

Newspaper and magazine distribution in the United Kingdom

Public consultation on the OFT's proposed decision
on a request for a market investigation reference

October 2008

OFT1027

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Note: [...]

This report has been edited for publication in accordance with Part 9 of the Enterprise Act 2002. Among other things, this Part requires that the Office of Fair Trading has regard to the need for excluding from the published report, so far as is practicable, commercial information whose disclosure it thinks might significantly harm the legitimate business interests of the undertaking to which it relates.

EXECUTIVE SUMMARY

The market investigation reference (MIR) request

In December 2006, the National Federation of Retail Newsagents (NFRN) submitted a request for the OFT to investigate the supply chains for newspapers and magazines in the UK. It asked the OFT to consider whether the conditions for making a market investigation reference (MIR) to the Competition Commission (CC) were met, and if so, whether undertakings in lieu of a reference may be available.

This request arose in the context of two pre-existing strands of OFT work in relation to the distribution of newspapers and magazines: the OFT's Opinion, and the OFT's review of the National Newspapers Code of Practice (the Code). The NFRN's request enabled the OFT to build on these existing work-strands and undertake a wide-ranging analysis of the newspaper and magazine supply chain.

The OFT's Opinion and the OFT's Code Review are published alongside this proposed decision on an MIR. These documents may provide useful further background to this proposed decision. In addition, all three documents are accompanied by an introductory overview paper. This paper provides an introduction to the newspaper and magazine supply chains. The paper is supplementary to, and does not form part of, this proposed decision, but it may be informative for those outside the industry who are unfamiliar with these supply chains to read the introductory overview paper in conjunction with this proposed decision.

The reference test

Under section 131 of the Enterprise Act 2002 (EA02), the OFT may make an MIR to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom 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 part of the UK.

In its request, the NFRN raised a variety of features which it considered prevented, restricted or distorted competition. The OFT has considered these features, and identified five individual key features of the conduct of publishers and wholesalers for analysis under the reference test. These are:

- **Absolute Territorial Protection (ATP):** the system of ATP results from agreements between national newspaper publishers or consumer magazine publishers / distributors on the one hand, and wholesalers on the other in which the former grant the latter exclusive territories for distribution of their products from which all competing wholesalers are excluded. The exclusive territorial rights conferred by the agreements are underpinned by contractual provisions prohibiting both active and passive sales between territories.
- **Competition for the market:** the process by which publishers tender territories to wholesalers for the distribution of their magazines and newspapers, and wholesalers bid to win those tenders.
- **Sale or return:** the system by which retailers can return unsold copies to wholesalers and be reimbursed for them.
- **Copy allocation:** the degree of control that newspaper and magazine publishers exercise over the allocation of titles and copy numbers to retailers.
- **Cover prices:** the printing by publishers of prices on the cover of publications and the limits that places on retailer pricing.

Analysis of the features

The OFT has engaged extensively with stakeholders and has received a wide range of submissions and data from relevant parties. The OFT has also appreciated the views and representations made by industry parties and their willingness to attend frequent meetings and provide written information to assist the OFT's assessment of different aspects of the distribution process. In so far as it is relevant, information received and analysis conducted in relation

to the other work-strands has been shared with this proposed MIR decision. This has reduced the burdens of information provision for stakeholders and ensured consistency and coherence across the three distinct areas of work.

Following its analysis, the OFT is minded to decide that there are reasonable grounds for suspecting that three of the five features identified above individually prevent, restrict or distort competition:

- ATP for newspapers and magazines: by awarding wholesalers exclusive territories and by preventing passive sales between those territories, ATP may well remove the potential for competition to emerge between wholesalers for a proportion of the individual retailers within some of these exclusive territories.
- Copy allocation for magazines: in contrast to newspapers, there is considerable scope for retailers to differentiate their magazine ranges. Longer distribution timescales for magazines should also give more scope for wholesalers to respond to individual orders or requests from retailers to reflect local demand preferences. This scope for a retailer to compete on the basis of their magazine title ranges may be restricted by the degree to which wholesalers, in conjunction with publishers, control the allocation of magazine copies to individual retailers.
- Cover prices for newspapers and magazines: cover prices appear to restrict the ability of retailers to increase their prices independently and control their margins. Cover prices might also be expected to limit the ability of retailers to compete on non-price dimensions of their newspaper and magazine offer. In addition, although they do not restrict retailer discounting directly, cover prices may generate a degree of pricing inertia at the retail level, particularly for magazines.

The OFT has also examined the collective impact of the five features it has analysed. The OFT is minded to find that, taken together, the individual features contribute to a high degree of publisher control over the entire distribution process for newspapers and magazines (publisher-led distribution) and that:

- In relation to newspapers, the very limited time-window for the distribution of newspapers, the limited range of titles, the unpredictability of content from day-to-day, and the habitual nature of consumer purchases mean that there is limited scope and incentive for retailers to differentiate their newspaper offers. As such, the OFT is minded to decide that there are not reasonable grounds for suspecting that publisher-led distribution for newspapers is a feature that prevents, restricts or distorts competition.
- In relation to magazines, however, there would appear to be significant scope in the absence of such a high degree of publisher control over the distribution process for retailers to differentiate their magazine offers and for wholesalers to respond to more individualised retailer demands, responding to local demand preferences. The OFT considers that this degree of publisher control over the distribution process for magazines affects not only the ability of retailers, in competition with other retailers, to influence the range of magazines they offer but also their ability to promote individual titles, offer different types of discount to customers, and to improve the availability of titles, sensitive to local demand and demographics. The OFT, therefore, is minded to decide that there are reasonable grounds for suspecting that publisher-led distribution for magazines prevents, restricts or distorts intra-brand competition between retailers in relation to magazines.

Exercise of the OFT's discretion

Given the OFT's proposed decision that the reference test is met, the decision on whether to make a reference rests on the exercise of the OFT's discretion. The OFT's guidance sets out four criteria, all of which must, in its view, be met before it can decide to make a reference:¹

¹ OFT 511, Market investigation references, paragraph 2.1.

- Appropriateness of a reference: the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it.
- Availability of remedies: there is a reasonable chance that appropriate remedies will be available.
- Undertakings in lieu: it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- Alternative powers: it would not be more suitable to deal with the competition issues identified by applying the CA98 or using other powers available to the OFT.

Taking account of the relevant factors outlined in the OFT's guidance for assessing whether these criteria are met,² the OFT is minded to decide that, although the reference test is met, the balance of the evidence reviewed and the resulting assessment points in favour of exercising the OFT's discretion not to make a reference to the CC of newspaper or magazine distribution in the UK. In summary:

- In relation to ATP, it is expected that publishers and distributors will self-assess their agreements with wholesalers following the guidance set out in the OFT's Opinion. From the Opinion it would appear that there are factors that may demonstrate that ATP in newspaper agreements satisfies the exemption conditions, whereas it may be difficult to demonstrate that magazine agreements satisfy the exemption conditions. Parties need to assess their agreements in light of the guidance set out in the Opinion. Where ATP is not compatible with the Competition Act 1998, one would expect parties to self-assess correctly in line with the OFT's guidance and to resolve the issues arising from the agreements in the short term. In such circumstances, the feature giving rise to competition concerns would not persist.

² OFT 511, Market investigation references, paragraphs 2.1 to 2.32.

- In relation to cover prices, the OFT is minded to decide that a reference would not be proportionate due to the strong offsetting customer benefits from cover prices identified that the OFT considers exceed the likely detriment from the adverse effect on competition identified. In particular, the OFT is minded to find that publisher-set cover prices would, in general, be significantly lower than retailer-set prices.
- In relation to the individual/collective features of magazine distribution that have been identified – publisher control of copy allocation and publisher-led distribution in general - the OFT is minded to find that it is at least possible that a period of flux will result from the parties' self-assessment following the guidance issued in the OFT's Opinion. The OFT is minded to find that the process of self-assessment and the developments in the sector that may result for a period of time would make it difficult for the CC to gather sufficient evidence at this point in time to enable it properly to assess the state of the markets. This, in turn, would make it difficult, at least in the short term, to assess the impact and effectiveness of any possible remedies in the case of magazine copy allocation and publisher-led magazine distribution in general.

Undertakings in lieu of a reference

Under section 154 of the EA02, the OFT has the power to accept undertakings in lieu of a reference only when it otherwise intends to make a market investigation reference. Since in this instance, for the reasons set out above, the OFT is minded to decide not to make such a reference, the OFT does not have the power to accept undertakings in lieu in the circumstances.

Consultation on the OFT's proposed decision

Under section 169 of the EA02, where the OFT is proposing to make a reference it must first consult so far as is practicable any person on whose interests the reference is likely to have a substantial impact. Although in this case the OFT is minded to decide not to make a reference, it invites views from industry parties as well as other interested parties given, among other matters,

the complex nature of the markets and supply chains examined in this proposed decision, and the complex interplay of this proposed decision with the OFT's work-strands regarding the Opinion and the Code Review, the outputs of which have been simultaneously published with this proposed decision. A consultation is also appropriate in this particular case given the high level of stakeholder engagement and consultation that has been maintained across all work-strands.

Persons who wish to submit comments to the OFT on its proposed decision not to make a reference to the CC in relation to newspaper and magazine distribution in the UK should send them to:

Ed Smith
Markets and Projects
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX
Email NMD@oft.gsi.gov.uk

In order to give parties the opportunity to consider the decision of the Secretary of State on the Code Review, the deadline for representations on the OFT's MIR consultation is set at 28 days following the publication of the Secretary of State's decision on the Code Review. Parties should not hesitate to, and it would assist the OFT's progression of the consultation in the meantime if parties could, make representations on any matter that they were able to prior to the Secretary of State's decision on the Code Review. Parties will of course be able to supplement any such representations if necessary once the final decision on the Code Review is published.

1 INTRODUCTION

The proposed decision not to make a market investigation reference to the Competition Commission

- 1.1 This document sets out the proposed findings of the OFT's examination into newspaper and magazine distribution in the UK, including the roles of publishers, distributors, wholesalers and retailers, following a request by the National Federation of Retail Newsagents (NFRN) that the OFT should consider whether the conditions for making a market investigation reference (MIR) to the Competition Commission (CC) are met, and if so, whether undertakings in lieu of a reference may be available. The document also sets out the reasoning behind the OFT's proposed decision not to make an MIR to the CC and not to accept undertakings in lieu of a reference.
- 1.2 The request by the NFRN highlighted a number of features relating to the distribution of newspapers and magazines in the UK that it considered were features that prevent, restrict or distort competition. These features were concerned in particular with the supply chains for daily national newspapers and consumer magazines³ and are outlined in paragraph 2.2 below. Other publications, such as regional newspapers and business magazines, most often use different means of distribution and are not, therefore, the focus of this proposed decision. Future references in this document to 'newspapers' and 'magazines' should, therefore, be read as references to national newspapers and consumer magazines respectively.

³ Consumer magazines are typically aimed at customers' leisure interests and generally made available through retail channels, although they may also be sold via subscription, as distinct from business magazines or other periodicals which are typically focused on an industry or profession and are generally distributed via subscription and not available in retail outlets.

The Enterprise Act 2002

1.3 Under section 131 of the Enterprise Act 2002 (EA02), the OFT may make an MIR to the CC if the OFT 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. Section 131(2) provides that, for this purpose, reference to 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 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 supplies or acquires goods or services.

In addition, section 131(3) provides that 'conduct' includes any failure to act (whether or not intentional) and any other unintentional conduct.

1.4 It is also important to note that the OFT has the discretion, rather than a duty, to make a reference where the statutory test set out in section 131 appears to be met. In its MIR guidance published in March 2006, the OFT provides that it will only make references to the CC when the reference test set out in section 131 of the EA02 and, in its view, each of the following criteria have been met:

- It would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998, (the CA98)⁴ or using other powers available to the OFT or, where appropriate, to sectoral regulators.
- It would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- The scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it.
- There is a reasonable chance that appropriate remedies will be available.

The OFT's proposed decision

1.5 The OFT is minded to decide that, although there are reasonable grounds for suspecting that there are certain features of a market which prevent, restrict or distort competition in connection with newspaper and magazine distribution in the UK, there are currently several factors which mean that it is not appropriate to make a reference to the CC. The OFT's analysis and reasoning for this is set out in the following chapters.

1.6 Under section 154 of the EA02, the OFT has the power to accept undertakings in lieu of a reference only if it considers that it has the power to make a reference under section 131, and it otherwise intends to make such a reference. Since in this instance the OFT is minded to decide not to make such a reference, for the reasons set out in chapter

⁴ The CA98 prohibits agreements which have the object or effect of preventing, restricting or distorting competition (the 'Chapter I' prohibition), and the abuse of a dominant position (the 'Chapter II' prohibition). These two prohibitions are described in further detail in the Competition Act Guidance OFT 401 and OFT 402 respectively.

5, the OFT does not have the power to accept undertakings in lieu in the circumstances.

1.7 The OFT does however note the desire on the part of some industry parties, including the NFRN, to agree some form of new code of conduct in relation to the supply of both magazines and newspapers to retailers, possibly to include mechanisms for redress. Appropriate steps towards self-regulation that would improve the functioning of the market and address any issues in the supply chain that are of concern would be welcome, provided they comply with competition law.

1.8 The remainder of this document is structured as follows:

- Chapter 2 provides background to the market investigation request by the NFRN and the context of the OFT's work on this request, alongside its work on the Opinion and the Code Review.
- Chapter 3 provides an overview of certain key characteristics of newspapers and magazines and the different stages of the supply chains. It also sets out a definition of the relevant markets.
- Chapter 4 sets out the OFT's analysis of the features of the markets for the purposes of the reference test set out in section 131 of the EA02.
- Chapter 5 sets out the reasons why the OFT considers the reference test pursuant to section 131 of the EA02 to be satisfied and why the OFT is proposing to exercise its discretion not to make a reference applying the criteria as set out in the OFT's guidance.
- Chapter 6 sets out the next steps in the OFT's consultation.

2 BACKGROUND

The request from the National Federation of Retail Newsagents

2.1 In December 2006, the NFRN submitted a request for the OFT to investigate the supply chain for newspapers and magazines in the UK and to consider whether the conditions for making a market investigation reference to the CC were met, and if so, whether undertakings in lieu of a reference may be available. In its request, the NFRN highlighted a number of features which it considered prevented, restricted or distorted competition.⁵ The NFRN indicated that its main concern was the degree of publisher control over the newspaper and magazine distribution process which, it argued, required a wide-ranging examination of the supply chains.

2.2 The NFRN highlighted eight features of the distribution process for newspapers and magazines which it said the OFT should examine regarding its concerns in relation to publishers' control over aspects of the supply chains. These were:

- the two-sided nature of the markets
- the existence of absolute territorial protection
- the way in which publishers award contracts to wholesalers
- the use of cover prices
- the sale or return process
- the use of carriage service charges

⁵ The NFRN supplemented its request by further submissions dated June 2007 and September 2007 in response to requests from the OFT. The OFT also met the NFRN to clarify aspects of its request in July 2007 and at subsequent meetings with the NFRN. The OFT has also had regular follow-up meetings, and received further written submissions from the NFRN and these have also illuminated some of the points raised by the NFRN.

- cross-subsidisation of the distribution of newspapers by the distribution of magazines, and
- poor terms of supply to retailers.

2.3 In a subsequent submission to the OFT in September 2007, the NFRN argued that, following an investigation under section 131 of the EA02, the OFT should exercise its powers under section 154 of the EA02 to establish a code of practice between members of the industry in the form of statutory undertakings in lieu of a reference to the CC.

The context of the MIR Request

2.4 The request for the OFT to consider an MIR arose in the context of two pre-existing strands of OFT work in relation to the distribution of newspapers and magazines: the OFT's Opinion, and the OFT's Code Review. The scope of each of these strands of work is summarised below in order to set the context of the OFT's work on the MIR request. In addition, the holistic manner in which the OFT has engaged in an overview of both magazine and newspaper distribution throughout the supply chain in conducting the MIR analysis is introduced below.

The OFT's Opinion

2.5 Until May 2005, newspaper and magazine distribution agreements benefited from an exclusion from scrutiny under the Chapter I prohibition of the CA98, which prohibits anti-competitive agreements, by virtue of the Vertical Agreements Exclusion Order (VAEO).⁶ On 17 June 2003, the then Department of Trade and Industry (DTI) proposed that the VAEO should be repealed in the light of changes to the rules relating to enforcement of EC competition law (these changes are

⁶ SI 2000, No. 310, Competition Act 1998 (Land and Vertical Agreements) Order 2000.

referred to as 'modernisation').⁷ The decision to repeal the VAE0 was confirmed on 1 March 2004, and took effect on 1 May 2005.

- 2.6 Following this announcement, newspaper and magazine publishers, distributors and wholesalers expressed concern about the repeal of the VAE0, as it meant that newspaper and magazine distribution agreements would cease to be automatically exempt from the Chapter I prohibition of CA98. On 7 May 2004, a group of publishers, distributors and wholesalers known as the Block Exemption Initiative (the 'BEI') made a submission to the OFT putting forward its case as to why the OFT should recommend to the DTI that it grant an industry-specific block exemption under section 6 of the CA98 to remove the agreements from the scope of the Chapter I prohibition. The request for a block exemption was subsequently followed by a request that, should the OFT decline to recommend such a block exemption, it should issue an Opinion instead. Given the background and the very specific circumstances of the case, the OFT considered it appropriate to provide guidance to the industry in the form of an Opinion.
- 2.7 The OFT published a draft Opinion for consultation in May 2005. Having taken account of the points raised in responses to that consultation, the OFT published a revised draft Opinion for consultation in May 2006.
- 2.8 The Opinion is published alongside this document and reference should be made to that document for the guidance it provides.

