interpreted as applying to those regulators with concurrent jurisdiction, unless the text indicates otherwise. See paragraph 3.14 for the names of the regulators concerned.

exhaustive list of factors which may prevent, restrict or distort (adversely affect) competition, not least because markets and thinking about competition continue to evolve. The guidance will be updated as and when necessary.

- 1.5 The guidance is structured as follows: the remainder of this chapter sets out the OFT's powers to make references (referred to elsewhere in the guidance as 'the reference test'); the rest of Part I describes other aspects of the reference process, that is when references will be made and various procedural points; and Part II explains how the OFT will apply the reference test.

Power to make references

- 1.6 Under [clause 126] of the Bill, the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.
- 1.7 [Clause 126 (2)] states that a feature of a market is to be construed as a reference to:
- a) the structure of the market concerned or any aspect of that structure
 - b) any conduct (whether or not in the market concerned) of one or more than one person who, in the course of business, supplies or acquires goods or services in the market concerned, or
 - c) any conduct relating to the market concerned of customers of any person who, in the course of business, supplies or acquires goods or services.
- 1.8 [Clause 126(3)] adds that 'conduct' includes any failure to act (whether intentional or not) and any other unintentional conduct.
- 1.9 It may not always be clear whether a feature of a market that affects competition is structural or an aspect of conduct; for example, a firm's supply contracts or distribution arrangements may add to entry barriers in a market. However, the

separate references to structure and conduct in [clause 126] do not require the OFT to state whether particular features of a market that is the subject of a reference are to be considered structural features or some aspect of conduct.

1.10 The OFT has the discretion rather than a duty to make a market investigation reference where the statutory criteria appear to be met. Before making a reference, it must therefore consider:

- a) whether it has reasonable grounds to suspect that competition is prevented, restricted or distorted in some market in the UK or in a part of the UK
- b) whether it is a feature, or combination of features, of a market that gives rise to this adverse effect on competition, and
- c) whether a market investigation reference to the CC would be the most appropriate way of proceeding.

Points a) and b) are considered in Part II of this guidance; point c) is discussed in the next chapter of Part I.

1.11 Following a reference it will be for the CC to decide whether competition is indeed prevented, restricted or distorted, and (if so) what, if any, action should be taken to remedy the adverse effect on competition or any detrimental effect on customers resulting from it (in the form of higher prices, lower quality or less choice of goods or services, or less innovation in relation to goods or services in any market in the UK).

2 WHEN REFERENCES WILL BE MADE

2.1 The OFT will make references to the CC when the reference test set out in [clause 126] of the Bill and each of the following criteria have been met:

- a) It would not be more appropriate to deal with the competition issues identified by applying CA98 or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- b) It would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- c) The scale of the suspected problem, in terms of its detrimental effect on customers, is such that a reference would be an appropriate response to it.
- d) There is a reasonable chance that appropriate remedies will be available.

Points a) to d) are discussed in the remainder of this chapter and the OFT's application of the reference test in Part II.

Relationship with CA98

2.2 CA98 prohibits agreements which have the object or effect of preventing, restricting or distorting competition, and abuses of a dominant position. These two prohibitions are described in the Competition Act Guidelines *The Chapter I Prohibition* (OFT 401) and *The Chapter II Prohibition* (OFT 402). Market investigations are concerned with something different from particular anti-competitive agreements or abuses of dominance. Their purpose is to determine whether the process of competition is working effectively in markets as a whole and they will provide a framework for identifying, analysing and, where appropriate, remedying industry-wide or market-wide competition problems which there is no legal basis for addressing under CA98.

2.3 When dealing with a suspected competition problem it is OFT policy always to consider first whether it may involve an infringement of one or both of the CA98 prohibitions and to investigate accordingly. It will only go on to consider a reference to the CC in one of two circumstances:

- a) When it has reasonable grounds to suspect that there are market features which prevent, restrict or distort competition, but not to establish a breach of the CA98 prohibitions.
 - b) When action under CA98 has been or is likely to be ineffective at dealing with the adverse effect on competition identified.
- 2.4 Adverse effects on competition which do not involve either agreements between undertakings or abuses of dominance are beyond the reach of CA98. Market investigation references are therefore likely to focus on competition problems arising from uncoordinated parallel conduct by several firms or industry-wide features of a market in cases where the OFT does not have reasonable grounds to suspect the existence of anti-competitive agreements or dominance. Such problems may have a variety of sources such as competition-dampening common practices whose origins have long been forgotten, customers who are poorly informed relative to suppliers (information asymmetries), and sheer inertia on the part of ostensible competitors.
- 2.5 Oligopolistic markets in which firms engage in apparently co-ordinated parallel behaviour while falling short of actually concerting their actions (often referred to as tacit collusion) present a more complicated issue. The OFT recognises that EC case law has confirmed that the concept of collective dominance may be applicable in these circumstances, which would bring the conduct involved within the ambit of CA98. But this case law has not yet developed sufficiently to cover all types of co-ordinated parallel behaviour that have an adverse effect on competition. Furthermore, market features that can lead to adverse effects on competition in an oligopolistic market can be wider than the conditions which the case law has found to be necessary for collective dominance, that is, for the oligopolists successfully to engage in tacit collusion. What qualifies as an abuse of collective dominance is also under-developed in the case law. For these reasons a market investigation reference will be able to address wider competition concerns than could be addressed by a CA98 case and might, therefore, be a better way of proceeding.
- 2.6 Market investigation references may, in certain circumstances, also be relevant for dealing with possible competition problems arising from vertical agreements. Such agreements, unless they involve price fixing, are currently excluded from the

Chapter I prohibition of CA98. Although it is possible for the OFT to withdraw the benefit of the CA98 exclusion from a particular agreement this might not be the best way of dealing with the consequences of a network of parallel agreements involving many firms, particularly when the question of penalties does not arise. A market investigation reference may be the most appropriate way to proceed where vertical agreements are prevalent in a market and have the effect of preventing the entry of new competitors, but there is no evidence of collusion between the firms involved which might have caused this situation to arise.

- 2.7. The problems referred to in the previous three paragraphs involve industry-wide market features or multi-firm conduct. It is likely that the majority of references the OFT will make will be of that type. Generally speaking single firm conduct will, where necessary and possible, be dealt with under CA98. However, on occasions it might be appropriate to make references when a competition problem arises from the conduct of a single firm. Examples of this could be:
- a) Where the firm in question has a sufficient degree of market power to prevent, restrict, or distort competition but falls short of meeting the test for dominance.
 - b) Where a firm is dominant and abusing its position but the only effective remedies for the problem are structural ones, in particular divestment by the offending firm. Although the OFT will not normally make references in such circumstances until it has first tried to deal with the problem under CA98, on occasions it might be sufficiently clear that nothing short of a structural remedy not available under CA98 would be effective and that a reference instead of a CA98 investigation would therefore be justified.

