

Classified directory advertising services market investigation

Provisional findings

Contents

	<i>Page</i>
Findings	4
1. Introduction	4
2. Overview of the sector	6
Industry background.....	6
Classified directory publishers	10
Yell.....	11
Thomson.....	12
BT	13
Trinity Mirror	15
Kingston.....	16
Other directory publishers	17
Other media for classified advertising	18
Regional and local newspapers.....	18
Classified advertising on the Internet	19
European CDAS markets	24
3. Regulatory factors	26
History of the reference.....	26
The Yell undertakings	27
Rate card	27
Prices.....	28
Directory areas	29
Good faith provision.....	29
Competition law.....	30
4. Trends in classified directory usage and advertising	30
Usage trends.....	30
Advertising trends	33
5. Market definition.....	35
Overview	35
Introduction to market definition.....	36
Sources of evidence on substitutability and switching	37
BMRB survey.....	37
AIA Study.....	37
FDS Survey	38
Implications for market definition of aspects of the present case.....	38
Two-sided nature of market.....	38
Yell undertakings	38
Effectiveness of classified directories	39
Potential substitutes to CDAS	40
Demand side substitutes	40
Supply side substitutes.....	41
Narrower market than all classified directories	41
Individual classifications	41
Advertisement type.....	42
Small directories	42
Wider market than all classified directories—Internet.....	42

Current levels of advertising on the Internet by CDAS advertisers	42
Possible barriers to switching between CDAS and the Internet	43
Large advertisers' attitudes to CDAS	49
Pricing responses to Internet.....	50
Growth in CDAS revenues in classifications popular on the Internet	51
Wider market than all classified directories—newspapers.....	52
Wider market than all classified directories—other media	55
Critical loss analysis based on the BMRB survey	55
Retention rate patterns.....	56
Small directories.....	58
Non-classified advertising in classified directories	60
Conclusion: product market definition	61
Geographic market definition	64
6. Competition in the market	65
The two-sided nature of the market	65
Market concentration.....	66
Price competition.....	70
Pricing: rate card determination and discounts	70
Revenues and realized prices, 1999 to 2005	75
Price competition and pricing constraints	82
Non-price competition	91
Competition for users	92
Effect on competition of BT's combined classified and A–Z directory	94
Advertiser switching	99
Countervailing buyer power	103
Barriers to entry and expansion	104
Assessment of competition	107
'Second tiering'.....	108
Prospects for competition.....	110
7. Profitability.....	110
Recent trends in profitability.....	110
Yell.....	111
Thomson.....	114
BT	115
Profitability analysis of the major CDAS providers.....	118
Introduction.....	118
Issues	121
Approaches to measuring profitability for Yell and Thomson.....	123
Comparison of return on assets (measured as truncated IRR or ROCE) with our calculation of the appropriate cost of capital	125
Commentary on the Results	127
Limitations of the approach used above to estimate truncated IRRs and ROCE figures in this case.....	128
'Lifetime' internal rate of return	130
Limitations of the approach used to estimate 'lifetime' IRRs	131
Comparison of accounting ratios for Yell and Thomson with various comparators	132
Benchmarking of accounting ratios results.....	133
Limitations of the benchmarking of accounting ratios approach.....	136
Benchmarking of accounting ratios: summary of results	137
Consideration of Yell's efficiency and innovation	139
Colour	140
Incremental advertisers	142
Yell: future profitability.....	143
Thomson future profitability.....	144
BT CDAS future profitability	144

Conclusions on profitability	145
8. Provisional findings	147
Market definition.....	147
Relevant product market	147
Relevant geographic market.....	149
Assessment of competition	149
Market concentration	149
Pricing behaviour	150
Non-price competition.....	150
Switching patterns	151
Buyer power	151
Profitability analysis	151
Competition within CDAS	151
Analysis of potential entry as competitive constraint.....	152
Provisional conclusions on competitive analysis	153
Publication by Yell of local directories	153
Features which prevent restrict or distort competition	153
9. Remedies	155

Appendices:

1.1 Terms of reference and conduct of the investigation
1.2 The Yell undertakings
5.1 Analysis of <i>Yellow Pages</i> ' revenues in classifications which are popular on the Internet
6.1 Yell discounts
6.2 Yell pricing and revenues
6.3 Thomson pricing and revenues
6.4 BT pricing and revenues
6.5 Yell price index
6.6 Thomson price index
6.7 Analysis of the pricing of colour
6.8 Analysis of rates in Yell rescope areas
6.9 Evidence on switching
7.1 Assessment of Yell's and Thomson's profitability
7.2 Cost of capital for a UK CDAS provider
7.3 BT profitability

Glossary

Findings

1. Introduction

- 1.1 On 5 April 2005, the Office of Fair Trading (OFT) referred the supply of classified directory advertising services (CDAS) in the UK to the Competition Commission (CC) for investigation. Classified directory advertising services are defined in our terms of reference as ‘the undertaking and performance of engagements to publish advertisements in printed directories which (a) show suppliers of goods and services classified by reference to the goods or services supplied; and (b) are distributed wholly or mainly to consumers’.
- 1.2 In line with our terms of reference we use the term ‘classified directories’ to refer to printed classified directories.
- 1.3 Our investigation into CDAS is a market investigation under the Enterprise Act 2002 (the Act). Section 134(1) of the Act requires us to decide whether ‘any feature, or combination of features, of each relevant market 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’. If so, there is said to be an ‘adverse effect on competition’.¹ A ‘feature of the market’ means:
- (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.²

¹Section 134(2).

²Section 131(2).

1.4 If the CC decides that there is an adverse effect on competition, it is required under section 134(4) of the Act to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers³ so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and, if so, what action should be taken and what is to be remedied, mitigated or prevented.

1.5 This is not the first time the CDAS market has been investigated. As explained in more detail below (see paragraphs 3.1 to 3.3), following an inquiry by the Monopolies and Mergers Commission (MMC, now CC) in 1996,⁴ undertakings were given by British Telecommunications plc, the then owner of *Yellow Pages*, the leading printed classified directory. Those undertakings included a price control on advertising rate card prices. Following a review by the OFT in 2000/01, the price control was strengthened in 2001. The present inquiry has, however, involved a completely fresh evaluation of the market for CDAS, independent of the work carried out by the MMC in 1995/96 or by the OFT in 2000/01. Inevitably, the pricing and other market data available to us reflect the effect of the price control which has been in place since 1996, and our analysis has had to take account of impact of the undertakings on the CDAS market.

1.6 The process which our investigation is following is explained in Appendix 1.1.

³A detrimental effect on customers is defined in section 134(5) of the Act as one taking the form of: (a) higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or (b) less innovation in relation to such goods or services.

⁴*Classified directory advertising services*, HMSO, Cm 3171, March 1996.

2. Overview of the sector

2.1 This section provides a brief overview of the sector. It then considers the various publishers of classified directories and describes their directories. Finally, it describes other types of classified advertising.

Industry background

2.2 Businesses have a range of different advertising media available to them to bring their goods and services to the attention of consumers. These include the press—newspapers, magazines and directories—television, direct mail, outdoor, radio, cinema and the Internet. Table 1 shows the relative size of these different media within the total market which in 2004 was worth £18,385 million.⁵

TABLE 1 **Share of expenditure of advertising media 2004**

<i>Advertising medium</i>	<i>Share of advertising expenditure; 2004 %</i>
Press—newspapers, magazines and directories	47.5*
Television	25.8
Direct mail	13.4
Outdoor	5.4
Internet	3.6
Radio	3.3
Cinema	1

Source: Advertising Association's *Advertising Statistics Yearbook 2005*.

*Including production, split equally between display and classified advertising.

Note: Display advertising is a combination of graphics and text, designed by the advertiser, which appears in a newspaper or magazine on the same page as or on an adjacent page to editorial text.

2.3 Classified directories, as part of the wider advertising industry, compete, to some extent, with other advertising media for a share of advertisers' budgets. It is customary to distinguish advertising that is intended to stimulate demand (such as television or radio advertising to create awareness or promote a brand) and advertising that is intended to direct consumers who have already decided that they need a certain product or service to a specific supplier. This latter category is often referred to as directional advertising and includes media such as classified

⁵*Source:* Advertising Association's *Advertising Statistics Yearbook 2005*. 2005 data is not yet available.

directories, classified advertisements in newspapers, online directories and certain forms of Internet advertising.

2.4 Another distinction between different types of advertising relates to the 'life' of the advertisement: an advertisement in a classified directory will last typically for one year, whereas advertisements in other media will normally change or be withdrawn after a much shorter period. Moreover, advertisements in classified directories (unlike those, say, on billboards) cannot be replaced before the end of their circulation period.

2.5 The user's requirement of a directory is that it has a reasonably full list of relevant suppliers and enough information about their goods or services to enable him or her to make a selection of suitable contacts and find relevant contact details. The advertiser's requirement of a directory is that its advertisement should generate enough new business leads to cover at least the cost of advertising. The demand for advertising in classified directories by advertisers will be influenced by their expectation of the number of calls they will receive as a result of use of the directory; this in turn depends on the amount of useful information users find in the directory. This interaction of usage and advertiser demand creates a 'network effect', by which more advertising attracts more usage, which, in turn, attracts more advertisers (see also paragraph 5.9). This effect has been described to us by CDAS providers as a 'virtuous circle'.

2.6 As well as numerous 'paid-for' advertisements, directories produced by the larger publishers also contain comprehensive free line entries within the relevant classified section of the directory. Businesses located in the distribution area of the directory will generally be offered a free line entry. Businesses outside the distribution area may nevertheless choose to advertise, and a significant number of businesses do so,

for example insurance companies and other advertisers seeking national coverage. Businesses outside the distribution area will not typically be offered free line entries.

- 2.7 Classified directories differentiate themselves in various ways, including the size and shape of the geographic area ('footprint') served, the layout and physical design of the directory, its brand image and its editorial content. Directory providers have to establish classification systems (the term 'classification' is used to describe the heading under which an advertisement appears) and systems for sequencing the advertisements within classifications. The sequencing of advertisements is an important issue for advertisers as many have strong preferences for their advertisement to appear at, or towards, the beginning of a classification.
- 2.8 As well as deciding in which directories and which classifications they wish to appear, advertisers have various choices relating to the size of the advertisement and the use of colour. In addition, special options may be available such as spine advertising, inside front cover, or 'filler' space, which utilizes gaps in the run of advertising resulting from the page composition process.⁶
- 2.9 Directory publishers describe the potential readership of specific directories by reference to the number of copies they guarantee to distribute in the relevant distribution area; this is known as the guaranteed minimum circulation (GMC). The cost of advertising is often expressed in terms of cost per thousand, based on GMC, relating the cost of advertising to the number of potential users addressed.
- 2.10 The geographic footprint of a directory is an important feature. A larger footprint will bring a larger GMC and more advertisements for the user; however, some users may

⁶These advertisements are not sorted by classification but appear randomly.

consider those advertisers located further away to be less relevant and some may dislike the physical size of a very large directory.

2.11 Many advertisers measure effectiveness by asking callers where they saw the advertisement, but there is also widespread use of more sophisticated methods, such as metering, using dedicated telephone numbers for each advertisement. The most sophisticated advertisers, typically those operating at a national level, will measure the cost of each lead generated from a particular advertisement relative to the value of that lead. This will be a function of the rate at which leads can be converted into sales, the value of the initial sale, and the subsequent ('lifetime') value to them of the customer.⁷

2.12 In order to compile a classified directory, it is necessary to have a list of businesses and their telephone numbers. Some major directory providers obtain business listings from a subdivision of BT,⁸ known as BT Wholesale Directory Solutions, which operates the Operator Services Information System (OSIS) database,⁹ although other sources such as providers' own databases, commercial databases and lists of new business accounts bought from banks, are also used to supplement this data.¹⁰ The OSIS licence effectively requires that consent is obtained before a directory publisher uses this data. The publisher's staff contact each business to confirm its name and address, whether it wishes to appear (as a line entry, free of charge) in the directory, and under which classification it wishes to appear. Sales staff will subsequently contact those businesses which have confirmed that they wish to appear in the directory and seek to sell them an enhanced entry. Potential accounts

⁷See the summary of evidence from insurance companies on the CC website: www.competition-commission.org.uk/inquiries/ref2005/classdirec/third_party_submissions_insurance_companies.pdf.

⁸BT Group plc, see paragraphs 2.27 to 2.30.

⁹The OSIS database is a database compiled by BT based on all business telephone numbers in the UK and sold to major directory providers.

¹⁰Yell uses OSIS data for the purposes of comparing the information supplied with its own database in order to identify (and then contact) prospective new customers.

likely to have low value will normally be handled by telesales, although a new directory provider might make greater use of face-to-face contact in order to maximize its sales impact. Higher potential value accounts will be contacted by a field sales executive. Very high potential value accounts will normally be dealt with by a separate team, for example a national sales team.

- 2.13 An updated directory for each distribution area is typically published each year, and the national directory publishers will have a rolling publication programme, preceded by a sales campaign for advertisers in the relevant directory.

Classified directory publishers

- 2.14 Classified directories, as defined in our terms of reference, encompass a wide variety of publications, from large, comprehensive directories which together cover all parts of the UK, to very small 'community' directories distributed in just one town or village.

- 2.15 We distinguish two different types of classified directory offerings. Major directories provided by Yell,¹¹ Thomson¹² and BT are exhaustive, providing free line entries for all businesses, and advertisements. These directories tend to be large, have a high level of brand recognition and usage, and have national or near-national distribution. The directories published by Trinity Mirror¹³ and by Kingston¹⁴ have similar characteristics, albeit with much more limited distribution. Purely local directories, such those described in paragraphs 2.41 to 2.45 are smaller in size, have much lower levels of usage and usually have smaller geographic coverage than Yell, Thomson and BT.

¹¹Yell Group plc, see paragraphs 2.17 to 2.23.

¹²Thomson Directories Ltd, see paragraphs 2.24 to 2.26.

¹³Trinity Mirror plc, see paragraphs 2.31 to 2.37.

¹⁴Kingston Communications (Hull) PLC, see paragraphs 2.38 to 2.40.

2.16 The three largest directory publishers—Yell, Thomson and BT—together account for about 98 per cent of UK CDAS revenues.

Yell

2.17 BT's predecessor, the General Post Office, first launched *Yellow Pages* (known as BTYP) within its Brighton telephone directory in 1966. In 1973, the roll-out of stand-alone *Yellow Pages* began. In June 2001, BT sold its directory business (including the *Yellow Pages* brand) to a consortium of investment funds called Castaim Ltd (Castaim) which subsequently became Yell Limited and which, in July 2003, was listed on the London Stock Exchange.

2.18 Yell published in 2005/06 104 classified directories, entitled *Yellow Pages*, covering the whole of the UK. Yell also offers a telephone-based, operator-assisted classified directory service (118 24 7) and an Internet-based classified directory service, Yell.com. Yell's turnover for the whole business for the year ended 31 March 2006 was £1,621 million and for its UK CDAS business was £619 million.

2.19 In recent years, Yell has acquired a number of classified directory businesses in the USA, which are published under the Yellow Book name.

2.20 In April 2006 Yell announced that it had entered into an agreement with Telefonica SA to purchase its 60 per cent stake in Telefonica Publicidad e Informacion SA (TPI), the leading publisher of print and online directories in Spain. TPI also has significant positions in a number of Latin American countries, including leadership positions in Peru and Chile.

- 2.21 Yell's directories generally have a larger footprint than Thomson's or BT's. Since 2001,¹⁵ however, Yell has moved towards smaller footprints in a number of areas by subdividing directories, a process known as 'rescoping'. As a result, the average GMC of Yell's directories fell by around 20 per cent between 2001 and 2005.
- 2.22 By way of editorial content, the *Yellow Pages* directories have a section called 'Essential Information' which includes telephone numbers of helplines and emergency services; an area guide to shopping, entertainment and travel, with maps; and 'Consumer Information', explaining consumer rights when making a purchase and sources of consumer help and advice. At the beginning of some classifications, Yell includes general information produced in conjunction with the Department of Trade and Industry about, for example, choosing a solicitor.
- 2.23 At the end of each directory, Yell provides a Classified A–Z index. This lists its classifications alphabetically and also points the user to relevant classifications. For example, a user looking up 'Fascias' in the index will be given several different classifications in which to search. Unlike the other large directory publishers, Yell does not include an A–Z listing of businesses in its directories.

Thomson

- 2.24 Thomson has historically been the second-largest CDAS provider (although much smaller than Yell). Before 1980, Thomson had a contract with BT to sell its *Yellow Pages* advertising. In 1980, BT moved this business elsewhere and Thomson established its own classified directory business. Thomson has had a number of owners and since August 2000 it has been owned by SEAT Pagine Gialle, a leading European publisher of telephone directories, and the leading provider of CDAS in Italy.

¹⁵Yell had undertaken rescoping before this, but to a relatively small extent.

2.25 Thomson publishes 173 *Thomson Local* directories, covering about 90 per cent of all homes and businesses in England, Scotland and Wales; sparsely populated areas are not covered. Generally, its directories have a smaller geographic footprint than Yell's and it positions its product as a more 'local' directory. Thomson publishes other database products and services, including an Internet-based classified directory service, ThomsonLocal.com. For the year ended 31 December 2005, the turnover of SEAT's whole business was €1,425 million¹⁶ and the turnover of its UK CDAS business was £99 million.

2.26 In its *Thomson Local* directories Thomson includes an A–Z listing of businesses in its directories, including the Internet address of the business's website, if available. Each directory includes a 'Local Plus' section containing information on leisure and entertainment, community services, travel, maps and motoring. Local Plus also contains advertising from relevant businesses. At the end of each *Thomson Local* directory in England, there is a 60-page self-help guide produced in collaboration with NHS Direct.

BT

2.27 Having sold its classified directories business to Yell in 2001, BT re-entered the CDAS market in October 2002 by including a classified advertising section in its existing A–Z directory, the *Phone Book*. Under General Condition 8,¹⁷ BT is required to produce a printed directory containing an A–Z listing for every household and business that is a BT customer. Pursuant to European legislation, namely the Universal Service Directive,¹⁸ which came into force in 2002, BT has an obligation to distribute a directory annually, rather than every 18 months as it had been doing. At

¹⁶Equivalent to £975 million at the average exchange rate of €1.4621:£ for the calendar year 2005.

¹⁷Ofcom notification setting general conditions under section 45 of the Communications Act 2003.

¹⁸ Universal Services Directive 2002/22/EC.

the same time, BT decided to distribute a copy of the *Phone Book* to all households and businesses in the UK, rather than just to its own customers.

2.28 BT told us that it considered re-entry to the CDAS market to be an attractive opportunity, with the potential for BT to become a vigorous competitor. It was therefore willing to make the investment necessary to re-enter. An additional factor in its decision was the imminent liberalization of the provision of directory enquiries services, including the replacement of the BT 192 number. BT felt it would be important to have the ability to offer classified search options in response to expected demand from directory enquiries callers and to competition from new directory enquiries providers who would offer classified searches alongside traditional directory enquiries services.

2.29 BT commenced sales of classified directory advertising in October 2002. Three directories were published in the financial year ended 31 March 2003, 111 in the financial year ended 31 March 2004 and 171, covering the whole of the UK, in the financial year ended 31 March 2005.¹⁹ This aspect of BT's business is managed as part of BT Retail's Directories unit (BTD). BTD also includes operator services (118 500), and an Internet-based classified directory service called ThePhoneBook.com. The turnover of BT's whole business for the year ended 31 March 2006 was £19,514 million and of its CDAS business was £[redacted] million.

2.30 BT's *Phone Book* contains relatively little editorial content. Its preface, which runs to at least 17 pages, includes emergency contacts and various details which direct the user to the source of information most relevant to specific needs. In addition to

¹⁹ BT publishes directories covering 171 different localities. In 2005/06 four of these directories were published twice so that the total number of published directories for 2005/06 was 175.

information on telephony services, there is local information such as details for regional government and local authorities relevant to each Phone Book area.

Trinity Mirror

- 2.31 Trinity Mirror, which describes itself as the UK's largest newspaper publisher, publishes over 240 regional newspapers, five national titles and four sports newspapers, and generates sales in excess of £1,000 million. Its national newspaper division is formed of two operating companies: MGN Ltd and Scottish Daily Record and Sunday Mail Ltd. Its directory business was created by an initiative of its Scottish operating company.
- 2.32 Trinity Mirror launched its directory, *The One*, in 2004. In 2004, it published directories covering Glasgow and Edinburgh. In 2005, it published four directories covering Lanarkshire, Ayrshire, Edinburgh and Fife. In 2006, it aims to distribute [X] directories covering [X]. Although *The One* benefits from the *Scottish Daily Record's* advertising sales and marketing expertise and order processing systems, Trinity Mirror has told us that there is little overlap between its directory and newspaper advertisers. *The One* is, however, promoted in the *Scottish Daily Record*.
- 2.33 As well as a classified section, editions of *The One* include an A–Z listing of businesses containing just addresses and telephone numbers. These directories also include local emergency services telephone numbers and helplines.
- 2.34 In addition, they feature a series of local guides covering, for example, Health and Beauty which starts with general advice on health and fitness and is followed by a series of 'advertorials'²⁰ featuring suppliers. Analogous guides are provided on home

²⁰Copy in an editorial format produced in cooperation with an advertiser.

improvement, entertainment, shopping, sport and children's entertainment. Relevant advertising appears in these local guides.

2.35 Uniquely, editions of *The One* provide a 'Membership Card' which it runs in conjunction with the *Scottish Daily Record*. The card entitles users to discounts from a range of suppliers. Some of the suppliers included in this scheme are listed in the directory. To be kept up to date on offers available, users need to register with *The One*.

2.36 The Glasgow edition of *The One* also features a 146-page eating out guide. The guide is printed on glossy paper and is in full colour; it carries advertising. The guide is prefaced with advice on eating out and then covers restaurants by cuisine and also clubs and pubs in its 'After Dark' section.

2.37 For the year ended 1 January 2006, Trinity Mirror's turnover for its whole business was £1,122 million and for its CDAS business was £[~~] million.~~

Kingston

2.38 Kingston is the independent communications company which serves the Kingston upon Hull area. As the principal telecommunications provider in that area, it is required to provide a printed directory to its customers. This it does as a separate 'white pages' A–Z business and residential directory.²¹

2.39 In addition, it publishes a separate classified directory, *Hull Colour Pages*, for Kingston upon Hull and also a directory for the Isle of Man.²² Its classified directory includes an A–Z listing of businesses, with addresses, telephone and fax numbers of

²¹ 'White Pages' are an alphabetic business and residential listing, usually printed on white paper.