⁷ On 1 May 2004, EC Council Regulation of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (Reg. 1/2003/EC) (the 'Modernisation Regulation') came into force. The Modernisation Regulation substantially changed the framework for the enforcement of European competition law. The Modernisation Regulation, amongst other things, devolved powers to the courts and designated National Competition Authorities (NCAs) of the Member States to apply and enforce Articles 81 and 82 of the EC Treaty ('Article 81' and 'Article 82' respectively) in full. It also requires the NCAs and courts to apply and enforce Articles 81 and 82 when national competition law is applied to agreements which may affect trade between Member States. The Modernisation Regulation also established a 'legal exception' regime.

The review of the undertakings relating to the National Newspapers Code of Practice

2.9 In 1993, the Monopolies and Mergers Commission (MMC) reported on the supply of national newspapers in England and Wales, following a reference by the then Director General of Fair Trading under the monopoly provisions of the Fair Trading Act 1973 (FTA73).⁸ The MMC concluded that newspaper publishers' adherence to exclusive distribution arrangements did not operate against the public interest.⁹ However, the MMC identified two wholesaler practices which it concluded operated or may be expected to have operated against the public interest:

- the refusal by wholesalers to supply newspapers to a new retail outlet where, in the wholesaler's view, the area was adequately served; reinforced by,
- the imposition by the wholesaler of a condition that the retailer must sell the national newspapers supplied only by retail and from its own retail outlet.¹⁰

2.10 The National Newspapers Code of Practice (the Code), underpinned by statutory undertakings given by the wholesalers then operating in the market, was accepted by the then Secretary of State for Trade and Industry (SoS) to remedy or prevent the adverse effects specified in the MMC's Report.¹¹ Although, due to the ambit of the MMC's findings, the Code formally applies only in respect of the supply of newspapers in

⁸ The reference was made under sections 9(1), 10(3), 10(4), 47(1), 49(1) and 50(1) of the FTA73.

⁹ *The supply of national newspapers: A report on the supply of national newspapers in England and Wales*, MMC, December 1993, Cm 2422 (MMC (1993)) paragraphs 1.8 – 1.10. The MMC Report was published under the former regime of the Fair Trading Act 1973, well before the entry into force of the Act, in March 2000. As a result, the MMC applied a public interest test and could not have taken account of the Chapter I prohibition.

¹⁰ MMC (1993), paragraphs 11.92 and 11.95.

¹¹ The undertakings were given under section 88 of the FTA73. In addition to the statutory undertakings, two additional parties signed voluntary undertakings to comply with the Code.

England and Wales, the Code is also applied on a voluntary basis in relation to the distribution of newspapers in Scotland and Northern Ireland.¹²

- 2.11 Pursuant to the Code, wholesalers agree to adhere to a number of obligations with respect to newspaper supply to new retail applicants. One of these obligations is that wholesalers must supply all new retail applicants within a territory who meet the Minimum Entry Level (MEL obligation).¹³ In addition, wholesalers are prohibited from accepting an application for the supply of newspapers from an applicant retailer located outside the wholesaler's area of operation as defined by the newspaper publisher or distributor; and they agree not to permit a retailer or sub-retailer to sell or transfer newspapers to locations outside of the wholesaler's area of operation as defined by the newspaper's publisher or distributor.¹⁴
- 2.12 The OFT has a statutory duty to keep under review the carrying out of undertakings given under section 88 of the FTA73, such as those which underpin the Code, and from time to time to consider whether, by reason of any change of circumstances, an undertaking is no longer appropriate and either the relevant parties (or any of them) can be released from the undertaking or the undertaking needs to be varied, or superseded by a new undertaking. Where it appears to the OFT that any person can be released or that an undertaking has not been or is not being fulfilled, or needs to be varied or superseded, it is the duty of the

¹² Magazine publishers have also noted that because of the joint distribution of newspapers and magazines, the Code, by facilitating the supply of newspapers to new retail outlets, also facilitates the supply of magazines to those retailers.

¹³ The MEL obligation is commonly referred to by industry participants as the universal service obligation. The MEL obligation was introduced to remedy the problem of some wholesalers refusing to supply certain retailers. The MEL was defined as being half of the average value of the newspapers invoiced weekly to all existing retailers in the wholesaler's area, calculated as the average weekly newspaper invoice value for the six months ending 31 March 1994. Only those newspapers which the wholesaler was capable of supplying to the applicant was included in the calculation.

¹⁴ The Code, paragraphs 1.3 and 6.3.

OFT to give such advice to the SoS as it may think proper in the circumstances.¹⁵

- 2.13 The OFT announced a Code Review alongside the publication of the second draft Opinion in May 2006. The OFT's advice to the SoS on the Code, based on the Code Review, is published alongside this document. In summary, the OFT's advice to the SoS is that, due to a number of changes of circumstances, the undertakings underpinning the Code are no longer appropriate to remedy or prevent the adverse effects specified in the MMC's Report and that the parties which signed the undertakings should therefore be released from them. It is for the Secretary of State, who is the ultimate decision-maker on this matter, to determine whether or not the parties can be released from the Code.
- 2.14 The Code Review is published alongside this document and may provide useful further background to this proposed decision.

The interrelationship between the review of the Code, the Opinion and the request for an MIR

- 2.15 The OFT's work regarding the Opinion, the review of the Code and the examination of the request for an MIR have different product and geographic focuses and legal frameworks. However, given the interplay between the three work-strands and the overlap between some of the underlying issues, the OFT has approached the three work-strands holistically. In general, whereas the Opinion focuses on the specifics of the agreements between publishers and wholesalers and the Code Review on the performance of the Code in relation to newspapers, the request for an MIR has allowed the OFT to take an overview of both magazine and newspaper distribution throughout the respective supply chains which has benefited the OFT's analysis across all three work-strands.

¹⁵ Section 88(4) of the FTA73, which continues to apply in respect of the Code by virtue of schedule 24, paragraph 14 of the Enterprise Act 2002.

Approach and methodology

- 2.16 Although this examination has been triggered by a specific request from the NFRN, the OFT has used the opportunity to conduct a holistic analysis of the newspaper and magazine distribution process covering the roles of publishers, distributors, wholesalers and retailers within the supply chains, building on the work already underway in relation to the Code and the Opinion. As a result, the OFT has not rigidly focussed its analysis only on the aspects and features of the supply of newspapers and magazines that the NFRN highlighted, but rather has used the OFT's existing and developing knowledge, experience and analysis of the supply chains to consider how to assess the MIR request in the context of the markets as effectively as possible.
- 2.17 In conducting this examination, the OFT has engaged extensively with stakeholders at each level of the supply chain, including individual parties and trade associations. The OFT has had six meetings with the NFRN, as well as regular meetings with other retailer, wholesaler and publisher associations and with individual parties. In addition, there have been three iterative information requests on the MIR specifically aimed at different parties in the supply chain. These have helped to refine further the OFT's understanding of certain features. The OFT has valued the constructive engagement it has had in this context with very many stakeholders.
- 2.18 In so far as it is relevant, information received and analysis conducted in relation to one work-strand has been shared with the others. This has reduced the burdens of information provision for stakeholders and ensured consistency and coherence across the three distinct areas of work. As a result, the consideration of the NFRN's request for a MIR has been able to draw on a wide evidential base. This has allowed the OFT's analysis to be more detailed than might usually be the case in relation to a reference request. The OFT has benefitted from being able to use this wide evidential base to inform its thinking on the appropriateness of a reference.

3 OVERVIEW OF SECTOR AND MARKET DEFINITION

3.1 This chapter provides an overview of the intrinsic product characteristics of newspapers and magazines in the UK that are of most relevance to the MIR analysis. Further details are contained in the introductory overview paper. This chapter also deals with market definition for the purposes of the MIR analysis.

Characteristics of the products: an overview

3.2 The following characteristics of newspapers and magazines in the UK are key to understanding the complexities of each supply chain and the nature of competition within them:

- two-sided markets
- high perishability, particularly of newspapers
- demand unpredictability, and
- high fixed costs, low marginal costs.

These are addressed in turn below.

Two-sided markets

3.3 Newspapers and magazines carry advertising as well as editorial content. As a result, publishers, unlike retailers or wholesalers, receive income from the sale of advertising space as well as from copy sales – in other words they face two-sided markets. The revenue that publishers obtain from the sale of advertising space depends, amongst other things, on the size of a publication's circulation. This gives publishers a strong additional incentive to increase circulation - an incentive that is not shared by the wholesalers and retailers that distribute the copy.

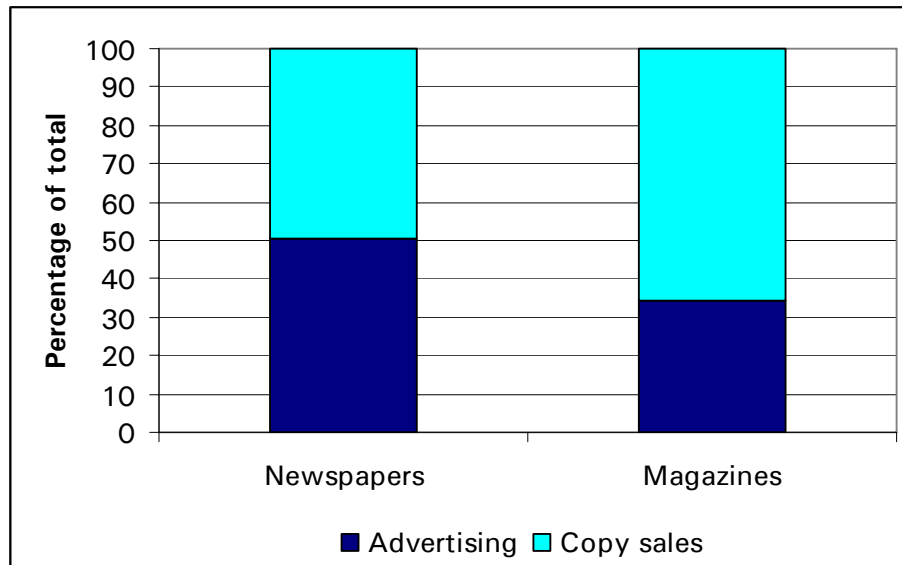
3.4 A publisher therefore has a strong interest in controlling aspects of the supply chain in order to achieve particular circulation targets. In

particular, a publisher desires influence over the price at which its publications are sold. A publisher may also want to control the risk in the supply chain to ensure its products are widely available. Magazine publishers and distributors, in particular, may also want to have control over where publications are sold in order to target particular, local demographics.

- 3.5 Fig 3.1 shows that the proportion of revenue derived from advertising is, on average, higher for newspapers (50 per cent) than it is for magazines (34 per cent).¹⁶ This indicates that, on average, the incentives for newspaper publishers provided by the two-sided nature of the markets are stronger than those for magazine publishers.
- 3.6 However, that is not to say that advertising revenues do not generate incentives for magazine publishers. In particular, the ability of some magazines to attract niche readerships (for example teenage, male health) by virtue of their more specific content compared to newspapers, is likely to be attractive to certain advertisers. In order to maximise profits from both copy sales and advertising revenues, magazine publishers may therefore have an incentive to publish a portfolio of titles targeted at different market niches, and to target these niche readerships in different locations and through different retail outlets. In this way, the two-sided nature of the magazine markets may generate stronger incentives for magazine publishers to control how titles are allocated to retailers. These incentives are considered further in chapter 4.

¹⁶ Advertising Statistics Yearbook, 2008, World Advertising Research Centre

Fig 3.1: Revenue sources of UK newspaper and magazine publishers in 2007¹⁷



High perishability

3.7 Around seventy per cent of the daily sales of national newspapers are realised by 10:00. This gives newspaper publishers a compelling commercial incentive to get copy to retailers as early as possible. If a newspaper were to arrive at retail outlets a few hours late, most local demand is likely to have expired.

3.8 For these reasons, newspapers are a highly perishable product.¹⁸ The process of wholesaling national newspapers, involving delivery to

¹⁷ Based on OFT analysis of *Advertising Statistics Yearbook 2008*, World Advertising Research Center.

¹⁸ It may be that some newspapers are slightly less perishable than others if their content is less focused on perishable up-to-date news. This may be the case for weekend newspapers, although this is unlikely to have much, if any, effect on their distribution timescales.

54,000 outlets across the UK needs to be completed within a three-hour window from 03:00 to 06:00.¹⁹ The logistics of this operation are very complex and demand a high degree of coordination between publisher and wholesaler.

- 3.9 At the same time, demand for newspapers is sensitive to breaking news. Publishers compete to have the most up-to-date news and sports information in their newspapers, and copy deadlines will often be delayed until the last possible minute in order to capture breaking news and/or sports events. Publishers also place pressure on wholesalers to be more efficient in the distribution process so that time lost due to late printing can be recouped.
- 3.10 Newspaper publishers, therefore, have strong incentives to control the distribution process, to ensure copy is delivered as accurately and punctually as possible, while also ensuring the wholesaler is flexible enough to respond to late publisher delivery on account of breaking news. As highlighted in the Code Review,²⁰ the imposition of stringent contractual obligations upon wholesalers in relation to service issues by newspaper publishers has increased significantly in recent years. In particular, publishers have agreed detailed Service Level Agreements (SLAs) and Key Performance Indicators (KPIs) with their wholesalers, and these are now the norm through the industry. Each of the newspaper publishers has also submitted that they closely monitor wholesaler performance and have provided the OFT with information on these mechanisms which they use to monitor wholesaler performance. These mechanisms differ between individual publishers, but typically include regular performance meetings with wholesalers, a requirement on wholesalers to provide information to publishers on performance levels or publisher visits to wholesale depots. Publishers also write financial incentives into their SLAs to create further commercial

¹⁹ See chapter 3 and Annexe A of the introductory overview paper for a summary of timescales in the newspaper supply chain

²⁰ See paragraphs 3.9 to 3.21 of the Code Review.

motivations and impose penalties for failure by wholesalers to meet their KPIs. This is reviewed in greater detail in chapter 4.

- 3.11 While magazines are also perishable, they are less so than newspapers on average because the information value of magazines does not diminish as quickly as the information value of newspapers. This is highlighted by the lower frequency of new magazines comprising weeklies /fortnightlies (20 per cent); monthlies (38 per cent); alternate monthlies (19 per cent); quarterlies (17 per cent) and less frequently published titles (six per cent).²¹ It is also evident from the longer timeline for distribution of magazines to retailers in the UK. Information available to the OFT shows that weekly magazines typically take around 18 – 30 hours to pass through the supply chain,²² with fortnightly and monthly magazines taking significantly longer still,²³ although there are some exceptional cases where timescales are more compressed than this.²⁴ But even for these magazines, the period over which the majority of sales are realised is often considerably longer than for newspapers, for example two to three days. Thus, given their greater news sensitivity and tight sales windows, newspapers are considerably more perishable than magazines on average.
- 3.12 That is not to say that the punctuality of delivery is unimportant for magazine publishers, particularly for the more time-sensitive titles. Like newspaper publishers, magazine publishers and distributors²⁵ have also implemented service level agreements (SLAs) and key performance

²¹ Based on the OFT's analysis of supplementary data provided by the PPA in relation to their submission dated 20 October 2006.

²² These figures are based on the time taken from collection of the magazine from the printer to the time of first delivery to retailers.

²³ Fortnightly magazines can take between 2-3 days to pass through the supply chain, with monthly magazines taking up to eight days.

²⁴ For example, the OFT understands that the timescale for certain classified advertising magazines is around six hours.

²⁵ Magazine publishers often use distributors to act as an intermediary with wholesalers, and to market their titles to retailers. Distributors often act as an interface between the publisher and the wholesaler, agreeing contracts with the latter for the distributor's portfolio of titles and monitoring the wholesaler's performance against those contracts.

indicators (KPIs) across wholesalers. In addition to stringent measures regarding punctuality of deliveries,²⁶ the KPIs imposed on wholesalers measure a number of different performance indicators which magazine publishers and distributors regard as most significant. These KPIs relate to the accuracy of copy allocations to different retailers (in terms of the product ranges for each retailer and title promotions), the levels of copies returned unsold and the availability of publications on retail shelves throughout the on-sale period. These issues are also discussed in chapter 4.