Modernisation of EC competition law

- 2.8 The European Commission is currently revising the main regulation implementing Articles 81 and 82 of the EC Treaty (Regulation 17/62/EEC), a process widely known as 'modernisation'. The outcome of modernisation is not yet known but it is likely to give the competition authorities of Member States the responsibility, shared with the Commission, for the enforcement of Articles 81 and 82 and to place some limitation on their use of national competition law in preference to Articles 81 and 82. This may have an impact on the scope of market investigation

references, particularly when agreements between undertakings are involved. The OFT will issue further guidance about the effect of modernisation when the position is clearer.

OFT market investigations

2.9 In addition to enforcing CA98, the OFT actively investigates markets that do not appear to be meeting the needs of consumers. Such investigations, which are made public, are in areas where there are concerns that a particular market is not working well for consumers and where competition or consumer regulation enforcement action (including a reference to the CC) does not appear, immediately, to be the appropriate response. Outcomes of these investigations could include:

- a clean bill of health
- enforcement action by the OFT's competition and consumer regulation divisions
- recommendations that Government consider changes to the laws and regulations and to regulators, self-regulatory bodies and others to consider changes to their rules
- campaigns to promote consumer education and awareness, and
- a reference to the Competition Commission (provided the criteria described in paragraph 2.1 are met).

Undertakings in lieu

2.10 [Clause 149] of the Bill gives the OFT the power to accept undertakings instead of making a reference to the CC. In exercising this power the OFT must have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to any adverse effects on competition identified (and any detrimental effects on customers so far as they result or may be expected to result from such adverse effects). It may also have regard, as appropriate, to the effect of the possible undertakings on any relevant customer benefits arising from the adverse effect concerned.

- 2.11 Undertakings in lieu of a reference are unlikely to be common. In many cases the OFT will not have done a sufficiently detailed investigation of a competition problem prior to making a reference to the CC to be able to judge with any certainty whether particular undertakings will achieve as comprehensive a solution as is reasonable and practicable. This is particularly likely to be the case when the adverse effects on competition arise from market features involving several firms or industry-wide practices. Moreover, trying to negotiate undertakings with several parties in circumstances in which possible adverse effects on competition have not been comprehensively analysed is likely to pose serious practical difficulties. By contrast, where an adverse effect on competition arises from the conduct of a single firm there may be more scope for accepting undertakings in lieu.
- 2.12 In assessing customer benefits the OFT will take into account the same factors as the CC when it considers customer benefits during its assessment of possible remedies to the adverse effects on competition it has identified in the course of one of its investigations. Such benefits comprise lower prices, higher quality and greater choice of goods or services, or greater innovation in relation to goods or services in any UK market.
- 2.13 Before accepting any undertaking in lieu the OFT must publish the proposed undertaking in a notice which, among other things, states the purpose and effect of the undertaking and identifies the adverse effect on competition and any resulting detrimental effect on customers identified by the OFT which the proposed undertaking is intended to remedy. The OFT must consider any representations arising from the publication of the notice. There is a power for the Secretary of State to intervene at this stage if she believes that wider public interest matters are relevant to the case. The Secretary of State is able to block the acceptance of undertakings in lieu that she believes would operate against the public interest. In such a case, the OFT may consider other undertakings in lieu or may make a reference.
- 2.14 When an undertaking in lieu is accepted by the OFT it may not make a market investigation reference involving the same goods or services for a period of 12 months unless it considers the undertaking has been breached or it has been given false or misleading information by the person responsible for giving the undertaking.

2.15 The FTA was amended in 1994 to give the Director General of Fair Trading the power to accept undertakings in lieu of a monopoly reference to the CC. These powers have never been used for monopoly references though on a few occasions informal assurances (rather than statutory undertakings) have been accepted. The absence of the use of powers to accept undertakings in lieu in the past suggests that their use in future will not be extensive.

Scale of the problem

2.16 When deciding whether to make a reference the OFT will consider whether the suspected adverse effects on competition are likely to have a significant detrimental effect on customers through higher prices, lower quality, less choice or less innovation. Where it seems likely that this effect is not significant the OFT will normally take the view that the burden on business, particularly in terms of management time, and the public expenditure costs of an investigation by the CC, are likely to be disproportionate in relation to any benefits that may be obtained from remedying the adverse effects.

2.17 It is not possible to make a definitive statement about the circumstances in which the customer detriments arising from a competition problem will not be significant and the OFT is not required to identify such detriments before making a reference, However the following factors are relevant and will be taken into account by the OFT:

- a) The size of the market. Generally speaking the cost of a CC investigation into a very small market would not be justified. However, problems in some relatively small specialised or local markets could have a detrimental impact on customers affected by them.
- b) The proportion of the market affected by the feature giving rise to adverse effects on competition. When this proportion is small the adverse effects will be unlikely to lead to significant customer detriment. The OFT does not think that it would be appropriate to specify a figure for the proportion of the market affected below which it would not make a reference, not least because the precise definition of the market (or markets) concerned and the extent of the market features having an adverse affect on competition may not be clearly

established until after the CC has conducted its investigation. However, where possible the OFT will act in a way that is broadly consistent with its practice when applying its powers under CA98. In relation to the Chapter I prohibition (on anti-competitive agreements), it has said that such agreements generally have no appreciable effect on competition if the parties' combined share of the relevant market does not exceed 25 per cent, although there will be circumstances in which this is not the case particularly where agreements involve price fixing.

- c) The persistence of the feature giving rise to adverse effects on competition. If the feature concerned seems likely to be short lived, for example because of an expected change in regulations, or clearly relates to a one-off incident, and there are no other market features giving cause for concern, then a reference to the CC is not likely to be justified.

- 2.18 In some cases the market features which adversely affect competition may also produce offsetting customer benefits. Such benefits might arise, for example, where customers gain when more of them use the same good or service (network effects) or where there are substantial economies of scale. Where it is clear that offsetting customer benefits exceed the likely detriment from the adverse effect on competition the OFT will not make a reference. However, where there is uncertainty the OFT will normally wish to leave the weighing of benefits and detriments to the CC.