²² Directories in the Isle of Man are outside our jurisdiction.

the businesses concerned. Kingston's directory contains emergency services numbers and a local guide section covering travel, shopping, sports and leisure activities and helplines. The guide section carries some display advertising.

2.40 For the year ended 31 March 2005, Kingston's turnover for its whole business was £364 million and for its CDAS business was £[~~3~~] million.

Other directory publishers

2.41 There are a number of publishers of small local directories and their products vary widely in size and sophistication. A list of organizations publishing directories is provided as part of Appendix 1.1. We describe below directories which were mentioned as competitors by Yell, Thomson or BT.

2.42 Dentons Directories Ltd (Dentons) publishes 22 local directories, mainly in the West Country. Its directories tend to have relatively low circulations—less than 20,000—although it distributes over 60,000 copies of its Bath edition. The directories are A5 in format and black and white with a laminated cover. Local street maps are included. Dentons does not offer a comprehensive range of classifications, and its directories are mainly oriented to consumers rather than business services. Some free line entries are included but most line entries (bold or feint) are paid for. Dentons told us that it included free line entries if a classification had very few advertisements in it.

2.43 The Local Group of Directories Ltd (Tele-Pages) publishes 12 local directories in the Thames valley. The directories are of A4 size and have circulations of between 50,000 and 80,000. It offers various colour options, and its directories feature a local information section and map. A page of money-off coupons from advertisers is printed in each directory.

- 2.44 Capital Directories Ltd publishes a series of directories in London, north of the river. In total it distributes 500,000 directories. The directories are A4 in format. The cover is glossy and printed in colour, and full colour advertisements are available throughout the directory. Its West End directory runs to over 200 pages.
- 2.45 The Pink Local Directory Ltd (Pink) publishes four directories in East Anglia. The directories list all businesses within the relevant dialling code areas and are distributed to around 85,000 households in total. According to its website, Pink does not source its data from BT, but researches it itself and, as a result, includes up to 25 per cent more local businesses than other directories. It permits only local businesses to advertise in its directory (though including local branches of national businesses). The directory is in A5 in format with a glossy cover and offers monochrome advertising in its classified pages.

Other media for classified advertising

Regional and local newspapers

- 2.46 Regional and local newspapers account for half of the UK's total classified advertising revenues, but a large proportion of such classified advertisements are too short term to be suitable for the directory medium: 40 per cent is recruitment, 20 per cent is property, and 17 per cent is automobiles.²³ In addition, newspapers have much shorter shelf lives which make them more expensive to advertise in continuously on an annual basis, but make them more suitable for different types of advertising (such as special offers). In terms of usage, the figures compiled by Yell show that usage of regional and local newspapers in order to look at advertisements or for local information is very small compared with usage of printed directories, and declining.

²³Source: *Advertising Statistics Yearbook 2005*.

Classified advertising on the Internet

2.47 Much of the information provided by classified directories can now also be found on the Internet. Use of the Internet has grown rapidly since 2001 and continues to grow, particularly with the widespread adoption of broadband: Ofcom estimates that at the end of December 2005, there were 9.8 million broadband connections in the UK, up more than 50 per cent on December 2004; as at April 2006 we estimate that about 36 per cent of adults had broadband access at home.²⁴ In addition there is increasing use of handheld, portable devices (including Internet-enabled mobile telephones) for Internet access.

2.48 The paragraphs that follow describe Internet services through which consumers may identify potential suppliers of goods and services. These may be broadly divided into online directories and search engines/portals but the distinction is becoming somewhat blurred as search engines acquire directory content and online directory publishers increase the functionality of their search engines and the sophistication of their pricing models.

Online directories

2.49 The product characteristics and functionalities of online directories are similar to those of printed directories. However, online directories provide additional services, for example, mapping and directions.

2.50 Online directories provide users with access to a database of suppliers of goods and services that they have compiled. Yell, Thomson and BT each operate online directories. All three offer the basic 'business finder' search facility, through a template into which the user enters the type of business being sought and the

²⁴57% of adults live in households with Internet access and 63% of Internet households say they have broadband connections. Source: *The Communications Market: Nations and Regions*, Ofcom, 2006.

location required. Yell.com and ThomsonLocal.com allow the user to search by business type and name simultaneously. Yell.com's 'supersearch' facility allows the user to search for a particular brand stockist, eg Hotpoint.

- 2.51 Results from the search are displayed in slightly different ways by the three services. In BT's case,²⁵ a list of results is displayed with a link to an image of the advertiser's advertisement in the *Phone Book*. If advertisers have websites there may be links to these as well (including those hosted by Yell.com or ThomsonLocal.com) Some entries on the BT site have a mapping facility to show the user the advertiser's location. The user may also text the name and telephone number of the business to a mobile phone from the site.
- 2.52 Yell.com provides mapping and directions for all local businesses listed, including free entries. Paid-for local entries and entries by advertisers from outside the area specified in the search are displayed first in the list, followed by free entries.
- 2.53 The functionality of ThomsonLocal.com is similar to that of Yell.com. Maps and directions are provided for all entries. Links are available to an image of the business's advertisement in Thomson's print product, where they have one, and also to the business's website, if there is one.
- 2.54 In all three cases, an advertiser from outside the area specified in the search may pay to be included in areas other than the 'home' location. All three online directory publishers sell 'banner' advertising (akin to display advertising) as well as classified entries.

²⁵www.thephonebook.bt.com.

- 2.55 Online directory publishers generally charge advertisers a fixed fee for an advertisement which entitles them to greater prominence in the list of entries retrieved and allows them to add more information on the services they provide;²⁶ this contrasts with the pricing of Internet search engines which is somewhat more complex (see paragraph 2.64).
- 2.56 In addition to Yell.com, ThomsonLocal.com and ThePhoneBook.com, we found several smaller online directories which appeared to cover a reasonably wide range of classifications, including 192.com, Touch Local (touchlocal.com), near2me.uk and near.co.uk, telephone.co.uk, Kyotee.co.uk, Local.co.uk, lifestylelocal.co.uk and Townpages.com. Kingston, Dentons and Telepages also offer searchable databases.
- 2.57 Yell reported sales of over £59.6 million for Yell.com for the financial year ended 31 March 2006. For the calendar year 2004, Yell reported sales of £33.3 million for Yell.com and Thomson reported sales of £7.5 million for its internet services business. Using the total sales figure of £90 million for Internet directories in the *Advertising Statistics Yearbook*,²⁷ this would imply a 37 per cent share for Yell.com and an eight per cent share for ThomsonLocal.com of online directories. Total sales of online directory advertising, although growing, remain very small (just over 10 per cent) compared with total sales of printed CDAS.

Search engines and portals

- 2.58 It is clear from the evidence we have received that advertising on Internet search engines is playing an increasingly important role for advertisers.

²⁶Thomson offers advertisers the possibility of paying by pay-per-click for its online directory.

²⁷*Advertising Statistics Yearbook 2005*, p122, Table 10.1.

- 2.59 Consumers may use Internet search engines to find suppliers, although using the standard interface may produce a large number of irrelevant results. Further, search engines will only find websites and many small and medium sized enterprises (SMEs) do not currently have websites.²⁸
- 2.60 Google, MSN and Yahoo! have 'local' interfaces²⁹ specifically designed to help users find businesses in a particular area. Google's Local site is populated with data supplied by Yell. MSN's and Yahoo!'s equivalent services use Thomson data. This tends to overcome the problem of SMEs not having their own website, as the link is to the SME's web page hosted by Yell or Thomson. It will also help the user as more relevant content will be available. Google Local will retrieve other links, for example to other portals (like UFindUs) which carry listings, and to more general sites.³⁰ MSN Local retrieves both Thomson listings and web results.³¹
- 2.61 Google Local displays its list of results³² on a map, as does MSN Local,³³ rather than just providing a location map for each result .
- 2.62 Thomson has its own local search engine, WebFinder. This provides advertisers with the opportunity to gain prominence for their websites through its 'paid search' facility. It is also linked to a network of other search engines. Searches on WebFinder will generate links to, among others, UFindUs, Scoot, UpMyStreet as well as Google.
- 2.63 In revenue terms, paid search is the largest form of advertising on the Internet. Paid search is a means of gaining prominence compared with the standard results

²⁸Though they may have a web presence: a page on a directory website.

²⁹Google Local, MSN Local and Yahoo! Business Finder.

³⁰Search engines will find all sites where the relevant keyword appears. A search for 'cinema' would be likely to retrieve shops selling home cinema equipment, books on cinema etc.

³¹Although Thomson's print coverage of the UK is incomplete, its online data base is comprehensive.

³²Not all results have map locations.

³³MSN only locates the Thomson listings on the map, not web results.

generated by the normal operation of a search engine. Sites benefiting from this facility will appear at the head of the results list and/or on the right-hand side of the screen.

- 2.64 Internet search engines tend to use 'pay-per-click' pricing, so that the price paid by advertisers will depend directly on the amount of usage they get, unlike pricing in printed classified directories. The amount charged per click is usually the result of an 'auction' whereby businesses bid for keywords and the more popular the search term the higher the price will be. Advertisers making higher bids than others will tend to feature towards the top of the list.
- 2.65 Yahoo! Search Marketing and Google AdWords are two paid search products. In 2005, Thomson became a reseller of Google Adwords. As a result, searches on Google (rather than GoogleLocal) will retrieve links to ThomsonLocal.com advertisers that have bought AdWords.³⁴
- 2.66 Other search engines with a local business finder function include Scoot, AskAlix, UpMyStreet, Wanadoo, and UFindUs. UpMyStreet uses Thomson content for its business-finder service. Wanadoo's local channel is ThomsonLocal.com.
- 2.67 Other portals/search engines which provide a business finder service include Dogpile and Localcoverage.
- 2.68 There is a plethora of 'vertical' sites that cater for consumers seeking particular local business types which may also be popular search subjects on online directories. Squaremeal.co.uk, for example, contains listings and reviews for restaurants, bars, caterers, weekend breaks etc. Both GoogleLocal and Yell.com advertise on this site.

³⁴Searches on GoogleLocal, as noted elsewhere, will link to Yell content.

- 2.69 There are many portals in the area of travel and entertainment, for example lastminute.com, Expedia and e-bookers.
- 2.70 There are various aggregator (or 'scraper') services which, with some information from the user, search other sites for quotations. Confused.com, for example, obtains a variety of insurance premium quotations for customers. Reallymoving.com performs a similar function for consumers moving house and looking for removal quotes. Moneysupermarket.com provides a similar service in financial services.
- 2.71 As is noted above, much of the content of print directories can now be accessed via the Internet. However, the functionality of the Internet services described here is considerably more powerful than the print medium, and this may be particularly relevant in some sectors. For a consumer seeking a car insurance quotation, for example, a print directory may be a useful first step in terms of obtaining telephone numbers of insurance companies and brokers. On the Internet, the consumer can not only identify potential providers, but also invite quotes and actually complete the transaction in one online session. To this extent, the two may be seen as qualitatively different even though performing a somewhat similar function—in the same way that candles and electric light bulbs provide similar services (illumination) but have very different features.

European CDAS markets

- 2.72 We looked at CDAS markets in other European countries. As shown in Table 2, in the vast majority of cases, each national market is dominated by one provider.³⁵ In just two countries is the market split fairly evenly: Finland and the Netherlands.

³⁵Source: *Global Yellow Pages 2005*, The Kelsey Group.

TABLE 2 Domestic market shares of leading European CDAS providers

<i>Country</i>	<i>Market leader</i>	<i>Market share (%)</i>
Italy	Pagine Gialle	91
Germany	DeTeMedien	95
France	PagesJaunes	97
Spain	Pagina Amarillas	90
Netherlands	Gouden Gids	50
	Telefoongids Media	50
Sweden	Eniro	83
Norway	Findexa	94
Belgium	Pages d'Or	94
Finland	Eniro	51
	Fonteca	44
Ireland	Golden Pages	93

Source: CC, from *Global Yellow Pages 2005*, The Kelsey Group.

2.73 The situation in Finland has arisen as a result of action taken by the competition authorities there. In 2004, the Finnish Competition Authority ruled that a joint venture between Eniro and Fonecta, under which they copublished directories in Finland's two largest cities, was anti-competitive. They now face each other as direct competitors in these cities.

2.74 In the Netherlands, Telfoongids has captured a significant market share from Gouden Gids since 2000. According to The Kelsey Group, there is no single explanation for the shift in market share though 'one clear factor is strong leadership and solid execution by Telfoongids.' Kelsey goes on to note that some observers point to 'missteps' by Gouden Gids and refers, in this context, to its decision to match the product offering of Telfoongids by including a 'white pages' section in its directory. It adds that 'there are some signs that Gouden Gids is regrouping and will fight to regain market share from Telfoongids' citing management action by its new owner, World Directories.

3. Regulatory factors

History of the reference

- 3.1 As mentioned in paragraph 1.5, our current investigation follows a previous investigation. In March 1996, the MMC reported on the supply of CDAS;³⁶ it found that a monopoly situation existed in favour of BT in the supply of CDAS in the UK.
- 3.2 Following that report, in July 1996, undertakings were given under section 88 of the Fair Trading Act 1973 by BT in regard to its classified directory advertising business, Yellow Pages (BTYP). The key undertakings included a price control on advertising rate card prices³⁷ and a restriction on the publication of overlapping directories. Further details of the undertakings are given in paragraphs 3.6 to 3.15.
- 3.3 A review of the undertakings was announced by the OFT in May 2000 and a report was published in May 2001. The review found that effective competition was absent from the market and that effective competition from new entry was not likely in the foreseeable future. The OFT concluded that the lack of competitive constraint meant that the adverse effects identified by the MMC in 1996 would continue to exist without regulatory intervention. The OFT noted the growth in Internet advertising services but found that there was no strong evidence that such services offered strong competition to printed directories and that it remained to be seen how much they would constrain market power in the provision of CDAS in the future. As a result of the OFT review, the price control was strengthened by the Secretary of State to RPI –6 per cent; at the same time, certain obligations in relation to discount schemes were relaxed. BT gave undertakings accordingly in May 2001.

³⁶www.competition-commission.org.uk/rep_pub/reports/1996/383classified.htm#full.

³⁷Rate card prices were capped at the lower of: (a) the rate as set out in the July 1995 rate card; and (b) the immediately-preceding rate, adjusted by a factor of RPI –2 per cent a year.

- 3.4 In June 2001, BT sold the whole of the BTYP business (including the *Yellow Pages* brand) to Castaim, a consortium of investment funds, which subsequently became Yell Ltd and which was listed, in July 2003, on the London Stock Exchange. In June 2001, Castaim gave fresh undertakings to the Secretary of State, incorporating the changes referred to in paragraph 3.3. We refer to these as the ‘Yell undertakings’. The undertakings are reproduced in Appendix 1.2.
- 3.5 In its statement of reasons³⁸ for referring the supply of CDAS in the UK to us, the OFT stated that it had reasonable grounds for suspecting that there are features present in the supply of printed classified directory advertising services which prevent, restrict or distort competition. The OFT also said that while the undertakings given in 2001 were appropriate for the market conditions at that time, it was not clear that they remained appropriate to current market conditions.

The Yell undertakings

- 3.6 The Yell undertakings cover a number of areas, including the preparation and publication of separate accounts for the CDAS business (see paragraph 3.14); the publication of rate cards (see paragraphs 3.7 and 3.8); prices to be charged to advertisers (see paragraphs 3.9 and 3.10); and directory areas (see paragraphs 3.11 to 3.13). They also contain a good faith provision (see paragraph 3.15).

Rate card

- 3.7 Yell must publish a rate card containing details of all the prices it will charge to display advertisements in any edition of a classified directory, including details of all discount schemes, for the period set out on the rate card. Yell must make the rate card available to anyone requesting it.

³⁸The OFT's reasons for making the reference are published at: www.of.gov.uk/NR/rdonlyres/A9B3409E-5D42-499C-BF18-06C9BA415373/0/of787.pdf.

3.8 Yell provides the OFT with a master rate card on each update (eg in 2005 copies were supplied in April, June and October). The master rate card contains different rate card prices for each directory and different rate card prices for different types of advertisements. The rate card includes details of colour premiums and details of 'special pricing' (discounts), but the conditions for receiving a discount are not included. The rate card also includes details of rescoping offers. Actual rate card prices for each area come into effect at different times, depending on when the directory in question is published. The date of publication is indicated on the rate card which Yell publishes.

Prices

3.9 On the basis of a like-for-like comparison, starting from the base level of prices in effect as at 1 December 2001, Yell's rate card prices for advertisements in classified directories have been required to decline, relative to the RPI, by at least 6 per cent each year.³⁹

3.10 If Yell alters the distribution area for a directory, prices for advertisements featuring in the first edition of a rescoped⁴⁰ directory should not exceed the average of: prices charged for advertisements in the five directories with immediately greater GMC (see paragraph 2.9) and the five directories with immediately smaller GMC. Certain rate card prices are excluded from the calculation. If Yell extends the size of an area in which a directory is distributed, it must not increase the rate card prices for advertisements in that directory as a result.

³⁹Rate card prices were capped at the lower of: (a) the applicable rate for the same category of advertisement as set out in the December 2001 rate card; and (b) the immediately preceding rate adjusted by a factor of RPI -6 per cent.

⁴⁰Rescoping is described in paragraph 2.21.

Directory areas

- 3.11 Yell must ensure that a map showing the area in which each directory is to be distributed is included in each directory (the directory's 'distribution area').
- 3.12 Yell must not distribute a directory outside its distribution area, unless this is specifically requested by a user; or unless the distribution is to a neighbouring distribution area which (a) represents less than 5 per cent of the whole of that neighbouring area (calculated by reference to the directory circulation by number of households); and (b) where it can show that 55 per cent of households in that part of the neighbouring distribution area want that directory.
- 3.13 With some exceptions,⁴¹ Yell must ensure that the distribution areas for its directories do not overlap. This has the effect of preventing Yell from publishing more than one directory in any area. The background to this prohibition is discussed further in paragraph 6.128 and the footnote to paragraph 6.131.

Yell accounts

- 3.14 Yell must prepare discrete accounts for its printed directory business and send them to the OFT. In addition, it must also make them freely available to anyone who requests a copy.

Good faith provision

- 3.15 The Yell undertakings contain a 'good faith' provision whereby Yell must 'have regard ... to the objective' of the pricing obligations, namely to ensure that on the basis of a

⁴¹There are exceptions for: (a) overlapping directory distribution areas that existed when the undertakings were imposed; (b) areas in which there was no supplier other than Yell in 2003; and (c) areas in which users have requested a second directory in accordance with a mechanism set out in the undertakings.

like-for-like comparison, prices paid for advertisements in its classified directories decline by at least 6 per cent each year relative to RPI.

Competition law

3.16 In the UK, an abuse of a dominant position in a market is prohibited under Chapter II of the Competition Act 1998 (the Competition Act) and may be prohibited under Article 82 of the EC Treaty if there is an effect on trade between EU member states. These provisions can be enforced by the OFT, either on its own initiative or in response to a complaint, and fines can be imposed. In addition, a civil action may lie for damages or an injunction. The possibility of action under the Competition Act or Article 82 may therefore act as a constraint on the behaviour of a company which could be found to enjoy a dominant position in a particular market.

4. Trends in classified directory usage and advertising

Usage trends

4.1 As discussed above, advertiser demand for CDAS depends on usage of printed directories. We analysed several sources of data on usage of classified directory and other media:

(a) *The National Readership Survey (NRS)*. This provides an estimate of the number and type of readers of publications. It is widely used by publishers of newspapers and magazines, advertisers and advertising agencies to plan, buy and sell advertising space in print media. Every year, a total of some 36,000 individuals are interviewed for the NRS.

(b) *Yell User Study*. Yell tracks usage of its own and other companies' products within the context of the Regular User Study in terms of 'million of uses per month'.

(c) *BT Tracker Survey*. BT has recently (January 2005) started tracking data on usage of the classified section of its *Phone Book*.

(d) *Thomson's research into CDAS usage.* Thomson undertakes an annual survey using BMRB's telephone omnibus survey.

4.2 Overall, the data on usage suggests that classified directory usage has been declining over the past five years, although since BT's introduction of a classified section into its *Phone Book*, there are indications that total classified directory usage may have started to increase again. Usage of the Internet for searches similar to those in classified directories has risen sharply in the past five years; usage of the local press to look at advertisements appears to have declined.

4.3 Data supplied to us by the NRS suggests that usage of *Yellow Pages* fell between 2000 and 2005 but that usage of Thomson directories remained stable, though at about half the usage level enjoyed by *Yellow Pages*. In 2000, 29 per cent of respondents to the NRS claimed to have used *Yellow Pages* in the last seven days compared with 24 per cent in 2005. This equated to 13.6 million users in 2000 and 11.2 million in 2005, a fall of just over 17 per cent.

TABLE 3 **Estimated usership of Classified Directories in 000s as a percentage of population**

12 months ended:	December 2005		December 2000	
	'000s	%	'000s	%
All adults age 15+ in Great Britain	47,771	100	46,461	100
Used <i>Thomson Local</i> in last seven days*	5,599	12	5,764	12
Used <i>Yellow Pages</i> in last seven days*	11,228	24	13,568	29

Source: National Readership Surveys Ltd.

*The NRS also asks respondents about their use of directories in the last four weeks and the last 12 months. We have cited the responses for the last seven days because this is the closest to the question that Yell asks in its regular user survey and is also likely to be the most reliable data.

4.4 According to the Yell User Study, total *Yellow Pages* usage [X] by around [X] per cent between June 2000 and March 2005. Usage of Thomson directories is [X] *Yellow Pages* usage, and has remained relatively constant throughout the period,

with a slight increase in 2003 and 2004. The Yell User Study does not enable us to analyse trends in usage of BT's classified section. Usage of the local press, to look at advertisements or obtain local information, has fallen over the period by almost half. Internet usage for searches comparable to classified directory use has risen by over [redacted] per cent during the period. The figures do not, however, show a direct relationship between the changes in usage of *Yellow Pages* and the Internet; the timings of the most significant changes in these usage figures do not coincide.

TABLE 4 Yell's data on usage of different media, (MAT millions)

	1 June 2000	1 June 2001	1 June 2002	1 June 2003	1 June 2004	1 March 2005
Yellow Pages Thomson Local Press Internet	[redacted]					

Source: CC, based on Yell materials.

Notes:

1. These figures are expressed as moving annual totals of millions of uses, which express the value of a variable in a period of 12 months in order to factor out seasonal factors. Each month, the figure for the new month is added to the moving annual total, while at the same time the figure for the first month out of the former 12 is subtracted.