Demand unpredictability

- 3.13 Newspaper publisher submissions to the OFT suggest that demand for newspapers is sensitive to changes in the news agenda and the news-value of the headline stories they feature. Because of their proximity to the news stories, and their understanding of how different content drives circulation, newspaper publishers are in general in a better position than retailers to predict consumer demand for each issue. For newspapers, the role of publishers in predicting demand is particularly important, given that there is no time for retailers to order additional copies. Publishers, therefore, have an incentive to ensure that enough copy is circulated to cover potential peaks in demand. Submissions by newspaper publishers indicate that there are numerous events each year (such as major sporting events or the issue of the Budget) which can be anticipated to increase demand and, to an extent, can be planned for. Otherwise publishers use historical data and experience of consumer behaviour to forecast demand and then try to respond and change supply accordingly.
- 3.14 Magazine content also varies from issue-to-issue, although for some magazines the sensitivity of demand to the news agenda is less significant. On the other hand, survey evidence seen by the OFT indicates that consumers show less brand loyalty in their choice of

²⁶ This is usually measured by the proportion of magazines that are delivered on their particular on-sale dates.

magazine, and will often decide in-store which title to buy. Magazine promotions and cover-mounted gifts by distributors can also lead to fluctuations in sales from issue-to-issue. For this reason, a title's circulation can still be variable and publisher or distributor experience is important for predicting retail sales. However, for weekly, fortnightly and monthly magazine titles, there is a potential at least for many retailers to replenish stocks over the course of the sales period so that unexpected demand can be met through subsequent retail orders. This makes the initial copy allocation to retailers less decisive, and should in theory give retailers greater possibility to control stocks to cater for local demand. The issue of magazine copy allocation and re-ordering is considered in chapter 4.

- 3.15 At the level of the individual retailer, demand can also be unpredictable. Newspaper sales can fluctuate for an individual retailer both overall and for the relative sales of each title. However, for many retailers these fluctuations will be less significant than those for magazines due to a consistent level of newspaper sales (approximately 25 per cent) through home news deliveries (HND) for which customers make longer term orders. In addition, customers often buy newspapers as part of their daily routine and habitually use the same shop, making sales volumes far more predictable on a day-to-day basis for individual retailers. For magazines, survey evidence indicates that many magazine purchases are made on impulse once a customer has entered a store. Magazine customers are likely to use a wide range of stores from which they buy magazines, making it less predictable how many customers a particular retailer might get for a title in any one week.

High fixed costs, low marginal costs

- 3.16 Each issue of a newspaper or magazine incurs high fixed costs to generate the content, complete the editorial process, and set up the print run, but low marginal costs in printing copies - the costs of creating the first copy are high, while printing an extra 1,000 copies in the same print run is relatively cheap. In the face of unpredictable demand, there is therefore an incentive for publishers to print and distribute more copies as a precaution. Provided the expected marginal

revenue from an additional printed copy is higher than the low marginal cost of printing and distributing it, a publisher has an incentive to increase distribution. In line with the two-sided nature of the newspaper and magazine markets and the unpredictability of demand identified above, this gives publishers incentives to increase distribution and availability.²⁷

Conclusion on characteristics of the products

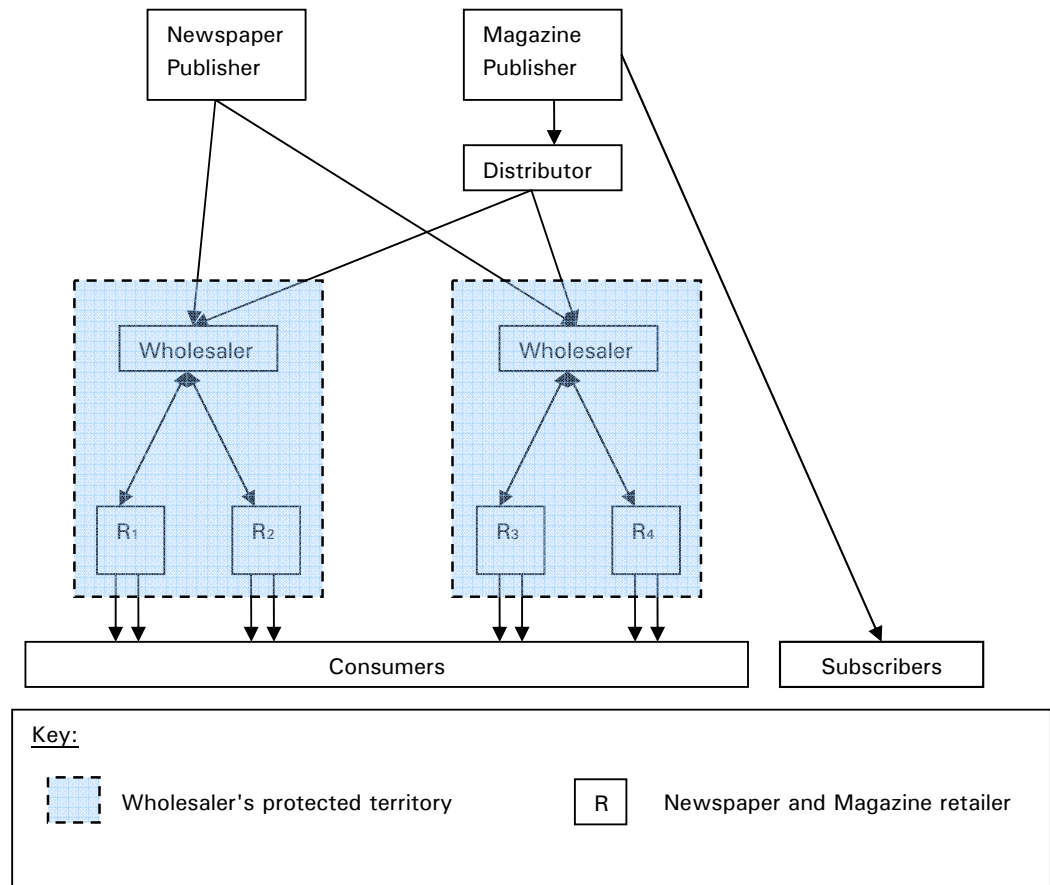
- 3.17 The OFT has examined the above four characteristics – two-sided nature of the newspaper and magazine markets, high perishability, demand unpredictability and high fixed costs, low marginal costs – that distinguish newspapers and magazines from many other products and which give publishers strong incentives to exercise control over aspects of the distribution of newspapers and magazines through the supply chains. These characteristics lie behind some of the unique aspects of the newspaper and magazine supply chains in the UK that are examined in the following chapter. The OFT also notes that in relation to the two-sided nature of the newspaper and magazine markets, and the perishability of the products in particular, these characteristics are more pronounced on average for newspapers than they are for magazines.

²⁷ For some mainly monthly magazines, the marginal print costs can be greater as the quality of the paper and ink is considerably higher. For these magazines, the incentives to increase distribution and availability may be somewhat lower.

Overview of the stages in the newspaper and magazine supply chains

3.18 Figure 3.2 below illustrates the main stages in both the supply chains for newspapers and magazines.²⁸

Figure 3.2 The newspaper and magazine supply chains



²⁸ As noted above, the focus of this document is on national daily newspapers and consumer magazines since these account for the vast bulk of publications delivered through the wholesalers and retailers. Business publications are in general distributed through mail delivery systems.

- 3.19 As the diagram shows, for newspapers, publishers produce and print the newspaper, including advertisements from advertisers. The newspaper publisher determines the number of copies to produce and distributes these to the wholesalers across the country. Magazine publishers undertake similar tasks, although in some cases, printing is out-sourced to third parties, and distributors are often used to assist with determining the number of copies to be printed, the allocation of copies to different retailers and/or with transporting magazines to wholesalers across the country.
- 3.20 The wholesalers collect, sort and deliver both newspapers and magazines to retailers in the territory for which they have exclusivity. Wholesalers manage the number of copies each retailer receives according to the requirements of publishers. In addition, and unlike wholesaling in many other sectors of the economy, newspaper and magazine wholesalers also collect unsold copies from retailers, process the returns and then recycle them. For these services, wholesalers receive a margin agreed as a percentage of the title's cover price. They also charge retailers a carriage service charge (CSC) which is a charge for the delivery of their newspaper and magazine requirements.
- 3.21 The number of retailers of newspapers and magazines has risen from around 44,000 in the early 1990s to stabilise at around 54,000 from 2000.²⁹ Most of this increase occurred around the time of the 1993 MMC report and the years that followed it. Newspapers and magazines are sold by a number of different retail outlets, including newsagents, which often provide home delivery services,³⁰ convenience stores, petrol stations, supermarkets, travel points and roundsmen.³¹

²⁹ Source: ANMW Retail Outlets Report, April 2007.

³⁰ Home news delivery is the direct delivery of newspapers or magazines to individual households or offices. Approximately 25 per cent of newspapers are distributed to customers in this way.

³¹ Roundsmen sell mainly newspapers via home news delivery without having a fixed outlet.

Market definition

- 3.22 The OFT's guidance provides that, in making an MIR to the CC, the OFT must specify the goods or services for whose supply or acquisition competition is adversely affected and that this will require 'some consideration of the definition of the relevant market'. It goes on to provide that '[t]he effects on competition of some feature may be clear enough that firm conclusions on the definition of the relevant market by the OFT are unnecessary'.³²
- 3.23 Although in this case the OFT proposes *not* to make a reference to the CC, given the holistic approach the OFT has adopted across the three simultaneous work-strands, the OFT has in fact considered the definition of the relevant markets.
- 3.24 However, the OFT's objective in this regard has not been to arrive at definitive conclusions on the definition of the markets concerned, as the OFT does not consider this to be necessary for an examination of the features. Instead the analysis has focussed on what competitive constraints act on operators at each level.
- 3.25 The OFT defines the relevant market as comprising all those substitute products/services and substitute areas that provide a competitive constraint on the supply of the product or service within the area under consideration. Given that this proposed decision concerns the operation of the newspaper and magazine supply chains, it is necessary to consider market definitions at three levels: publishing; wholesaling; and retail. However, since many of the features examined in chapter 4 concern the wholesale level, this particular market segment is considered in more detail.

³² OFT 511, '*Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act*' (March 2006), at paragraph 4.8.

Newspaper and magazine publishing

The product markets

- 3.26 In relation to the publication of national newspapers, it appears likely that 'national newspapers' would constitute the relevant product market.
- 3.27 On the demand side, there are numerous other methods by which people can find out about news items and the other editorial content included in newspapers, including radio and television broadcasts, and internet news websites. However, there are significant variations in how these alternative channels transmit the news and other content. For example, it is often possible for newspapers to cover more of the background to a news story than can be covered in a TV or radio news broadcast. Regional newspapers are also likely to be complements to, rather than substitutes for, national newspapers, given the different content and advertising they contain.
- 3.28 Among national newspapers, it is possible that certain categories, for example broadsheets and tabloids, may not be demand-side substitutes. However, for the purpose of this proposed decision, the primary focus of which is on the distribution process, it has not been necessary to develop the analysis at this level. Moreover, there is likely to be some degree of supply-side substitution between any such categories.
- 3.29 In terms of supply-side substitutes, there appear to be very few firms that could easily begin producing national newspapers at short notice and without incurring significant sunk costs. It is therefore unlikely that the product market goes wider than this.
- 3.30 In relation to the publication of magazines, on the demand side, there is an array of different types of magazines covering a wide range of different subjects, and it would seem unlikely that consumers would substitute, for any given title, another title that had very different content. This would suggest that it is unlikely that there is a single product market for magazines and instead, consumers may view

magazines as forming a number of product markets based on the content, target audience and frequency of their publication.³³ In terms of supply-side substitution, there may be some opportunities for substitution between different categories or types of magazine, which may broaden the definition of the relevant product market in some cases.³⁴ There appear to be very few firms, however, that could easily begin producing magazines at short notice and without incurring significant sunk costs so the product market is unlikely to be broader than magazines.

The geographic markets

- 3.31 The geographic market for magazine publication is likely to be national, since the content will typically be targeted at a UK audience. The geographic market for national newspaper publication may also be the UK for the same reasons, although the OFT notes that a wider range of titles is published in Scotland.³⁵ National newspapers typically publish regional editions³⁶ and it is possible that the geographic market may be narrower on this basis.

The advertising sector

- 3.32 As noted above, publishers of newspapers and magazines typically have two demand relationships. In addition to readers paying for the

³³ For example, in *Anticipated acquisition by Magicalia Publishing Limited of Good Woodworking magazine from Future Publishing Limited* (16 March 2007) the OFT took 'a cautious view and considered woodworking magazines alone for the purpose of assessing this transaction'.

³⁴ However, in *Anticipated acquisition by Future plc of Highbury House plc* (14 April 2005) the OFT found that, while supply-side substitution may be relatively easy within certain segments (such as motoring and motorcycling), the ease of substitution was less clear across segments, where publishers would only be able to extract very limited benefit from existing advertising contacts and expertise, and there was mixed picture of past attempts at such supply-side substitution.

³⁵ The OFT also notes that there are national newspapers for Wales, such as *The Western Mail*.

³⁶ The main differences between these regional editions relate to television listings, although there are also variations in some other editorial content (such as which football matches are reported) and some advertising.

editorial³⁷ content, advertisers pay to have their adverts printed. Adverts appear in a wide variety of media, including newspapers, magazines, radio, television and the internet, as well as other static and mobile advertising locations. In order to consider whether these different forms of media are substitutable from an advertiser's point of view, it would be necessary to consider the ability of the medium or publication to reach and influence consumers of a certain type or group. Given the primary focus of this proposed decision on the distribution sector, the OFT has not sought to develop this analysis further.

Newspaper and magazine wholesaling

The product market

- 3.33 Current practice in the supply chains would suggest that the relevant product market is likely to be the wholesaling of both national newspapers and magazines. However, it is possible that there are some limits to the extent that some wholesalers that currently handle just national newspapers may be substitutable for magazine wholesalers, and that there is scope for new entry into magazine wholesaling by operators who would not also be substitutable for newspaper wholesalers. This may mean that the market should be defined more narrowly.
- 3.34 In relation to current practice, newspapers and magazines are typically distributed together, although independent wholesalers do not currently distribute magazines. This is likely to be largely driven by the economies of scope from joint distribution. In particular, there are significant economies of scope from delivering newspapers and magazines together since most retail outlets receive both newspapers and magazines³⁸.

³⁷ Although readers are likely to be primarily interested in the editorial content, they are also likely to value the advertising content. For example, readers may be interested in travel supplements for adverts for hotels as well as editorial material on a featured destination.

³⁸ Information provided by multiple wholesalers suggests that over 90 per cent of outlets receive both newspapers and magazines.

There are also economies of scope³⁹ from packing newspapers and magazines at the same depot. These arise because magazines can be packed during the day, allowing for more efficient utilisation of depots that would otherwise be used only for short periods in the early hours of the morning.

- 3.35 In addition to the economies of scope, there is a significant degree of similarity in terms of the tasks that need to be performed in relation to newspaper and magazine wholesaling (for example, copy allocation, packing, delivering and processing returns). There is, however, some variation in terms of the equipment used, with magazine wholesaling generally requiring more sophisticated and expensive equipment for packing and returns processing.⁴⁰
- 3.36 However, it is possible that not all newspaper wholesalers would be substitutable for magazine wholesalers, and vice versa. First, information provided to the OFT suggests that independent newspaper wholesalers may well not be able to provide magazine distribution services due to their inability to make the substantial investments in the systems and infrastructure required to meet the stringent service requirements necessary to obtain major publisher / distributor contracts.⁴¹
- 3.37 Second, there appear to be few practical alternative methods of distribution other than using existing traditional wholesalers that would be substitutable for national newspaper wholesalers. In particular, the need for early morning deliveries within tight time-windows means that there are few opportunities for economies of scope for delivering newspapers with other products. In addition, newspaper wholesaling requires additional tasks, in particular in relation to copy allocation and

³⁹ Economies of scope arise when the average cost of production falls as the number of different products that a firm supplies increases.

⁴⁰ This is illustrated by the significant additional investments that have been made by multiple wholesalers specifically in relation to magazine packing and returns processing equipment.

⁴¹ Response by the Periodical Publishers Association (PPA) to consultation on the draft 2006 Opinion, page 84.

processing returned products, which are not typically required of wholesalers of products other than newspapers and magazines. The OFT understands that publishers have sought to attract bids from new entrants but with little or no success to date.

- 3.38 In contrast, as discussed above, the timescales for distributing magazines are typically substantially longer than those for national newspapers, so deliveries could be made at different times of the day to achieve economies of scope of distribution with other products. This suggests that publishers of magazines could in theory consider a wider selection of possible wholesalers than newspaper publishers, and may consider the wholesaling and delivery of magazines being undertaken together with retail products other than newspapers (for example, wholesale suppliers to record stores could also supply magazines), or possibly by general logistics firms.⁴²

The geographic market

- 3.39 The geographic scope of the wholesaling market is likely to vary depending on whether or not publishers award exclusive contracts, and if so, whether those contracts include absolute territorial protection (ATP). As examined in further detail in chapter 4, ATP results from publishers conferring on wholesalers, as part of their distribution agreements, exclusive territories for the distribution of their products from which all competing wholesalers are excluded. The exclusive territorial rights conferred on wholesalers by the agreements are underpinned by contractual provisions prohibiting both active and passive sales between territories.
- 3.40 In the absence of ATP, retailers would be able to seek passive sales from wholesalers outside the exclusive territory who could provide the deliveries they require. The choices a retailer would have in such circumstances are likely, subject to any potential new entry, to be

⁴² The OFT understands that this possibility may depend on there being sufficiently large territories to serve.

limited to a small number of newspaper and magazine wholesalers who have a depot reasonably close, and this would vary between different areas. For newspapers, given the tight timescales for distribution, it is likely that the choice would be relatively limited, and it is likely that there would be a significant number of retailers for whom there was no such choice at all. For magazines, the longer timescales may mean that wider choices of alternative wholesalers would be available to retailers, particularly for supermarkets or other multiple retailers which may be able to negotiate a regional or national supply arrangement. It is possible that these wider choices would be sufficient for there to be a 'chain of substitution'⁴³ leading to a wider regional or national geographic market, even if regional or national supply arrangements do not arise.