Availability of remedies

- 2.19 The OFT will also take into account the likely availability of remedies in the event that the suspected adverse effects on competition were found by the CC to exist. Where the OFT has not investigated a market in sufficient depth to be confident that it is in a position to identify the possible remedies it will not give this factor much weight. However, where the OFT has a reasonably good understanding of a market, perhaps because it has investigated it using its own market investigation powers or because a reference is being considered following an investigation under CA98, it will not normally make a reference when it believes that no appropriate remedies (including recommendations for action by the European Commission or other bodies) are likely to be available. For example, it may have

established that a particular market is global in scope, or at least goes much wider than the UK, and that any remedy for the UK (which would be all that was available under the Bill) would have no discernible impact on the way the market operated even in the UK. In such circumstances a reference to the CC is not likely to be an appropriate use of public resources, and would impose unnecessary burdens on business.

- 2.20 Where the OFT is satisfied that adverse effects on competition arise primarily from laws, regulations, Government policies or the actions of regulators it is unlikely to make a reference, as the CC will not be able directly to remedy such adverse effects. Instead the OFT will submit a report to the Government or the appropriate regulator in accordance with its own market investigation role (see paragraph 2.9) with recommendations for changes to the relevant laws and so forth as appropriate. However, where regulatory or similar problems are only one market feature among others adversely affecting competition and it is reasonable to expect that remedies which mitigate the adverse effects arising from the other features are feasible, the OFT will consider a reference.

3 POWERS AND PROCEDURE

OFT's powers of investigation

3.1 [Clause 169] of the Bill gives the OFT certain investigatory powers which it may use when it believes it has the power to make a reference, that is when it has reasonable grounds for suspecting that any feature of a market prevents, restricts or distorts competition. As the threshold for the use of these powers is the same as that for making a reference there will be occasions when the OFT will decide not to use its powers and to move to a reference immediately. However, there will be other occasions when the OFT will decide that it needs to investigate a market further before making a reference, for example in order to be clearer about the appropriateness of a reference. Such further investigation will not necessarily involve the use of these investigative powers but may do so.

3.2 [Clause 169] gives the OFT three investigatory powers:

- a) To require the attendance of parties to give evidence
- b) To require the production of specified documents, and
- c) To require the supply of specified information.

The OFT's special investigation powers for cartels cannot be used for market investigation references.

3.3 These powers are identical to those possessed by the CC. The OFT thinks that, in practice, it is unlikely to summon parties to give evidence in normal circumstances.

3.4 Where the OFT is considering a reference to the CC following a CA98 investigation in which it used its powers under that Act, the information it has obtained from the earlier investigation may be used as a basis for making a reference. Conversely, when the OFT has used its investigative powers under the Enterprise Bill but subsequently decides to proceed by means of a CA98 investigation rather than by a reference to the CC, the information it has obtained under Enterprise Bill powers can be used for the purposes of the CA98 investigation. Sectoral regulators may

similarly use information obtained under Enterprise Bill powers in connection with their functions under sectoral legislation, in particular for the purpose of investigating possible licence breaches.

Consultation and publicity

3.5 Where the OFT is proposing to make a reference to the CC it must first consult, so far as practicable, any person on whose interests the reference is likely to have a substantial impact ([clause 164] of the Bill).

3.6 In undertaking this consultation the OFT must, so far as practicable, give its reasons for the proposed reference. The content of any statement of reasons will vary from case to case but the OFT expects that it would normally cover the following points:

- a) a description of the goods or services concerned
- b) the identity of the main parties affected by the reference, whether as suppliers or as customers – this may involve the identification of categories of persons rather than individuals.
- c) a view as to the possible definition of the market (or markets) affected
- d) the evidence that has led the OFT to have a reasonable suspicion that competition has been prevented, restricted or distorted, including the possible market features that may be relevant.

Market definition, the prevention, restriction or distortion of competition, and market features are all discussed in part II of this guidance.

3.7 The OFT will not attempt to make more than a preliminary analysis of these points in its statement of reasons. It will be for the CC to produce a definitive analysis if a reference is made.

3.8 The length of the formal consultation period following the issue by the OFT of a statement of its reasons for a proposed reference will depend upon the complexity of the issues and the extent to which discussions have already taken place with the parties affected. In general, the OFT expects to have discussed the issues

thoroughly with the parties concerned, where they have been identified, before the start of the formal consultation period. In such cases a formal consultation period of about two weeks, in line with current practice for FTA monopoly references, is likely to be appropriate. At the end of this period, if the OFT is satisfied that a reference is still justified, it will proceed to make it. Any reference which it makes must be published together with the reasons for it. It is likely that the published reasons for making a reference will cover the same ground as the reasons for a proposed reference, taking account of any relevant points that have arisen from the consultation on the proposal.

- 3.9 It is the duty of the OFT, when considering whether to make a reference, to bring to the attention of the Secretary of State any case which it believes raises considerations relating to public interest issues specified in the legislation (currently only national security). In practice this is likely to be a very rare occurrence. No monopoly reference under the FTA in recent years has involved national security issues.

Content of references

- 3.10 [Clause 126] of the Bill states that a market investigation reference shall specify the enactment under which it is made, the date on which it is made, and the description of the goods or services to which the feature or combination of features concerned relates. In order to avoid the CC being led into investigation of markets that do not involve the adverse effect on competition which has given rise to the reference, the OFT may describe the goods or services in the reference in terms of the persons to whom they are supplied (or by whom they are acquired) or the places where they are supplied (or acquired). The reference is not required to specify the market affected or the features giving rise to an adverse effect on competition.
- 3.11 A single reference may involve several different markets or several different features provided that they all relate to the specified goods or services. This will occur, for example, when the supply of goods involves a chain with several links (such as manufacturer to wholesaler, wholesaler to retailer, and retailer to consumer) and features giving rise to competition concerns exist at each level.

- 3.12 The content of references gives the CC scope to identify markets affected which differ from those that were considered by the OFT when making the reference, and to identify features giving rise to adverse effects on competition of which the OFT was not aware. Notwithstanding this scope, it may be that the goods and services described in the reference are sufficiently complicated that as the CC proceeds with its investigations it discovers that the description of the goods or services in the reference is inadequate. For example it may find that certain related goods and services are affected by the same market features as those it is investigating or, conversely, that some of the goods or services specified are not affected by these features and need not be investigated further. In those circumstances it may wish to ask the OFT to vary the reference. It is very likely that the OFT would respond positively to such requests.
- 3.13 It may be that an inadequacy in the original reference is brought to the OFT's attention by someone other than the CC. If the OFT believes that the reasons for varying a reference are sound it must consult the CC before proceeding further. It is likely that, when deciding whether to make a variation, the OFT will follow the advice of the CC.