2. Yell compiles information on 'Yellow Pages equivalent Internet usage' by asking respondents who have used the Internet whether they could have used *Yellow Pages* for this instead, and therefore the measure is only an estimate of the part of Internet usage that is equivalent to *Yellow Pages* usage. Yell told us that this measure probably underestimates the Internet usage that is directly substitutable for *Yellow Pages* usage.

4.5 Yell told us that the latest figures showed that usage of *Yellow Pages* had [redacted] since March 2005. Yell also told us that its figures showed that usage of *The Phone Book* classified listings has [redacted] in the same period.

4.6 BT also tracks usage of classified directories as part of the BT Tracker Survey. The BT Tracker Survey started in January 2005 so full comparisons with Yell's survey are not possible. According to the BT Tracker Survey, the percentage of UK adults regularly using BT's classified directory has increased over the 13 months from January 2005. The number of uses per month of both BT's classified directory and classified directories overall have also increased during the same period.

- 4.7 The figures from the BT tracker survey suggest a slight decrease in the percentage of UK adults regularly using *Yellow Pages* over the 13 months from January 2005. In terms of number of searches per month, they apparently suggest a slight increase in *Yellow Pages* usage over the past year (by [X] per cent from January 2005 to December 2005), unlike Yell's regular study which suggests a decline in *Yellow Pages* usage. However, the difference between BT and Yell's results may be entirely due to the [X] margin of error in BT's estimates.⁴²
- 4.8 Thomson told us that it believed that usage of printed classified directories has increased over the last couple of years, through the BT entry and a period of increased advertising to users. Thomson undertakes an annual survey, the 'Thomson Usage Monitor', using BMRB's telephone omnibus survey (Access) of around 1,000 respondents; the survey is less regular than Yell's and is based on a relatively short questionnaire covering usage of print classified directories, the Internet and online directories. The Thomson Usage Monitor confirms Yell's much higher share of usage than Thomson's, but suggests Yell's share has declined, between 2003 and 2005, and that usage of Thomson directories has increased slightly between 2003 and 2005.

Advertising trends

- 4.9 According to the *Advertising Statistics Yearbook 2005*, total classified advertising expenditure has grown from £4,850 million in 2000 to £5,837 million in 2004, that is, a total growth of 20 per cent over the period (see Table 5). These figures include directory advertising (both print and online), classified advertising on the Internet,⁴³ classified advertising in the national and regional/local press,⁴⁴ as well as in consumer and business magazines. Within this, printed classified directory

⁴²BT told us that the margin of error [X].

⁴³Most of classified advertising on the Internet is recruitment.

⁴⁴Most of newspaper classified advertising is recruitment, property and automobiles.

advertising increased by 17 per cent over the period, and classified advertising in the local and regional press by 16 per cent. Classified advertising on the Internet experienced the strongest growth, from £64 million in 2000 to £419 million in 2004.⁴⁵ In 2005, total Internet advertising grew to £1.3 billion, of which paid search accounted for 56.2 per cent and classifieds 19.2 per cent. Between 2004 and 2005, search revenue grew by 79 per cent and classifieds by 62 per cent.⁴⁶ Within Internet classified advertising, Internet search engine advertising expenditure grew the fastest, from £8 million in 2000 to £258 million in 2004.⁴⁷ Revenues derived from search engine advertising remain less than one-third that of printed directory advertising revenues, and revenues from online directories are only about one-tenth that of printed directory advertising revenues.

TABLE 5 Total classified advertising expenditure

	<i>£ million</i>				
	2000	2001	2002	2003	2004
National newspapers	536	498	460	466	479
Regional newspapers	1,844	1,911	1,938	2,013	2,138
Consumer magazines	158	160	164	162	171
Business and professional	512	518	477	460	480
Directories	868	959	990	1,030	1,075
<i>of which:</i>					
Printed directories*	828	902	918	941	972
Online directories and CD-ROM	40	57	72	89	103
Internet classified advertising	64	82	112	230	419
<i>of which:</i>					
Recruitment	38	46	56	81	121
Paid-for search	8	19	42	138	258
Other	17	16	15	12	40
Total classified	4,850	5,087	5,131	5,391	5,837

Source: CC, from *Advertising Statistics Yearbook 2005*.

* Data for directory revenue is collected from directory publishers. Although a large proportion of the revenues shown derive from CDAS, information is also collected from publishers of specialist industry and commercial directories which are outside the scope of our investigation.

4.10 The strong growth in Internet advertising revenues has not been mirrored by a fall in printed directories revenues. Indeed, Yell and Thomson have managed to increase printed advertising revenues over the past five years, even though unit prices have

⁴⁵Source: 2000, 2004: *Advertising Statistics Yearbook*. 2005:

⁴⁶Internet Advertising Bureau.

⁴⁷The second-largest category was recruitment. Other categories would include property and automobiles on sites such as, for example, Fish4.

fallen. Yell increased its total print revenues by 18 per cent in nominal terms between 2000 and 2004, that is, an 8 per cent growth in real terms. Thomson increased total revenues by 20 per cent in nominal terms between 2000 and 2004, that is, a 9 per cent growth in real terms. Increases of revenues were obtained through increases in the number of advertisers, coupled with relatively stable revenue per advertiser.

4.11 The increase in revenues by Yell and Thomson, against the background of falling rate card prices, might suggest that demand is relatively responsive to prices. However, we believe it likely that other factors explain the revenue growth. Yell told us that it believed that the UK was ‘under-penetrated’ (ie that the number of businesses advertising in classified directories was relatively small) compared with other European countries.⁴⁸ Moreover, in some classifications, the increase in advertiser demand appears to have been led by competition between advertisers for ‘share of voice’⁴⁹ within classifications, driving advertisers to purchase larger and larger advertisements, rather than by price reasons alone.

5. Market definition

Overview

5.1 In this section, we begin by explaining the CC’s approach to market definition. We explain the sources of evidence we have used to analyse substitutability and switching patterns. We set out some factors which have complicated the market definition exercise in the present inquiry. We consider whether the reference services comprise one or more relevant economic markets (for example, individual classifications or advertisement types), or whether they form part of a wider economic market (for example, comprising the Internet or local newspapers). We end

⁴⁸According to the Kelsey report, advertiser penetration is indeed higher in Scandinavian countries, but is lower in the larger European countries.

⁴⁹‘Share of voice’ refers to the proportion, in volume or value terms, of a classification an advertiser has.

the section with our conclusions on the relevant product market and our analysis of, and conclusions on, the relevant geographic market.

Introduction to market definition

5.2 The relevant economic market is the framework for our analysis of the effects of market features.⁵⁰ There are normally two dimensions to the definition of a market: a product dimension and a geographic dimension. The key to market definition is substitutability, ie whether goods or services are economically interchangeable. This involves an analysis of the extent to which either: (a) customers can readily switch between substitute products, or (b) suppliers can readily switch to supplying alternative products.

5.3 We use the SSNIP test⁵¹ (also known as the hypothetical monopolist test) to analyse the extent of the market, which defines substitutability by reference to the extent to which a small non-transitory rise in the price of one product causes customers or suppliers to switch to another product. The framework is an iterative process: starting with the smallest conceivable economic market, we ask whether this could be monopolized profitably or whether substitute products would prevent this. The relevant market is the smallest group of products that could be profitably monopolized. We adopt the same process to define the relevant geographical market.

5.4 For the purposes of market definition, we are interested in switching by marginal customers following a hypothetical small increase in prices. Moreover, it is not necessary that these marginal customers switch all of their expenditure to other

⁵⁰The CC's approach to market definition in market investigations is set out in Part 2 of CC3, *Market Investigation References: Competition Commission Guidelines*, 2003.

⁵¹SSNIP stands for 'Small but significant non-transitory increase in price'. The SSNIP test is described in CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, paragraphs 2.4 to 2.25.

products; what matters is that a sufficient proportion of expenditure is switched in order to make a small price increase unprofitable.

Sources of evidence on substitutability and switching

5.5 As explained above, to test substitutability we have used the hypothetical monopolist framework and have examined empirical evidence of substitution and substitutability between advertisements in classified directories and other media. The main sources of evidence we used in order to assess substitutability were:

- the results of a quantitative survey of advertisers (the BMRB survey);
- the results of a qualitative study of large advertisers (the AIA study);
- data on pricing and revenues of CDAS and other potential substitutes; and
- the results of a survey of advertisers that lapsed or decreased spend with Yell, which was submitted to us by Yell (the FDS survey).

BMRB survey

5.6 We commissioned a telephone survey by BMRB of CDAS advertisers (the BMRB survey). BMRB drew a stratified random sample of advertisers of Yell, Thomson and BT, selecting advertisers in proportion to expenditure.⁵² BMRB also interviewed lapsed advertisers, advertisers in small directories, and advertisers with Kingston's *Hull Colour Pages* and Trinity Mirror's *The One* directory. We have made extensive use of the results of the BMRB survey in our analysis, reported below.

AIA Study

5.7 A survey of the type conducted by BMRB would be unlikely to report adequately the views of the largest advertisers, because they are few in number and yet represent a large proportion of revenues. We therefore also commissioned a study, by Andrew

⁵²This sampling strategy meant that the proportion of respondents expressing a particular opinion represented the proportion by value of advertisers who held that opinion.

Irving Associates (AIA), of the views of these advertisers (the AIA study). A relatively small number of very large advertisers contribute a significant proportion of CDAS expenditure; this pattern is particularly pronounced for Yell (Yell's top [X] per cent of advertisers generate over [X] per cent of Yell's CDAS revenue). AIA interviewed in depth executives responsible for purchasing CDAS, picked from 40 businesses within the 400 highest-spending CDAS advertisers.

FDS Survey

5.8 Yell submitted the results of a survey on substitution by advertisers that had ceased to advertise in Yell or decreased spend with Yell (the FDS survey). This survey is discussed in paragraphs 5.34 to 5.37.

Implications for market definition of aspects of the present case

Two-sided nature of market

5.9 Industries such as CDAS are described as 'two-sided markets'—providers of CDAS compete both for users and for advertisers. The value of CDAS for advertisers depends on the level of usage by consumers, which, in turn, depends on the total amount of useful advertising they find in these publications. This creates a 'network effect', by which more advertising attracts more usage which in turn attracts more advertisers. Because users do not pay directly for the use of CDAS, CDAS providers' profitability will be determined by advertiser revenues (although these, in turn, may be affected by usage); therefore we examined the market at the advertiser level.

Yell undertakings

5.10 The existence of price regulation created some difficulties for the application of the SSNIP test. Yell has reduced its rate card prices by the amount required by the Yell

undertakings in all directories.⁵³ Therefore, absent rescopings, there have been no movements in the relative rate card prices of advertisements in different directories. The absence of relative movements in Yell's local rate card prices made it difficult to define the relevant geographic market using data on past prices. The abilities of other market participants to vary relative prices have been indirectly affected by the Yell undertakings: Thomson and BT told us that they tend to set their prices with reference to Yell's published rate card (see paragraphs 6.47 and 6.50).

Effectiveness of classified directories

5.11 The BMRB survey and the AIA study asked advertisers for their views on the effectiveness of classified directories, in order to contribute to our understanding of why advertisers advertised in classified directories. A summary of the responses is set out below.

5.12 The BMRB survey asked current CDAS advertisers about the importance of classified directories to their business: 85 per cent of advertisers said that advertising in CDAS was 'fairly important' or 'very important' to them. The BMRB survey found that *Yellow Pages* was a very important source of new business for classified directory advertisers, with 32 per cent of national/regional advertisers,⁵⁴ and 18 per cent of local advertisers,⁵⁵ citing *Yellow Pages* as their second most important source of new business, after word of mouth.

5.13 The AIA study found that classified directories were a proven source of enquiries for large advertisers, and an established, first point of reference for users, being readily accessible and in the home. Because classified directories usually reach and target

⁵³As discussed in paragraphs 6.55 to 6.59, on certain occasions, following rescoping, the rate card prices for Yell's new directories have been set at levels below the maximum permitted by the undertakings.

⁵⁴As agreed with us, BMRB categorized 'national/regional advertisers' as the top 50 per cent of classified directory advertisers in terms of expenditure.

⁵⁵As agreed with us, BMRB categorized 'local advertisers' as the lower 50 per cent of classified directory advertisers in terms of expenditure.

consumers at the moment when they have made a decision to purchase, some AIA interviewees perceived them to be more effective than other media on a cost per lead basis. Some advertisers also thought that the relatively long shelf life of classified directories could be an advantage over other media. However, there was also a sense among the larger advertisers in the AIA study that the effectiveness of classified directories was declining slowly. Many of the advertisers surveyed were advertising in the more crowded classifications, such as insurance.

- 5.14 The AIA study found that large advertisers generally felt that they were dependent on classified directories as a source of sales and enquiries. In addition, the AIA researchers noted some conservatism among large advertisers, in that they appeared unwilling to switch away from tried and tested methods.

Potential substitutes to CDAS

Demand side substitutes

- 5.15 As set out in paragraph 2.3, CDAS are part of a wider advertising industry, and as such may compete with other media for a share of the advertisers' budget. The potential for switching to other media is likely to depend on the type of advertiser: there are likely to be differences according to the type of business considered, its size, its geographical coverage (eg depending on the suitability of the business for Internet shopping, or the type of users targeted), and the length of time the business has been advertising in classified directories.

- 5.16 The BMRB survey found that local newspapers, online directories and Internet search engines were the preferred alternatives to classified directories if classified directories were no longer available. 36 per cent of advertisers said that they would advertise in local newspapers if no classified directories were available, and 34 per cent on the Internet (19 per cent on online directories and 20 per cent on Internet

search engines). Therefore, we concentrated our analysis of substitution mainly on local newspapers and on Internet advertising.

Supply side substitutes

5.17 The most likely candidates for supply-side substitution⁵⁶ would be providers of other types of media (eg local newspapers). However, the potential for supply-side substitution from other media into CDAS seems to be very limited because of the existence of barriers to entry into CDAS provision (due to the existence of network effects and the need to establish a strong brand identity). Barriers to entry are discussed in paragraphs 6.110 to 6.122.

5.18 We consider below first whether the relevant market for CDAS may be narrower than all classified directories. We then analyse whether the relevant market for CDAS might include the Internet, then whether it might include newspapers or other media.

Narrower market than all classified directories

Individual classifications

5.19 We considered whether there might be separate markets for individual classifications (corresponding to different types of advertisers). Most classifications are not substitutes for each other from the point of view of advertisers. However, directory providers can generally provide all relevant classifications, and are able readily to switch supply of advertisements between these classifications; this potential for supply-side substitution indicates that individual classifications do not form separate markets.

⁵⁶See CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, paragraph 2.19.

Advertisement type

5.20 Although there are different advertisement types within directories (in terms of size, and whether they are coloured or monochrome advertisements), the potential for demand- and supply-side substitution between these products makes it unlikely that the market would be defined at individual advertisement type level, and therefore we start our analysis from classified directories.

Small directories

5.21 Classified directories, within our terms of reference, encompass a wide variety of publications. In paragraph 5.69, we consider whether there is a relevant market for both (a) those major directories that are large, have a high level of brand recognition and usage, and have national, or near-national, distribution; and (b) those directories that are smaller in size, which have much lower levels of usage and usually smaller geographic coverage than the major directories. Some directories may not fall clearly into one of these categories, but rather share some characteristics with (a), and other characteristics with (b). This is discussed further in paragraph 5.68.

Wider market than all classified directories—Internet

5.22 Online directories and advertising on Internet search engines were described in paragraphs 2.47 to 2.71. This showed that these types of advertising fulfil similar functions to CDAS advertising. Paragraph 4.9 showed that classified advertising on the Internet has been growing rapidly in the past five years—in particular, paid-for search.

Current levels of advertising on the Internet by CDAS advertisers

5.23 The BMRB survey found that 29 per cent of current classified directory advertisers were also using Internet-based forms of advertising to promote the business that they publicized in classified directories (18 per cent online directories and 17 per cent

search engines). Advertising on the Internet was more widespread for large advertisers than small advertisers.

5.24 Yell provided data on its own advertisers, which indicates that the proportion of its printed advertisers that also advertise in Yell.com has increased from [x] per cent in the financial year ended 31 March 2003, to [x] per cent in the financial year ended 31 March 2004, to [x] per cent in the financial year ended 31 March 2005. The penetration of Yell.com varies widely depending on the classification: Yell provided data for its top 20 classifications by usage, which shows that, within these 20 classifications, the proportion of *Yellow Pages* advertisers that also advertise on Yell.com varies from [x] per cent for take-away food to [x] per cent for hotels and inns (the broader geographical scope of online advertising is particularly attractive to hotels). In the financial year ended 31 March 2005, Yell had 141,000 Yell.com advertisers and 478,000 printed advertisers. Most Yell.com advertisers also advertise in *Yellow Pages*; only [x] per cent of Yell.com advertisers do not.

5.25 Thomson told us that the proportion of its print directory advertisers that now purchased online advertising units had [x] from [x] per cent in 2000 to [x] per cent in 2004, and [x] per cent for 2005. Unlike Yell, Thomson usually sells its online advertising as a package with its printed advertising (so that an advertiser that does not want to advertise online must opt out of the Internet option). This is likely to have encouraged Thomson's CDAS advertisers to advertise in its online directory.

Possible barriers to switching between CDAS and the Internet

5.26 For those advertisers not already advertising on the Internet, we analysed whether there were any barriers to switching between CDAS and the Internet. There do not appear to be any intrinsic costs of switching between printed and online directories

for advertisers and the advertiser does not need to have a website in order to advertise in an online directory.

5.27 There may be more switching costs between CDAS and advertising using Internet search engines. In order to advertise on Internet search engines, it is necessary for the advertiser to have their own website, which could create a switching cost. However, the BMRB survey found that 84 per cent of national/regional advertisers, and 58 per cent of local advertisers already had a website. We were also told that acquiring a website rapidly is possible, and at a low cost. Therefore, we do not think that ownership of a website is likely to create any significant switching costs for most advertisers.

5.28 The pricing structure for Internet search engine products is very different from the pricing structure for classified directories, which makes price comparisons difficult and could create a switching cost. However, Yell told us that pay-for-performance (which the pay-per-click mechanism provides) was attractive to some advertisers, since it held the provider accountable for advertising results. Our survey showed that over one-half of respondents said that they believed that it was easy to switch from CDAS to other media.

Substitutability of search engines and online directories for CDAS

5.29 The lack of barriers to switching, and the fact that almost one in three CDAS advertisers already use some form of Internet advertising, does not necessarily indicate that the Internet is part of the CDAS market. Internet advertising could be used as a complement rather than as a substitute to CDAS. We therefore analysed the evidence on switching between CDAS and the Internet, as well as evidence on the extent to which the growth in Internet advertising has constrained CDAS prices.

Evidence on switching from CDAS to the Internet

- 5.30 The BMRB survey asked advertisers a number of questions on whether they had ceased or started advertising in classified directories. It also asked whether advertisers had increased or decreased their expenditure on classified directories in the past three years, and if so, whether they had switched to, or from, other directories or other media.
- 5.31 According to the BMRB survey, 38 per cent of advertisers that had lapsed from CDAS had switched the expenditure to other media (15 per cent to local newspapers and 9 per cent to some form of Internet advertising), but the proportions of advertisers that have completely lapsed from CDAS are low: we estimate, based on our survey and on data provided by the parties, that those lapsing completely from CDAS are about 9 per cent of the total advertiser base. Thus, the BMRB survey indicates that fewer than 1 per cent of all CDAS advertisers had lapsed from CDAS in order to switch to Internet advertising. The majority of lapsed advertisers are likely to be businesses that have been closed during the period. Indeed, Yell estimated the rate of business closures to be of the order of 5 to 6 per cent in a six-month period.
- 5.32 The BMRB survey found that only 6 per cent of CDAS advertisers said that they had decreased spend in a directory in the past three years and switched the expenditure to other media, and of these, approximately one-half switched the expenditure to some form of Internet advertising (online directories, search engines or advertisement words). Thus, the BMRB survey indicates that about 3 per cent of classified directory advertisers decreased expenditure in a directory in order to switch to some form of Internet advertising in the past three years.
- 5.33 Yell told us that a business might decide to reduce the amount spent on CDAS because it has a good website. However, it is not clear that this would make the

business more likely to reduce its remaining CDAS expenditure in response to a price increase. We do not think that this pattern of behaviour is likely to change the appropriate market definition.

5.34 Yell submitted the results of a survey on substitution among certain of its lapsed advertisers and those reducing spending (the FDS survey). Yell argued, based on the results of the FDS survey, that levels of switching to other media, and to the Internet, were higher than those found in the BMRB survey. About two-thirds of respondents either:

- said after prompting that they had cut advertising with Yell because they preferred the other media or other classified directories they used; or
- said that they were using other media or other classified directories as a result of cutting advertising with Yell; or
- said that they had recently increased spend in other media or other classified directories; or
- said that they intended to increase spending in other media or other classified directories⁵⁷ in the next year; or
- intended to increase spending in other media or other classified directories at some time in the near future.

5.35 FDS asked which advertising media these advertisers were using in preference to *Yellow Pages*, where they were spending more, or where they intended to spend more. FDS surveyed three groups of advertisers (advertisers placing adverts in 'Gold' classifications,⁵⁸ advertisers placing advertisements in 'Silver' or 'Bronze' classifications⁵⁹ and London-based advertisers; Yell's classification systems are

⁵⁷FDS reported that intentions to increase spending in the next year included a range of media or other directories but none was foremost.

⁵⁸Excluding London.

⁵⁹Excluding London.

explained in paragraph 6.14). We noted that the sample sizes were small and so can only give a broad indication of proportions; advertisers were allowed to give multiple responses so that a single advertiser was able to indicate more than one alternative to *Yellow Pages*. The proportion of respondents who mentioned their websites ranged from [X] to [X] per cent. [X] to [X] per cent mentioned other Internet use, with more mentions by London advertisers who had reduced spend with Yell. [X] to [X] per cent mentioned local newspapers, with fewer mentions by those reducing spend and by lapsing London advertisers. [X] to [X] per cent mentioned BT, and [X] to [X] per cent mentioned Thomson. About [X] per cent mentioned specialist magazines, direct mail or leaflets. Other media were mentioned less often.

5.36 One difference between the FDS survey and the BMRB survey is that FDS asked advertisers who had lapsed or reduced spend with Yell whether they were intending to increase expenditure on other media or other classified directories in the next year or the near future. Yell argued that the BMRB survey would fail to capture some switching because of timing issues: an advertiser may have decreased or ceased spending with Yell, but only increased spending on another media or other directories after being surveyed. We accept that this may be the case for advertisers that are considering switching to other directories because the length of the publishing cycle for directories can create a lag in their response. This is less likely to be an issue when switching to other media such as newspapers or the Internet because these can be switched to at any time.