3.41 At the time publishers conclude contracts for exclusive territories, the choice of wholesalers available to them may be wider. When contracts are tendered, it is possible that publishers would be able to:

- choose between two competing wholesalers that could serve a particular area from their existing depots, or
- induce wholesalers to make changes to their depot locations that would enable them to compete for additional areas, or
- induce new entry by firms which do not currently wholesale newspapers or magazines.

⁴³ Two products do not have to be direct substitutes to be included in the same market; there may be a chain of substitution between them. The concept of a chain of substitution refers to a situation where two or more products can be regarded as belonging to the same product market, without being direct substitutes for each other, because their pricing may be constrained by another product, which is a substitute for the first product: see Commission Decision 2003/176/EC *Pirelli/BICC* (2003) OJ L70/35, paragraph 17. In the context of the geographic scope of the wholesaling market, customers of wholesaler A might only be able to switch to wholesaler B, but the ability of customers of wholesaler B to switch to wholesaler C might mean that wholesalers A and C are in the same geographic market further to a chain of substitution. See also OFT guideline 403, *Market definition* (December 2004), paragraph 3.11 for further information.

- 3.42 If contracts include ATP, it may be easier for publishers to induce changes in depot locations or new entry if, for example, the wholesaler were guaranteed that only it would serve all or most of the customers in an area thereby indicating that the wholesaler's investment would likely be worthwhile. In this way, although ATP restricts sales across territory boundaries, it does not prevent the geographic market for newspaper and magazine wholesaling in specific territories being wide and possibly wider than if contracts do not include ATP.

Newspaper and magazine retailing

The product market

- 3.43 There is a wide range of different types of retailers of newspapers and magazines in the UK. Typically, retailers sell both newspapers and magazines, although some only sell either newspapers or magazines, or a small group of titles.⁴⁴
- 3.44 In terms of demand-side substitution, it is relevant to consider whether consumers find all types of retailer to be substitutable, or whether there are distinctions between different retailer types, such that they would not be easily substitutable. This may differ between newspapers and magazines. As noted above, newspapers are highly perishable, with the majority of copies purchased before 10:00. Customers are generally likely to purchase from a convenient local outlet (for example, one on their route to work, or one that will deliver to their home).
- 3.45 Customers may have greater flexibility in terms of where they purchase magazines given the longer time available for purchases, for example delaying their magazine purchase until they do their weekly shop at a supermarket. These differences appear to be reflected in the trends in purchases from different outlet types over time. Figures provided to the OFT illustrate that the proportion of total magazine sales through

⁴⁴ Retailers that offer a limited range of titles are referred to as niche or specialist outlets. Such outlets stock a limited range of titles, usually to complement other product categories within their business. Examples of niche outlets are HMV and Virgin Retail, who stock NME.

supermarkets has risen from 19 per cent in 1995 to 31 per cent in 2005.⁴⁵ The proportion of newspaper sales through supermarkets appears to be significantly lower (around 15 per cent), although sales can be higher at weekends.⁴⁶

- 3.46 On the supply side, the OFT is aware that newspaper publishers are seeking to address the general decline in newspaper circulation by making newspapers available in a wider range of retail outlets.⁴⁷ For example, The Times is supplied to Starbucks, the Mail on Sunday is supplied to Boots the Chemist, and the Express is supplied to British Home Stores and Debenhams. This implies that there are further possibilities for supply-side substitution beyond the current range of retailers. However, such possibilities appear limited. One case study provided to the OFT showed that this form of expansion, in respect of one newspaper, only generated increased sales of one million copies per annum (around 3,000 copies per issue). This suggests that, although this may be an alternative, new channel of supply for national newspapers in a declining market, it still represents an extremely small proportion of total newspaper sales.

The geographic market

- 3.47 In terms of the geographic market, this is likely to be highly localised, in particular for newspapers given the need for convenient local purchases. It is possible that the geographic market for magazine retailing is slightly wider than for newspapers given that, as set out above, customers may use a wider variety of retail outlets from which to buy magazines.

⁴⁵ These figures were provided to the OFT by the PPA in January 2006 in response to an OFT request for further information. The information provided did not indicate whether these are shares by value or by volume.

⁴⁶ Based on information provided by Dawson News on 10 September 2007 and Smiths News on 12 February 2007.

⁴⁷ Magazine publishers have also tested selling a range of titles through alternative routes to market other than traditional retailers (for example, placing computer magazines in computer shops). However, the PPA estimates that sales through these 'niche' outlets account for less than 0.1 per cent of total sales.

However, it is likely that the geographic scope of this market is still local.

4 ANALYSIS OF THE FEATURES OF THE SUPPLY OF NEWSPAPERS AND MAGAZINES

Introduction

4.1 This chapter identifies a number of features of the supply chain for newspapers and magazines in the UK for the purposes of the reference test set out in section 131 of the EA02.

4.2 The OFT has set out the following guidance on how it will apply the reference test:⁴⁸

- The test of whether a feature 'prevents, restricts or distorts' competition is interpreted broadly, in line with EC precedent and past practice of the CC, to encompass any reduction or dampening of actual or potential competition.
- The application of the reference test may embrace several levels of a supply chain.
- Information on prices, profitability and other performance indicators can sometimes be a useful supplement to the OFT's evidence on the features of the market.
- The OFT will usually wish to consider a combination of features and their inter-relationships and will look at various types of information and sources of evidence.

The features

4.3 Following its consideration of the NFRN's request, and in the context of its holistic approach to the three simultaneous work-strands, the OFT identified the following distinct features of the supply chain for analysis in the application of the statutory reference test:

⁴⁸ See paragraphs 4.2 to 4.7 of OFT 511, Market investigation references.

- Absolute Territorial Protection (ATP): under the system of ATP resulting from agreements between publishers/distributors and wholesalers the publisher awards a wholesaler the exclusive right to serve retailers with its publications within a defined territory. The exclusive territorial rights conferred on wholesalers by the agreements are underpinned by contractual provisions prohibiting both active and passive sales between territories.
- Competition for the market: the process by which publishers tender territories to wholesalers for the distribution of their magazines and newspapers, and wholesalers compete to win those tenders.
- Sale or return (SoR): the system by which retailers can return unsold copies to wholesalers and be reimbursed for them.
- Copy allocation: the degree of control that newspaper and magazine publishers exercise over the allocation of titles and copy numbers to retailers.
- Cover prices: the printing by publishers of prices on the cover of publications and the limits that places on retailer pricing.

4.4 The OFT has considered whether there are reasonable grounds for suspecting that, individually and/or in combination, these features prevent, restrict or distort competition. In this connection, the OFT has also considered the NFRN's concern in relation to the degree of control exercised by publishers over the respective supply chains overall. This is addressed in the final section of this chapter.

4.5 The NFRN also suggested three other possible features of the supply chains in its request to the OFT to consider an MIR. These are the two-sided nature of the markets; CSCs; and the possible cross-subsidisation of wholesaling activities whether in terms of wholesalers cross-subsidising the cost of wholesaling newspapers with the margins they earn on magazines, or whether in terms of wholesalers cross-subsidising

the cost of supplying some territories with the margins they earn on supplying to other territories.

- 4.6 As analysed in chapter 3, the OFT considers the two-sided nature of the newspaper and magazine markets to be an intrinsic characteristic of the newspaper and magazine products, rather than a free-standing feature which should be addressed in isolation. As such, the consequences of the two-sided markets, and the incentives they create, are examined throughout this chapter in the context of the other features analysed. In relation to CSCs – the charge that wholesalers levy on retailers for delivery – the fact of the charge itself as the price for delivering a service to retailers is not considered to be a feature of supply that merits analysis as a potential competition concern. However, the level of the charge may provide evidence of an underlying competition concern if that level is not sufficiently constrained by competition. The OFT has therefore analysed the level of these charges in paragraphs 4.35 and 4.36 to see whether they provide evidence of a competition concern at the wholesale level. In relation to the NFRN's request for an examination of cross-subsidisation as a feature in the supply chain, this is considered in the context of the analysis of competition for the market in paragraphs 4.27 and 4.28 below.
- 4.7 Finally, alongside its analysis of the individual and collective features outlined, the OFT has looked at relevant indicators or measures of whether competition is functioning effectively to see if these indicate any competition concerns. Certain indicators, such as high price and profit levels, or a high volume of complaints, may be symptomatic of an underlying issue with the way competition functions in these supply chains. This is consistent with OFT guidance that performance indicators can be a useful supplement to analyse market features.⁴⁹ The specific performance indicators the OFT has examined are the volume of complaints against wholesalers; the level of wastage; the level of CSCs; and the levels of wholesaler profitability.

⁴⁹ OFT 511, Market investigation references, paragraph 4.5.

Analysis of individual features

Absolute Territorial Protection

- 4.8 The system of ATP results from agreements between newspaper publishers or magazine publishers/distributors on the one hand, and wholesalers on the other, in which the former grant the latter exclusive territories for distribution of their products from which all competing wholesalers are excluded.
- 4.9 The exclusive territorial rights conferred by these agreements are underpinned by bans on both active and passive sales between territories. The ban on active sales means that a wholesaler is prevented from actively marketing its products to retailers outside its allocated territory. The ban on passive sales means that the wholesaler supplying newspapers and/or magazines is contractually barred⁵⁰ from responding to unsolicited requests to supply those products from retailers outside its allocated territory. The combination of exclusive territories and bans on active and passive sales across distribution territories results in ATP.
- 4.10 Although it is possible that more than two wholesalers can serve the same territory with different publications (a 'split-sheet' territory), this is increasingly rare.⁵¹ Given the cost efficiencies in combining deliveries of different newspapers and magazines to retailers, one wholesaler will usually be awarded contracts by all publishers for a particular territory. This means that, for the duration of each publisher-wholesaler contract, retailers in that territory are tied to one wholesaler for deliveries of all their publications. The potential for competition between wholesalers for retail customers to emerge within that territory (competition in the market) is, therefore, removed.

⁵⁰ The prohibition imposed upon wholesalers concerning passive sales is also included in paragraph 1.3 of the Newspaper Code of Practice, which is typically incorporated into the Newspaper Agreements by reference.

⁵¹ Approximately 71 per cent of the postcode areas in the UK are full-sheets, while around 29 per cent are split-sheets.

- 4.11 Furthermore, each publisher-wholesaler contract providing for ATP exists alongside similar agreements entered into by other publishers in respect of the same territory and by the same publisher (and other publishers) in respect of other territories. These agreements providing for ATP entered into by the same publisher are mutually reinforcing in that the exclusive territory awarded to one wholesaler is protected by restrictions in the agreements providing for ATP with other wholesalers in neighbouring territories which prevent those other wholesalers (either explicitly or implicitly) from engaging in active or passive sales into areas outside their own territories.
- 4.12 The degree to which the existence of a system of ATP restricts competition depends on the degree of competition in the market that might be expected to emerge in the absence of ATP.
- 4.13 In relation to newspapers, it might be expected that a degree of competition would emerge between wholesalers within territories absent ATP. However, there are two limitations on this. First, the very limited time window for the distribution of newspapers by wholesalers means that wholesalers can, in effect, only deliver to retailers within a one hour drive-time of a depot. Depots, therefore, need to be sufficiently numerous and the geographic scope of territories sufficiently small, to ensure retailers can be supplied within this time window. Second, distribution from a depot is characterised by economies of scale⁵², scope⁵³ and density⁵⁴ which means that it would rarely be cost effective for more than one depot to serve a particular territory.
- 4.14 Overall, the nature of newspaper distribution appears to determine a pattern of wholesaling whereby one depot serves a largely separate territory that is determined by the distances that can be reached within

⁵² Economies of scale arise when the average cost of production falls as the quantity produced increases.

⁵³ Economies of scope arise when average costs fall as the number of different products that a firm supplies increases.

⁵⁴ Economies of density arise when average costs fall as the number of customers in the same area increases.

a one-hour drive time of a depot. Therefore, in the absence of a system of ATP as a feature of newspaper distribution, competition in the market between newspaper wholesalers is likely to be limited to competition between newspaper wholesalers to serve those retailers that are situated at, or near, the boundary of some territories. The extent of competition that could emerge in any particular territory is likely to depend on the circumstances of that territory, notably in terms of whether a rival depot is located close enough to the boundary in a neighbouring territory.⁵⁵

- 4.15 To the extent that a system of ATP regarding the distribution of newspapers removes the possibility that competition between wholesalers in the market could emerge around the boundaries between some territories or elsewhere, the OFT is minded to decide that there are reasonable grounds for suspecting that ATP for newspapers is a feature that prevents, restricts or distorts competition in this market.
- 4.16 In relation to magazines, the time window for distribution is significantly longer. Wholesalers are, therefore, not constrained to deliver within a short radius around their depot, and could compete for retailer contracts and passive sales across a much wider area.
- 4.17 The OFT considers it likely that the scope for effective competition in the market to emerge between magazine wholesalers, in the absence of a system of ATP as a feature of magazine distribution, is greater than for newspapers. The OFT is, therefore, also minded to decide that there are reasonable grounds for suspecting that ATP as a feature of magazine distribution removes the potential for competition in the market to emerge between magazine wholesalers in a number of territories and, therefore, is a feature that prevents, restricts or distorts competition in this market.

⁵⁵ There may also be scope for some large retailers, situated further from the boundaries, to attract a rival wholesale supplier by virtue of the high volume of copies they can take.

Competition for the market

- 4.18 Publishers⁵⁶ usually award exclusive distribution agreements with ATP to wholesalers for a period of up to five years on the basis of a tender process. The bidding that takes place between wholesalers to win a contract to serve a publisher's specified territory is referred to as 'competition for the market'. When assessing tender bids for a territory, a publisher will consider a number of factors, including the margins offered in the bids by different wholesalers as well as the performance record of wholesalers in delivering to retailers against key performance indicators (KPIs). This tendering process, and the desire to succeed and be awarded a contract, is the main driver of competition between wholesalers.
- 4.19 Concerns have been raised by the NFRN and others that such competition for the market does not represent a process of competitive bidding, that multiple wholesalers have strong advantages in the bidding process and are able to cross-subsidise their bids for some territories, and that the process favours the incumbent wholesaler in bidding for a territory.
- 4.20 As a result, the OFT has looked in detail at the operation of the tender process and outcomes of previous tender rounds, and has received evidence from both publishers and wholesalers about how tender rounds function.
- 4.21 The analysis below highlights two outcomes of the process of competition for the market – the high proportion of tenders won by the incumbent wholesaler (the incumbency effect) and the level of regional consolidation among wholesalers – that might indicate that the three

⁵⁶ In the case of magazines, wholesaler contracts are controlled and tendered by distributors acting on behalf of publishers. However, the large magazine publishers typically have shareholdings in magazine distributors. For the purposes of this section, the term 'publishers' is used to cover both newspaper publishers and magazine distributors, unless specified to the contrary.

large multiple wholesalers⁵⁷ have advantages in relation to tenders and, therefore, in the competitive process for the market. However, the analysis then indicates that there is a number of ways that publishers can use their buyer-power, and their control over the bidding process, to offset any incumbency advantages among the three multiple wholesalers and can ensure a competitive process of bidding across all territories.

The incumbency effect

- 4.22 The OFT's analysis of the results of a number of tender rounds by newspaper publishers between 2004 and 2006 indicates that, on average, 62 per cent of territories in these tender rounds had one bidder. They also indicate that, on average, the incumbent firm made the winning bid in 90 per cent of tenders. For magazines, publishers have, over time, replaced incumbents that were independent wholesalers with one of the multiple wholesalers, such that all magazines are now wholesaled by one of the multiple wholesalers. The evidence seen by the OFT on tenders awarded by publishers to these multiple wholesalers appears to indicate a similar likelihood of incumbent success in relation to magazines.
- 4.23 This analysis would seem to indicate a strong advantage for the incumbent bidder. One explanation for this may be that the contracts of different publishers for a territory do not start and finish at the same time. If during one publisher's tender round, a wholesaler already has a large number of contracts with other publishers for that territory, it will have a considerable cost advantage in bidding for the new publisher contract. This is because the wholesaler already benefits from the economies of scale and scope associated with delivering for all the other publishers in that territory. In addition, an incumbent wholesaler may have an advantage in the tendering process because it can readily demonstrate the competencies required to service a territory and would avoid the disruption (both to the publisher and the wholesaler)

⁵⁷ Smiths News, Dawsons News and Menzies Distribution.

associated with a switch of wholesaler or a split-sheet. Some publishers have indicated that concerns regarding the disruption a switch of wholesaler may create in terms of the accuracy and timeliness of supplies to retailers can influence their tender decisions.

- 4.24 The apparent advantages possessed by the incumbent wholesaler may also act as a barrier to entry for new firms at the wholesale level. In this regard, it is noteworthy that there have been no significant new entrants at the wholesale level over the past ten years. However, this absence of new entry may equally be explained by the fact that newspaper circulations have been declining, and that wholesaling of newspapers and magazines has undergone a significant degree of consolidation over the past fifteen years.