Concurrency

- 3.14 The Bill makes provision for the market investigation functions exercised by the OFT (with the exception of maintaining a register of undertakings and orders) also to be exercised by sectoral regulators with concurrent powers. These are the Director General of Telecommunications, the Gas and Electricity Markets Authority, the Director General of Water Services, the Director General of Electricity Supply for Northern Ireland, the Director General of Gas for Northern Ireland, the Rail Regulator, and the Civil Aviation Authority. These regulators have the power to make references in relation to the supply of some or all of the goods or services which fall within their regulated sectors.
- 3.15 When either a sectoral regulator or the OFT is considering a reference of such goods and services they must consult the other. As a matter of practice where a market investigation reference is appropriate for goods or services which are unambiguously part of a regulated industry, and are the subject of concurrent

powers, the reference would normally be made by the regulator. In ambiguous cases it would be made by whichever authority is better placed to do so. The factors to be considered in determining which authority deals with the matter include the extent to which sectoral knowledge is relevant and recent experience of dealing with the markets concerned.

PART II: APPLICATION OF THE REFERENCE TEST

4 PREVENTION, RESTRICTION OR DISTORTION OF COMPETITION

- 4.1 'Competition' is not defined in the Bill (any more than in other competition legislation). It is not a static state of affairs but a process by which firms strive in various ways to win customers from rivals. Competition will be effective and markets will work well when firms engaged in the market are subject to competitive constraints from other firms already in the market and/or from firms that could readily enter it, perhaps with new products, and from their customers.
- 4.2 The phrase 'prevention, restriction or distortion of competition' is familiar from the complex monopoly provisions of the FTA, section 2 of CA98 and Article 81(1) of the European Community Treaty. EC case law and the past practice of the CC both indicate that the phrase should be interpreted broadly to encompass any reduction or dampening of actual or potential competition. The OFT will use this interpretation when considering references. In particular, the OFT takes the view that conduct which adversely affects the opportunity for others to compete is not the only type of conduct that could prevent, restrict or distort competition. Competition can also be adversely affected by firms which fail to compete as actively, for example on price, as would be expected under fully competitive conditions.³
- 4.3 The OFT's enquiries into a possible market investigation reference may also embrace several levels of a supply chain. It might be, for example, that competition appeared to be prevented, restricted and distorted in some way by the structure of the market, or the conduct of firms, at the manufacturing stage yet further examination of the situation suggested that practices at the downstream

³ This is the view taken by the CC in its report *The Supply of banking services by clearing banks to small and medium-sized enterprises*, Cm 5319, March 2002, paragraph 2.439.

level could also have an adverse effect on competition. A market investigation reference could require that the effectiveness of competition at various levels of a supply chain should be assessed.

- 4.4 Although [clause 126] of the Bill sets out the three types of market feature that could have an adverse effect on competition, in practice there may not be a clear divide between structural features and those relating to conduct. For example, exclusionary conduct by firms in the market will affect structure to the extent that it raises entry barriers. In most cases the OFT's assessment that a reference would be appropriate is likely to be based on a combination of features and will include evidence about both structure and conduct. It may also include evidence about the performance of firms in the market.
- 4.5 Information on prices and profitability in particular can sometimes be a useful supplement to the OFT's evidence on structural features of a market and on firms' market conduct. Indeed, evidence on prices and profitability might be the beginning of the OFT's interest in a particular market. This is because complaints of anti-competitive conduct will often focus on excessive prices and high levels of profitability, perhaps making comparisons with prices or the profitability of firms in other similar markets or in other countries. Other performance indicators such as the level of costs or efficiency measures may, on occasions, also be a useful supplement to analyses of market features.
- 4.6 The OFT is well aware of the limitations of such information for its purpose. Performance indicators in isolation yield little useful information about the state of competition in a market. At best they should be used as an indirect indicator that a competition problem may exist. For example, profits in dynamic markets, where technological advances are important, can be lumpy so a snapshot of profitability will not give a good indication of a firm's performance. Furthermore, identifying the concept of excessive prices and profits and the 'normal' rate of return is extremely difficult. There is a need for care before any inferences about competition are drawn. Nevertheless the OFT will consider any available and reliable information on the dynamics of prices, profitability and other performance indicators in its assessment of the case for a market investigation reference.

4.7 In short, the OFT will usually wish to consider a combination of features and their inter-relationships in any competition assessment and will look at various types of information and sources of evidence. However, it is not required to reach firm conclusions before making references and it would be inappropriate for it to engage in extensive research. Provided it has reasonable grounds for suspecting that there are market features that adversely affect competition, the reference test has been met and further investigation can be left to the CC.

Market definition

4.8 In making a market investigation reference to the CC, the OFT must specify the goods or services in respect of the supply or acquisition of which it has reason to believe that competition is prevented, restricted or distorted. This will require some consideration of the definition of the relevant market, including whether it comprises the whole of the UK or a part of it. Market definition can be a useful step along the way to an analysis of market structure and an assessment of the extent to which firms may have market power, but it need not always be a necessary step. The effects on competition of some feature may be clear enough for firm conclusions on the definition of the relevant market by the OFT to be unnecessary.

4.9 That said, the OFT's approach to market definition in enquiries into a possible market investigation reference will conceptually be the same as in other competition cases.⁴ A market definition will usually comprise two dimensions, the product dimension and the geographic dimension. The product dimension comprises those products (or services) that are close enough substitutes for the price of one of the products to be constrained by the prices of the other products comprising the market. Products are close substitutes if a significant number of customers are able and prepared to switch their purchasing from one to the other on a change in their relative prices. This is referred to as demand-side substitutability.

⁴ For a detailed guide to the OFT's approach to market definition, see the Competition Act 1998 Guideline, *Market Definition*, OFT 403. For some caveats about the use of market definition see the report *Innovation and competition policy*, OFT377, paragraphs 4.43-4.59.