5.37 Another difference between the BMRB survey and the FDS survey is that the FDS survey adopted a very wide characterization of substitution that was insufficiently clear-cut to establish a connection between reduction in expenditure with Yell and increases in expenditure on other media. However, in certain questions, FDS had asked about a linkage between decreases in Yell spending and spending on other

media and these were similar to questions BMRB had asked; we found that results from these questions were similar to the results from the BMRB. FDS found that [X] to [X] per cent of lapsed Yell advertisers had switched to the Internet, and [X] to [X] per cent said that they were spending more on their website. [X] to [X] per cent of advertisers having reduced their expenditure on *Yellow Pages* were spending more on the Internet, and [X] to [X] per cent were spending more on their website. Using information from Yell,⁶⁰ we estimated that advertisers that had either lapsed or decreased expenditure with Yell within a six-month period, and had switched to Internet advertising or were using websites, represented very few (at most [X] per cent)of Yell's advertiser base according to the results of the FDS survey.⁶¹

5.38 The BMRB survey also showed that the level of switching from other media to CDAS in the past three years was limited, with only 3 per cent of advertisers that increased their expenditure in a directory having switched the expenditure from other media.

5.39 The results reported above for the BMRB and the FDS survey do not isolate advertisers switching to the Internet for reasons related to the relative pricing of directories and Internet advertising. We consider that a number of those that switched to the Internet did so for reasons independent of price. The Internet is a relatively new medium, and, as such, is likely to have attracted businesses for which online advertising is particularly suitable, independent of price differences between Internet advertising and classified directories (eg businesses suitable for online purchasing and businesses, such as hotels, which will want to attract business from outside their local area).

⁶⁰Yell provided data on the percentage of lapsed advertisers and of advertisers having decreased their expenditure.

⁶¹There may be some overlap in responses, ie advertisers that said that they switched both to the Internet and to using websites, and therefore this is an upper bound for the proportion of customers who switched.

5.40 BMRB asked lapsed advertisers why they had stopped advertising in classified directories, and the majority (52 per cent) said that this was because CDAS was not effective in generating sales leads. 25 per cent said that this was because CDAS was not good value for money, with a further 7 per cent saying that this was because of price increases. Lapsed advertisers were also asked whether they would advertise in CDAS again if the price of CDAS were to fall. Almost six in ten said that they would not advertise in CDAS again no matter what the price reduction was, while only one in eleven said that they would advertise again given a 5 per cent price reduction. The responses to both of these questions suggest that most of the switching had occurred for reasons other than price.

Large advertisers' attitudes to CDAS

5.41 The AIA study of large advertisers found that there was a widespread belief that the Internet was beginning to erode the popularity of CDAS, but that this was a slow process. It appears from the AIA study (confirmed by evidence from large insurers) that large advertisers would be more likely to advertise using search engines rather than online directories.

5.42 Many of those advertisers with an interest in, and an awareness of, the Internet believed that it was beginning to generate a substantial level of enquiries, and most believed that there would be a growth in the enquiries and sales generated by the Internet in coming years. However, the Internet was seen as a less obvious and less relevant source of enquiries for certain situations (eg emergencies in the house), or for older users.

5.43 Although some large advertisers interviewed by AIA believed that as volume of Internet business increased, they would invest in online opportunities with a possible reduction in CDAS expenditure, it is clear from the AIA study that there was a

reluctance to move away from CDAS until the Internet became an established source of business. This applied in particular to those advertisers for whom CDAS provided an established 'shop window' for their business.

Pricing responses to Internet

5.44 We analysed Yell's pricing policy and realized prices for classified advertisements, and the extent to which Yell's prices and pricing policy had responded to the growth in Internet advertising. Although Yell's prices have been falling over the past five years, in our view our analysis of prices in paragraph 6.55 shows that the entire fall in the prices of more than half of Yell's advertisements is attributable to the price regulation imposed by the Yell undertakings.⁶² Indeed, rate card prices have fallen by exactly the amount required by the price cap. Yell offers discounts to certain advertisers (these discounts are described in paragraphs 6.13 to 6.21); these discounts have the effect of lowering prices below the levels required by regulation for 35 per cent of advertisements.

5.45 We analysed whether Yell's discount schemes were a reaction to the growth of the Internet. The Internet is more suitable for certain types of businesses than others, and therefore we examined whether Yell's discount policy appeared to be targeted at those types of advertisers that are most likely to switch to the Internet. However, we found that Yell's discount policy was mainly targeted at new advertisers and advertisers renewing their expenditure for the first time, rather than at existing advertisers who were decreasing their expenditure with Yell. The only discounts to established advertisers were 'move-up' discounts—discounts to advertisers increasing their expenditure with Yell. Yell did not offer discounts aiming at providing incentives for established advertisers to maintain their expenditure with Yell.

⁶² As discussed in paragraph 6.57, Yell disagrees with our interpretation of the undertakings and therefore with this analysis.

5.46 Although Yell does offer different discounts to new advertisers depending on their classification (described in paragraph 6.14), Yell's segmentation of classifications into the three different discount tiers (Gold, Silver and Bronze) depends mainly on the penetration of the classification and the potential return to advertisers; we found no indication that Yell's discounts had been directed towards those advertisers that were likely to switch to the Internet. In particular, Yell's segmentation of classifications into discount tiers does not depend on the extent to which a classification has been losing revenues to the Internet or to other media. We note that Yell has eliminated the new advertiser discount for car insurance, a classification that uses the Internet heavily.

Growth in CDAS revenues in classifications popular on the Internet

5.47 The growth of Internet advertising has not prevented total CDAS revenues from growing. We analysed the growth of Yell's printed revenues for its top 20 online classifications over the past five years (year ended 31 March 2000 to year ended 31 March 2005) in Appendix 5.1. One of the top 20 classifications was 'special advertising', which we did not analyse further because it does not correspond to an identifiable classification in the *Yellow Pages*. We found that 14 out of the 19 other classifications had experienced [redacted] in revenues over the period. Five classifications had experienced a [redacted] revenues over the period. These were: [redacted]. In four of these five classifications, [redacted] and [redacted], which means that total volumes of advertising or size and colour level of the advertisements purchased must have increased during the period. Only one classification [redacted] over the period—[redacted] over the period. [redacted] was also the [redacted] classification [redacted].⁶³

5.48 We also analysed the growth in Yell's revenues for the classifications which are most popular on Internet search engines. Revenues in the [redacted] in real terms, while

⁶³ In the 2004/05 publishing cycle, [redacted] was Yell's [redacted] revenue generating classification in *Yellow Pages* and generated [redacted] per cent of Yell's print classified revenue.

revenues [✂] in real terms. Almost half of the classifications analysed were receiving the maximum discounts under Yell's discount scheme for new advertisers and advertisers renewing for the first time; this may suggest a price reaction by Yell in some of these classifications, although these discounts are for new advertisers only and therefore are unlikely to affect the decision of an existing advertiser considering switching to the Internet.

5.49 Overall, the evidence shows that, up to now, switching (including partial switching or reweighting of expenditure) between advertising in printed classified directories and advertising on the Internet has been limited. In addition, our analysis of Yell's prices and pricing policy shows that Yell's pricing policy does not appear to be targeted to respond to the growth in Internet advertising.

5.50 Moreover, it is likely that a number of those that switched to Internet advertising did so for reasons independent of price. Indeed, the Internet is a relatively new medium, and, as such, is likely to have attracted businesses for which advertising on the Internet is particularly suitable, independently of price differences between Internet advertising and classified directories.

Wider market than all classified directories—newspapers

5.51 The BMRB survey showed that newspapers were the most popular other media used by classified directory advertisers, with 38 per cent of current classified directory advertisers also advertising in local newspapers, and 14 per cent in regional newspapers. The BMRB survey also found that local newspapers would be the most popular substitute advertising media should classified directories not be available (see paragraph 5.16).

- 5.52 However, as explained in paragraph 2.46 most classified advertising in newspapers tends to be for different purposes than classified advertising in classified directories: the large majority of classified newspaper advertising is for cars, homes and recruitment. In addition, the much shorter shelf life of newspapers makes them expensive to advertise in continuously on an annual basis, and makes them more suitable for different types of advertising (such as special offers) which are not suitable for classified directories.
- 5.53 Yell provided some data on newspaper advertising prices which suggested that they had risen during a period when CDAS prices had fallen. BT provided some data that showed that newspaper prices were, for a given circulation, much higher than those for CDAS. However, newspaper prices tend to be individually negotiated, so list prices and average prices may be a weak guide to realized prices for CDAS comparable advertisements.
- 5.54 The BMRB survey showed limited levels of switching from CDAS to newspaper advertising. Of the 9 per cent of advertisers which we estimated had lapsed completely from CDAS, 15 per cent had switched to advertising in local newspapers and 2 per cent to advertising in regional newspapers, representing around 2 per cent of total CDAS advertisers. The BMRB survey found that only 6 per cent of CDAS advertisers said that they had decreased spend in a directory in the past three years and switched the expenditure to other media, and of these 12 per cent had switched to local newspapers, and 3 per cent to regional newspapers, bringing the total proportion of advertisers who had decreased spend with a directory and switched to advertising in newspapers to less than 1 per cent.
- 5.55 The FDS survey (which we discussed in paragraphs 5.34 to 5.37) also found similar levels of switching to newspapers in responses to the question which established a

link between decreases in Yell spending and spending on other media: [x] to [x] per cent of lapsed Yell advertisers were spending more on the local press as a result of lapsing from *Yellow Pages*, and [x] to [x] per cent of advertisers reducing their expenditure with *Yellow Pages* were now spending more on the local press.⁶⁴ In total, advertisers having either lapsed or decreased spend with Yell within the sample period and switched to the local press represented a small proportion (around [x] per cent) of Yell's advertiser base.

5.56 We also analysed the levels of switching from newspapers to CDAS, as one would expect such switching to occur if newspapers and CDAS were in the same market, given that CDAS prices have tended to decrease while newspaper advertising prices have tended to increase. As reported in paragraph 5.38, there have been very limited levels of switching from other media to CDAS in the past three years, with only 3 per cent of advertisers that increased their expenditure in a directory having switched the expenditure from other media. The BMRB survey also analysed new CDAS advertisers. There were very few new CDAS advertisers, and the vast majority of these new advertisers had not switched expenditure from other media (92 per cent); this was partly explained by the fact that the majority of new advertisers to CDAS were in fact new businesses.

5.57 According to the AIA study of large advertisers, local newspapers and magazines were generally seen as a rather less cost-effective medium than classified directories by large advertisers. It is clear that the large advertisers interviewed by AIA do not view newspapers as a substitute to classified directory advertising, in that those that do use them do so for different types of advertising than classified directory advertising.

⁶⁴Proportions spending more on local papers were much lower for London advertisers.

Wider market than all classified directories—other media

5.58 The evidence we have received suggests that other media (such as radio, television, and direct mail) are not substitutes for CDAS. Indeed, these media tend to be used for different purposes than advertising in classified directories (advertising to create demand, rather than directional advertising). In addition, the BMRB evidence showed very limited levels of switching between CDAS and these other media. The AIA study of large advertisers confirmed that these other media (including television) were used by advertisers for different purposes from advertising in classified directories.

Critical loss analysis based on the BMRB survey

5.59 Yell submitted a detailed critical loss analysis to the CC, based on the answers to a question in the BMRB survey, which it said showed that the economic market was wider than CDAS. This question in the BMRB survey asked current advertisers whether they would change their advertising behaviour in the event of a 5 per cent increase in the price of advertisements in all directories. Over half (55 per cent) of advertisers said that they would not change their advertising behaviour while one in eight (13 per cent) would switch to a different advertising medium. 6 per cent said that they would stop using classified advertising. Among those respondents, one-half would stop advertising altogether and one-half would stop advertising just in classified directories. 8 per cent would change the size of their advertisement, and a further 7 per cent would reduce their expenditure on advertising.

5.60 Critical loss analysis estimates the proportion of sales that would need to be lost in order for a price increase not to be profitable at current levels of margin. We have examined Yell's analysis and conducted our own examination of the data. Critical loss analysis shows that, if we use the answers to the hypothetical 5 per cent price increase question from the BMRB survey, a 5 per cent increase in the price of all

CDAS would not be profitable if margins are higher than 40 per cent.⁶⁵ If margins are below 40 per cent, the profitability would depend on the proportion of CDAS expenditure switched by those advertisers that said that they would switch or reduce expenditure without completely ceasing to advertise in CDAS.

5.61 We consider that Yell's critical loss analysis should be treated with caution: Yell's analysis relies on the answer to a single question in the BMRB survey and the responses to this question are inconsistent with the balance of other evidence. Evidence on actual behaviour from a range of sources (eg volume data provided by the parties, answers to other questions in the BMRB survey) suggests that the levels of actual switching between CDAS and other media (discussed above) were lower than the responses to the hypothetical 5 per cent price increase question. There are also inherent problems using critical loss analysis in markets where there may be market power.⁶⁶

5.62 Therefore, for the above reasons, we do not think that this analysis provides strong evidence that other media should be included in the market.

Retention rate patterns

5.63 Yell argued that, even though its revenues had been increasing over the past five years, its retention rates⁶⁷ had been declining, which was an indication that it was facing increasing competition from the Internet and other media. Yell provided data which shows that retention rates have fallen from 83 per cent in the financial year

⁶⁵For the purpose of market definition, the relevant margin is the margin on marginal sales. Yell estimated that its incremental profit margin was [§<] per cent for 2004/05, based on an estimate as to the costs that would be saved in the medium term if it faced permanent quantity reductions of a magnitude consistent with the BMRB survey results. However, we note that this margin was calculated on the basis of average prices. The range of prices charged by Yell is very wide because of the existence of different advertisement types and of discounts to certain customers, and therefore this margin does not necessarily represent the margin on the marginal customers that would be lost in the event of a price increase.

⁶⁶Where margins and levels of switching are higher than they would be in a competitive market, the estimated loss due to a hypothetical price rise may be higher than in a competitive market.

⁶⁷Retention rates in year 1 are calculated as the number of customers in year 0 who continued advertising in year 1, relative to the total number of customers in year 0.

ended 31 March 2001 to 75 per cent in the financial year ended 31 March 2005. Yell acknowledged that part of this fall was likely to be attributable to the fact that Yell was attracting increasing numbers of new advertisers, which tended to have lower retention rates in their first year of renewal, than others. Yell provided data on retention rates for non-first-year advertisers and for advertisers that have been with Yell for at least three years. Retention rates for non-first-year advertisers fell less quickly, from [X] per cent in the financial year ended 31 March 2001 to [X] per cent in the financial year ended 31 March 2005 (ie a drop in [X] percentage points compared with [X] percentage points for overall retention rates).

5.64 Yell also provided data showing that retention rates for advertisers that have been with Yell for at least three years have also fallen, although less quickly than retention rates for all advertisers. Retention rates for advertisers that have been with Yell for at least three years fell from [X] per cent in the financial year ended 31 March 2003 to [X] per cent in the year ended 30 June 2005. During the same period, retention rates for all advertisers fell from 78.9 to 73.1 per cent, ie a fall of 5.8 percentage points compared with [X] percentage points for advertisers that have been with Yell for at least three years.

5.65 We do not consider that the decline in *Yellow Pages* retention rates is strong evidence of increased competition from other media for the following reasons:

- (a) the decline has been modest and retention rates remain high;
- (b) some of the decline is likely to be attributable to competition from other CDAS providers and, in particular, BT's entry; and
- (c) the decline is explained, in part, by the increasing proportion of relatively new advertisers, retention rates for newer advertisers typically being relatively low.

5.66 Our analysis of the data provided by Thomson shows that it has managed to increase its retention rates over the period: retention rates increased from [X] per cent in 2000 to [X] per cent in 2002; they remained stable at [X] per cent in 2003 and 2004, and dropped slightly in 2005 to [X] per cent.

Small directories

5.67 Classified directories within our terms of reference encompass a wide variety of publications. There are two main types of classified directory offerings: (a) those major directories that are large, have a high level of brand recognition and usage, and have national or near-national distribution; and (b) those directories that are smaller in size, which have much lower levels of usage and usually smaller geographic coverage than the major directories. We considered whether the relevant product market comprises both types of publications.

5.68 The directories published by Yell, Thomson and BT clearly fall into category (a) above. The directories published by Kingston and by Trinity Mirror do not fit clearly into the categories described above. Although local by nature, they have some important characteristics in common with the directories described in category (a): they are large directories and have a high level of brand recognition and usage in the areas where they are distributed. For these reasons, we consider that the directories published by Kingston and by Trinity Mirror are part of category (a) above, although it is not possible to draw a clear line and to determine with certitude which directories with limited geographic coverage form part of category (a).

5.69 We considered whether small classified directory providers would constrain a hypothetical monopolist of a market for major classified directories or existing providers of major classified directories and concluded that they would not. The BMRB survey showed that advertisers using directories provided by Yell, Thomson

and BT only advertised in other smaller directories to a very limited extent: only 4 per cent of advertisers had advertised in them in the past three years. This evidence suggests that the likelihood of advertisers in the major classified directories switching all or some of their expenditure to smaller classified directories in response to a 5 per cent price increase in major classified directories is low. Therefore, in general we do not expect small CDAS providers to constrain the prices charged by the major CDAS providers.

5.70 We also considered whether major classified directory providers would constrain a hypothetical monopolist of a market for small classified directories or existing providers of small classified directories and concluded that, in many cases, they were likely to do so. The BMRB study showed that over 70 per cent of advertisers in the smaller directories used at least one of Yell, Thomson and BT as well.

5.71 Yell's user survey showed that the usage of these smaller directories was likely to be limited: when asked which directories they had at home, [X] per cent of users said that they had the *Yellow Pages* for their area, [X] per cent that they had *Thomson Local*, and [X] per cent said that they had BT's *Phone Book*, [X] per cent said that they had another type of local directory⁶⁸ (although [X] per cent of Edinburgh users had a copy of Trinity Mirror's *The One*).

5.72 This evidence described above shows that there is a possibility that advertisers in the small classified directories would switch all, or some, of their expenditure to the major classified directories in response to a 5 per cent price increase in small classified directories. Therefore, we expect major CDAS providers to constrain the prices charged by the small CDAS providers, at least to some extent.

⁶⁸These are national averages; it is likely that the proportions using local directories in areas where these directories are present would be higher.

Non-classified advertising in classified directories

5.73 BT told us that advertising in the A–Z listings of directories and advertising in classified listings serve different purposes. Advertising in A–Z listings is not generally a way to generate sales leads because users looking in the A–Z listings already know the name of the company for which they are looking. It is often a way to provide a service to existing advertisers rather than to generate sales leads, eg by helping them find the correct contact details. BT argued that, in this sense, A–Z advertising was more a complement than a substitute to classified advertising. Yell argued that A–Z advertisements should be part of the same market as classified directory advertisements because: (a) BT sells advertising in the A–Z business listings and in the classified section at the same time and as part of the same product (the ‘three-in-one book’); (b) A–Z advertisements have the same purpose as classified advertisements, which is to generate leads; and (c) about half of BT’s current classified advertisers were also advertising in BT’s business A–Z.

5.74 For A–Z advertising to be in the same relevant market as classified advertising it is not sufficient that these are sold at the same time, and it seems unlikely that a 5 per cent increase in the prices of all CDAS would prompt advertisers to switch to A–Z advertising, because these advertisements appear to have different functions. Even if A–Z advertising were to form part of the relevant market, it would not make a large difference to market shares and would be unlikely significantly to affect our analysis.

5.75 We were told by Yell that some advertising in CDAS, such as loose inserts that were distributed with directories and advertisements appearing on the spine of the book, served different purposes from classified advertising and might not be part of the relevant market. We consider that such advertising is not directional, but instead creates demand, and as such is not a demand-side substitute for classified advertising.

Conclusion: product market definition

5.76 We conclude that:

- (a) The directories provided by Yell, Thomson and BT have high usage and benefit from strong brand images. In addition, certain other directories, notably that of Kingston in Kingston upon Hull, and those of Trinity Mirror in parts of Scotland, also appear to have relatively high usage in their distribution areas and are comparable (in presentation and format) to the directories provided by Yell, Thomson and BT.
- (b) Local newspapers have historically been the closest alternative to advertising in classified directories, but such advertising tends to fulfil different functions from directory advertising, is much more expensive and there has been limited past switching between classified directories and newspapers.
- (c) Advertising in A–Z business listings, although generally sold together with advertising in classified sections by BT and by Thomson, appears to fulfil different functions from advertising in classified directories and it seems unlikely that a 5 per cent increase in the price of all classified directories would prompt advertisers to switch to advertising in A–Z listings.
- (d) Smaller local directories have much more limited usage, and only a small proportion of advertisers in the major directories advertise in these directories. These directories appear unlikely to be effective substitutes to those provided by Yell, Thomson and BT.

5.77 We have given special consideration to the role of the Internet:

- (a) Although usage of the Internet for directory-equivalent searches has increased over the past five years, and there is some evidence that usage of directories may have decreased, this has not been translated into a decrease in CDAS revenues which have been increasing in the past five years.

- (b) Up to now, there have been limited levels of switching between classified directories and the Internet. Yell has continued to grow revenues in many of the classifications where the Internet appears to be a very suitable advertising medium (financial services and insurance). This suggests that, up to now, the Internet has been used more as a complement than as a substitute to directory advertising.
- (c) The evidence received does not suggest that Yell's pricing policies have responded to the growth in Internet use.
- (d) We expect that advertising on the Internet will increase in the future, and CDAS advertising may decrease. It appears that these future trends will be driven primarily by reasons other than relative prices. In particular, we expect those businesses for which the Internet appears to be a more effective medium than directories (for example, if online purchasing is viable or if access to consumers across the country is important) increasingly to switch to the Internet. However, we do not expect that directory providers would be able to retain many of these advertisers by lowering their prices, which would be necessary for this switching to act as a constraint on CDAS prices.

5.78 It is our view that movement of advertisers to the Internet is unlikely to be affected significantly by small changes in the relative prices of CDAS and Internet advertising. The Internet offers new opportunities to advertisers and users; while it can perform the role of directories, it has many additional capabilities and may be seen as a new product which will naturally take business from existing products such as CDAS. So long as there remain significant numbers of consumers using printed classified directories, however, advertisers will wish to use directories to address these consumers.

5.79 Therefore, we conclude that the reference services comprise at least one relevant product market: the provision of advertising services in major printed classified directories with a set of characteristics that includes strong brand image, high levels of usage and comprehensive business listings. Other media (such as online directories and Internet advertising) are not part of this relevant market. In our view, the relevant product market includes the directories provided by Yell, Thomson and BT nationally, and the directories provided by Kingston in Kingston upon Hull and Trinity Mirror in parts of Scotland. We also consider that those advertisements in classified directories that are not classified (such as A–Z sections, spine advertisements and loose inserts) do not form part of this relevant market.