Regional consolidation

- 4.25 There has been a significant degree of consolidation at the wholesale level. This has primarily occurred as the larger multiple wholesalers have acquired independent wholesalers and then won the territories associated with those independent wholesalers in subsequent tender rounds. In 1992, there were 78 wholesalers of newspapers operating in England and Wales. By 2007, this figure had fallen to 15 in England and Wales, with a further seven operating in other parts of the UK. Correspondingly, the number of independent wholesalers has declined from 74 in 1993 to 12 in 2007, and the three large multiple wholesalers now have a combined market share of around 80 per cent of sales.
- 4.26 Moreover, each of the three large multiple wholesalers has built up clusters of territories to form a region or regions where it is the major wholesaler.⁵⁸ Many of the contracts previously operated by independents were taken over by a multiple wholesaler that was

⁵⁸ See Annexe B of the introductory overview paper for maps of the territories of the different wholesalers. These show a tendency for wholesalers to have clusters of territories in particular regions. However, with the exception of Menzies Distribution in Scotland, regions are not solely served by one wholesaler and there are significant gaps or split-sheets in each region where other wholesalers maintain a presence.

operating in a contiguous territory and able to exploit technological advantages, and service advances that allowed it to benefit from a number of scale efficiencies by centralising certain functions at the region or sub-region level. These functions include, magazine sorting at hub depots, call centres, human resources, and finances.

- 4.27 As noted in paragraph 4.5 above, the NFRN has raised concerns that multiple wholesalers, when bidding for contracts, are able to cross-subsidise their bids for territories tendered by newspaper territories through the higher margins they earn on magazine wholesaling. Since independent wholesalers do not wholesale magazines, the NFRN argues that the independent wholesalers are at a disadvantage competing for newspaper tenders. The NFRN also claims that multiple wholesalers can cross-subsidise their bids for some territories by the higher margins they earn in other territories. In this way, the NFRN claims, multiple wholesalers have been able to outbid competing independent wholesalers.
- 4.28 Enabling publishers or retailers to make different contributions to fixed costs may be an efficient way for wholesalers to recover fixed costs and expand demand. In particular, expanding demand across territories and across products by charging different prices to publishers and retailers may allow wholesalers to realise economies of scale and scope, and thereby reduce average costs.⁵⁹ There is a number economies of scale at the firm-level and the region level that come primarily from wholesale firms centralising functions, such as call centres and returns processing across a number of territories, and these have been a major factor in the regional consolidation of wholesalers (see below). As such, the OFT would not necessarily consider such a pricing structure to be an indication of a competition concern. If, however, wholesalers were bidding for some territories at below the incremental cost of delivery to those territories, then that could be evidence of a competition concern insofar as this persisted and competition did not emerge to compete that cross-subsidy away. However, the OFT has seen no evidence that

⁵⁹ See paragraph 4.13 for a description of economies of scale and scope.

wholesalers are bidding for territories at prices below the incremental cost of delivery to them.⁶⁰

- 4.29 Concerns have also been raised that the process of regional consolidation reinforces the incumbency effect and vice versa. The process of regional concentration allows multiple wholesalers to exploit significant regional economies of scale in re-bidding for their territories. In turn, an incumbency advantage would make it difficult for a competing wholesaler to build up a significant presence in the region of a multiple wholesaler. In this way, it is possible that the process of regional consolidation, coupled with the incumbency effect, could give multiple wholesalers a degree of market power.
- 4.30 Market power describes a situation where the constraints which would usually ensure that a firm behaves in a competitive manner are not working effectively.⁶¹ It is often described as the ability to raise prices consistently and profitably above competitive levels. However, market power might also enable a firm to supply goods or services of a lower quality, or restrict output to a lower level than would be supplied in a competitive context. The analysis below considers some of the factors that might constrain any market power of wholesalers. The subsequent section considers some of the evidence.

Factors constraining wholesaler market power

- 4.31 The OFT's analysis has revealed a number of ways in which the nature and structure of competition for the newspaper and magazine wholesaling market, coupled with some features relating to the conduct of publishers in the supply chains, serve to counteract any market power that a wholesaler could potentially gain. These are:
- Publisher buyer power: when tendering for contracts, publishers hold a degree of buyer power. News International (The Sun, The

⁶⁰ Any assessment of the incremental profit received by a wholesaler in supplying a new territory would also need to take into account the revenue it received from CSCs.

⁶¹ See OFT Guideline 415 'Assessment of Market Power', paragraph 1.2.

Times, the Sunday Times and News of the World) accounts for 34 per cent, Associated News (Daily Mail and Mail on Sunday) 19 per cent and Trinity Mirror 18 per cent, respectively, of the circulation of national newspapers. In relation to magazines, the market shares of the largest magazine distributors are: Frontline, 34 per cent; Market Force, 30 per cent; Comag, 25 per cent; and Seymour, 11 per cent.⁶² Magazine distributors will tender wholesale contracts for their whole portfolio of magazine titles thereby increasing the degree of buyer power they can exert.

- Publisher control of the bidding process: publishers will invariably tender all of their UK territories in one go and publishers determine the structure of each of the subsequent rounds of bidding from applicant wholesalers. In this way, a publisher can ask wholesalers to bid for all, or a significant bundle, of territories at a single price. Wholesalers who might otherwise not be interested in bidding for a single territory for a single publisher, may nevertheless be enticed to bid competitively for this territory if it is offered as part of a bundle. This is because a bundle of territories would allow a wholesaler to realise greater economies of scale at the firm level and the region level. In addition, territories that are more contestable can be offered as inducements to encourage wholesalers to bid for less contestable territories.⁶³ For example, wholesalers might be expected to compete aggressively for territories at the borders of the regions they serve in an effort by each to expand their regions and thereby increase their region level economies of scale. By bundling these territories with territories that are less attractive, a publisher can receive competitive bids across a wider number of different territories.

⁶² Based on the OFT's analysis of distributor submissions. Market shares are calculated by retail sales volume in 2007.

⁶³ A territory could be more contestable because, for example, it is next to a region operated by a competing wholesaler and would, therefore, allow that competitor to extend its region and benefit from additional economies of scale or because it is a split-sheet territory in which a competitor is already present, and that competitor can increase its economies of scope and scale by distributing other titles.

- Parallel tenders: although different publishers do not tender contracts for their territories at the same time, the evidence seen by the OFT indicates that there can often be batches of two or more sets of publisher contracts tendered close together. In this way, a competing wholesaler may be able to bid for a sufficient number of contracts at once to overcome an incumbent's advantage.
- Using its buyer power, a publisher can also build up a competing wholesaler to contest another wholesaler's region in a future tender. For example, the OFT received submissions that in a recent tender round one wholesaler was awarded a number of territories in a region where previously another wholesaler held most territory contracts. This afforded the new wholesaler a significant foothold in the region, placing it in a stronger position to bid for tenders in this region in future.
- Publishers can restrict wholesaler margins: publishers print prices on the covers of their publications. As examined below, cover prices allow publishers to have a degree of control over the margins that a wholesaler can earn on copy sales. Publishers will agree wholesale margins in their contract awards as a percentage of the cover price. They will also recommend margins for retailers. As a result, a wholesaler is constrained in its ability to exploit any market power by charging higher margins in the supply chain. Furthermore, incentives for publishers to increase circulation in a two-sided market indicate that they would want to set low cover prices (so as to maximise their profits from advertising as well as sales). There is thus an incentive for publishers to further limit margins that can be earned at the wholesale level.⁶⁴ Evidence on the levels of wholesaler margins and wholesaler CSCs is reviewed in paragraphs 4.34 to 4.36 below.
- Regular monitoring of wholesaler service level provision: Publishers scrutinise previous performance by wholesalers regarding the

⁶⁴ See paragraph 5.14 for an explanation of the effect of cover prices in a two-sided market.

provision of services to retailers as part of the tender process. Publishers set performance targets, which are measured by regular monitoring of KPIs, in their service level agreements with wholesalers. The OFT has also seen evidence that publishers build financial incentives into wholesaler contracts to incentivise the maintenance of particular service levels. The OFT is also aware of wholesalers that have been penalised as a result of poor service levels. As such, competition for the market does allow for competition to develop between wholesalers on the basis of service performance.

Wholesale level performance indicators

- 4.32 The OFT has also looked at a number of indicators or measures to see whether these provide evidence of competition concerns at the wholesale level. These include an assessment of the level of wholesaler profitability, the level of CSCs, and the volume of complaints in relation to wholesaler service performance.
- 4.33 The OFT has seen recent figures dating from 2003 for the operating profit of the three major wholesalers: Menzies Distribution, Smiths News and Dawsons News. Although it is difficult to infer economic profitability from accounting data - and the OFT has not conducted a comprehensive analysis on this - the evidence seen by the OFT does not indicate a significantly high degree of wholesaler profitability. This appears to be in line with information in the public accounts of the wholesalers reviewed by the OFT.
- 4.34 In terms of wholesale margins, evidence supplied to the OFT from wholesalers suggests that the wholesale margins for newspapers agreed with publishers have been declining over the period 1992 to 2005. Declining wholesaler margins would be consistent with publishers having a degree of buyer power regarding the process of competition for the market amongst other things.

- 4.35 However, to some extent this decrease in margins has been offset by increases in the CSCs that wholesalers charge retailers. CSCs are a charge that retailers pay wholesalers for the delivery of newspapers and magazines. These have grown steadily in recent years. The OFT estimates CSCs to be around 20 per cent higher as a proportion of wholesalers' revenue in 2005/06 compared to 2001/02. However, CSCs still cover only 74 per cent of a wholesaler's distribution costs, and while this proportion rose between 2001 and 2003, it has been offset by a decline in margin revenues from copy sales and increases in distribution costs.⁶⁵ This is consistent with the evidence that wholesaler profitability has been static.
- 4.36 Wholesalers set CSCs transparently at the national level. This restricts the ability of wholesalers to vary CSCs for different retailers or according to different competitive conditions. There is also some evidence of publishers monitoring CSC levels, with one major publisher requiring the wholesaler to provide it with a copy of its current CSC template, and the formula applied to calculate annual increases. The wholesaler is obliged to inform the publisher if it intends to vary from this formula. The OFT is also aware that some magazine distributors include CSCs in their KPI monitoring. As such it is possible that publishers will consider the level of a wholesaler's CSC as a factor when deciding which wholesaler to award a contract. Further, the OFT has received indications from publishers that the level and structure of CSCs have been relevant considerations in recent tender rounds. Indeed, as publishers have a strong interest in maintaining an extensive retailer network, they will be concerned should CSCs start to threaten the extent of that network.
- 4.37 Complaints by retailers in relation to the service quality of newspaper and magazine wholesalers have been longstanding. In its submission to the OFT, the NFRN highlighted issues in relation to unsuitable delivery

⁶⁵ Source: Lucidea. The 74 per cent figure does not include recent increases in CSCs which wholesalers have attributed to the rising cost of fuel. These increases have been in the region of five per cent to eight per cent.

timing offered by wholesalers; late deliveries; poor delivery quality (for example missing or damaged copies); difficulty obtaining the quantity and variety of titles requested; and receiving titles that were not ordered. The NFRN states that the problems are generally of a minor nature but that cumulatively they result in operational problems for retailers. The NFRN also considers that there is a significant level of variation between the levels of service provided by different wholesalers: the wholesaler with the highest number of complaints has had twice as many complaints when compared to the second most complained about wholesaler.

- 4.38 Overall, it is not clear whether the level of wholesale service complaints is in fact high. The Industry Standard of Service Agreement (ISSA) details different categories of wholesaler performance and a complaints procedure for retailers. The frequency of complaints regarding newspaper and magazine wholesalers issued under the ISSA system seems to be reasonably low. In the twelve months to October 2007, only 341 ISSA complaint forms were issued.⁶⁶ This figure would equate to less than one per cent of all retailers complaining once per year.⁶⁷ It is also noted that 60 per cent of these complaints refer to the timing and quality of newspaper deliveries, where, given the very tight time windows and the incentives for publishers to delay distribution for late breaking news, wholesalers face considerable logistical challenges as discussed in paragraph 3.7 above.
- 4.39 Publishers also scrutinise wholesaler service performance in the tender process and set performance targets in their SLAs with wholesalers. These are measured by regular monitoring of KPIs. As noted above, and in the Code Review, the use of SLAs and KPIs has grown over the past decade and they are now used extensively by publishers/distributors. Publishers also benchmark the performance of wholesalers against their performance in other territories and against the performance of other

⁶⁶ ISSA report 2006/07, February 2008.

⁶⁷ Some retailer associations have argued that the complaints process is cumbersome, and that may explain why take up is so low.

wholesalers. The OFT has also seen evidence that publishers build financial incentives into wholesaler contracts to incentivise the maintenance of particular service levels, and it is also aware of wholesalers that have been threatened with the loss of a contract or otherwise penalised as a result of poor service levels. As such, when publishers compare competing bids between wholesalers to serve territories (competition for the market) the service performance record of different wholesalers is an important additional factor for publishers.

- 4.40 The evidence reviewed above seems to indicate that competition for the market does provide a competitive constraint on the behaviour of wholesalers in general. However, the effectiveness of competition for the market may vary between individual tender rounds and depend on how each individual tender is structured and the number of bidders. In this respect it is still possible that the impact of competition for the market may be variable between territories and wholesalers. In addition, while the evidence indicates that competition for the market provides a competitive constraint on the behaviour of wholesalers, it does not necessarily indicate that competition for the market provides the most effective competitive constraint on wholesalers. This again may vary between products, territories and wholesalers. Finally, while the volume of complaints may not be especially high, the OFT has taken note of the strength of retailer views particularly in relation to issues such as copy allocation. These views are explored further in the section on copy allocation below.

Conclusion on competition for the market

- 4.41 The OFT's analysis has highlighted a number of ways in which publishers are able to use competition for the market pursuant to the tender process to generate effective competition between wholesalers, despite the tender process itself appearing to lend certain advantages to the incumbent wholesaler in a particular territory. In particular, publishers have been effective in using their buyer power and their control over the bidding process to leverage competitive bids from wholesalers, even following the significant degree of consolidation at the wholesale level recently. There is also evidence that competition for

the market is used by publishers to drive enhanced wholesale service delivery performance and to constrain the level of CSCs. Finally, there are other constraints that would appear to counteract any market power at the wholesale level, including publishers' ability to control wholesale margins through cover pricing.

- 4.42 In addition to this, the relevant performance indicators examined by the OFT, including wholesaler profitability, do not provide evidence that this competition for the market is failing to provide a competitive constraint on wholesalers overall. For these reasons, the OFT is minded to decide that there are not reasonable grounds for suspecting that competition for the market is a feature that prevents, restricts or distorts competition.
- 4.43 The OFT, however, notes that competition for the market, although providing a competitive constraint on wholesalers, serves to make publishers, rather than retailers, the primary customers of the wholesaler. In this respect, it is the demands or targets of the publisher that a wholesaler will respond to in the first instance, and a wholesaler's success in meeting those targets will determine its success in subsequent tender rounds. Publishers, not retailers, are therefore the focal point of competition for the market. This may not create tensions in so far as the incentives of publishers and retailers are aligned. However, it can be a source of frustration for retailers on issues such as copy allocation where, as a result of the two-sided nature of the markets, retailer incentives are not necessarily aligned with those of publishers or distributors. This issue of copy allocation is examined further below.

Sale or return

- 4.44 Through SoR, publishers reimburse wholesalers and retailers for any copies of newspapers or magazines that are not sold at the end of the sale period. Retailers can return any unsold copies to wholesalers and be reimbursed for the wholesale copy cost. This process is administered by the wholesaler, on the publisher's behalf and at the publisher's expense. Newspapers and almost all magazines are supplied on this basis.

4.45 SoR is not unlimited, and the degree to which wholesalers and retailers can benefit from SoR varies from title to title, and sometimes from issue to issue. In line with the number of copies of an issue they print and their expected sales, publishers set a SoR limit beyond which they will not compensate for any unsolds. This limit is agreed between a publisher and wholesaler (and the distributor in the case of magazines). It is then up to the wholesaler, in conjunction with the publisher, to allocate copies to retailers to ensure that SoR limit is not exceeded.

Risks and availability

4.46 SoR means that publishers, rather than retailers or wholesalers, carry the product-specific financial risk in the supply chain, while retailers continue to carry risks associated with the provision of retail space and services. In this respect, it departs from usual supply chain practice whereby the product is sold at each stage of the supply chain on a firm sale basis and each level of the supply chain takes the product risk.⁶⁸

4.47 The publisher incentives for SoR stem from the product characteristics examined in chapter 3: namely the two sided nature of the product markets; the perishability of newspapers and magazines; demand unpredictability; and low marginal costs of production.

4.48 The primary incentive for a publisher to use SoR is to ensure the wide availability of its titles. There are numerous reasons why retailers and wholesalers are more risk averse than publishers, and why, under a fixed sales system whereby retailers carry all the risk for any unsolds, retailers might have a tendency to order too few copies and/or a narrower range of titles to meet demand. These are:

- Individual retailers can be exposed to significant fluctuations in the sales of titles from period-to-period given the diminishing value of

⁶⁸ It is noted, however, that there are other examples of perishable products such as bread and sandwiches, or products such as books and CDs where there might be unpredictable demand, where some degree of SoR has been used in the supply chain.

the information, the short period which the product is on the shelves, and the fact that many purchases are made on impulse.⁶⁹ These fluctuations are likely to be strongest for magazine titles on average. Publishers, on the other hand, are less exposed, as store-level fluctuations are evened out on aggregate.