- 4.10 A market may also be defined from the supply side, recognising the fact that a competitive constraint will apply wherever firms who do not currently supply a particular product could speedily, and at little cost, switch their facilities to the production of that product, should it become profitable to do so on a change in relative prices.
- 4.11 The geographical area that constitutes the relevant market will also be determined by reference to demand-side substitutability and, where it is appropriate, supply-side substitutability. This geographic market may be a lesser or a wider area than that of the UK, though where it is wider the reference to the CC will be concerned only with the UK part of it.
- 4.12 In all cases, the OFT's purpose in defining markets will be to achieve a sufficient understanding of the competitive constraints that apply to firms supplying or acquiring the goods or services that would be the subject of a possible market investigation to enable it to reach a view on whether any effects on the competitive process are of sufficient significance to justify a reference. That purpose may be achieved without the OFT having come to any final or fully considered definition of the market.

5 STRUCTURAL FEATURES OF A MARKET

- 5.1 Structure describes the environment within which firms in a particular market operate. The OFT interprets it broadly to include such matters as Government regulations and any information asymmetries that are inherent in the nature of the market. Any assessment of the working of competition in a market will begin with an analysis of market structure and the implications of this structure for the conduct of the firms engaged in the market. A wider range of structural features can give rise to concern under the market investigation reference provisions of the Bill than would normally arise in considering whether a firm or firms had infringed one of the CA98 prohibitions.
- 5.2 This part of the guidance gives a brief account of the more important structural features. Readers may also find it useful to refer to various of the Competition Act Guidelines, particularly OFT 402, *The Chapter II Prohibition*, OFT 415, *Assessment of Market Power*, and OFT 414 *Assessment of Individual Agreements and Conduct*.

Concentration

- 5.3 Market concentration is about the number and size distribution of firms in a particular market. It is generally accepted that, other things being equal, the larger the market share of a firm, the greater is its market power likely to be, particularly if its high market share has persisted over a period of time. This applies to both sellers and buyers. Market shares are not conclusive indicators of a firm's market power, of course. Other factors can be relevant. Notable among these are entry barriers. Often, however, though certainly not necessarily, markets in which firms have high market shares are markets with high entry barriers. In assessing the degree of concentration it is important for the market to be correctly defined as too narrow a definition will overstate concentration (and vice versa).
- 5.4 Market share is an important factor in determining whether a firm is dominant in terms of CA98. In the words of the relevant guideline: 'The European Court has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50 per cent. [The OFT]

considers it unlikely that an undertaking will be individually dominant if its market share is below 40 per cent although dominance could be established below that figure if other relevant factors (such as the weak position of competitors in that market) provided strong evidence of dominance.⁵

5.5 However, a firm may have market power, and the capacity to act in ways that may prevent, restrict or distort competition, with a market share below that usually regarded as necessary to suggest dominance. Much will depend upon the effectiveness of the constraints exerted by its competitors or its customers. Generally speaking a firm with a stable market share will be more likely to have market power than one whose share fluctuates from year to year.

5.6 In markets comprising a small number of firms (oligopolies) each firm might find it relatively easy to predict the reaction of its competitors to any action it might take. This could provide an opportunity for firms to co-ordinate their behaviour for mutual advantage or it could simply dull the incentive to compete, leading to a situation in which rivalry to attract new customers becomes muted. By no means all oligopolistic market structures produce these results. Among the more important of the market features that may assist the co-ordination of behaviour are:

- a) the existence of substantial barriers to entry
- b) the homogeneity of the firms' products
- c) the similarity (symmetry) of the firms with respect to their market shares, their cost structures, the time horizons of their decisions and strategies
- d) the stability of market conditions on both the demand and the cost side
- e) the degree of excess capacity
- f) the extent to which prices, outputs and market shares are transparent
- g) the structure of the buying side of the market (if the issue is possible co-ordination among sellers)
- h) the extent of any multi-market contacts.

⁵ Competition Act Guideline, *The Chapter II Prohibition*, OFT 402, para.3.13

- 5.7 This list is not exhaustive nor are any of the items on it necessary conditions for competition dampening to take place. It also is quite possible for a market displaying many of these factors to be competitive. Nevertheless, the more symmetrical are the firms in the oligopoly, the more homogeneous their products, and the more stable are market conditions, the more likely it is that an understanding on, say, a particular price can be reached and sustained. It can be difficult to sustain a co-ordinated price where buyers are large and may encourage sellers to offer special and secret deals.
- 5.8 A view on the likelihood of co-ordination or the existence of muted rivalry can only be reached after a close study of the market concerned, not least because the influence of some of the features listed in para 5.6 can be ambiguous. Thus, product homogeneity makes it easier for oligopolists to reach a tacit understanding, but it makes it easier for customers to compare the offerings of different firms, possibly encouraging greater keenness on price. However, research suggests as a generalisation that the combination of firm symmetries, market transparency and relatively stable demand and cost conditions appears to be the market characteristics most conducive to co-ordination.⁶

Vertical integration

- 5.9 A structural market feature that can have a bearing on market conduct and the effectiveness of competition is the degree (if any) of vertical integration of firms engaged in the market. A vertically integrated firm can have adverse effects on competition if it can foreclose non-integrated competitors from a significant part of their market either by refusing to supply or to deal with them or by discriminating against them in its pricing. Vertical integration may also add to entry barriers if a potential competitor would have to enter at both stages in order to be able to compete effectively with incumbent firms, and if the riskiness of the necessary investment is thereby increased.

⁶ See European Commission, *Assessment criteria for distinguishing between competitive and dominant oligopolies*, Enterprise Papers No.6, 2001 (a report prepared by Europe Economics, London).

5.10 For vertical integration to have any of these effects, the vertically integrated firm(s) will need to have a sizeable share of either of the vertically linked markets. Where only a single firm is vertically integrated adverse effects on competition will usually arise only if it is dominant in terms of CA98. A market investigation reference might be appropriate, however, if a number of firms in a market are vertically integrated, and they engage in some common form of anti-competitive conduct, for example, discrimination against any non-integrated competitors.

Conditions of entry, exit and expansion

5.11 Entry conditions are always a crucial part of any competition assessment. If there are no significant barriers or impediments to entry into the market under consideration, so that there is a realistic possibility that a new entrant could establish itself in the market on a viable basis within a reasonably short period of time, the established suppliers will have no lasting market power. However, while there can be such contestable markets, more often than not, in markets in which the OFT is interested, there will be some significant entry barriers facing any potential entrant.

5.12 One definition of entry barriers is any feature of the market that gives incumbent suppliers a cost or other advantage over efficient potential entrants. The 'height' of entry barriers may then be measured by the extent of the cost (or other) disadvantage that the entrant must bear.