5.80 From the perspective of small directories, we would expect, in general,⁶⁹ to find that the market included both major and small classified directories. Put differently, we expect major directories to constrain the pricing of small local directories, but not the other way around. Therefore, we consider that the relevant product market, from the perspective of small classified directories, is likely to be the provision of advertising services in printed classified directories (both large and small) and we will consider the competitive issues in that context. We do not, however, consider a separate market for small classified directories in detail. There are two main reasons for this: first, the major classified directories account for almost the totality of the reference services in the UK (around 98 per cent⁷⁰); and secondly, we have invited evidence from all CDAS providers, but we have not received any evidence to suggest that the structure of the supply of CDAS in small directories or the conduct of small directory providers raises any particular competition concerns. Since, from the perspective of small directories, the relevant economic market may include both major and small

⁶⁹There is a lot of variation between small local directories and there may be some exceptions.

⁷⁰CC calculations, based on sales data provided by CDAS providers.

classified directories, any competition concerns that might exist in relation to major directories could have an impact on small directory providers.

5.81 We have therefore focused our analysis mainly on the major classified directories (Yell, Thomson, BT, Kingston and Trinity Mirror).

Geographic market definition

5.82 Yell argued that the markets were local because, from the advertisers' point of view, the purchasing decision is mainly a local one. Thomson and BT argued that this was a national market because of the existence of some large national advertisers and because the three largest CDAS providers were present on a national basis (Thomson, Yell and BT).

5.83 Most evidence (see our working paper on market definition, paragraphs 86 to 98)⁷¹ suggests that, from a demand-side perspective, the markets are likely to be local. We examined whether substitution between neighbouring directories or supply-side substitution might widen these local markets, but considered that this was unlikely.

5.84 The fact that Yell, Thomson and BT are present on a national or near-national scale means that, even if markets are local from a demand-side point of view, there is strong interdependence in the local markets because the same providers meet in most markets, and competition is likely to take place mainly on a national basis. Although there may be some variations in the level of local competition due to the existence of local directories and differences in local preferences for the different directories, these are unlikely to be large.

⁷¹Our working paper on market definition is available on our website: www.competition-commission.org.uk/inquiries/ref2005/classdirec/working_papers.htm

5.85 In addition, pricing policies (pricing structures and discounts) are set centrally, even if levels of prices vary locally, and a provider's ability to price locally may be partially constrained by the ability of its competitors to react to these changes on a national basis. The existence of national advertisers that can compare the total cost of advertising with each provider also creates interdependence in local prices.

5.86 Therefore, while a number of factors point to the existence of local markets from the demand side, we analyse competition between the major CDAS providers mainly on a national basis because the three largest CDAS providers meet in almost every local market and because the competitive conditions are likely to be very similar in the different geographical markets.

6. Competition in the market

6.1 Having defined the market, we now move on to analyse the competitive situation within that market.⁷² In this section, we first discuss the two-sided nature of the market and the implications of this for our analysis. We consider market concentration and then move on to discuss the competitive strategies available to classified directory providers, and the extent to which they have used these to compete; this includes an analysis of price and non-price competition for advertisers and competition for users.

The two-sided nature of the market

6.2 As noted above, classified directory providers operate in a two-sided market in which success depends on their ability to attract both users and advertisers to their directory. This interdependence of advertiser and user demand for directories gives rise to a network effect or 'virtuous circle'; a directory provider that has built up high levels of usage and advertising is more attractive to new advertisers and users than a

⁷²As discussed above, we analyse competition mainly on a national basis.

competitor with less usage and less advertising whose offer, in terms of price, quality and service, may otherwise be the same.

- 6.3 Yell's CDAS business is the successor to BTYP, itself a successor to the directory launched in 1966 by the GPO. As the first directory in the market, it was able to build up networks of users and advertisers without competition from other providers. This made it more attractive to both users and advertisers than its subsequent rivals. As with the first directory providers operating in other European countries, Yell has benefited from this first mover advantage which has helped it develop its high market share, strong finances and well-established brand and reputation.

Market concentration

- 6.4 We estimate that, in 2005, Yell had around 75 per cent of the UK advertising revenues for major CDAS and that Yell, Thomson and BT had, between them, around 99 per cent. Table 6 contains our market share estimates for the calendar year 2005. It should be noted that the latest sales figures from BT show that BT has continued to increase its sales in the first quarter of 2006, with total sales of classified advertisements reaching £[~~8~~] million⁷³ for the year ended 31 March 2006.

⁷³ These are sales for the publishing year ended 31 March 2006 and include bookings. This figure differs from reported sales for the financial year ended 31 March 2006.

TABLE 6 UK market shares, calendar year 2005*

	<i>Sales of printed classified advertisements £m</i>	<i>Shares % (ranges)</i>
Yell†	605	75–80
Thomson	97	10–15
BT		5–10
Kingston‡	✂	0–1
Trinity Mirror		<u>0–1</u>
Total	770 to 780	100

Source: CC estimates based on data provided by the relevant parties.

*For Yell, BT and Thomson, the sales figures shown are less than reported sales, because non-classified advertisement revenues (A–Z listings and non-classified advertisements sold in classified directories) have been excluded.

†We estimated that Yell's sales of classified advertisements represented [✂] per cent of its total printed sales in calendar year 2005, ie we assumed that the proportion represented by Yell's classified sales in calendar year 2005 was the same as in its financial year ended 31 March 2005.

‡For Kingston, sales for the financial year ended 31 March 2005.

6.5 Until BT's entry, Yell's and Thomson's national shares were remarkably constant over time. Even though BT's entry has had the effect of decreasing both Yell's and Thomson's shares, both of them increased their nominal revenues, as shown in Table 7, although Yell's revenues declined in real terms between the financial year ended 31 March 2003 and the financial year ended 31 March 2005. The market has grown in real terms since BT's entry.

TABLE 7 UK nominal and real revenues, market shares and nominal and real growth rates

£ million

Company	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
<i>Revenues</i>										
Yell										
Thomson										
BT										
Kingston						✂				
Trinity										
Mirror										
Total market										
<i>Real revenues</i>										
Yell										
Thomson										
BT										
Kingston						✂				
Trinity										
Mirror										
Total market										
<i>Market shares</i>										
Yell										
Thomson										
BT										
Kingston						✂				
Trinity										
Mirror										
<i>Revenue growth over previous year</i>										
Yell										
Thomson										
BT										
Kingston										✂
Trinity										
Mirror										
Total market										
<i>Real revenue growth over previous year</i>										
Yell										
Thomson										
BT										
Kingston										✂
Trinity										
Mirror										
Total market										

per cent

Source: CC, based on Yell, Thomson, BT, Kingston and Trinity Mirror data.

Note: n/a = not available.

*Years refer to publishing cycles rather than financial or calendar years.

6.6 Trinity Mirror has been distributing directories in the Scottish central belt since 2004 under the brand name The One. Yell remains by far the largest CDAS provider in the Scottish central belt, having a higher market share than its total UK market share, and the impact of The One appears limited to date. Table 8 presents market shares and revenues for the Scottish Central Belt.

TABLE 8 Scottish Central Belt: market shares and revenues

Company						per cent
	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
<i>Market shares</i>						
Yell*	[]
Thomson‡						
BT†				✂		
Trinity Mirror§						
<i>Revenues</i>						
Yell	[]
Thomson						
BT				✂		
Trinity Mirror						
All						

£ million

Source: CC, based on Yell, Thomson, BT and Trinity Mirror data.

*Yell directories included: Ayr, Dundee, Edinburgh, Fife, Glasgow North, Glasgow South, Stirling.

†BT directories included: Edinburgh and Lothians, Glasgow North, Glasgow South.

‡Thomson directories included: Glasgow Northside & Bearsden, Glasgow East & Cumbernauld, Glasgow West & Renfrewshire, Glasgow Southside & Newton Mearns, Edinburgh.

§In 2003/04 and 2004/05, Trinity Mirror directories included Glasgow and Edinburgh.

6.7 In 2005/6 both Trinity Mirror and BT's revenues from directories published in the Scottish central belt rose compared to the previous year. Trinity Mirror's revenues were around £[✂] million (£[✂] million); BT's revenues were £[✂] million. Thomson's revenues were [✂].

6.8 In Kingston upon Hull, where Yell is a recent entrant (2005) and Kingston is the incumbent, Kingston still has the largest share of sales but Yell has rapidly acquired a significant market share.

TABLE 9 Kingston upon Hull: market shares and revenues*

Company	2000/01	2001/02	2002/03	2003/04	2004/05
<i>Market shares %</i>					
Yell†	[✕]
BT§					
Kingston					
					<i>£ million</i>
<i>Revenues</i>					
Yell	[✕]
BT					
Kingston					
All					

Source: CC, based on Yell, BT and Kingston data.

*Kingston provided data from 2000 to 2005.

†Yell entered the Hull area by rescoping its Hull and East Yorkshire book in 2005.

§BT covers half of the Hull area with its Scarborough and Yorkshire Coast directory.

6.9 Kingston's revenues fell slightly from £[✕] million to £[✕] million between 2004/05 and 2005/06.

Price competition

6.10 We examined the pricing of the major classified directory providers giving detailed attention to the pricing of Yell, Thomson and BT. We considered rate card determination and discounting policies. We also studied realized prices, the revenues of directory providers over time and the relative movements in prices and revenues over time, in order to analyse how pricing and price competition operate in this market.

Pricing: rate card determination and discounts

Yell's pricing system

6.11 As required by the Yell undertakings, Yell publishes a rate card specifying the rate card price for each product in each of its directories. Yell's rates vary according to the size of the advertisement, the colour option selected and the geographic region the directory covers. For any given directory, Yell's rate card prices are in proportion to the size of an advertisement: doubling the size of an advertisement doubles the rate card price. Rates increase less than proportionately with GMC so that

advertisements in directories with large GMC may be cheaper in terms of cost per thousand GMC than those in small-GMC directories, but more expensive in absolute terms. Yell offers monochrome and colour advertising; monochrome rate card prices form the basis of all rate card prices—colour rate card prices are calculated from a monochrome rate card price by applying a colour premium, set as a percentage of the monochrome rate card price. Colour advertisements are discussed further in paragraphs 6.36 to 6.44 and appendix 6.7.

- 6.12 The price control may have discouraged Yell from lowering any of its rate card prices more than is required by the price control, because the reduced rate card price would become the base for calculating the capped rate card price in the following years. The Yell undertakings do not prevent Yell from offering discount schemes.
- 6.13 Yell offers discounts to encourage new advertisers and to encourage advertisers to increase expenditure. The discount schemes offered have changed over time, and the levels of discounts offered within schemes have also changed (see paragraph 6.20). Yell does not engage in individual price negotiations with advertisers; it told us that it did not do so as the Yell undertakings obliged it to charge prices as notified to the OFT.
- 6.14 Since April 2004, Yell has operated a tiered system of classifications in order to establish the discounts available for a given advertisement. Yell classifications are assigned to a discount tier (known as Bronze, Silver or Gold) based on the demand for advertising generally and for colour advertising by businesses within the classification, the average advertisement size purchased in the classification and the estimated commercial benefits achieved by advertisers in the classification. Classifications in which a relatively large proportion of businesses advertise in *Yellow Pages*, those that contain large advertisements and those that are expected to

generate relatively high commercial benefits for advertisers are likely to be assigned to the Gold Yell classification; advertisements classified as Gold account for over half of Yell's revenues. Advertisements in insurance classifications are assigned to a special insurance tier. Table 10 illustrates the sizes of Yell's tiers and table 11 provides examples of the types of classification that fall within each tier.

TABLE 10 **Yell tiers, 2004/05**

<i>Segmentation tier</i>	<i>Bronze</i>	<i>Silver</i>	<i>Gold</i>	<i>No tier</i>
Number of classifications				
Percentage of advertisements			✂	
Percentage of revenues				

Source: CC, based on data provided by Yell .

TABLE 11 **Examples of Yell classifications and tiers**

<i>Top five Gold classifications by revenue</i>	<i>Top five Silver classifications by revenues</i>	<i>Top five Bronze classifications by revenue</i>
	✂	

Source: CC, based on data provided by Yell.

6.15 Advertisements purchased by advertisers advertising for the first time in a particular Bronze classification receive a 40 per cent discount from the rate card on certain advertisement sizes and those in Silver classifications a 30 per cent discount on certain advertisement sizes. New advertisers in Gold classifications or in insurance classifications receive no discount.

6.16 Advertisers renewing with Yell for the first time (advertisers going into their second year) are also eligible for discounts if they received a discount in their first year. Advertisers in their second year in Bronze or Silver classifications qualify for a 25 per cent repeat purchase discount or a 'buy-one-get-one-free' offer on certain

advertisement sizes.⁷⁴ Advertisers in their second year in Gold classifications or in insurance classifications that purchase the same-sized advertisement as in their first year receive no discount.

- 6.17 Established (second and subsequent years) advertisers (in all tiers) that decide to increase their representation in *Yellow Pages*, by purchasing larger advertisements or by purchasing additional advertisements in other classifications or other directories, receive a 'Move Up' discount of 20 per cent of the increase in advertising expenditure. For a colour advertisement, the Move Up discount does not apply to the colour premium, only to the monochrome base price.
- 6.18 Yell offers what it describes as a 'composite discount' to advertisers that purchase advertisements in directories that have been rescoped from one directory to two or more. The effect of the 'composite discount' is to make the rate card price paid for an advertisement in each of the rescoped directories no more than the cost of a single advertisement before rescoping. We describe this as a 'composite rate', since it does not lead to a reduction in price; instead it negates a potential price increase.
- 6.19 If Yell were not to offer its composite rate, rates for purchasing advertisements covering the original directory area would rise following rescoping. We consider that increasing the prices required to obtain advertising in a particular geographic area would be a breach of the good faith provisions in the Yell undertakings. Therefore, while the composite rate is not specifically required by the Yell undertakings, in our

⁷⁴Yell told us that existing advertisers purchasing advertisements in classifications that they had not been present in previously were treated as new advertisers in those classifications for the purposes of discount and tier application.

view the composite rate enables Yell to comply with the good faith provisions.⁷⁵ For this reason, we focus on Yell discount schemes other than the composite rate.

6.20 The discount schemes offered by Yell have changed over time, as have the level of discounts offered within schemes. One of the main changes was Yell's introduction of a tiered system of classifications in April 2004. Prior to this date, Yell's discounts to new advertisers and to advertisers renewing their advertising for the first year were not dependent on the classification advertised in; Yell offered a 50 per cent discount to new advertisers in all classifications on certain advertisement sizes, as well as a 20 per cent discount, or buy-one-get-one-free, to all advertisers renewing their advertising with Yell for the first time.

6.21 We analysed the effects of Yell's discounts (excluding the composite rate), and our analysis of Yell discounts is presented at Appendix 6.1. In the publishing year ended 31 March 2005, 35 per cent of Yell's advertisements (33 per cent in revenue terms) received some form of discount. The total amount of Yell discounts, calculated as the sum of the differences between the rate card (gross price) and realized price (net price) of advertisements, increased between the year ended 31 March 2002 and the year ended 31 March 2004, falling in the year ended 31 March 2005. The average discount per advertisement and per advertiser fell between the year ended 31 March 2002 and the year ended 31 March 2005, the period of BT's growth.

Pricing systems of other CDAS providers

6.22 Thomson, BT, Kingston and Trinity Mirror all use rate cards. Kingston publishes its rate cards; the other providers do not.

⁷⁵ Yell disagrees with our interpretation of the good faith provision; see paragraph 6.19.

6.23 These four providers offer discounts to encourage new advertisers and to encourage advertisers to increase expenditure. These schemes have several features in common with those offered by Yell. Some providers enter into negotiations with individual advertisers.

Revenues and realized prices, 1999 to 2005

6.24 We undertook studies of the realized prices and revenues of the Yell, Thomson and BT over the period 1999 to 2005. The study of Yell is included as appendix 6.2, the study of Thomson at appendix 6.3 and the study of BT at appendix 6.4.

Realized prices (including rescoping)

6.25 Our pricing analyses showed that the average revenue per advertisement (average price paid) for Yell and Thomson advertisements fell year-on-year between 1999 and 2005. The average revenue per Yell advertisement fell by [X] per cent between the year ended 31 March 2000 and the year ended 31 March 2005. The average revenue per Thomson advertisement fell by [X] per cent between 1999 and 2005. The data for BT showed that, over the short period that BT has been in the market, the average realized price per advertisement was [X].

6.26 The mix of advertisements sold changed over the study period such that the simple average calculation presented above reflects various mix effects. In particular:

- there has been a tendency to purchase more expensive types of advertisement including more colour advertisements; and
- as discussed earlier, due to rescoping, the average GMC of Yell's directories has fallen by around 20 per cent since 2001 (see paragraph 2.21).

6.27 One possible explanation for the increase in the number of large advertisements purchased is that the value an advertiser obtains depends on how its advertisement

performs against competing advertisements (its 'share of voice'). Thus, an advertiser might purchase a larger advertisement because rival advertisers are doing so.

6.28 To isolate price effects, we calculated price indices for Yell and Thomson; these indices track price changes between advertisements that are the same size, colour, and in the same directory in consecutive years and so are not susceptible to mix effects. The price indices show the price change an advertiser buying the same advertisement (or set of advertisements) in consecutive years would expect to face. Thus they provide an average trend which is helpful in understanding the overall pattern of price changes for a directory provider, and the relative pattern of price changes between providers. The price indices are presented in Table 12.

6.29 However, since advertisers do not necessarily buy the same advertisements in consecutive years, the price indices are not a good indicator of the amounts paid in consecutive years by individual advertisers. Average revenue per advertiser is more relevant to that question and is discussed in paragraphs 6.33 to 6.35.

6.30 Yell has carried out significant rescoping programmes in recent years. This has reduced average prices in affected areas, but the effects of rescoping are excluded from the price indices (which are designed to analyse only like-for-like comparisons, whereas rescoping effectively involves selling advertising in smaller units). The usual effect of rescoping is that a directory is divided into two. Advertisers that wish to achieve the same coverage as before do not see a price effect due to the composite rate.⁷⁶ Advertisers that choose to advertise in only one of the successor directories will pay a lower price for the advertisement (compared with the situation without the rescoping) and although the cost per thousand (see paragraph 2.9) will normally be

⁷⁶To benefit from the composite rate, advertisers must purchase the same type of advertisement in both the rescoped directories.

higher, the circulation of the chosen successor directory may be more relevant to the advertiser. It appears to us that the principal effect of rescoping is to make advertising more attractive to new advertisers, offering an advertisement at a lower price than previously, albeit with a smaller footprint.

6.31 Yell's rate card prices have fallen at the minimum rate required by the price cap.⁷⁷ As shown in Table 12, both the Yell and Thomson price indices fell by more than the annual reduction that applied to Yell's rate card prices. Yell has granted discounts over the period, and therefore the Yell price index has fallen faster than the price cap. The overall level of discount is affected both by the discount schemes in place and the composition of Yell's advertiser base—since new advertisers receive relatively high discounts, increasing the number of new advertisers will tend to increase the average level of discounts.

TABLE 12 Yell, Thomson and price cap price indices

	1999	2000	2001	2002	2003	2004	2005
Price cap index	100	101	101	96	93	91	87
Yell price index*	n/a	[✂]
Thomson price index	100						

Source: CC, based on data provided by Yell and Thomson

*The figures for Yell represent Yell publishing cycles which run from April to March. The figure for 2005 represents the index for the 2004/05 publishing cycle.

6.32 Thomson's price index has fallen faster than Yell's, indicating a reduction in the relative price of Thomson advertisements.

Revenues

6.33 Yell's revenues from classified advertising rose by [✂] per cent between the publishing year ended 31 March 2000 and the publishing year ended 31 March 2005.

⁷⁷As discussed in paragraph 6.59, on certain occasions, following rescoping, the rate card prices for some of Yell's new directories have been set at levels below the maximum permitted by the undertakings.

While Yell's average revenues per advertisement (average realized price) fell over this period, the average revenue per advertiser has been broadly stable. The number of advertisers rose from 378,000 to 473,000 over the period; this fact, combined with the broadly stable average revenue per advertiser, explains the growth in Yell revenues in the face of declining average realized prices. The reasons for the stable expenditure per advertiser are an increase in the average number of advertisements per advertiser and the purchase of more expensive advertisements, in particular, much greater use of colour. Over this period, the average number of advertisements per advertiser rose from [x] to [x]. The take-up of colour rose substantially from [x] to [x] per cent of advertisements. The average advertisement size in Yell directories [x].

6.34 Thomson's revenues from classified advertising rose by [x] per cent over the period 1999 to 2005. Average revenues per advertisement fell, while the average revenue per advertiser was broadly stable. The number of classified advertisers rose from [x] to [x] over the period; this fact, combined with the broadly stable average revenue per advertiser, explains the growth in Thomson revenues in the face of declining average realized prices. The stable average revenue per advertiser is explained by the trends towards a greater number of advertisements per advertiser, a greater use of colour and increased advertisement size: the average number of advertisements per advertiser rose from [x] to [x]; use of colour rose from [x] to [x] per cent of advertisements; and the average size of an advertisement [x].

6.35 BT started selling CDAS in October 2002, incorporating classified sections into three of its directories, and built up to full coverage of the UK in the year ended 31 March 2005. BT's revenues from classified advertising during the publishing year ended 31 March 2005 were £[x] million, growing to £[x] million in the publishing year ended 31 March 2006. In the year ended 31 March 2005, the number of classified

advertisers in the *Phone Book* was [redacted], rising to [redacted] in the year ended 31 March 2006. BT's average price per advertisement has been [redacted] over this short period; while its average revenue per advertiser has [redacted].

Colour advertisements: price setting and revenues

6.36 Full colour advertising was offered by Kingston in 1998; Thomson followed, rolling it out across its directories between 1999 and 2004; Yell introduced its colour options nationwide in the year ended 31 March 2002 after trialling colour in three directories⁷⁸ in the year ended 31 March 2001. BT introduced colour in the year ended 31 March 2006 and in that publishing cycle offered colour at no additional premium to monochrome advertising; BT has now begun selling advertising for the next publishing year (ending 31 March 2007) [redacted]. All the advertisements in Trinity Mirror's directories contain some level of colour. We analysed the impact of colour on revenues and the colour premiums charged by Thomson and Yell.