- The marginal cost of an unsold publication is also considerably higher for the retailer than it is for the publisher. For the former, the marginal cost is the cover price minus its margin discount. By contrast, for the publisher, the marginal printing costs are low (see paragraph 3.16 above). In this respect, the financial loss of an unsold publication would be greater for a retailer than for a publisher and one would expect retailers to be more risk averse as a result.
- In addition, in a two-sided market, publishers have a greater incentive to maximise availability than wholesalers or retailers in order to increase circulation and maximise profits from both copy sales and advertising. Thus, publishers would be more willing to 'push' copy into the system than wholesalers or retailers would be willing, in the absence of guaranteed demand, to 'pull'.
- Finally, publishers have a better understanding of variations in demand that might result from the content of different editions and the news headlines.

4.49 Given the scope of the SoR system in this supply chain, and its prevalence since 1992, it is difficult to compare the implications of a

⁶⁹ Evidence of impulse buying in the magazine category provided by the PPA submission to the OFT dated 20 October 2006. The research indicates that consumers often purchase magazines on impulse. In addition, the PPA's research indicates that, on average, only 50 per cent of consumers knew which magazine they were going to purchase before entering a store, indicating that some consumers do not display brand or title-based loyalty. The PPA notes, however, that although consumers may not consistently purchase the same title, they often display significant loyalty to a portfolio of titles from which they will consistently choose a title. This portfolio is often a limited subset of magazines within a category.

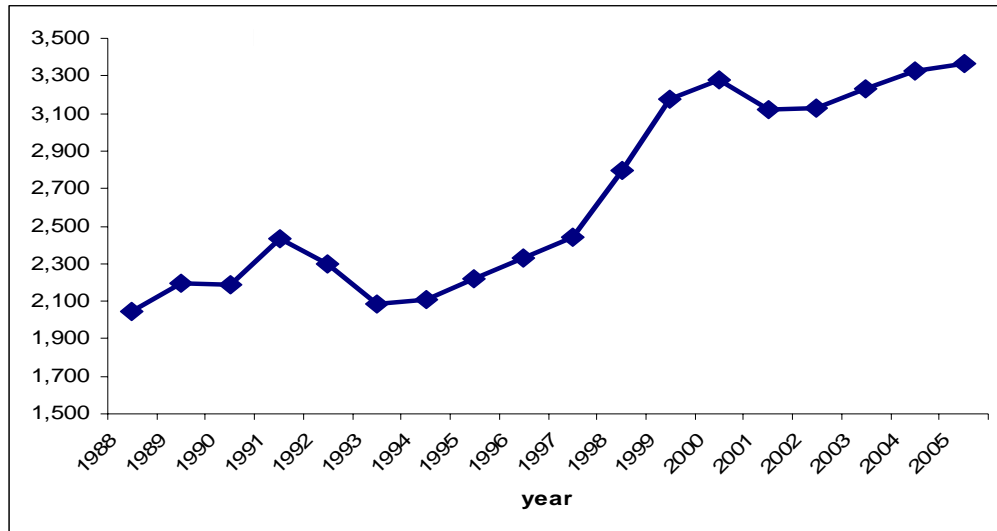
SoR system against a fixed sale system in terms of availability and increased circulation of publications. However, all publishers and wholesalers submitted views to the OFT that a fixed sales system would reduce the availability and circulation of their titles. As evidence, magazine distributors pointed to the performance of part-works titles which are sold on a fixed sales basis and where there is evidence that retailers under-order and engage in significant re-ordering.

New launches of magazine titles

- 4.50 By alleviating demand unpredictability at the retail level, SoR may also facilitate the launch of new magazine titles by publishers.⁷⁰ New titles are often given a high SoR allowance by publishers faced with the unpredictability regarding sales. Distribution of a new title is, therefore, easier under SoR than under a fixed sale system where the retailer may often not take the risk of an untested product. In this way, the PPA attributes much of the growth in magazine titles over the 1990s to the introduction of SoR in 1992 (see figure 4.1 below).

⁷⁰ New title launches are relatively frequent in the magazine sector owing to shifting leisure interests and fashions and to the desire of publishers to attract particular demographics and niche readerships (see paragraph 3.6 above). SoR would in principle facilitate the launch of new newspaper titles as well, but in practice these are rare.

Figure 4.1: Number of consumer magazine titles, 1988-2005



Source: Periodical Publishers Association, PPA.

- 4.51 Wider availability and greater product choice should in principle benefit all parts of the supply chain, including final consumers. From the consumer's perspective, this should increase the number of retail outlets in which customers can find their desired publication. As a result, consumer welfare should be enhanced. Survey evidence seen by the OFT gives some indication that consumers value a wide choice of titles, although this is by no means conclusive.⁷¹
- 4.52 However, excessive variety could be a competition concern. First, by publishing a very wide range of titles, publishers could make it more difficult for new entrants to find market niches or to distinguish themselves from existing titles.⁷² Second, in a situation of limited retail shelf space, existing publishers might use the variety of their titles to crowd-out titles of new publishers by limiting their access to shelf

⁷¹ The survey was conducted by Other Lines of Enquiry and analysed by Wessenden Marketing on behalf of the PPA. A sample of 600 respondents was used.

⁷² See, for example, Scherer, FM (1979), 'The Welfare Impact of Product Variety: An application to ready-to-eat cereal', *The Journal of Industrial Economics*, 28(2), pp 131-34.

space. In both of these ways, excessive variety may act as a barrier to entry. Finally, an excessive range of titles may result in allocative inefficiency, for example where less popular titles absorb resource that could otherwise be deployed to improve more popular titles or to innovate.

- 4.53 The OFT does not have specific evidence that existing publishers have expanded their ranges of magazine titles in order to crowd-out new publishers in either of the ways described above, and no concerns have been raised to this effect by parties. Moreover, title proliferation could be a sign of strong competition between publishers in terms of product innovation. As noted in paragraph 3.6 above, magazine publishers have a strong incentive to experiment with different formats and content in order to isolate different demographic groups and enhance their advertising potential.
- 4.54 SoR can also ease the route of smaller publishers and niche titles to market by reducing the retailer risk associated with new products. In this connection, it is instructive that evidence indicates that smaller magazine publishers continue to enter the market. There were 1,970 businesses in the periodical publishing industry in 2006, up from 1,790 in 2004, while two-thirds of these firms have a turnover of less than £500,000.⁷³

Effects on retail competition

- 4.55 By relieving retailers of some of the commercial risk, SoR may take away some of the incentives for retailers to compete with one another in terms of price. In particular, SoR could eliminate the incentive for retailers to clear stock at the end of the sales period by reducing the price below the level they would be reimbursed under the SoR system.
- 4.56 However, SoR does not eliminate the incentive to discount altogether if retailers can still make some margin on top of the wholesale price. In

⁷³ *Consumer Magazines Market Report 2007*, Keynote Limited.

particular, retailers still carry the risk associated with retail costs (shelf space, retail service) of any unsolds, and therefore have an incentive to make some margin on a sale. In addition, there are a variety of reasons, independent of SoR, why retailers may not be inclined to discount magazines and newspapers. These are examined in the section on cover prices below.

Conclusion on SoR

- 4.57 It would not be appropriate to interfere in the determination of the efficient allocation of risk through the supply chains unless there were clear distortions of competition that resulted from this allocation. By encouraging wide availability and facilitating the route-to-market, in particular for smaller publishers and new titles, SoR is likely to have a positive effect on competition and ultimately consumer welfare. Furthermore, the OFT has found no evidence to indicate that SoR has a detrimental effect on competition or entry at the publisher level or at the retail level.
- 4.58 The OFT, therefore, is minded to decide that there are not reasonable grounds for suspecting that SoR prevents, restricts or distorts competition.

Copy allocation

- 4.59 A feature of distribution that is related to SoR is that publishers and wholesalers determine the variety and quantity of newspapers and magazines that a retailer receives by controlling their copy allocation. In this way, the system of newspaper and magazine distribution is primarily a 'push' system whereby the quantities of titles that are distributed to retailers are determined by allocation choices at the top of the supply chain, rather than a 'pull' system whereby individual retailers decide the range and number of titles they wish to stock and order them from wholesalers.
- 4.60 The copy allocation process is linked to the SoR system. As noted above, publishers agree with wholesalers the SoR limit for the number

of unsold copies for a particular title that can be reimbursed. On the basis of these limits, publishers and wholesalers will also agree targets for the level of unsolds that can differ according to areas or retailers. The purpose of the targets is to balance ensuring availability of copies with moderating the level of unsolds. Publishers determine how many copies of a title to print based on a forecast of demand derived from their knowledge of the news agenda and experience of consumer behaviour and historic sales levels. It is then for the wholesaler, in conjunction with the publisher (or the distributor in the case of magazines), to allocate copies between retailers so that the unsold target is met.

- 4.61 As already noted, there are benefits associated with a degree of publisher control over retailer copy allocation. In particular, publishers have a better understanding of how overall demand for different titles is driven by content and the news agenda. They also appear better placed to take on the risk of demand variability and to ensure availability of titles through SoR.
- 4.62 The issue is, therefore, whether the degree of publisher control over copy allocation, and the way in which control is exercised, prevents, restricts or distorts competition.

Scope for retailer influence over copy allocation

- 4.63 An individual retailer's allocation of newspaper and magazine titles is decided by the wholesaler, in conjunction with the publisher or distributor, in order to meet targets for unsolds and to ensure availability. Allocations of newspapers and magazines are usually assessed on the basis of historical sales data in the first instance. These will then be amended to cater for any predicted increases in demand as a result of the news agenda or promotions. In relation to magazines, factors such as the type of retailer, its location, and the amount of display space will also be relevant for determining the range of titles a retailer receives. The OFT also understands that larger retailers may be able to agree 'range agreements' with wholesalers or publishers to

increase the number of copies of certain titles they receive or to limit the range of magazine titles they receive.

4.64 Within this framework, there are currently two main ways in which a retailer might try to amend its copy allocation:

- For newspapers and magazines, the large multiple wholesalers have put in place centralised call centre and on-line functions so that wholesale depots can respond to retailers' order requests and amend their allocations.
- For magazines only, wholesalers are expanding a sales based replenishment (SBR) system. This allows a wholesaler to use a retailer's electronic point of sale (EPOS) data to monitor the availability of a particular magazine title in store. The wholesaler can use this data to trigger replenishment, supplying copies of the title throughout a title's sale period (for example, fortnightly or weekly). This often goes hand-in-hand with a reduction in the retailer's initial supply.

4.65 In terms of newspaper allocations, the evidence seen by the OFT suggests that extensive use is made of call-in facilities to adjust delivery orders. For example, Smiths News allows retailers to alter their allocation on a daily basis provided notification is made before a deadline.⁷⁴ Smiths News indicates it receives in excess of [...] amendments to newspaper allocations in a typical week, and that 97.7 per cent of retailer amendments to newspaper orders are implemented.⁷⁵ The OFT is not aware of retailers wanting more influence over their newspaper copy allocations than this. This seems to be confirmed by evidence seen by the OFT of local trials in which wholesalers have given retailers the option of day-to-day control over the number of copies that are delivered to them. The vast majority of retailers did not make use of this provision.

⁷⁴ Smiths News submission to the OFT dated 20 October 2006.

⁷⁵ Smiths News submission to the OFT dated 12 February 2007.

- 4.66 In relation to magazine allocations, retailers can in principle adjust their allocations or replenish their stocks through call-in facilities and SBR services offered by wholesalers. SBR has been under development in the industry since 2000. Despite this, evidence suggests that the availability of SBR remains limited. The top 300-350 magazine titles are available through SBR,⁷⁶ and while this figure is growing, it still represents a fraction of all available titles. In addition, to qualify for SBR, retailers have to use EPOS systems, which are generally only options for large retailers, and to sell a minimum level before qualifying for additional stock. Many smaller retailers do not, therefore, currently qualify for SBR.
- 4.67 Retailer submissions received by the OFT highlight a particular concern in relation to magazine allocation and ordering. Submissions from the NFRN indicate that one of the most frequent complaints received from its members relates to problems independent retailers have with their allocation of magazine titles and their requests to increase or reduce particular allocations regarding their wholesale delivery.⁷⁷ The NFRN also claims that, whilst a wholesaler will take note of a retailer's order, the order is typically not processed by the wholesaler's allocation system.
- 4.68 The British Retail Consortium (BRC) points to evidence that wholesalers have allocated magazine titles to retailers which the retailers had explicitly requested not to receive. The BRC has also argued that it is difficult to keep track of orders, deliveries and invoices since there is little visibility in the wholesaler system – inaccuracies exist by title and by issue. It stresses that the bulk of these problems occur in relation to

⁷⁶ PPA meeting with the OFT December 2006.

⁷⁷ Between January and December 2006, the NFRN call centre received approximately 5,695 telephone complaints from its members related to wholesaler service issues which were allocated into 21 categories. The evidence shows that complaints in relation to delivery shortages and order amendments are the first and third most frequent complaint categories.

magazines. The BRC also points to problems integrating supermarkets' normal ordering systems with wholesalers' SBR systems.⁷⁸

- 4.69 The Association of News Retailing (ANR) stated that the current copy allocation system results in '[magazine titles] being in the wrong place'.⁷⁹ It quotes research by one of its members that almost half of its stock returned to wholesalers should never have been delivered in the first place.
- 4.70 The OFT notes that wholesalers are trying to broaden initiatives, such as SBR, in order to meet retailer concerns about magazine allocation. However, these initiatives have already been underway for some time, and it would seem there is some way to go before these ordering facilities satisfy retailer concerns.
- 4.71 It is also likely that retailer concerns stem, at least in part, from the fact that magazine publishers/distributors and retailers have different incentives in terms of copy allocation as a result of publishers' desire to maximise profits from advertising as well as copy sales.⁸⁰ In a situation of limited shelf space, a publisher will want to allocate its titles in order to maximise expected revenues from both copy sales and advertising revenue. So even if the chance of a title selling at a particular retailer is low, the publisher may allocate this title over a more popular one if the revenue that an additional sale may generate in advertising is sufficiently high. Magazine publishers may also choose particular titles for a retailer in order to target a particular advertising demographic.
- 4.72 Magazine publishers are also interested in the performance of their own titles whereas retailers are interested in the performance of the category as a whole. Publishers use shelf-space as a way of advertising their titles and (particularly for magazines) have incentives to place their publication on the shelf in preference to rival publications. Publishers use promotions and guidance to wholesalers to achieve this, particularly

⁷⁸ BRC meeting with the OFT on 11 December 2006.

⁷⁹ ANR submission to the OFT dated 20 October 2006.

⁸⁰ See paragraph 3.3 above for a description of the two-sided markets.

for new titles. In contrast, retailers may not wish to stock an individual magazine because it would take away space from other more popular publications on which they could earn higher revenues

- 4.73 In this respect, wholesalers are likely to face competing demands from publishers and retailers in relation to copy allocation. As discussed in paragraph 4.43, competition for the market means that publishers are the primary customers of wholesalers. As such, most conflicts between the allocation instructions of publishers and the orders of retailers are likely to be resolved by wholesalers in favour of the former. It is, therefore, not clear that an ordering system managed by wholesalers could result in more effective retailer influence over magazine copy allocation. Instead, it appears that greater retail influence over copy allocation would require close interaction between publishers and retailers in this connection.

The importance of retailer influence

- 4.74 Publisher copy allocation limits the degree to which a retailer can differentiate its offer from other retailers in terms of its publication range in order to respond to local demand. As a consequence, a retailer might be unable to match local consumer preferences, and competition between local retailers can be restricted, resulting in both allocative and dynamic inefficiencies.
- 4.75 The competition restriction that results from an inability of a retailer to influence its allocation of titles might be expected to be more significant in the case of magazines than newspapers. Most retailers will want to take the full range of national newspapers in large part because there are only ten national titles⁸¹ which occupy a limited amount of shelf space.⁸² There is thus less scope for retailer differentiation in terms of product range in the case of newspapers. Moreover, to the extent that

⁸¹ The ten national daily newspapers are Daily Express, Daily Mail, Daily Mirror, Daily Star, Daily Telegraph, Financial Times, The Guardian, The Independent, the Sun and The Times.

⁸² Submissions by various wholesalers to the OFT. A number of wholesalers noted that there are only two daily newspapers which some retailers preferred not to stock.

demand for newspapers varies most significantly in relation to the news agenda, retailers generally seem to prefer to give publishers a degree of control over the number of copies delivered to each retailer as noted above.

- 4.76 For magazines, there are many possible titles that a retailer could stock.⁸³ There is thus much greater scope for a retailer to use the variety of magazines that it stocks as a means of differentiating its retail offering to that of its competitors. A retailer is also in a better position to know about local requests or interests and reflect these in the titles it stocks. And although many retailers need guidance from a wholesaler in managing the complex magazine category, this need not be at the expense of the retailers' influence over the range and number of titles they stock.

Wastage

- 4.77 At the end of a publication's shelf-life, retailers return unsold copies to the wholesaler for recycling where possible. The level of wastage is an indicator of whether newspapers and magazines are being allocated efficiently to retailers. The OFT's analysis of submissions by newspaper publishers shows the level of newspaper unsolds to be 18 per cent on average across all titles. By contrast, the circulation data for a sample⁸⁴ of magazine titles seen by the OFT shows the average level of wastage for magazines to be 41 per cent with a standard deviation from the average of 6 per cent. Although this was a small sample, this figure conforms with the average levels of wastage indicated in submissions from magazine publishers and distributors. Wholesaler records supplied to the OFT also indicate that many titles have persistently high levels of wastage, ranging from 25 per cent to 54 per cent, with an average of 40 per cent.