5.13 There are various sources of entry barriers and they can be classified in a number of ways. Here three sources of entry barrier are distinguished:⁷

- a) absolute advantages such as access to a scarce input, intellectual property rights, and regulatory barriers that limit the number of market participants
- b) strategic or 'first-mover' advantages of incumbents. An entrant will be concerned to make a return on the commitment it makes in entering the market. This will depend on the response to entry of the incumbents and the size of the commitment the entrant has to make. First-mover advantages can be

⁷ This follows the treatment of entry barriers in Competition Act Guideline, *The Assessment of Market Power*, OFT 415.

particularly potent in an industry where economies of scale are important or in a market where incumbents have built up brand loyalty through advertising and promotion

- c) exclusionary behaviour by incumbents, for example, predatory price cuts directed at an entrant or restrictive distribution arrangements which raise entrants' distribution costs.

5.14 Strategic entry barriers will tend to be more important the greater are the sunk costs of entry (costs that will be incurred on entry but cannot be recovered on exit from the market) and therefore the commitment that any potential entrant would have to make. Sunk costs can include the set-up costs in entering the market (market research, finding a location and getting planning permission, attracting and training staff etc), investment in specific assets and advertising and promotion costs.

5.15 Some entry barriers are 'natural' in that they arise from the technology of the industry, such as economies of scale, from statutory provisions such as exclusive rights under intellectual property law or from government regulations (see next chapter). Other entry barriers can more readily be loosened by action under the competition legislation. These are entry barriers created by the conduct of incumbent firms. Sometimes such barriers involve actions by a dominant firm, such as a refusal to supply essential inputs to a downstream competitor or to grant access to an essential facility, and can be dealt with under CA98. On other occasions they may involve several incumbent firms, for example where there are networks of restrictive distribution agreements or the exploitation of information advantages to deter the entry of new competitors, and these may be more suited to investigation by means of a market investigation reference.

5.16 Barriers to expansion determine how easy it is for an entrant to grow once they have entered a market, thereby gaining customers and market share from the incumbents. This could be closely related to the degree of switching by consumers and the information asymmetry inherent in the market: the sunk costs for entry may be small but if customers are unwilling to switch (due to brand loyalty for example) then price competition will not provide a basis for expansion.

5.17 Barriers to exit relate to the cost of exit from the market if the business does not go according to plan. This is closely related to the degree of sunk costs incurred on entry and the extent to which investment can be recovered on exit. Where the barriers to exit are high, the firms in the market have burnt their bridges providing them with a credible threat that they will not consider exiting the market easily. This could lead to situations where tacit collusion becomes the optimal strategy rather than intense price competition.

Regulations

5.18 Government regulations can have a direct effect upon competition when they limit the number of firms that can operate in a market. This might be achieved by a licensing system or by specified entry criteria, for example a minimum capital funds requirement as in much of the financial sector. It does not follow, however, that such entry barriers will necessarily have significantly adverse effects upon competition. That will depend upon how seriously the regulations limit the number of firms in the market, for example, whether the restrictions are quantitative or qualitative, and how active is the competition between those that are in the market.

5.19 Regulations can also affect firms' conduct. Often they will be innocuous in competition terms such as regulations on product labelling, emissions of pollutants, hiring and firing of employees, although they will raise firms' costs and can bear more heavily on small firms than on their larger competitors. Sometimes the effects on competition will be more significant, for example the imposition of demanding product standards, restrictions on trading hours or the restrictions on advertising of tobacco products or on the marketing of drugs. The circumstances in which markets affected by regulation might be suitable for a reference to the CC were mentioned in paragraph 2.20.

5.20 Competition can also be affected by the rules emanating from systems of self-regulation, for example, those applicable to financial services and to a number of occupations and professions. In many cases this can be adequately addressed using CA98 or sector-specific legislation. Where it cannot the market affected might be suitable for a reference to the CC.

Information asymmetries

- 5.21 Where customers are well informed, they can make efficient choices and their purchases will provide useful information to sellers about customers' preferences. Sellers then have the incentive to provide the goods and services that customers most value. Without such information, the incentives to compete on price, quality and other terms are likely to be diminished. In short, adequate information available to customers is one of the pre-requisites for markets to work well. If customers have inadequate information, or are unwilling or unable to search for the best deal, firms may be able to exercise a degree of market power, even if there are many firms supplying the market.
- 5.22 In many markets, suppliers will have more information than their customers about the quality and other attributes of their products. Where the quality is difficult for customers to assess, either because of their complexity or the infrequency with which they are purchased, information asymmetries can have a significant impact on the nature and degree of competition in the market for the product or service: used cars and life insurance products are examples. Information asymmetries can restrict competition by adding to customers' switching costs.

Switching costs

- 5.23 For competition to work effectively, it is often necessary that customers should be able readily to switch their patronage if a competing supplier is found to offer better value for money. Where customers face difficulties in switching between suppliers, whether because of the monetary costs or the administrative hurdles or inconvenience of doing so, competition can be affected. If firms find it difficult to persuade customers to switch their incentive to compete with each other may be reduced and rivalry between them dulled.
- 5.24 Switching costs allow firms potentially to charge high prices to 'captive' customers. Firms face conflicting incentives. They want to offer low prices to attract new customers but to charge high prices to their existing customers. Even

if the firm is unable to discriminate between the two types of customer, it is still possible that the existence of switching costs will permit firms to charge higher prices than they would set in the absence of these costs.

- 5.25 Firms may engage in practices that increase switching costs, for example, by not releasing information needed for a switch to be feasible or by not doing so in a timely fashion. In its report on *Banking Services to Small and Medium Sized Enterprises*, the CC identified as a factor discouraging switching between banks the 'hassle in moving direct debits, standing orders etc and a fear that crucial payments could be missed whilst a switch was in progress'. It also found that banks reduced charges selectively and in a discriminatory way to enterprises likely to switch to another bank. Marketing devices such as loyalty cards, often seen as pro-competitive, can have the effect of increasing switching costs. Negative advertising may also be used to reduce switching by creating doubts in customers' minds about the acceptability of competitors' offerings.
- 5.26 In some markets, the problem may be more that the customer is unaware of the existence of competing products. For example a consumer may not be aware of a generic pharmaceutical product having the same medicinal properties as a more expensive branded product.

Countervailing power

- 5.27 The structure of the buying side of the market can also be relevant to the assessment of the effectiveness of competition between suppliers. It may suggest that any market power of suppliers would be countervailed by the bargaining power of customers, or that any attempt of suppliers not to compete on price would be eroded by the temptation to negotiate special terms with large buyers.
- 5.28 The effectiveness of buyer power as a constraint on suppliers will depend upon a number of factors, particularly upon the relative dependence of seller and buyer on the business of the other and the credibility of any threat by the buyer to switch its business to an alternative supplier.