6.37 The prices to be charged by Yell in accordance with the price control are calculated with reference to the price for the category of advertisement in question in the December 2001 rate card or the price for the category of advertisement in question in the immediately preceding edition of a particular classified directory (whichever is the lower). Thus the Yell undertakings do not regulate the pricing of new products in the year of their introduction. This allowed Yell to introduce colour advertisements at prices that were not constrained by the Yell undertakings.⁷⁹ For the second and subsequent years, Yell has applied the price cap to its colour prices, as required by the Yell undertakings.

⁷⁸Bournemouth, Dundee, Taunton.

⁷⁹Note that when Yell introduced colour advertisements, the business was still governed by the 1996 Undertakings which required the consent of the Director General of Fair Trading to be given before any significant change in business practice (including the range of advertisement sizes or features offered to potential advertisers) could be made. Yell told us that the introduction of colour advertisements and the premium to be charged were approved by the Director General of Fair Trading.

- 6.38 Yell offers six levels of colour advertisement. It charges a colour premium that is based on its monochrome price; this rises from 30 per cent for an advertisement using one colour to 75 per cent for a full colour advertisement. Yell's colour premium appears to be much greater than the incremental costs incurred (see paragraphs 7.94-7.96, and Table 24).
- 6.39 Thomson offers four levels of colour advertisement. Our analysis of Thomson's rate card suggests that the premium charged by Thomson for colour tends to be lower (in percentage terms) than Yell's colour premium. Thomson charges a premium of [X] per cent over the monochrome rate card price, depending on the level of colour and the advertisement size.
- 6.40 Kingston's colour premium for full colour advertisements was 90 per cent in its 2006 edition of *Hull Colour Pages*. Kingston's colour premium has been at this level since 2000.
- 6.41 Both Yell and Thomson introduced colour advertisements at a premium over their own monochrome rates. We compared Yell's and Thomson's colour premium based on average realized prices (rather than rate cards). Yell's colour premium, calculated as the average price of a full colour advertisement minus the average price of a monochrome advertisement of the same size, was higher than Thomson's for all the sizes of advertisement we studied, with Yell's colour premium being much higher than Thomson's for larger advertisement sizes.
- 6.42 Appendix 6.6 contains comparisons of colour premiums for other advertisement sizes we studied. In 2004, Yell's average colour premium was higher ([X]) than Thomson's for all advertisement sizes we studied, and considerably higher ([X]) for half-column advertisements. Yell's advertisements tend to be more expensive than

Thomson's advertisements for the same size, and therefore we also compared Yell's and Thomson's colour premiums expressed as a percentage of the price of a monochrome advertisement. We found that Yell's colour premium expressed as a percentage of the monochrome price was higher than Thomson's for three of the five sizes of advertisement we studied.

6.43 Our analysis of the colour premiums charged by Yell and Thomson showed that Thomson's colour premium has fallen markedly between 2000 and 2005: for all of the advertisements sizes studied, Thomson's average colour premium fell by [✂] per cent or more during the period, and in the case of one product (half-column advertisement), the average colour price was the same as the average monochrome price in 2005. Yell's colour premium has fallen less markedly than Thomson's colour premium, as illustrated in Table 13 for the period 2001 to 2004.⁸⁰

TABLE 13 Fall in Thomson and Yell's average colour premiums, 2001 to 2004

	<i>per cent</i>	
	<i>Thomson</i>	<i>Yell</i>
Double quarter column	()
Half column	()
Half page	()
Quarter column	()
Whole page	()

Source: Yell and Thomson time series data sets; CC calculations.

6.44 In percentage terms, the Yell colour premium has tended to increase during the period, ie the average colour premium fell less than the average monochrome price. Thomson monochrome prices fell less quickly than Thomson's colour prices, meaning that Thomson's colour premium fell in percentage terms.

⁸⁰Yell introduced colour nationally only in 2001, which is why we start the comparison in 2001. We stop the comparison in 2004 because we do not have pricing data for Yell for 2005.

Price competition and pricing constraints

6.45 Both the Yell and Thomson price indices fell markedly in 2002. In 2002, the Yell price cap was strengthened from RPI –2 per cent to RPI –6 per cent and Thomson cut its rates by [redacted] per cent in order to remain competitive with Yell; BT entered the market, selling advertising space in the three classified directories it published in the year ended 31 March 2004. The fall in the Yell and Thomson price indices was not as marked in 2003 and 2004. In particular, in 2004, the Yell price index fell only 1 percentage point more than the amount required by the price cap.

6.46 Thomson's price index has fallen faster than Yell's, indicating a reduction in the relative price of Thomson advertisements. Given these relative price changes, shifts in expenditure away from Yell and towards Thomson might be expected. However, the stability in Thomson's and Yell's market shares over time (until BT's entry) suggests that advertisers have not been switching between Yell and Thomson at an aggregate level. There are a number of possible explanations for this lack of switching, for example:

- Yell's rescoping activity has reduced the differentiation of Thomson's product and Thomson has cut prices in response; and
- increases in Yell's relative prices (decreases in Thomson's relative prices) may have been offset by corresponding improvements in the quality of Yell's offering.

6.47 Thomson told us that Yell's advertisement prices were a key determinant of its prices. Yell has been reducing its rate card prices in line with the price cap; Thomson has cut prices and told us that it did so in order to remain competitive. Thomson has set rate card prices at a discount to Yell's rate card prices across the full range of advertisements in order to be seen as competitive; Thomson aims to have rate card prices that are [redacted] per cent of those in a comparable Yell directory. An implication of

Thomson's strategy is that any price cap applied to Yell also constrains Thomson's prices.

- 6.48 As well as setting overall rate card prices at a discount to Yell's, Thomson has cut rate card prices further on a number of occasions. Rate card prices on Thomson's standard and national rate cards were reduced by [redacted] per cent in 2002. Thomson told us that it needed to reduce its rate card prices [redacted]. It is likely that Thomson has come under pressure as a result of Yell's rescoping, which has reduced the difference in footprint size between Thomson and Yell, and has lowered Yell's prices in absolute terms (although raising them on a cost per thousand basis).
- 6.49 Thomson has used various pricing and sales schemes in order to improve its CDAS sales revenues: Thomson has periodically offered rate cards that incorporate additional discounts in order to stimulate advertisement demand in response to underperformance in particular classifications or geographic regions; in 2002 it focused its sales teams on the 'added value' gained by CDAS advertising as a way of encouraging advertisers to take out advertisements. This is discussed further in paragraph 7.15.
- 6.50 BT's strategy in terms of pricing and discounting policies has been constructed with reference to Yell's pricing. BT's initial quarter-column rate card price was set to undercut Yell's rate card price (by about [redacted] per cent), BT then [redacted]. BT's discounts have been changed [redacted] in order to retain BT's price competitiveness.
- 6.51 The evidence above suggests that the prices of Thomson and BT are constrained by those of Yell. Thomson and BT both set their rate cards with reference to Yell's, and have sought to amend their discounts to ensure that their prices remain competitive

with Yell's. Thomson and BT are both following strategies in which they adjust their prices in order to remain competitive with Yell.

6.52 We have also considered whether Yell's rate card prices and realized prices are constrained by Thomson and BT. Since 92 per cent of the advertisers in our survey used *Yellow Pages* and Yell has around 75 per cent of the revenues in this market, the determinants of Yell's pricing have been a key question for this investigation.

6.53 Yell told us that competition in the market was intense and that there was no scope for price increases since prices were constrained by competitive forces.

6.54 Yell provided the CC with evidence relating to proposed price-based responses to competition. Yell carried out research into the pricing of its competitors that was designed to identify areas where *Yellow Pages* was becoming less competitive. Yell told us that this research 'raised questions as to whether Yell's prices for its largest advertisements were sustainable, given the pricing structure of directory competitors'. Yell provided evidence of a number of pricing initiatives that it was considering using. Strategies mentioned included [REDACTED]. Yell's actions could be seen as an indication that it will begin to compete on price; however we have seen no evidence that Yell is currently acting on these intentions.

6.55 Our analysis of Yell's sales in the year ended 31 March 2005 showed, however, that 65 per cent of the advertisements sold in that year ([REDACTED] per cent in revenue terms) were sold at a rate card price.⁸¹ In some areas, following rescoping, Yell has set its rate card prices at levels that are lower than the maximum permitted (which is calculated by applying the rescoping formula contained in the Yell undertakings). This is discussed further in paragraph 6.59 below. Adjusting for the areas where,

⁸¹Out of a total of [REDACTED] advertisements, [REDACTED] were sold without discount (excluding composite offer).

following rescoping, new rate card prices were set at less than the maximum level permitted by the Yell undertakings, the rate card prices for 57 per cent⁸² of advertisements ([X] per cent in revenue terms) sold in the year ended March 2005 fell by no more than RPI-6 per centt, the minimum rate required by the Yell undertakings.

6.56 We considered the possibility that those rate card prices apparently determined by the Yell undertakings might also be the prices that Yell would find optimal, in the absence of the Yell undertakings. We considered this to be unlikely for two reasons. First, Yell told us that if the price cap had not been in place, the prices of some advertisements to some advertisers might have fallen more slowly, at least in the early years of the price cap. Second, we find it highly unlikely that the reduction in Yell's optimal prices would be exactly equal to that specified by the Yell undertakings and that the optimal reduction, over a ten-year period, for each of Yell's rate card prices would be identical.

6.57 The 57 per cent of advertisements referred to in paragraph 6.55 above includes advertisements that were sold at 'composite rates' (25 per cent of all Yell's advertisements were sold at composite rates without discounts); the composite rate is a mechanism available when Yell 'rescopes' that avoids disadvantaging advertisers who wish to have the same geographic coverage that was available before the directory was rescoped. In our view, composite rates are effectively required by a good faith provision within the Yell undertakings which provides that on the basis of a like for like comparison, prices paid for advertisements in classified directories published by Yell must decline by at least RPI-6% each year. Yell disagrees with this interpretation of the Yell undertakings, but we consider that, in

⁸²32 per cent receive no discount from rate cards that are set at the maximum level permitted by the undertakings; 24 per cent pay composite rates (see paragraph 6.18).

any case, these rates, which are designed to avoid disadvantaging advertisers, were not determined by competition. We therefore consider that the Yell undertakings, rather than competition, effectively provided the binding constraint on Yell's prices for 57 per cent of its advertisements ([redacted] per cent in revenue terms) in the year ended 31 March 2005.

6.58 Advertisements sold at a discount from the rate card are sold at prices influenced by demand factors, competitors' prices and the relationship with other Yell prices. We have examined the 44 per cent of advertisements ([redacted] per cent in revenue terms) that were sold at rates below the maximum permitted by the Yell undertakings in the publishing year ended 31 March 2005 in order to analyse the forces which constrained these prices.

6.59 44⁸³ per cent of advertisements were sold at prices below the maximum permitted by the undertakings. 35⁸⁴ per cent were sold at prices below the price cap because of the existence of discounts over the rate card. For the remaining 9⁸⁵ per cent, the price was below the maximum permitted by the Yell undertakings because these advertisements were sold in directories which had been rescoped and in which Yell had set the rate below the maximum authorized by the Yell undertakings (calculated using the rescoping formula). We analysed the regulatory formula that sets the maximum authorized rates after a rescoping. This formula is based on an average of the rates charged in other areas with equivalent levels of circulation to the rescoped directories, and it does not take into account the rates prior to rescoping or any 'area-specific' factors. Our analysis suggests that the rate was set below the maximum authorized by the formula in areas where the formula would have generated rates after rescoping which were relatively high compared with pre-rescoped rates. In

⁸³[redacted] per cent in revenue terms.

⁸⁴[redacted] per cent in revenue terms.

⁸⁵[redacted] per cent in revenue terms.

many instances, it does not appear that competition played a role in setting these prices below the maximum authorized. In particular, we noted that in some of the areas which we were told were subject to more competition (such as Edinburgh and all the London areas), the rate after rescoping was set at the level required by the Yell undertakings.

6.60 As discussed in the context of market definition (see paragraphs 5.45 and 5.46), Yell's discounts appear to be generally aimed at encouraging new business and encouraging existing advertisers to increase expenditure. We analysed the extent to which Yell's discount schemes may be a response to increasing competition. Large discounts to new advertisers and advertisers increasing their expenditure may be a competitive tool in order to create incentives for other providers' advertisers to switch to Yell. If this were the case, one would expect that the advertisers attracted through these discount schemes would have increased spend with Yell by switching some spend from other providers. However, discounts aimed at attracting new advertisers and encouraging existing advertisers to increase expenditure could be equally appropriate for a firm with market power. A firm with market power would find it optimal to offer discounts to new customers if this allowed it to attract new customers without having to cut prices to old customers. This type of pricing is particularly appropriate for CDAS because it provides incentives for new advertisers to sample the effectiveness of CDAS. In this case, one would expect new advertisers to be new to classified directories, rather than to have switched from other classified directories.

6.61 The evidence on switching (see paragraphs 6.99 to 6.108) suggests that the majority of new advertisers attracted by Yell are likely to be brand new to CDAS, and that a majority of advertisers that have increased their spend with Yell have not done so by switching spend from other providers or other media. Yell told us that the main rationale of their Move In discount scheme was to attract new advertisers to

directories. This is reflected in the discount tiers, where the highest new advertiser discounts go to the classifications which contain relatively few advertisements (Bronze classifications) while the classifications containing a large number of advertisements (Gold classifications) do not attract any new advertiser discounts.

6.62 As discussed in paragraph 6.20, Yell introduced its tier-based system for new advertiser discounts in April 2004; this had the effect of reducing the discount available to new advertisers in 192 of its classifications, representing over half ([redacted] per cent) of revenues, from 50 per cent to zero. Yell's decision to remove the new advertiser discount for these Gold tier advertisers at a time at which BT was entering and targeting the advertisers in Yell's top classifications (the majority of which are Gold classifications) suggests that these discounts were not being used by Yell as a response to increased competition.

6.63 Yell provided a study of the number of advertisers new to CDAS that it and BT attracted to their directories in 2004/05; Yell argued that this study indicated that BT had been successful at attracting brand new advertisers to CDAS.⁸⁶ While BT was able to attract advertisers new to CDAS to the Phone Book, we note that in 12 of the 14 areas studied, Yell attracted more advertisers new to CDAS to its directory than BT did. In all 14 of the areas studied, however, BT attracted more advertisers new to CDAS than it would have done if it had attracted new advertisers in proportion to its market share.

6.64 BT's apparent success with advertisers new to CDAS suggests that Yell may have found it harder to attract advertisers new to CDAS to its under-penetrated classifications since BT's entry and it is therefore possible that competition played a role in setting the level of discounts to new advertisers for the less penetrated Bronze

⁸⁶Yell submitted a study of 13 directory areas. Yell had previously submitted a similar study of [redacted].

and Silver classifications. On the other hand, we note that Yell reduced its discounts to new advertisers shortly after BT had entered the market: from a 50 per cent discount to all new advertisers in year ending 31 March 2004, Yell lowered new advertiser discounts to 40 per cent, 30 per cent or 0 per cent depending on the discount tier in the year ending 31 March 2005.

6.65 Yell's introduction of its tier-based system of discounts in April 2004 also affected the discounts available to first year renewing (FYR) advertisers by making FYR discount conditional on the advertisers having received a discount in their first year (ie having been in a Silver or Bronze classification). This had the effect of reducing the discount for FYR advertisers in the Gold classification from 20 per cent to zero during a period in which BT was entering. In the year ended 31 March 2006, Yell increased the value of the FYR discount from 20 per cent to 25 per cent, though the discount was still restricted to Bronze and Silver classifications.

6.66 We found that, in revenue terms, most of the discounts apply to Yell's small advertisements, and that Yell's quarter-, half- and full-page advertisements only attracted a very small proportion ([x%] per cent) of total discounts on average in the year ended 31 March 2005. The application of discounts to smaller products, combined with Yell's linear rate card, means that the realized prices per square centimetre of Yell advertisements increase with the size of the advertisement purchased. In contrast, Thomson's and BT's realized prices per square centimetre [x%], and BT grants discounts of between [x%] and [x%] per cent off its rate card for quarter-, half- and full-page advertisements. This suggests that Yell is not using discounts to respond to Thomson's and BT's pricing structures.

6.67 Our analysis of colour pricing (see paragraphs 7.94 to 7.96) showed that, despite being second to introduce colour nationally, Yell was able to charge a colour

premium that appears high compared with its costs and which exceeds that of Thomson. It has been able to maintain that percentage premium while Thomson's has fallen. BT introduced colour at no additional cost to monochrome advertising, and [X]. We consider that this indicates that Yell's pricing of colour advertisements is not constrained by Thomson or BT.

6.68 We found the general pattern of price competition to be that:

- (a) BT and Thomson set their prices with reference to Yell's and are constrained by Yell's prices and each other's.
- (b) For 57 per cent of Yell's advertisement prices in the year ended 31 March 2005, the binding constraint was the Yell undertakings rather than its competitors' prices. Yell disagrees with our interpretation of the good faith provisions in the Yell undertakings and considers that advertisements to which the composite offer applies were not constrained by the undertakings. Even if Yell's interpretation of the undertakings were correct, the prices for advertisements to which the composite offer applies, are in our view designed to avoid disadvantaging advertisers and were not determined by competition.
- (c) 9 per cent of Yell's advertisement prices in the year ended 31 March 2005 were sold without a discount, but at prices that were below the maximum permitted by the Yell undertakings. These advertisements were sold in directories that had been rescoped and, for the reasons set out above, we do not think, in general, the fact that prices were below the maximum permitted level was due to competition.
- (d) For the remaining 35 per cent of Yell's advertisement prices in the year ended 31 March 2005, we analysed the extent to which conditions of demand or competition provided the binding constraint on prices. While we consider that, particularly for some types of new advertisers, competition may influence the level and extent of discounts, Yell's discount schemes appear to be those that a

firm with market power would use; Yell's changes to its discount schemes indicate that competition has not been a significant factor in the setting of many of Yell's discounts.

- (e) Yell's colour prices are not constrained by its competitors' prices: Yell was able to charge introductory prices that were higher than those of its competitors and it has been able to maintain high colour premiums, in both absolute and percentage terms, over a period in which its competitors colour premiums have fallen.

Non-price competition

6.69 We also analysed the extent of non-price competition between CDAS providers. As discussed below, the BMRB survey indicated that advertisers considered a number of non-price factors to be important, and therefore we analysed whether there was evidence of a lack of competition between CDAS providers on non-price factors.

6.70 The BMRB survey indicated that, when choosing a directory, advertisers considered a number of non-price factors to be important. These included: strong brand image, number of readers, local area covered by a directory and the number of businesses listed.

6.71 There are a number of aspects of non-price competition within this market, including: rescoping, competition for users, product innovations, quality improvements and offering additional services with classified advertisements. Of these, we consider scoping (footprint) of directories and competition for users to be the most significant since they potentially alter the number and targeting of business leads generated by classified advertisements.

- 6.72 Thomson has offered smaller footprints than Yell and used this as a key differentiating factor, appealing to advertisers that wish to address a more local area and users who prefer a local focus. Yell has reduced its average footprint, in response to a number of factors, and this has reduced the degree of Thomson's differentiation.
- 6.73 Competition for users is discussed separately below; it forms a vital part of the non-price competition for advertisers as usage is the major determinant of the number of responses to an advertisement that an advertiser can expect.
- 6.74 Classified directory providers told us that they invest in quality improvements and innovations. Quality improvements have included reorganizing classifications to make them more relevant to advertisers and users, service improvements, and simplifying the advertisement purchase and design process. Innovations have included the introduction of colour, development of process to improve the measurement of the return generated by classified advertising and development of pricing systems based on the number of leads generated by advertising.
- 6.75 BT offers advertising in the residential A–Z section of its directory. This is discussed below.

Competition for users

- 6.76 Advertisers need to ensure that their advertisements deliver leads; leads are generated as a result of usage. Competition for users is the other half of the 'virtuous circle' that classified directory providers try to develop in this two-sided market. Directories are distributed free to users, so increasing the usage of directories through price competition is not possible. Instead, providers seek to increase usage

by advertising, product differentiation and offering additional services with their directory. Usage trends are discussed in paragraphs 4.1 to 4.8.

6.77 The most immediate and direct means of competing for users is by advertising. National advertising campaigns are highly visible to advertisers and users alike. Competing for users through advertising also has the benefit of signalling to advertisers that usage of a directory will be high.

6.78 Yell, Thomson and BT all have national or near-national advertising strategies. They use a combination of television, radio and poster advertising to promote awareness and usage of their directories. All three national classified directory providers have increased their advertising expenditure in recent years. Between the financial year ended 31 March 2002 and the financial year ended 31 March 2006, the total advertising expenditure of the three national classified directory providers rose from just over £20 million to just over £30 million; Yell's advertising expenditure is several times greater than that of any other CDAS provider. Yell's expenditure on advertising designed to promote its CDAS product rose from £[redacted] million to £[redacted] million between the year ended 31 March 2002 and the year ended 31 March 2006; Thomson's total (CDAS and other services) advertising expenditure rose from £[redacted] million to £[redacted] million between 2000 and 2005; BT's advertising expenditure was £[redacted] million in the financial year ended 31 March 2006. Parties told us that expenditure on advertising for users [redacted] in the current year.

TABLE 14 Advertising expenditure by classified directory providers (£'000s)*

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Yell (whole UK business)							
Yell (UK CDAS)				✂			
Thomson							
BT (CDAS)							

Source: CC, based on data provided by Yell, Thomson and BT.

Note: n/a = not available.

* = estimate.

- 6.79 Evidence provided by each of the major CDAS providers indicates that the usage of an individual provider's classified directory responds to advertising for that provider. Such advertising may also increase the total usage of classified directories; however, providers had differing opinions on the extent of such an effect.
- 6.80 The evidence on advertising and usage suggests that competition through advertising for users has not delivered large increases in usage. However, it is possible that it may have helped to counteract an underlying trend towards reduced usage of classified directories.
- 6.81 CDAS providers have invested in product differentiation and offer additional services with their classified directories in order to attract users and improve the leads generated by advertising. Examples of product differentiation are the scoping of books, the dimensions of books, and the degree of editorial content. Additional services offered include Thomson's NHS Direct self-help guide and the business A–Z listings provided by Thomson, BT and Trinity Mirror. BT offers residential A–Z listings with its directory; this is discussed in a separate section on BT below.

Effect on competition of BT's combined classified and A–Z directory

- 6.82 This section discusses potential effects on competition arising from BT's provision of a combined classified and A–Z directory. BT's re-entry is discussed in paragraphs 2.27 to 2.30.
- 6.83 BT provides a 'three-in-one' *Phone Book* free to users, comprising classified advertising, residential A–Z and business A–Z listings. There are various advertisements in the business A–Z listings, and there are also advertisements in the residential A–Z listings. BT's A–Z sections distinguish it from its competitors in that:

- other CDAS providers do not provide residential sections and would have to make a considerable investment in OSIS data in order to provide them; and
- while some other providers (Thomson and Trinity Mirror) do offer A–Z business listings, the advertising in BT’s A–Z business sections appears to be more substantial than in other providers’ A–Z business sections.