⁸³ The Key Note Limited *Market Report Market Report Consumer Magazines 2007*, indicates that there were 3,445 consumer magazine titles in 2006.

⁸⁴ The sample consisted of circulation data for each issue of 18 titles, covering categories such as music, cars, computing, art, women's interest and others, across a period of between one and two years.

- 4.78 The circulation data from wholesalers also shows a high average level of wastage for magazine titles, but a low standard deviation from this average from issue to issue. This suggests there is not a significant variation in the level of unsolds overall from issue to issue of a title. Taken together this suggests that, relative to newspaper publishers, magazine publishers consistently print considerably more copies than are demanded for many titles.
- 4.79 As noted in chapter 3, there are reasons to expect a degree of wastage in this industry given the product characteristics relating to the two-sided nature of the markets, perishability, demand unpredictability and the low marginal costs of production. The OFT also notes that the impulse nature of magazine purchases, compared to newspaper purchases, means that it is less predictable where and when a sale might occur. As such, publishers/wholesalers might be expected to build in a higher margin in the number of copies of magazines they allocate to retailers to allow for this risk, compared to newspapers in respect of which a customer's choice of retailer and title is more predictable.
- 4.80 However, whilst recognising these factors, a consistent level of wastage of around 40 per cent or more for many magazine titles seems high. Whilst the OFT has not extensively examined the degree of magazine sales volatility at the level of individual stores, it does not appear as though the consistent level of wastage can be easily explained by fluctuations in demand. This extent of wastage may, therefore, be connected with a lack of retailer influence over the copy allocation of magazines.

Conclusion on copy allocation

- 4.81 As stated above, demand for newspapers is sensitive to the news agenda. This means that, together with wholesalers, newspaper publishers appear, in general, better placed than retailers to allocate copies more efficiently. In addition, given the limited number of newspaper titles, there is less scope for publisher control over copy allocation to result in allocative inefficiencies than in the case of magazines. Evidence on newspaper wastage seems to support this.

- 4.82 In addition, publisher and retailer incentives are better aligned in the case of newspaper copy allocation since newspaper publishers do not face the same incentives as magazine publishers to target advertising demographics in their copy allocation to different retailers. Neither do newspaper publishers face the same challenge as magazine publishers to have the full range of their titles displayed on a retailer's shelf.
- 4.83 The OFT, therefore, is minded to decide that there are not reasonable grounds for suspecting that newspaper copy allocation is a feature that prevents, restricts or distorts competition.
- 4.84 In relation to magazine copy allocation, the OFT has noted that there is significantly more scope for retailers to respond to local preferences and more scope for allocative inefficiency to result from a centralised control of copy allocation by publishers. The analysis has also highlighted the different incentives faced by magazine publishers and retailers as a result of advertising, and how this might result in magazine publishers and retailers taking different views as to which magazine titles should be stocked on a retail shelf. This analysis, coupled with the evidence on wastage and retailer complaints, points to a potential competition concern. For these reasons, the OFT is minded to decide that there are reasonable grounds for suspecting that magazine copy allocation is a feature that prevents, restricts or distorts competition.

Cover prices

- 4.85 Publishers print prices on the covers of their newspaper and magazine titles. This section considers the extent to which cover prices limit intra-brand competition between retailers on price, and other components of the retail offer. It also considers whether cover prices affect price competition between publishers.

Effect on retail price competition

- 4.86 In principle, cover prices are prices that publishers recommend to retailers for pricing each individual title (recommended retail prices). In practice, however, cover prices appear to restrict the ability of retailers

to raise prices. In order to increase their price above the cover price, retailers would need to ensure that the new price is properly displayed and in such a manner as to avoid customer confusion. In line with consumer law, this would usually mean putting a new price sticker over the cover price on each copy. Given the tight timescales and potentially large quantities of copies involved of both newspapers and magazines (particularly in relation to newspapers), the need to 'over-sticker' the cover price is likely to act as a significant obstacle to many retailers raising the price. In addition to the effort required, smaller retailers also complain that it is very difficult for them to over-sticker cover prices with a higher retail price, since this would be perceived adversely by customers. Finally, the OFT has also come across provisions in some agreements between wholesalers and retailers that preclude retailers from raising the price of certain newspaper titles. In this sense, cover prices can operate contractually, as well as in effect, as maximum prices.

- 4.87 In terms of whether cover prices restrict retail discounting, retailers would be free to reduce prices below the cover price simply by placing signs in the shop indicating a certain amount off the marked price. Moreover, there are numerous other ways that retailers might discount a title apart from lowering the price (for example, two-for-one offers, product bundles, and by charging less for bundled services such as home news delivery).
- 4.88 However, retailers are unlikely to gain much advantage from discounting newspapers. Newspapers are regular, low cost purchases which command strong loyalties to particular titles. Moreover, a customer's choice of retailer is often determined by their daily routine, and they are unlikely to break that routine significantly to benefit from a discount. Nevertheless, there may be opportunities for retailers to discount newspapers later in the day in order to sell off spare copies.
- 4.89 Retailer incentives to discount magazines are likely to be stronger given that customers have greater flexibility about when and where they purchase magazines, with evidence indicating that customers use a range of shops to buy magazines. The OFT has also been provided with

examples of such magazine discounts that were specific to certain large retailers. There is also more scope for a larger discount off a magazine cover price, given that magazine prices are generally higher than newspaper prices.

- 4.90 Although retailers' incentives to discount their publications may not be large, particularly in the case of newspapers, cover prices may reduce these incentives further. The fact that retailers do not automatically have to price the copies or titles they offer, unlike other items they sell, makes it less likely that they will consider rival pricing and the degree of price competition on these titles. In this sense, cover prices might generate inertia in relation to retail pricing, and dampen intra-brand price competition at the retail level as a result.

Effect on retail margins and non-price components of retail competition

- 4.91 Publishers have a significant degree of influence over the margins that retailers receive from the sale of newspapers and magazines. In the case of magazines, retail margins are often set in the wholesaler-retailer supply agreement. For newspapers, publishers usually recommend a retail margin to wholesalers. However, the combined effect of cover prices, and the agreements between newspaper publishers and wholesalers on a maximum wholesale margin, means that the retail margin is in effect limited to the residual between the wholesale price and the cover price. As noted above, retailers can in theory increase their prices above the cover price, but in practice this appears difficult and instances of 'over-stickering' are rare. Evidence indicates that some retailers can negotiate a higher margin with wholesalers (lower wholesale price), although this seems to be limited to the large multiples. In this respect, therefore, publishers either directly or indirectly control retailer margins.
- 4.92 Publisher control of margins in this way may limit the degree to which retailers can compete on other dimensions of their retail offer. For example, such control may limit the ability of a retailer to trade off higher prices for greater service provision (for example, a late-night

store). Margins that are low may also limit entry into retailing and, therefore, dampen competition at the retail level. In this way, cover prices, by limiting the margins that retailers can earn from the sale of magazines and newspapers, can restrict the size and variety of the retail network affecting the degree of competition between retailers.

4.93 However, for a number of reasons any such restriction is likely to be limited since in two-sided markets, publishers have a strong incentive to maximise the availability and circulation of their titles through an extensive retail network. The rapid expansion of retail outlets selling both newspapers and magazines during the 1990s reflected, amongst other things, a desire on the part of publishers to expand retail availability in non-traditional outlets, such as supermarkets, convenience stores and petrol stations. Since then the retail network has remained stable at about 54,000 outlets with those retailers exiting the market broadly offset by new retailers entering it. There were 1,800 applications per year for new supply to retailers between 2002 and 2005.⁸⁵

4.94 The effect of cover prices on a retailer's level of service provision (for example, its level of staff, opening hours, premises) is also likely to be limited, as there is unlikely to be much competitive advantage for retailers in offering extensive service provision to customers in their purchases of newspapers and magazines.

Effect on competition between publishers

4.95 Cover prices increase the price transparency of publications and, by enabling publishers to observe accurately each other's prices, may in theory facilitate tacit price coordination or collusion between publishers. However, the OFT has found no evidence in the context of the three work-strands undertaken to indicate that either newspaper publishers or magazine publishers coordinate prices tacitly or collusively in this way.

⁸⁵ Based on a submission by the ANMW dated 20 October 2006.

- 4.96 Although the OFT has not considered the issue extensively, the evidence it has seen on price competition between publishers does not indicate a competition concern. In relation to newspapers, the OFT has seen evidence of various promotional activities and increases in product quality that are consistent with active competition in the market. A number of titles have engaged in regional price reductions (for example, the Independent on Sunday reduced its price from £1.80 to £1 in selected regions in late 2007 and 2008) and other price promotions, such as subscription voucher schemes (offered by, among others, the Telegraph) and special offers (such as free or discounted linked purchases, used extensively by the Mail). Promotions involving cover-mounts, for example DVDs and CDs, are also common. In relation to magazines, the OFT has also seen evidence of competition between magazine publishers, for example publishers have informed the OFT about price discounts (particularly at the time a magazine is launched), discounts for bundled purchases, and the widespread use of cover-mounts, such as books and bags on women's magazines.
- 4.97 The OFT also considers that many characteristics of competition in the newspaper and magazine product markets would not be conducive to price coordination. First, competition between publishers takes place in many different dimensions, notably in relation to the content, headlines and quality, as well as price of their publications. Examples of newspaper and magazine publishers competing on quality include increases in the amount of colour and adding pages, especially supplements.⁸⁶ These additional dimensions of competition would make it difficult for publishers to sustain any coordination based on price alone.
- 4.98 Second, the two-sided nature of the newspaper and magazine markets, creates significant incentives for publishers to undercut the prices of competitors, as advertisers compare the circulations of different titles

⁸⁶ From the 1990s onwards the number of newspaper supplements increased significantly including titles on personal finance, travel, education, sport, food and entertainment listings. These tend to appear weekly or monthly, although the *Guardian* and the *Times* carry daily supplements *G2* and *T2*, respectively.

and usually offer premiums to the market leaders. This gives publishers additional incentives to lower their cover prices in order to boost circulations. Since the price of advertising space in different titles is not easily observed, any attempt to coordinate cover prices could be destabilised by competition in the advertising side of the market in this way.

- 4.99 In relation to magazines, the proliferation of titles and the entry of smaller publishers noted in paragraph 4.54 above, could also make any coordination or collusion between magazine publishers difficult to sustain.
- 4.100 Finally, it might also be expected that competition between newspaper publishers would intensify in a declining market. With the exception of 2001, total copy sales have been declining steadily for newspapers since 1996. Internet advertising and on-line publications have been a significant factor in this decline. This would also make collusion or coordination of prices difficult to sustain since there are strong incentives for newspaper publishers to maintain falling circulations by cutting prices or through other forms of competition. Indeed, some newspaper publishers have responded to declining sales by cutting prices.

Conclusion on cover prices

- 4.101 Cover prices appear to restrict the ability of retailers to increase prices independently and control their margins. The use of cover prices may, therefore, be expected to limit the ability of retailers to compete on non-price dimensions of their newspaper and magazine offer. In addition, although they do not restrict retailer discounting directly, cover prices may generate a degree of pricing inertia at the retail level, particularly for magazines. For these reasons, the OFT is minded to decide that there are reasonable grounds for suspecting that cover prices for newspapers and magazines prevent, restrict or distort competition.
- 4.102 The analysis has noted, however, that when considered against other factors that might limit price and/or non-price competition between

retailers, any such restriction resulting from the use of cover prices is likely to be limited.

Analysis of combined features

Publisher-led distribution

- 4.103 In addition to considering each of the above features on an individual basis, consistent with the holistic approach the OFT has taken in considering the entire newspaper and magazine supply chains, the OFT has also considered the features in combination. When assessed in isolation, a particular feature may not of itself indicate competition concerns. However, when assessed in combination with other features, the overall effect may be that these features do prevent, restrict or distort competition.
- 4.104 Following the OFT's analysis of each feature individually, as set out above, the OFT is minded to decide that, in some cases, there are reasonable grounds for suspecting that an individual feature prevents, restricts or distorts competition (as in the case of ATP, copy allocation for magazines and cover prices), whereas in others, this test is not met, albeit that the individual feature in question does result in the publishers gaining greater control over aspects of the distribution process for newspapers and magazines (for example competition for the market and SoR).
- 4.105 The OFT's analysis indicates that in combination, however, the individual features examined also result in publishers (via wholesalers) having a high degree of control over most aspects of the distribution process for newspapers and magazines, including:
- the prices of publications
 - the margins earned by wholesalers and retailers
 - the allocation of copies between retailers
 - the process of re-ordering titles to ensure copy availability

- the degree of risk borne by different levels of the supply chain, and
- the timing, and quality of delivery.

4.106 As a consequence, retailers have very little scope to differentiate their overall offering. However, since there is likely to be little scope for retailers to differentiate their newspaper offering in any event, this degree of control may not result in a restriction or distortion of competition. In relation to magazines, the OFT considers there is far more scope for retailers to differentiate their offer. As a result, the OFT proposes to find that publisher control likely results in a restriction or distortion of competition. The issue is considered below in relation to each of newspapers and magazines.

Newspapers

4.107 In relation to newspapers, the scope for retailers to differentiate their offer is likely to be limited even in the absence of the publisher control of the distribution process identified. As noted in paragraph 4.75 above, most retailers will stock the full range of national titles. Copy allocation does not, therefore, restrict the range of titles a retailer can offer. Likewise, the degree of customer service offered is usually limited to the provision of home news delivery which retailers are in general free to provide at their own separate prices. Beyond this, evidence suggests that consumers purchase daily newspapers based on habit and pre-formed perceptions, and choose retailers that fit with their daily routine. This also indicates that the scope for retailers to attract customers through particular retailer-specific newspaper offers or promotions is also limited.

4.108 The scope for differentiation is also limited by the product characteristics of newspapers. In particular, the very limited time window between the copy deadline for newspapers and the time by which the majority of newspapers are sold to customers means that the scope for retailers to differentiate their offers in the narrow intervening period is also very limited. For example, there is no scope for retailers to assess their stock requirements or establish promotions for different

issues. Equally, the scope for wholesaler innovation in relation to the distribution of newspapers is restricted by the sheer logistical challenge of overnight national delivery. The need for deliveries to all retailers to take place between 03:00 and 06:00 determines in large part the nature of the wholesale process.

Magazines

4.109 In relation to magazines, the OFT considers there is scope for retailers to differentiate their offers in a number of dimensions. The analysis above has examined the scope for retailers to differentiate their offer, in particular with regard to the range of titles they stock. In addition to this, there is scope for retailers to differentiate their offers in two further ways:

- Discounts and promotions: given the greater range of magazine titles, the longer time window for distribution and the longer on-sale period, there is more scope for retailers to promote particular titles, offer linked purchases or other forms of promotion. In addition, as noted in paragraph 4.89, there is more incentive and scope for retailers to discount magazines or offer promotions than is the case for newspapers.
- Availability: there is scope for retailers to distinguish their offers in terms of the availability of titles throughout the on-sale period and the prompt offer of new titles.

4.110 It might also be expected that the scope for retailer differentiation and competition in magazine supply has also increased with the changing composition of the retail network. In particular, supermarkets accounted for 31 per cent of magazine sales by value in 2005, compared to just 19 per cent in 1995.⁸⁷ In addition to this, there has also been an increase in the variety of outlets seeking to sell magazines. These changes at the retail level have placed new demands on publishers and

⁸⁷ PPA submission to the OFT dated January 2007.

wholesalers in terms of discounting, promotions, availability and other types of supplier provision.

- 4.111 Availability levels are usually measured by the percentage of stores that have unsold stock of a magazine title at the end of the on-sale period. The OFT understands that, on this measure, availability levels for magazines are around 70 to 80 per cent. The BRC stated that availability levels of magazines for members (large multiples including supermarkets and WHSmith) range from 65 per cent to 85 per cent.⁸⁸ It expressed strong concerns to the OFT that this level was too low in comparison to other products. The BRC also highlighted a number of examples of a lack of transparency that its members faced in their relationships with wholesalers, such as the inability of wholesalers to supply full inventory information to large multiple retailers on request, uncertainty over whether orders have been fulfilled, and inaccurate invoicing.
- 4.112 The OFT is aware of some initiatives that publishers and wholesalers have established to address availability concerns in the context of industry fora, such as the Joint Industry Group (JIG). These include the SBR scheme discussed in paragraph 4.64 above. However, the continuing concerns of retailers, as highlighted above, indicate that these initiatives are not adequately addressing the problems raised. Moreover, as noted in the context of copy allocation, magazine publishers have a strong incentive to control the availability and promotion of popular titles in retailers in order to leave shelf-space in retailers to promote their other titles. In this respect, there may be a limit to how far publisher or wholesaler initiatives can provide a solution to these concerns.
- 4.113 In relation to promotions, the OFT is aware that some publishers work with large retailers in designing retailer-specific promotions.⁸⁹ However, the BRC has expressed a frustration to the OFT that magazine

⁸⁸ BRC meeting with the OFT December, 2006.