Summary

5.29 There are many dimensions of market structure. In its assessment of a possible market investigation reference, the OFT will examine any structural feature which, on its own, or more likely in combination with other market features, could enable suppliers (or buyers) to behave in ways that prevent, restrict or distort competition, or that exploit the absence of effective competition in a market. Where there is no abuse of a dominant position but structural features of the market nevertheless appear to affect the competitive process adversely, then a market investigation reference will be a possibility.

6 FIRMS' CONDUCT

- 6.1 The conduct of firms refers to their behaviour and practices in the broadest sense including what decisions they take, how they make them and the resulting action or lack of it. [Clause 126(3) states that conduct includes failure to act and unintentional conduct. A significant part of the evidence on which the OFT will base its case for a market investigation reference will normally concern the conduct of firms (as sellers or buyers) who, because of structural or other features of the market, are in a position to exercise a degree of market power.
- 6.2 The conduct of the firms in a market may affect competition in that market (horizontal effects) or it may affect competition in the (upstream) market of its suppliers or in the (downstream) market of its customers (vertical effects). It is also possible for conduct adversely to affect competition in a market for some related product.
- 6.3 As stated in paragraph 2.7, although conduct on the part of an individual firm may occasionally be the basis for making a reference, most market investigation references are likely to involve markets where the conduct of a number of the firms (whether sellers or buyers) appears to have the effect of preventing, restricting or distorting competition (without an agreement or concerted practice that would be unlawful under Chapter I of CA98). This part of the guidance gives a number of examples of such conduct. These should not, however, be regarded as in any way exhaustive or exclusive.

Conduct of oligopolies

- 6.4 Many of the markets in which the OFT is likely to be interested will be oligopolistic. These are markets comprising very few firms (or few firms of any significance) where those firms are aware of the mutual interdependence of their actions. Each firm's strategy is therefore determined at least partly by its beliefs about its rivals' likely reactions. These strategies can take various forms, ranging from competitive rivalry to conduct that is tantamount to collusion, even without an explicit agreement not to compete. With either of these extremes, the outcome

can be parallel behaviour. The task will then be to determine whether the oligopolists' conduct reflects a restriction of effective competition and would be an appropriate ground for an OFT investigation.

- 6.5 It is a common feature of oligopolistic markets that competition takes forms other than competition in price. These include competitive advertising and promotional activity, rebates and discounts linked to purchases, and more explicit customer loyalty-inducing schemes such as retailers' store cards or airlines' frequent flyer programmes. These forms of conduct are often pro-competitive but they may have effects which, especially when combined with other market features, blunt the competitive process, for example by adding to entry barriers.
- 6.6 Where firms in an oligopolistic market reach a tacit understanding to pursue their joint interests by co-ordinating their behaviour (tacit collusion) the adverse effects on competition are likely to be severe. The OFT will not need to establish conclusively that any observed parallel conduct reflects co-ordinated rather than competitive behaviour by oligopolists. However, it will need to establish that the market features that make tacit collusion a feasible strategy are present (see paragraph 5.6 for an indicative list) and to have a reasonable suspicion that the oligopolists are not competing effectively with consequences that are likely to be detrimental to their customers.
- 6.7 Among the evidence that the OFT might examine in this regard are:
- a) the pattern of price changes over time, with a view to establishing the degree of parallelism in the face of any changes in demand or cost conditions, and whether the pattern seems more consistent with collusive than competitive behaviour
 - b) price inertia, such as when sustained exchange rate advantages are not exploited by importers
 - c) any evidence that, notwithstanding evidence of parallelism in, say, published prices, the oligopolists compete in discounts or other concessions off the published price, and

d) the oligopolists' rates of return compared to returns in comparable markets or to the cost of capital (since the expected outcome of tacit collusion is that the level of prices will be higher than could be sustained in a competitive market); however, where there is persistent excess capacity excessive prices may not be reflected in high rates of return.

6.8 Even if the conditions necessary for tacit collusion are not met, other market features such as switching costs and informational inadequacies may limit the effectiveness of competition, especially price competition. Competition can be muted in oligopolistic markets without any co-ordination of firms' decisions. In the *Supermarkets* complex monopoly reference, for example, the CC concluded that the market was 'broadly competitive' with no suggestion of collusion, but that competition was concentrated on certain products or in certain areas and was less than fully effective elsewhere. This was held to distort the competitive process.

6.9 The OFT will therefore be concerned to consider, in contemplating a reference, whether there are any steps that could be taken to facilitate entry into an oligopolistic market and any conduct that serves to reinforce the market features that are conducive to tacit collusion and that could, if appropriate, be struck down. One such possibility is facilitating practices.

Facilitating practices

6.10 Facilitating practices are conduct of firms that make it easier for oligopolists to arrive tacitly at a collusive outcome and to maintain it in the face of the temptation of all colluders to cheat on the other participants. Examples would be a practice of announcing price increases well in advance of the date of implementation, most-favoured-customer clauses in contracts, uniform systems for reflecting transport charges in prices, and information exchanges, for example, on costs.

6.11 There can be objective justifications for such practices and they do not necessarily have the effect of restricting competition. However, where other market features appear conducive to tacit collusion, practices of firms that appear to facilitate such conduct will be closely scrutinised by the OFT. They could even be the focus of a market investigation in their own right.

Custom and practice

- 6.12 Practices that may restrict competition can be adopted widely in a market apparently as a custom of the trade and with no agreement or understanding between them. A good example is provided by the monopoly reference of *Underwriting Fees*. Custom and practice appeared to be the reason why underwriting fees for new share issues were charged on a common basis virtually throughout the industry.
- 6.13 Another example could be the practice of manufacturers' recommended retail prices. While the practice can be innocuous, its widespread use in a market can have the effect of restricting competition in the downstream (retail) market, by dampening price competition should retailers generally choose to follow the recommended price, or of restricting competition in the upstream market, by making it easier for a manufacturer to monitor competitors' prices and thereby to detect, and hence to deter, competitive price cutting. Examples of anti-competitive effects of the practice are to be found in CC's reports on the monopoly references of *Domestic Electrical Appliances*.
- 6.14 Any common practices in a market that appear to reflect a restriction of competition and to have no objective justification could be the subject of a market investigation reference.