6.84 We considered how the combination of BT’s A–Z listings with its classified directory might affect competition in the CDAS market.

Potential benefits from usage of the A–Z sections

6.85 An effect on competition could arise if BT was able to exploit the usage of its A–Z section to secure higher CDAS sales. It has been suggested that BT has marketed its CDAS by citing usage figures for the *Phone Book* as a whole, and that advertisers are, for the most part, prepared to assume that usage of BT’s A–Z section is likely to lead to usage of the classified section.

6.86 Thomson provided the CC with the results of a survey of advertisers who had decided to stop or reduce advertising expenditure with Thomson in 2006.⁸⁷ The survey provides some evidence of advertisers choosing, or intending, to increase expenditure with BT while reducing expenditure with Thomson; the level of this ‘switching’ to BT is of a similar magnitude to switching to Yell⁸⁸ and Thomson argued that this showed that BT was having an effect on Thomson that was disproportionate to BT’s market share. Thomson argued that this survey further showed that advertisers are prepared to assume that usage of the A–Z section of BT’s directory is likely to lead to usage of the classified section in the same directory, because a

⁸⁷Thomson commissioned Pensare to carry out a survey of [redacted] advertisers who in 2005 advertised in one or more Thomson local print directories and who had not advertised or reduced advertising expenditure in 2006.

⁸⁸[redacted] per cent of respondents had increased spend with BT; the equivalent figure for Yell was [redacted] per cent. A further [redacted] per cent of respondents intended to increase spend with BT.

majority of advertisers described reasons linked to BT's offer of A–Z listings as 'quite important' or 'very important' reasons for advertising in the *Phone Book*.

6.87 However, we have a number of concerns with the methodology used in Thomson's Pensare survey and do not consider that it provides strong evidence that advertisers perceive usage of the BT classified section to be high, based on high usage of its A–Z section. In particular, we consider that a number of questions in the survey were framed in a way that may have rendered the results unreliable. Moreover, the survey did not ask advertisers about the importance of other reasons (not related to BT's ability to offer an A–Z section) for advertising in the *Phone Book*. Another survey submitted to us by Thomson⁸⁹ showed that the reason the largest number of advertisers stated as being important was related to BT's prices. The BMRB survey showed that the reasons stated as important by the largest number of advertisers was the strength of BT's brand image.

6.88 We note that searching for residential phone numbers and for the numbers of businesses classified by the service they offer are separate types of search and that users would be expected to use the directory that is best for the type of search that they wish to perform; this suggests that there is no obvious link between A–Z and classified directory usage. We also note that Thomson's usage has not declined significantly since BT's entry. We do not consider that the evidence suggests that BT's 'three-in-one' offer has benefited its CDAS usage; indeed BT told us that this slogan is no longer the focus of its strategy in selling classified advertising.

6.89 Although advertisers may not have been able to judge whether BT's cited usage figures were a good indicator of likely responses, we consider that advertisers do react to actual performance. Even if the relationship between A–Z residential usage

⁸⁹The BT bundling survey, which surveyed [X] advertisers in the classified section of the *Phone Book*.

and classified directory usage has been overstated, we expect demand to be driven by actual performance rather than marketing statements.

Potential to bundle sales of CDAS and residential A–Z advertising

6.90 We considered whether BT could exploit its ability to offer a ‘bundle’⁹⁰ of classified and residential A–Z advertising, given its special position with regard to A–Z residential listings.

6.91 BT told us that it did not sell, and had never sold, a combined offer of classified advertising with advertising in the residential section of the BT *Phone Book*, or discounts linking these two products.

6.92 Even if BT were to offer a combination of classified advertising with advertising in the residential section of the *Phone Book*, we considered it unlikely that BT could derive significant benefits from this. The low revenues generated by BT from advertising in the residential A–Z section (of approximately less than £[redacted] million a year—that is, less than [redacted] per cent of total CDAS revenues) indicated to us that the demand for such advertising was low, and would not enable BT to encourage a significant number of advertisers to switch classified advertising from other providers.

Potential to bundle sales of CDAS and business A–Z advertising

6.93 We considered whether BT could exploit its ability to offer a bundle of classified and business A–Z advertising, given its relatively strong position with regard to the latter.

6.94 BT has made various price offers available to advertisers that link business A–Z advertisements to CDAS, in the form of promotions giving a free business A–Z advertisement to CDAS advertisers. Such promotions appear directed towards

⁹⁰Bundling: sale of at least two products together at a price that is less than the sum of each of them individually.

gaining additional A–Z sales. However, it is theoretically possible that such offers could take advantage of customers for whom advertising in BT’s A-Z business section is important to drive up BT’s CDAS sales.

6.95 We considered this to be unlikely in view of the low revenues generated by BT from advertising in the business A–Z section (of approximately £[redacted] million a year, [redacted] per cent of the total CDAS market) and due to the small number of advertisers advertising in BT’s business A–Z compared with the total number of CDAS advertisers. This indicated to us that the demand for business A–Z advertising was low and that the large majority of classified advertisers did not find it necessary to advertise in the business A–Z, and therefore that BT would not be able to encourage a significant number of advertisers to switch classified advertising from other providers through such offers.

Potential cost advantages deriving from BT’s ability to offer A–Z listings and CDAS

6.96 It was put to us that BT enjoys certain cost advantages deriving from its regulatory obligations and its ability to offer a ‘three-in-one’ book. We have considered whether they allow BT to compete from a cost base that is lower than the equivalent costs of its competitors. The ability to compete from a lower cost base which results from a regulatory obligation could have a detrimental effect on competition if it enables BT to set prices at levels which would not be profitable if matched by its competitors. We have seen no evidence, however, that BT’s prices are set at levels which would not be profitable for its competitors if BT’s prices were matched by them. We do not consider the fact that BT enjoys economies of scale and of scope to harm competition in itself, as these economies may result in lower prices.

6.97 We have looked at the way in which BT recovers certain costs incurred in connection with the *Phone Book* through its wholesale line rental (WLR) charges to other

communication providers. A specific cost breakdown is compiled by BT and included in the WLR charges which are regulated by Ofcom (previously Oftel). The costs allowed for inclusion in the WLR charge are reviewed at five-yearly intervals. At the last review in 2002, a sum of £[~~8~~] million was allowed by Oftel for A–Z costs, for delivering 15.9 million books based on an 18-month cycle. This figure reflected the direct costs of production for A–Z listings at that time and an allocation of overheads according to the Accounting Separation rules applied by Ofcom. The cost recovery is not dependent on the volume of classified advertising, but rather is related to a pre-determined volume of books delivered. Therefore this does not affect BT's incentives when setting prices for classified advertisements.

Assessment of BT's combined offering

6.98 We consider that BT's combination of classified and A–Z sections distinguishes it from its competitors and provides it with certain scale economies. As described in paragraphs 2.27 and 2.28, BT's *Phone Book* also enables it to fulfil certain regulatory requirements and its regulated line rental pricing takes account of this. However, we do not consider that BT's publication of combined A–Z and classified listings constitutes a feature of this market that prevents, restricts or distorts competition in connection with the supply of CDAS in the UK.

Advertiser switching

6.99 Advertiser switching provides an insight into the substitutability of CDAS products and of advertisers' responsiveness to price or value differentials. Switching behaviour may also provide an insight into the impact of BT's entry to the market. We note that while advertiser switching may be indicative of a competitive marketplace, a lack of switching does not necessarily indicate a lack of competition: potential switching may be as effective as actual switching in constraining prices.

6.100 Yell has experienced declining retention rates in recent years: its retention rate fell from 83 per cent in 2001 to 75 per cent in 2005. Our analysis of the data provided by Thomson shows that its retention rates have remained broadly stable over the same period: Thomson's retention rates increased from [redacted] per cent in 2001 to [redacted] per cent in 2002; they remained stable between 2002 and 2004 at [redacted] per cent, and declined slightly in 2005 to [redacted] per cent. Yell's decline in retention rates, and Thomson's recent decline in retention rates, may be partially explained by the increase in new advertiser acquisition that both Yell and Thomson have been successful in achieving: new advertisers are less likely to renew advertising and so tend to depress retention rates. Despite the decline in advertiser retention, Yell's number of advertisers grew between the year ended 31 March 2000 and the year ended 31 March 2004 and was broadly stable between the year ended 31 March 2004 and the year ended 31 March 2005; Thomson's number of advertisers grew between 2001 and 2005.

6.101 We consider that, although some advertisers may switch their entire expenditure between CDAS providers, switching part of an advertiser's CDAS expenditure may be more common and therefore more significant. While our survey showed that about half (46 per cent) of current CDAS advertisers use only one directory provider, 54 per cent use two providers or more (35 per cent use two, and 17 per cent use three providers). In particular, very few advertisers do not advertise in *Yellow Pages*: our survey suggests that 92 per cent of all current CDAS advertisers with the three main directories advertise in *Yellow Pages*, and therefore we would consider the most likely response by Yell's advertisers to increased competition to be partial switching, moving some expenditure from Yell to another directory provider.

6.102 Our pricing analysis, discussed in paragraphs 6.45 to 6.68, indicates that there have been changes in the relative prices of CDAS products. We have not observed any

associated change in the distribution of advertisers between providers. This may be due to offsetting changes in non-price competition, a lack of responsiveness to prices and/or the fact that the various CDAS products are seen as complements, rather than substitutes, by some advertisers.

6.103 The BMRB survey and the survey from FDS commissioned by Yell indicated a degree of switching between CDAS providers. Overall, BT appears to provide an alternative to Yell for a larger number of advertisers than Thomson does. Survey evidence indicates that switching behaviour varies by advertiser type, with larger advertisers being more prone to switch than smaller advertisers.

6.104 The BMRB survey asked respondents whether they had decreased spend in a directory in the past three years, and, if so, whether they had switched expenditure to other directories.⁹¹ By focusing on decreases in expenditure, the BMRB survey covered both total switching and partial switching. In general, this showed that 17 per cent of all current CDAS advertisers who had reduced expenditure with one directory had switched that expenditure to another directory in the past three years, representing 7 per cent of all current CDAS advertisers. The results suggested that BT provided an alternative to Yell for a larger number of advertisers than Thomson does, with 12 per cent of advertisers who decreased expenditure with Yell having switched to BT, against 4 per cent to Thomson. Advertisers who had decreased expenditure with Thomson were more likely to have switched to Yell (12 per cent) than to BT (9 per cent). In both cases, the proportions switching to BT was higher than would be suggested by market shares.⁹²

⁹¹Or to other media; these results were presented in paragraphs 5.30 to 5.32 .

⁹²The sample sizes of those advertisers reducing expenditure and switching to other CDAS are small.

6.105 Yell argued that these figures would underestimate the amount of switching because of timing issues: an advertiser may have decreased, or ceased, spending with Yell, but only increased spending on another medium or another directory after being surveyed. Yell submitted the results of a survey on substitution by advertisers who had lapsed from Yell or ceased advertising with Yell (the FDS survey) which also takes into account advertisers' intentions in terms of future advertising. This survey is discussed in section 5. We accept that timing issues may create a lag in the response of advertisers that are considering switching to other directories because the length of the publishing cycle of the different directories. As discussed in paragraph 5.34, the FDS survey asked advertisers who had ceased to advertise with Yell, or reduced expenditure with Yell, what advertising they were using in preference to Yell, or where they were spending more on, or where they intended to spend more. About one-tenth of lapsed advertisers, and about one-tenth of advertisers decreasing expenditure with Yell, mentioned BT or Thomson. BT and Thomson were mentioned in similar proportions.

6.106 The BMRB survey suggested that price and quality of response to advertising were the main reasons for switching expenditure to another directory.⁹³ Price was particularly important to advertisers who had switched to BT and to Thomson, while the most important reason for switching to Yell was the quality of the response to advertising.⁹⁴

6.107 Yell provided the CC with information from a database that captures information on the advertising media used by its current, lapsed and prospective advertisers. This suggests that the degree of switching may be lower than the surveys suggest. In

⁹³p. 30 of the BMRB report.

⁹⁴The sample sizes for this question are small

particular, Yell's database shows that [redacted] per cent of Yell lapsed advertisers are still using BT.

6.108 Though the surveys suggest a degree of partial switching between directories, the average revenue per advertiser has remained stable for both Yell and Thomson since BT's entry. The BMRB survey evidence also suggests that the large majority of advertisers who increased expenditure with Yell and Thomson in the past three years did so by increasing total CDAS spend, rather than by switching expenditure between CDAS providers. In the case of BT, the proportions of advertisers increasing spend by switching from Yell or Thomson were somewhat higher (33 per cent), but the majority (67 per cent) had increased spend with BT by increasing total CDAS spend.⁹⁵ This suggests that a large number of advertisers using BT are currently making additional CDAS expenditure rather than switching expenditure from Yell or Thomson.

Countervailing buyer power

6.109 We considered whether it was the case that advertisers buying classified advertisements possessed sufficient buyer power to enable them to constrain the prices of CDAS providers through bargaining. We found this to be unlikely because individual advertisers, even those with a large expenditure, represent a low percentage of classified directory providers' overall revenues⁹⁶ and therefore the loss of a single advertiser is unlikely to affect profits significantly.

⁹⁵These proportions are likely to underestimate switching, as some advertisers who increased spend with BT without decreasing spend with Yell and Thomson, might otherwise have increased their spend with Thomson or Yell.

⁹⁶For example, Yell's largest spending customer represented [redacted] per cent of Yell's revenue.

Barriers to entry and expansion

6.110 As our guidelines state,⁹⁷ the threat of entry or expansion can act as a constraint, preventing firms from exercising market power. Adverse effects on competition are thus less likely where entry is easy, provided that such entry is sustainable and likely to have an impact on the potential for existing firms to exercise market power.

6.111 Yell's CDAS business is the successor to BTYP, the original major CDAS provider. As such it benefits from a first mover advantage, resulting in a high market share, strong finances and a long-established brand and reputation. It appears to have been very hard for other providers to erode this advantage.

6.112 Other providers have told us that Yell also obtains an advantage because 'Yellow Pages' is used as a generic term. Thus, a user that has used another directory may tell an advertiser that he or she 'saw an advertisement in Yellow Pages', leading the advertiser to attribute the inquiry to Yell's directory.

6.113 We observe the following barriers to the establishment of a major CDAS business:

(a) *Overcoming the network effect to establish enough usage to offer a convincing product for advertisers.* The network effect appears to give Yell a significant advantage over smaller providers and any new entrant. It is difficult for a new provider to compete for users—it cannot introduce a directory at a discounted price to users, since the product is already free for them. It is not clear how rapidly, and at what cost, a new entrant, intending to gain national coverage, could persuade users to use, or increase use of, its directory. Very high levels of advertising and marketing expenditure would probably accelerate the process. It took Thomson a considerable time to establish its business. BT has grown more rapidly and its entry is discussed below (see paragraphs 6.120 to 6.122).

⁹⁷CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, page 21, paragraph 3.17.

(b) Need to establish a strong brand identity. A strong brand identity appears to be essential to support strong usage of directories. This must be maintained by high levels of brand advertising and marketing, which is more affordable for successful businesses. Companies with a relevant or transferable brand are more likely to be able to enter the market.

6.114 The BMRB survey indicated that brand image and usage were the most important factors for advertisers when choosing their main directory: a strong brand image was the most important factor when choosing the main directory (90 per cent of advertisers), followed by having a larger number of users than others (82 per cent). For the secondary directory, a strong brand image was also the most important factor (64 per cent of advertisers), but having a higher number of readers than other directories was less important (35 per cent).

6.115 These barriers to entry appear to be substantial, and apply both to first-time entry and to local classified directories aspiring to become national in scope. This interpretation appears consistent with the stability of the market over many years.

6.116 It was submitted to us that there were a number of other costs to entry, such as the cost of hiring a sales force, the costs of sourcing and maintaining a database of businesses, and the costs of publishing and distributing directories. We consider that some of these costs (such as maintaining a database of businesses) are ongoing, rather than start-up, costs and therefore less likely to act as barriers to entry. Potential entrants would assess these costs, offsetting them against the expected revenues of entry.

6.117 Yell told us that the Yell undertakings deterred entry and it provided anecdotal evidence of potential entrants being dissuaded by the Yell undertakings. We would

expect any potential entrant to take account of the Yell undertakings, although the extent of their significance as an entry barrier is not clear.

6.118 The two companies (BT and Trinity Mirror) that have entered this market in recent years have had significant brand and operational synergies with their existing businesses.

6.119 Trinity Mirror's entry has utilized the distribution and marketing experience and opportunities linked to Trinity Mirror's ownership of the *Scottish Daily Record*. In particular, this has included promotion of *The One* using the *Scottish Daily Record*, and offering bundles of classified advertising in *The One* and the *Scottish Daily Record*. We consider these factors make it unlikely that Trinity Mirror will expand its directory business further into the UK.

6.120 When BT re-entered the CDAS market, it combined its CDAS product with its A–Z directory, the *Phone Book*—a directory that was already in national circulation. It appears to benefit from substantial economies of scope, particularly in its directory distribution costs. In addition, BT has a strong brand which is relevant to this market, substantial financial resources and an existing user base (of its A–Z sections), which provide it with a credible proposition to put to potential advertisers and thus help overcome the network effect.

6.121 BT enjoys considerable advantages compared with other potential entrants. While other companies may have some advantages, we have not identified any other potential entrant with comparable relevant strengths. We therefore do not consider that BT's re-entry necessarily gives any indication of the feasibility of any other company entering the CDAS market or expanding to national scope.

6.122 In addition, we observe that while BT's entry has increased the level of competition in the market, its entry could act as an additional disincentive to any business considering entry into the market, both because BT's particular strengths may make it a substantial competitor and, more generally, because the market opportunities for an entrant are reduced by the presence of an additional national provider.

Assessment of competition

6.123 CDAS is a two-sided market in which competition takes place both for users and advertisers, and these are linked. In particular, one way of competing for advertisers is by competing for users.

6.124 We found that the market for CDAS is highly concentrated, with Yell having a market share of around 75 per cent, over five times that of its nearest competitor. We found that barriers to entry and to expansion into this market were high, in particular due to the existence of a network effect and the need to establish a strong brand identity.

6.125 Our analysis of competition for advertisers suggested that there is non-price competition for advertisers, including scoping. Our analysis of competition for users shows that providers compete in a number of ways; advertising is the most evident and immediate, but product features (such as the footprint of directories) are also important.

6.126 With regard to price competition for advertisers, we find that, although Thomson and BT are constrained by Yell, the evidence indicates that Yell is, in general, not currently constrained by Thomson or BT and does not compete on price in any significant way.

6.127 Overall, we find that although there has been some non-price competition for advertisers and competition for users, price competition for advertisers in the market for CDAS has been deficient. This finding, coupled with Yell's substantial market share and the high barriers to entry and expansion in this market, indicates that Yell has market power.

'Second tiering'

6.128 The Yell undertakings prevent Yell from publishing more than one directory in a given area (see paragraph 3.13). This restriction has been in place since the 1996 MMC inquiry *Classified directory advertising services*. The MMC's view was that the publication by Yell of local directories (see below) would reduce the effectiveness of competition to BTYP and thereby reduce choice and increase prices of CDAS in the longer term.

6.129 The introduction of a second directory publication in a given geographic area, sometimes described as 'second tiering', has some similar effects to rescoping: the aim of second tiering is to produce directories with smaller footprints and lower unit prices in order to attract new advertisers and to encourage existing advertisers to purchase additional advertisements. However, the difference between rescoping and second tiering is that, in the case of second tiering, a directory provider does not alter its existing directories and therefore continues to offer the original CDAS product to advertisers.

6.130 We have received evidence that suggests that the publication by Yell of additional small directories could have pro-competitive effects. We received evidence from Yell that indicated that there was an unmet demand for more localised directories.

6.131 We have also received evidence that suggests such conduct could have anti-competitive effects. We considered evidence provided by other CDAS providers that believe that Yell should continue to be prevented from second tiering in order to protect competition. It has been put to us that in the absence of the second tiering restriction, Yell would selectively target its competitors' areas of greatest strength, causing competitors significant damage and weakening competition.⁹⁸ Other CDAS providers have argued that second tiering is less risky for Yell than rescoping because it could offer targeted price cuts in the smaller directories without cutting the prices of its main directories.

6.132 As discussed above, we have received evidence suggesting both beneficial and harmful competitive effects from second tiering. Additional small directories may meet a currently unfulfilled market demand, and may well be pro-competitive. We consider, however, that Yell has market power and therefore has particular abilities to affect competition in the market. We note that certain of the strategies that could be used by Yell in order to take advantage of its market power in order to sell advertising in additional smaller directories might be prohibited by the Competition Act 1998.

6.133 We consider that the publication of additional smaller directories by Yell has the potential to harm Yell's competitors by inducing advertisers to switch away from competitors' directories. However, we do not believe that damage to individual competitors would necessarily lead to less effective competition or hinder the development of competition. On balance, we do not consider that the evidence submitted to date enables us to form an expectation, at this stage in our inquiry, that

⁹⁸In this connection, we were referred to the MMC's report in 1996, when it said: 'We have seen strategy documents produced by BTYP in reaching its decision to produce local directories, and various research by BTYP as to the effects of the introduction of the local directories. It is clear from BTYP's strategy documents that it regarded London as Thomson's strongest area, and that, among its objectives, it intended the introduction of local directories to have a damaging effect on Thomson. BTYP documents referred to the 'need to reinforce our position at the expense of Thomson'; gave as one rationale for the strategy 'to surround the competitor with other Yellow Pages products [which] may be preferable than competing in the current way'; referred to '[competing] on product quality ... [with a] standard [advertising] rate ... slightly below Thomson'; and stated that 'the plan is to publish slightly before Thomson'. MMC report on *Classified directory advertising services*, HMSO, Cm 3171, 1996, paragraph 2.78.

second tiering would prevent, restrict or distort competition or give rise to a detrimental effect on customers.

Prospects for competition

6.134 Although the market has been, and remains, highly concentrated, it is clear that BT is becoming a more significant operator in this market. The evidence indicates, however, that BT is not, in general, currently a constraint on Yell's prices. BT's market share is much smaller than that of Yell and it currently sets its prices by reference to Yell. It appears likely that BT will become a stronger competitor, but the pace of its future growth is unclear and the extent to which its future presence will translate into a significant constraint on Yell's prices is uncertain.