⁸⁹ Various submissions from magazine publishers and distributors to the OFT, March 2008.

publishers and their wholesalers have been unable, or unwilling, to work efficiently within the normal ordering and promotion processes of large multiple retailers. In this respect, a general concern expressed by the BRC is that magazine publishers, together with their wholesalers, do not engage as fully as possible with retailers in achieving the promotion of titles and driving sales. This level, and tenor, of complaint may partially reflect problems at the wholesale level, but it is also likely to be associated with the degree of control that magazine publishers and distributors have over the magazine supply chain.

Conclusion on publisher-led distribution

- 4.114 The individual features of the markets – ATP, competition for the market, SoR, copy allocation and cover prices – combine to give publishers a high degree of control over the newspaper and magazine distribution process (publisher-led distribution). As a consequence, retailers have very little scope to differentiate their offer overall.
- 4.115 In relation to newspapers, in the absence of such publisher control, the scope for retailers to compete on the basis of a differentiated newspaper offer is limited. The very limited time-window for the distribution of newspapers, the limited range of titles, the unpredictability of content from day-to-day, and the habitual nature of consumer purchases mean that there is limited scope and incentive for retailers to differentiate their newspaper offers. As such, the OFT is minded to decide that there are not reasonable grounds for suspecting that publisher-led distribution for newspapers is a feature that prevents, restricts or distorts competition.
- 4.116 In relation to magazines, however, it seems there is greater scope for retailers to differentiate their offers were the balance of control over the supply chain to move in some degree away from publishers towards retailers. Competition between retailers could, therefore, be improved across a number of dimensions including discounts, promotions and availability. This is consistent with the view of a number of retailers expressed to the OFT.

4.117 For these reasons, the OFT is minded to decide that there are reasonable grounds for suspecting that publisher-led distribution is a feature that prevents, restricts or distorts competition regarding magazine distribution as it restricts intra-brand competition between retailers.

5 PROPOSED DECISION ON A REFERENCE

- 5.1 This chapter summarises the OFT's proposed decision on a reference and sets this out in the context of the statutory reference test and the exercise of the OFT's discretion.

The section 131 reference test

- 5.2 In order to make an MIR, the OFT must have 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 (the section 131 test). Where this threshold is met, the OFT has discretion as to whether to make a reference.
- 5.3 For the purposes of the test as set out in section 131, the relevant market features can be either structural in nature (relating to the structure of the market or any aspect of that structure) or relate to the conduct of suppliers, acquirers, or their customers. As noted in the OFT's guidance,⁹⁰ in practice there may not be a clear divide between structural features and those relating to conduct. Most of the features examined in chapter 4 relate to the conduct of firms in the market, although as noted in the analysis much of this conduct is closely related to the specific characteristics of the product.
- 5.4 The NFRN's request for an MIR raised a variety of features that it considered prevented, restricted or distorted competition. These are outlined in paragraph 2.2 above. Following its consideration of the NFRN's request, including the inter-relationship between the various aspects of the supply chains, the OFT identified five individual features of the conduct of publishers and wholesalers as features under the reference test.

⁹⁰ OFT 511, 'Market investigation references: guidance about the making of references under Part 4 of the Enterprise Act', paragraph 1.9.

5.5 In the course of its analysis of these features, the OFT has engaged extensively with stakeholders and has analysed a wide range of evidence, including relevant evidence gathered in relation to both the Opinion and Code Review work strands. Following its analysis, the OFT is minded to decide that there are reasonable grounds for suspecting that three of the five features analysed in chapter 4 individually prevent, restrict or distort competition:

- ATP for newspapers and magazines: by awarding wholesalers exclusive territories and by preventing passive sales between those territories, ATP may well remove the potential for competition to emerge between wholesalers for a proportion of the individual retailers within some of these exclusive territories.
- Copy allocation for magazines: in contrast to newspapers, there is considerable scope for retailers to differentiate their magazine ranges. Longer distribution timescales for magazines should also give more scope for wholesalers to respond to individual orders or requests from retailers to reflect local demand preferences. This scope for a retailer to compete on the basis of their magazine title ranges may be restricted by the degree to which wholesalers, in conjunction with publishers, control the allocation of magazine copies to individual retailers.
- Cover prices for newspapers and magazines: cover prices appear to restrict the ability of retailers to increase their prices independently and control their margins. Cover prices might also be expected to limit the ability of retailers to compete on non-price dimensions of their newspaper and magazine offer. In addition, although they do not restrict retailer discounting directly, cover prices may generate a degree of pricing inertia at the retail level, particularly for magazines.

5.6 The OFT's analysis also examined the collective impact of the five features. The OFT is minded to find that, taken together, the individual features contribute to a high degree of publisher control over the distribution process for newspapers and magazines (publisher-led distribution) and that:

- In relation to newspapers, the very limited time-window for the distribution of newspapers, the limited range of titles, the unpredictability of content from day-to-day, and the habitual nature of consumer purchases mean that there is limited scope and incentive for retailers to differentiate their newspaper offers. As such, the OFT is minded to decide that there are not reasonable grounds for suspecting that publisher-led distribution for newspapers is a feature that prevents, restricts or distorts competition.
- In relation to magazines, however, there would appear to be significant scope in the absence of such a high degree of publisher control over the distribution process for retailers to differentiate their magazine offers and for wholesalers to respond to more individualised retailer demands, responding to local demand preferences. The OFT considers that this degree of publisher control over the distribution process for magazines affects not only the ability of retailers, in competition with other retailers, to influence the range of magazines they offer but also their ability to promote individual titles, offer different types of discount to customers, and to improve the availability of titles, sensitive to local demand and demographics. The OFT, therefore, is minded to decide that there are reasonable grounds for suspecting that publisher-led distribution is a feature that prevents, restricts or distorts competition regarding magazine distribution as it restricts intra-brand competition between retailers.

Conclusion on the s131 test

- 5.7 The OFT is minded to decide that there are reasonable grounds for suspecting that four features of the market prevent, restrict or distort competition: ATP in relation to newspapers and magazines; copy allocation for magazines; cover prices on newspapers and magazines; and following a collective analysis, the degree of publisher control (publisher-led distribution) over the magazine supply chain in general.

Exercise of the OFT's Discretion

5.8 As noted in paragraph 1.4 above, the OFT has the discretion, rather than a duty, to make a reference where the section 131 test for making a reference is met. The OFT's guidance on market investigation references sets out four criteria all of which must, in its view, be met before the OFT decides to make a reference:⁹¹

- Appropriateness of a reference: the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it.
- Availability of remedies: there is a reasonable chance that appropriate remedies will be available.
- Undertakings in lieu: it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.
- Alternative powers: it would not be more suitable to deal with the competition issues identified by applying the CA98 or using other powers available to the OFT.

5.9 These four criteria are considered below. Taking account of the relevant factors outlined in OFT's guidance for assessing whether these criteria are met,⁹² the OFT is minded to decide that, although the reference test is met, the balance of the evidence reviewed and the resulting assessment points in favour of exercising the OFT's discretion not to make a reference to the CC of newspaper or magazine distribution in the UK.

⁹¹ OFT 511, 'Market investigation references: guidance about the making of references under Part 4 of the Enterprise Act', paragraph 2.1.

⁹² OFT 511, Market investigation references, paragraphs 2.1 to 2.32.

Appropriateness of a Reference

5.10 In terms of the assessment of whether a reference is an appropriate response to the scale of the suspected problem, the OFT guidance provides that the OFT will only make a reference when it has reasonable grounds to suspect that the adverse effects on competition of the relevant features of a market identified are significant. In this connection, it will consider whether the suspected adverse effects are likely to have a significant detrimental effect on customers through higher prices, lower quality, less choice or less innovation.⁹³ The guidance sets out three relevant factors that are taken into account in assessing the significance of any adverse effects on competition or customer detriments arising from them:

- The size of the market.
- The proportion of the market affected by the feature or features giving rise to adverse effects on competition.
- The persistence of the feature or features giving rise to adverse effects on competition.

Size of the market

5.11 In relation to the first factor, the OFT notes that the supply of newspapers and magazines in the UK is worth at least £10bn annually. Taken as a whole, or even in terms of the size of each of the publishing, wholesaling or retailing segments, the size of the market is substantial.

Proportion of the market affected

5.12 In relation to the second factor, the OFT notes that the proportion of the market in each case that is affected by the features identified, whether individually or collectively, is not small so as to mean that the adverse effects on competition would be unlikely to lead to significant customer

⁹³ Ibid., at paragraph 2.27.

detriment. In this connection, it is noteworthy that the features identified affect all newspapers and most, if not all, magazines.

Persistence of the feature

- 5.13 The third factor – the persistence of a feature – is of particular relevance to ATP. Following the guidance issued in the OFT's Opinion, which is published alongside this document, it is expected that publishers and distributors will self-assess their agreements with wholesalers. From the Opinion it would appear that there are factors that may demonstrate that ATP in newspaper agreements satisfies the exemption conditions, whereas it may be difficult to demonstrate that magazine agreements satisfy the exemption conditions. Parties need to assess their agreements in light of the guidance set out in the Opinion. Where ATP is not compatible with the Competition Act 1998, one would expect parties to self-assess correctly in line with the OFT's guidance and to resolve the issues arising from the agreements in the short term. In such circumstances, the feature giving rise to competition concerns would not persist.

Offsetting customer benefits

- 5.14 In relation to cover prices, there appear to be strong offsetting customer benefits from publishers setting cover prices for newspapers and magazines. Given the two-sided nature of the newspaper and magazine markets, one would expect publisher-set cover prices to be significantly lower than retailer-set prices.

- 5.15 Since a title's circulation will increase with a reduction in cover price,⁹⁴ a reduction in the cover price should have a positive effect on advertising revenue over time. Accordingly, one would expect publishers to set a cover price in order to maximise their profits from both copy sales and advertising revenue. By contrast, retailers only receive revenue from copy sales, and might, therefore, be expected to set a higher price (than publishers) in order to maximise their profits. This is not to say that the prices of some retailers will not be discounted below the cover price on some occasions. As noted in paragraph 4.89, the OFT is aware of retailer-specific price promotions below the cover price of a magazine. However, in general, a publisher-set cover price is highly likely to be lower than a retailer-set price due to the two-sided nature of the markets.
- 5.16 Econometric studies of magazine markets in other countries indicate that publishers set cover prices low in order to increase advertising revenues and rely on the latter to cover most if not all of their costs.⁹⁵ The effect of the two-sided markets on cover prices of both newspapers and magazines is also borne out by submissions from publishers that confirm the importance of advertising revenue when setting cover prices. As noted in paragraph 3.5, advertising revenue accounts for 50 per cent of all revenues earned on newspaper titles on average, and 34 per cent of the revenue earned on magazine titles on average.⁹⁶

⁹⁴The OFT received some evidence on price elasticity from newspaper and magazine publishers from regional or national price experiments they have conducted. This indicated that while some titles were relatively price inelastic (as would be consistent with a product that is priced lower in order to benefit from two-sided markets), all were normal goods i.e. a price reduction would increase circulation over time. For magazines, the responsiveness of circulation to a price change can vary considerably between different titles. However, the precise effects of a price increase can be difficult to isolate in regional price tests given that other factors such as segment growth, headlines, content and perceived value for money can play an important role in circulation.

⁹⁵ Kaiser, U and Wright, J. (2006) 'Price structure in two-sided markets: Evidence from the magazine industry', *International Journal of Industrial Organisation*, vol 24 (2006) 1 – 28.

⁹⁶ Advertising Statistics Yearbook, 2008, World Advertising Research Centre

- 5.17 In view of the foregoing, the OFT is minded to find that a publisher-set cover price is highly likely to be lower than a retailer-set price, and that the customer will gain significant benefits as a result.
- 5.18 In terms of whether these offsetting customer benefits outweigh the detriment that arises from the restriction of cover prices, paragraph 4.88 above notes a number of reasons why the restriction cover prices puts on the ability of retailers to compete on price and non-price elements of their offer is likely to be limited. The OFT, therefore, is minded to find that in relation to cover prices there are strong offsetting customer benefits that exceed the likely detriment from any adverse effect on competition.

Availability of remedies and other practical issues

- 5.19 The OFT is minded to find that the expected process of self-assessment of individual ATP agreements between publishers and wholesalers that will follow the issue of the Opinion will create at least the possibility of a period of flux and uncertainty in the sector making it difficult to assess how the supply chains might evolve in the short term. For example, the expected process of self-assessment may raise the prospect of new wholesale firms entering the market and/or new models of distribution developing. The OFT is minded to find that the possibility of flux and the potential developments in the supply chains in the short term would make it difficult for the CC to gather sufficient evidence at this point in time to enable it properly to assess the state of the markets. This would also make it difficult, at least in the short term, for the CC to assess the impact and effectiveness of any possible remedies to address adverse effects it may identify arising from magazine publisher control of copy allocation and the degree of publisher control over the magazine supply chain in general.

Alternative powers

- 5.20 In view of the above, it is not necessary to go on to consider as an additional rationale for not exercising the OFT's discretion to make an MIR, the appropriateness of dealing with the competition issues arising

from the features identified pursuant to section 131 of EA02 by applying the CA98. It is noted nonetheless that ATP is the subject of the Opinion, which provides guidance to assist parties' self-assessment. The Opinion was requested by members of the industry, and has been progressed by the OFT, prior to the receipt of the MIR request from the NFRN.

Conclusions on the exercise of the OFT's discretion

- 5.21 In conclusion, the OFT is minded to decide that, although the reference test is met, the balance of the evidence reviewed and the resulting assessment points in favour of exercising the OFT's discretion not to make a reference to the CC of newspaper or magazine distribution in the UK.
- 5.22 In relation to ATP, it is expected that publishers and distributors will self-assess their agreements with wholesalers following the guidance set out in the OFT's Opinion. From the Opinion it would appear that there are factors that may demonstrate that ATP in newspaper agreements satisfies the exemption conditions, whereas it may be difficult to demonstrate that magazine agreements satisfy the exemption conditions. Parties need to assess their agreements in light of the guidance set out in the Opinion. Where ATP in agreements is not compatible with the Competition Act 1998, one would expect parties to self-assess correctly in line with the OFT's guidance and to resolve the issues arising from the agreements in the short term. In such circumstances, the feature giving rise to competition concerns would not persist.
- 5.23 In relation to cover prices for newspapers and magazines, the OFT is minded to find that there are strong offsetting customer benefits that exceed the likely detriment from any adverse effect on competition.
- 5.24 Finally, in relation to the individual/collective features of magazine distribution that have been identified – publisher control of copy allocation and publisher-led distribution in general - the OFT is minded to find that it is at least possible that a period of flux will result from the

parties' self-assessment following the guidance issued in the OFT's Opinion. The OFT is minded to find that the process of self-assessment and the developments in the sector that may result for a period of time would make it difficult for the CC to gather sufficient evidence at this point in time to enable it properly to assess the state of the market. This, in turn, would also make it difficult, at least in the short term, for the CC to assess the impact and effectiveness of any possible remedies in the case of magazine copy allocation and publisher-led magazine distribution in general.

Conclusions on the proposed decision on a reference

- 5.25 In view of the foregoing, the OFT proposes to exercise its discretion to decide not to make a reference to the CC.
- 5.26 Under section 154(1) of the EA02, the OFT has the power to accept undertakings in lieu of a reference if it considers that it has the power to make a reference under section 131 and otherwise intends to do so. Since in this instance the OFT is minded to decide not to make a reference, for the reasons set out above, it does not have the power to accept undertakings in lieu.
- 5.27 The OFT does, however, note the desire of certain industry parties, including the NFRN, to agree a new code of conduct in relation to the supply of both magazines and newspapers to retailers, including mechanisms for redress. Steps towards self-regulation that address the adverse effects identified may address features of the market which appear to fall within the statutory test for a reference to the CC. Any such voluntary agreements between industry parties should of course comply with competition law. Any developments in this connection that are relevant to the present consultation would be taken into account when the OFT comes to make its decision on a reference to the CC.

6 NEXT STEPS

Consultation on the OFT's proposed decision

6.1 Under section 169 of the EA02, where the OFT is proposing to make a reference it must first consult so far as is practicable any person on whose interests the reference is likely to have a substantial impact. Although in this case the OFT is minded to decide not to make a reference, it invites views from industry parties as well as other interested parties given, among other matters, the complex nature of the markets and supply chains examined in this proposed decision, and the complex interplay of this proposed decision with the OFT's work-strands regarding the Opinion and the Code Review, the outputs of which have been simultaneously published with this proposed decision. A consultation is also appropriate in this particular case given the high level of stakeholder engagement and consultation that has been maintained across all work-strands.

6.2 Persons who wish to submit comments to the OFT on its proposed decision not to make a reference to the CC in relation to the supply of newspapers and magazines in the UK should send them to:

Ed Smith
Markets and Projects
Office of Fair Trading
Fleetbank House
2-6 Salisbury Square
London EC4Y 8JX
Email NMD@oft.gsi.gov.uk

6.3 In order to give parties the opportunity to consider the decision of the Secretary of State on the Code Review, the deadline for representations on the OFT's MIR consultation is set at 28 days following the publication of the Secretary of State's decision on the Code Review. Parties should not hesitate to, and it would assist the OFT's progression of the consultation in the meantime if parties could, make representations on any matter that they were able to prior to the

Secretary of State's decision on the Code Review. Parties will of course be able to supplement any such representations if necessary once the final decision on the Code Review is published.