Networks of vertical agreements

- 6.15 Vertical agreements of one kind or another are commonplace in industry and are frequently pro-competitive or neutral. Agreements between manufacturers and distributors (wholesalers or retailers) will often include terms that restrict the freedom of action of one or other party, as will agreements between a manufacturer and suppliers of its inputs. Such restrictions could in some circumstances adversely affect competition. Where several firms in a market have agreements with their distributors or suppliers which contain restrictions which, taken together, have an adverse effect on competition in the market of one or other party, for example, by foreclosing the market to competitors or adding to entry barriers, a market investigation reference could be justified. It is not

necessary for there to be any horizontal agreement to engage in particular vertical arrangements (indeed, if there was such an agreement it would have to be considered under Chapter I of CA98). Such 'networks' of vertical agreements can result from the unilateral and independent decisions of the firms concerned, or even from long custom in a trade.

- 6.16 Types of vertical agreement that have been the subject of FTA monopoly references in the past may be suitable for market investigation references in the future include exclusive purchasing (i.e. where the retailer or other downstream party is tied to a single supplier), exclusive or selective distribution (where a supplier only sells to certain downstream outlets), and tie-in sales and product bundling. For a fuller discussion of the various types of vertical agreement and their effects see the Competition Act Guideline, *Assessment of Individual Agreements and Conduct*, OFT 414.
- 6.17 The effect on competition of vertical agreements will depend not just on the foreclosure and entry barrier enhancing effects but also on the effectiveness of competition between suppliers and the willingness of consumers to shop around among the competing suppliers' products. Where inter-brand competition is strong, the effects may not be significant. On the other hand, inter-brand competition can be weakened if consumers find that particular retailers are effectively tied to particular suppliers or (vice versa) and they are unwilling for one reason or another to shop around and switch to another retailer (brand) if it is found to offer better value for the consumer's money.
- 6.18 Vertical agreements are frequently efficiency enhancing so that even where the OFT suspects that they adversely affect competition it will need to consider the trade-off. A reference will only be appropriate where there are reasonable grounds to suspect that the net effect of the agreement is detrimental to the interests of customers.

Summary

- 6.19 The conduct of firms can affect competition in various ways. For the OFT to have any concern, it is the process of competition that needs to be affected not the fortunes of individual competitors. Such adverse effects are less likely to be a

concern where there are no structural features of the market that give rise to market power, either for an individual firm or a number of firms in a market. Single firm conduct will usually not be the cause of a market investigation reference, though the possibility cannot be entirely ruled out. It is conduct that embraces a number of firms engaged in a market that appears to prevent, restrict or distort competition, or to exploit the absence of effective competition, that is most likely to lead to a market investigation reference to the CC.

7 CONDUCT OF CUSTOMERS

7.1 [Clause 126 (2) (c)] of the Bill identifies the conduct of customers as a market feature that could give rise to adverse effects on competition and be the subject of a market investigation reference. The customers concerned may be businesses or final consumers. It may seem rather unlikely that the conduct of consumers could affect the competitive process until it is recalled that 'conduct' includes failures to act. One feature of consumers' conduct that can then affect competition is the search process.

Search costs

7.2 Competition requires customer choice. In order to make informed choices customers need to spend at least some time and effort finding out what alternative products are available to them. Where such search costs are perceived to be high searching is likely to be curtailed. Customer sensitivity about a product may also limit the amount of search that will be contemplated. Depending on other features of the market, reduced searching may blunt sellers' incentives to compete.

7.3 Even if a proportion of customers do engage in search activity, there may remain enough uninformed customers with high search costs who purchase from the first firm they encounter for the seller to be able to charge prices without regard to competition. In this situation, the profit foregone by losing informed consumers who buy elsewhere is more than offset by the increase in profits accruing from uninformed consumers who do not shop around. Markets serving both tourists (with high search costs) and local residents (with low search costs) may be an example.

7.4 Firms may engage in practices that increase search costs (or fail to engage in practices that would reduce search costs). For example, firms may choose not to display prices prominently. An example of price display reducing search costs, and increasing the effectiveness of competition, is the prominent display of petrol prices at filling stations. Restrictions on advertising in the rules of many professional bodies in the past also served to increase the difficulties of search.

- 7.5 Firms may fail to make available all the product information needed by consumers to make an informed choice. Customers may be ignorant of all the product attributes that they should consider in choosing between competing products. This is likely to be the case with many financial products, extended warranties on electrical products, certain professional services and some consumer durables. Where one-off purchases are involved, with no repeat sales, there will be little incentive for a firm to provide the consumer with the information that he needs. Indeed, there may be an incentive for the firm deliberately to provide consumers with partial and potentially misleading information.
- 7.6 Search costs are therefore a market feature that could be a factor pointing to a market investigation reference, especially when associated with sellers' conduct that is likely to have adverse effects on competition in its own right. Structural features of the market would also be relevant, but it is noteworthy that the effect of high search costs on prices will be greater the more firms that there are in the industry.
- 7.7 The effects of search costs on the competitive process are likely to be compounded when they are combined with high switching costs. A good example of such a combination of market features is durable goods where the consumer needs information on the availability and costs of 'aftermarket services' such as spare parts and maintenance if an informed choice is to be made between competing products. A competition problem can arise where the consumer is unable to factor in to his purchase decision all the aftermarket costs of all the products or where the aftermarket is not competitive. For some durable products such as new motor cars there are adequate sources of information on lifetime aftermarket costs for any customer willing to take a little trouble. For other products such information is inherently difficult to obtain. Suppliers are well placed to take advantage of customers who are short of relevant aftermarket information with little risk of losing sales to competitors.
- 7.8 High search and/or switching costs will therefore be features of markets that could justify a market investigation reference. They can feed into other market features by facilitating anti-competitive or exploitative conduct by suppliers and by adding

to entry barriers into a market. But the OFT will need to be convinced that market behaviour is affected. It is not necessary for all customers to be well informed and quick to switch suppliers in response to price differences for markets to work well.

7.9 Indicators that market behaviour may be little affected by search or switching costs with little risk of detriment to customers at large include:

- a) prices clustering together
- b) advertising of prices by all or most suppliers
- c) customary and inexpensive comparison shopping
- d) inability of suppliers to discriminate between informed and uninformed customers.

Summary

7.11 Customers' conduct is unlikely on its own to be sufficient to justify a market investigation reference. When combined with structural features of the market, however, a failure or the inability of customers to engage in meaningful search activity can add to firms' opportunities for anti-competitive conduct.