6.135 At present the market continues to grow. It is not clear for how long this will last. While we have been told that the market is 'under-penetrated', which suggests further growth potential, growth in the use of the Internet may cause the market for CDAS to decline.

6.136 These factors suggest that the competitive conditions could change substantially in the next few years, although we have no firm evidence on which to form a view as to the timing and speed of possible changes. In considering remedies, we will take these points into consideration.

7. Profitability

Recent trends in profitability

7.1 The following section outlines and provides commentary on the profit performance of the CDAS activities of Yell, Thomson and BT since the OFT Review of the Yell undertakings on Classified Directory Advertising Services in 2001, and recent trends in profitability.

7.2 It also looks at how Yell (and to a lesser extent Thomson) has been able to maintain profits in nominal terms (albeit with falling profit margins) during a period when prices have been falling in real terms by at least 6 per cent per year.

Yell

7.3 Table 15 shows the financial performance of Yell's CDAS business⁹⁹ for the five-year period to 31 March 2005, and the headline figures for the year ended 31 March 2006.¹⁰⁰

TABLE 15 Yell UK CDAS—financial performance, 2001 to 2006

	Years ended 31 March					
	2001	2002	2003	2004	2005	2006
Total advertisers	418000	438000	451000	480000	478000	462000
ARPA (£)	1239	1234	1272	1237	1281	1341
Net revenue	518.0	540.5	573.7	593.9	612.1	619.4
<i>Direct costs</i>						
Paper						
Printing						
Pre press						
Bad Debts						
Selling costs						
<i>Operating costs</i>						
Delivery						
Staff						
Accommodation						
Marketing						
Product development						
IS & Telecom charges						
Other operating costs						
Total costs	290.2	318.1	346.4	366.1	386.6	399.6*
EBITDA	227.8	222.4	227.3	227.8	225.5	219.8*
EBITDA margin (%)	44.0	41.2	39.6	38.4	36.8	35.5

Source: Yell.

*Calculated using International Financial Reporting Standards (IFRS). Using IFRS for the year ended 31 March 2005 produces EBITDA of £217.8 million and an EBITDA margin for that year of 35.6 per cent.

⁹⁹The figures include *Business Pages* as well as *Yellow Pages*.

¹⁰⁰Yell announced its financial results for the year ended 31 March 2006 on 23 May 2006.

- 7.4 During the five-year period to 31 March 2005, Yell's UK CDAS revenues increased from £518 million to £612 million, which equates to a compound annual growth rate of 4.3 per cent over the period. Although revenues increased mainly due to higher volumes, EBITDA¹⁰¹ remained at about £225 million over the period. Against a background of rising revenues, this means lower EBITDA margins, which declined from 44.0 to 36.8 per cent.
- 7.5 Yell attributed the decline in EBITDA margins to greater investment in its CDAS business, namely more sales staff, increased marketing support, and new IT systems to facilitate the increase in the numbers of new advertisers and the retention of existing advertisers. Most noticeable is the increase in selling costs over the period which increased from £[X] million to £[X] million, equating to a compound annual growth rate of [X] per cent.
- 7.6 Other direct costs, such as printing and bad debts, have moved in line with increases in revenues and advertisement volumes. Yell stated that there were some additional operating costs (corporate overheads) associated with *Yellow Pages* being a stand-alone business (from June 2001), rather than part of the BT Group.
- 7.7 The increase in revenue was due to a combination of growth in advertiser numbers (from 418,000 to 478,000) and a small increase in the average revenue per advertiser (ARPA) (from £1,239 to £1,281) despite the price control. Yell attributed this increase in ARPA largely to advertisers purchasing colour advertising which was rolled out across all *Yellow Pages* directories in 2001/02. In the year ended 31 March 2005, net incremental revenue associated with colour advertisements was about

¹⁰¹We have used EBITDA as a performance measure in this report as it is widely used in the industry. Yell states that it considers EBITDA is one of the key financial measures it uses 'to assess growth in its business and operational efficiencies'. We are content to use it in this report as we are interested in operating performance excluding amortization of goodwill and depreciation.

£[x] million.¹⁰² Additional increases in average spend are the result of advertisers purchasing multiple advertisements and larger advertisements. The average number of advertisements per advertiser increased over the period from [x] to [x] per year.

7.8 Yell argued that it has been able to achieve these outcomes because of the greater appeal of its *Yellow Pages* product, arising from investments in advertiser service, discounts granted to new and existing advertisers and, particularly, the introduction of colour advertisements. Yell provided us with actual values of its colour premium revenues for the four years to 31 March 2005, which are shown, along with our estimate for the year ended 31 March 2001, in Table 16. The contribution to Yell's revenues from colour premiums increased markedly, from an estimated £[x] million to £[x] million (an increase of £[x] million) during the five years to 31 March 2005 (see also paragraphs 7.94 to 7.96).

TABLE 16 Colour premium revenues

	Year ended 31 March				
	2001	2002	2003	2004	2005
Gross colour premium (£'m)	[x*]

Source: Yell.

*CC estimate from Yell data.

7.9 Yell has benefited from the depreciation of the US dollar, the currency used to price paper as an international commodity, which enabled Yell to incur lower £ per tonne paper prices than forecast. Without this benefit, EBITDA would have been £[x] million lower for the year ended 31 March 2005.

7.10 Yell's results for the year ended 31 March 2006 show a small increase in CDAS revenues and EBITDA on the prior year, with EBITDA margins staying steady.¹⁰³ The

¹⁰²This figure includes a deduction for Yell's estimate of revenue growth in the absence of colour (see Table 24).

increase in revenues was achieved through increased ARPA despite a fall in advertiser numbers.

Thomson

7.11 Table 17 shows the financial performance of Thomson's CDAS business for the five-year period to 31 December 2005.

TABLE 17: Thomson CDAS: financial performance 2001 to 2005

	year ended 31 December				£ million
	2001	2002	2003	2004	2005
Customer numbers					
ARPA (£)					
Revenue*					
Direct costs					
Paper					
Printing					
Selling costs					
Other direct costs					
Other operating costs					
Total costs					
EBITDA					
EBITDA margin (%)					

Source: Thomson management accounts prepared under Italian GAAP.

*Statutory accounts disclose UK paper directories revenues of £83.5 million in 2001, £85.6 million in 2002, £91.9 million in 2003, £98.2 million in 2004 and £99.3 million in 2005. Thomson told us [REDACTED].

7.12 During the five-year period, Thomson was able to [REDACTED] EBITDA margins [REDACTED] around [REDACTED] per cent in the three years ended 31 December 2003, before [REDACTED] in margins to [REDACTED] per cent for the following two years.

7.13 Revenues rose by approximately £[REDACTED] million over the five-year period. Thomson introduced various pricing and account growth schemes (eg the 'Value Plus' rate card) during 2001 and 2002, [REDACTED] (see also paragraph 6.49). It was able to achieve a [REDACTED] per cent revenue increase over the two years to December 2003 (increasing

¹⁰³Figures reported using IFRS.

from £[x] million to £[x] million). Its advertiser base grew by [x] per cent (from [x] to [x]).

7.14 Thomson achieved further revenue growth during 2004 (from £[x] million to £[x] million) from a combination of [x]. Thomson attributed [x] to the introduction of the NHS Self Help Guide in the English editions of Thomson's directories from April 2004 onwards, and a one-off national programme of insert cards by Ocean Finance.

7.15 Thomson also attributed [x] to the introduction of the 'added value' sales strategy, which it believed helped mitigate the impact of reductions in advertising rates charged during the period. This strategy was introduced in 2002, and along with the roll-out of full colour advertising in 2004, contributed to [x]. Thomson completed the roll-out of colour for all of its major directory areas in 2004.

7.16 Operating costs [x].

7.17 [x]

BT

7.18 The *Phone Book* business is part of BTD, which includes operator services, telephone directories and online directories. As described in paragraph 2.27, the A–Z and classified products are part of the same book, and these elements are not shown separately in the *Phone Book* management accounts. BT stated it could not easily split costs and hence profitability between the two. BT argued that separate management accounts would require the introduction of complex cost allocation methods.

7.19 Table 18 shows the financial performance of BT's *Phone Book* business since its entry into the CDAS market in the year ended 31 March 2003.

TABLE 18 BT Phone Book—financial performance, 2003 to 2006

	£ million			
	Years ended 31 March			
	2003	2004	2005	2006
<i>Revenue</i>				
BT Phone Book—A-Z & other				
BT Phone Book—CDAS				
Recharges				
<i>Direct costs</i>				
Paper				
Production				
Data				
Delivery				
Other direct costs				
Other operating costs*			✂	
Total costs				
EBITDA				
EBITDA margin (%)				

Source: BT.

*Includes selling costs.

7.20 Some of the costs incurred in complying with BT's obligation to compile and distribute a printed directory are recouped from recharges to various parts of BT. The recharge has been about £[✂] million per year for the two years to 31 March 2004, and [✂] million the following two years. The reasons for the increases in cost and, hence, for this increase, are explained in paragraph 7.22. BT states that this recharge is intended to be profit neutral.

7.21 BT achieved [✂] million of classified advertising revenue in the year ended 31 March 2003, but this grew to over £[✂] million in the year ended 31 March 2006. A-Z advertising revenue has averaged about £[✂] million over the period and is derived

from non-classified advertising revenue and other items such as loose inserts, as well as miscellaneous book sales.¹⁰⁴

7.22 [X] were incurred in the three years to March 2006 as BT's CDAS business was essentially in a start-up phase. In addition, the decision to [X] *Phone Book* which, as described in paragraph 2.27, BT is now required to distribute annually under European legislation,¹⁰⁵ rather than every 18 months. Coupled with BT's decision to distribute a copy of the *Phone Book* to all households and businesses in the UK, BT's costs increased.

7.23 We attempted to estimate the profitability of BT's CDAS business using a range of cost allocation methodologies. Most of the direct costs, such as paper, printing and distribution are incurred for the production of both listings. Table 19 shows the estimated profitability of the CDAS business for the year ended 31 March 2006, assuming that direct costs are allocated according to share of production. We also replaced the internal recharge referred to in paragraph 7.20 with the cost recovery income BT receives from line rental charges (see Appendix 7.3) in order to estimate the profitability of this activity to the BT Group as a whole. On this basis, the CDAS business made a [X] million in the year ended 31 March 2006. Different possible ways of allocating costs to BT's CDAS activities, and resulting estimates of the profitability of this activity, are set out in Appendix 7.3.

¹⁰⁴These are directory sales made to BT customers who request a copy of a directory outside their own directory distribution area.

¹⁰⁵Universal Services Directive (2002/22/EC), Article 5(1)

TABLE 19 **BT CDAS profit estimate based on share of production cost**

£ million

year ended 31 March 2006

	Total	A-Z	CDAS
<i>Revenue</i>			
BT Phone Book—A-Z & other			
BT Phone Book—CDAS			
Cost recovery via line rental			
<i>Direct costs</i>			
Paper			
Production			
Data			
Delivery			
Other direct costs			
Other operating costs*			
EBITDA profit/loss			

Source: CC calculation based on BT data.

*Includes selling and marketing costs.

Profitability analysis of the major CDAS providers

Introduction

7.24 In this section, we consider issues relating to the assessment of profitability within competition analysis in general, and relating to the existence of the price control in this case in particular.

7.25 An indicator of the extent of competition in a market is the level of profits of the firms involved. A competitive market is likely to generate significant variations in profit levels between firms as supply and demand conditions change, but with an overall tendency towards levels commensurate with the cost of capital of those firms. At particular points in time, the profits of some firms may exceed what might be termed this 'normal' level. Reasons for this could include, for instance, cyclical factors, transitory price or other initiatives, the fact that some firms may be more efficient than others, or earning profits gained as a result of past innovation. However, if competition is working effectively, it should put pressure on profit levels, for example by attracting new entry or expanded output from firms already in the market, so that

they move towards the cost of capital in the medium to long run. A situation where, persistently, profits are substantially in excess of the cost of capital for firms that represent a substantial part of the market, could be an indication of limitations in the competitive process.¹⁰⁶

7.26 In its statement of reasons for referring the supply of CDAS in the UK to us,¹⁰⁷ the OFT stated that, in its view, the profitability of the two leading suppliers (ie Yell and Thomson) provided evidence that structural features of the market may restrict, distort or prevent competition. It stated that information provided to it on profitability in the supply of CDAS indicated that the profits of the two leading suppliers, especially Yell, were high and significantly more than profits earned by other firms selected as comparators. Rates of profitability had, in its view, remained reasonably stable. It gave figures for ROS¹⁰⁸ for Yell's printed directories for the four years to 31 March 2004 and for Thomson's business in total for the four years to December 2003. It compared these returns with various firms it chose as comparators and concluded that the ROS for the two leading CDAS suppliers was significantly above these averages and that these rates were higher than those found for some of the most profitable firms among both comparator groups.

7.27 The CC's guidelines¹⁰⁹ on market investigation references¹¹⁰ (the Guidelines) discuss comparing profits with the cost of capital. In this context we usually aim to compare ROCE—defined as profit before interest and tax divided by the long-term capital employed in the business—with the cost of capital of the firms involved calculated using the Capital Asset Pricing Model (CAPM). As stated in the Guidelines, in measuring profitability, the CC's approach usually is to start with

¹⁰⁶See CC3, *Market Investigation References: Competition Commission Guidelines*, 2003—paragraphs 3.81 to 3.85 deal with the subject of profitability

¹⁰⁷See footnote 38.

¹⁰⁸The OFT considered ROS to be the most appropriate measure of profitability.

¹⁰⁹As above.

¹¹⁰See footnote 106.

accounting figures for both profit and capital employed and then to make adjustments. The principal types of adjustments that are required are either those that recognize assets not captured in traditional accounting systems (often types of intangible assets¹¹¹) or to value assets that are included in the accounts on a different basis, in order to reflect their current value¹¹² rather than a value based on depreciated historic cost.

7.28 An alternative method of measuring profitability that is often used in investment appraisal is to calculate an IRR. Assuming an outflow at the start of a project and then a series of cash inflows, this involves estimating the discount rate at which the discounted value of the future cash flows equals the initial cash outflow. A firm using this method for investment appraisal would then compare the IRR calculated with the cost of capital, and would proceed with the project if the IRR exceeded the cost of capital. An IRR approach has the advantages of taking account of the time value of money and, being based solely on cash flows, it is not dependent on accounting conventions in terms of measuring profits or valuing assets. IRR methodologies are most often used in ex ante project appraisal.

7.29 However, when looking at an ongoing activity of a firm,¹¹³ it is not possible to calculate a full (or 'lifetime') IRR as not all cash flows are known,¹¹⁴ but there is some support in these circumstances for using a 'truncated' IRR approach.¹¹⁵ This also might be considered the appropriate methodology when the issue is profitability over a shorter period than the whole life of the activity. To calculate a truncated IRR over a

¹¹¹An intangible asset is defined by International Accounting Standards as 'an identifiable non-monetary asset without physical substance'. Examples of intangible assets include trademarks, customer contracts, broadcasting rights and patented technology.

¹¹²There are a number of current value bases available. There is also a widely-known set of rules to determine which the appropriate value to use is in a given set of circumstances, which are known as the 'value-to-the-owner' or 'deprival value'.

¹¹³IRR is not much used for ex post evaluation. There are some disadvantages of using ex post IRR calculations for competition analysis even if all cash flows are known. Such a method allows for a return on all expenditure, even if it was incurred inefficiently and/or created no value to the business.

¹¹⁴There would be no final lump-sum cash inflow for a firm's ongoing activities.

¹¹⁵For example, the discussion paper entitled *Assessing profitability in competition policy analysis* – A report prepared for the Office of Fair Trading by OXERA, July 2003, in particular, Chapter 4 entitled 'The IRR and Proxy measures of Profitability'. www.offt.gov.uk/NR/rdonlyres/C410132C-F322-47CD-8AFA-38B13247A0AE/0/oft657.pdf

period, values of the opening assets and closing assets and the cash flows for the period are needed. The truncated IRR is then the discount rate at which the present value of the cash flows over the period, plus the discounted value of the closing assets at the end of that period, equals the opening value of the assets. Truncated IRRs that are calculated over a longer period have the advantage that relatively more weight is given to actual cash flows and relatively less to opening and closing asset valuations. As is clear from this definition, a truncated IRR calculation needs asset valuations. Thus asset valuation issues which affect the valuations of assets in calculating the ROCE when used in competition policy analysis also are relevant to truncated IRR calculations.

- 7.30 In the Guidelines, the CC recognizes the difficulties in measuring assets,¹¹⁶ particularly in some industries—including markets for services and for products with a high intellectual property value. The Guidelines state that in such circumstances, we may consider alternative measures such as the ROS.

Issues

- 7.31 The fact that Yell is subject to a price control and that the majority of Yell's prices were constrained by the undertakings makes an assessment of the relationship between Yell's profitability and its market power difficult. If there were no price cap and Yell were free to exploit fully any market power it may possess, Yell's profits might be higher. Therefore, profitability measures may underestimate the true extent of Yell's market power in the absence of the Yell undertakings.
- 7.32 There are also issues that relate to the measurement of profitability. One is asset valuation and, in particular, the identification and valuation of intangible assets (this is

¹¹⁶The Guidelines refer to measuring capital but these are equivalent as the capital is the means by which the net assets of the firm are financed.

relevant to the use of either ROCE or truncated IRR). The balance sheet for Yell's CDAS business shows a low level of tangible assets which comprise mainly office equipment and some building improvements, and thus their valuation is not significant in our calculations. The remaining net assets are also of low value and comprise principally the excess of stock (directories in progress) and trade debtors in excess of creditors and deferred income.¹¹⁷ On the subject of intangible assets, Yell mentions in its accounts acquired advertiser relationships (ie advertiser lists) and brand names as intangible assets.¹¹⁸ Historically, UK accounting principles have not permitted the inclusion of many types of intangible assets. The balance sheets for the UK Printed Directories Business of Yell Limited up to March 2001¹¹⁹ and Thomson¹²⁰ showed no intangible assets and hence relatively low levels of capital employed, and returns calculated based on these unadjusted accounting figures produce very high ROCE figures. The recent balance sheets of Yell, prepared under UK accounting principles, include substantial amounts of goodwill¹²¹ but no separately identified intangible assets.¹²²

- 7.33 When attempting to calculate the appropriate value of intangible assets for assessing profitability for competition purposes, there is a risk of creating a circularity: a return on assets (ie either ROCE or truncated IRR), when those assets are valued in a way that would capitalize any future excess profits accruing from the exercise of market power, is not a useful indicator of whether or not there are any such excess profits and, hence, whether market power exists. Given the reason for our examination of profitability, we were conscious that any approach to measuring intangible assets

¹¹⁷We have no reason to believe that these assets are not shown in the accounts at their current valuation.

¹¹⁸In Note 29 of its accounts in the discussion of US Generally Accepted Accounting Principles.

¹¹⁹These accounts were a requirement of the Undertakings and were sent annually to the OFT.

¹²⁰Thomson Directories Limited—Financial Statements for the year ended 31 December 2004.

¹²¹Goodwill on acquisition is the difference between the value paid for a business and the value of the assets acquired that are recognized individually in the balance sheet.

¹²²Yell has told us that under IFRS, it expects in its accounts for the year ended 31 March 2006 to identify acquired advertiser relationships (ie customer lists), brand names, in-process R&D, software goodwill and customer commitments (part of directories in development) as intangible assets.

needed, as far as possible, to avoid capturing any 'excess profits' or value attributable to the possession of market power in the future.

7.34 Given Yell's substantial share of the market and our wish to see if our assessment of profitability could provide any evidence of market power, we have concentrated our profitability analysis on Yell. We have also applied many of the same (or similar) methods to Thomson to provide estimates of Thomson's profitability. Given that BT [X] was still in essentially a start-up phase, it was clearly not earning profits in excess of the cost of capital. It is therefore not considered in the following sections, although we return later to its future profitability.¹²³

Approaches to measuring profitability for Yell and Thomson

7.35 With these considerations in mind, we used two types of approach:

- (a) comparison of return on assets, (measured as truncated IRR or ROCE), with our calculation of the appropriate cost of capital (these are set out in paragraphs 7.41 to 7.64); and
- (b) comparison of accounting ratios—ROS—with ratios for comparable, or 'benchmark', companies (these are set out at paragraphs 7.65 to 7.88).

7.36 Both types of approach to measuring profitability have their limitations, some general and some more specific to the circumstances of this case, (which are considered at paragraphs 7.52 to 7.57, 7.63, and 7.79 to 7.83), and accordingly, we believe that there is benefit in continuing to make use of both. By using a variety of methods our aim was to achieve a robust result.

7.37 Further detail on these two approaches, which are considered below, is set out in Appendix 7.1. At an early stage of our inquiry, Thomson produced its own calculation

¹²³We do not assess Trinity Mirror's or Kingston's profitability as these two providers comprise such a small share of the market.

of its profitability, based on very similar methodologies to those we use in the truncated IRR calculations shown below, together with criticisms of the approach used by the OFT. The result is summarized in paragraph 7.47. Thomson's views on IRR and ROS are detailed in paragraph 7.82.

7.38 For the first type of approach, we need a cost of capital with which to compare the results calculated. We estimated the pre-tax nominal WACC for the period 1999 to 2004 using the CAPM, which gave a range from 8.6 to 12.2 per cent with a mid-point of 10.4 per cent. The WACC declined over the period.¹²⁴ Yell estimated its WACC as [redacted] per cent post-tax nominal, which is equivalent to [redacted] per cent pre-tax nominal. Thomson estimated its own pre-tax nominal WACC for the period as being in the range [redacted] to [redacted] per cent. We have used our estimate of the range of industry WACC for all comparisons.

7.39 We note that Yell's and Thomson's estimates of their WACCs, of [redacted] and 12.5 per cent respectively, were slightly [redacted] than the top of the range of our estimate of the relevant WACC. We consider it likely that Thomson's WACC would be towards the top of our range and higher than Yell's as we consider that it might have a somewhat higher beta.¹²⁵ The basis of our calculations and the parameters on which we differ from the estimates provided by Yell and Thomson are discussed further in Appendix 7.2.

7.40 We also estimated a pre-tax real WACC for the period 1978 to 2004 of between 7.4 and 11.3 per cent.

¹²⁴ In 1999, the range of the WACC was 8.8 to 12.3 per cent with a mid-point of 10.6 per cent. In 2004, the range of the WACC was 8.0 to 11.6 per cent with a mid-point of 9.8 per cent.

¹²⁵ It is possible, for example, that advertising in Thomson is seen by advertisers as more discretionary than advertising in Yell and hence Thomson's business might be more affected by the economic cycle. The BMRB survey (described in paragraph 5.6) found that 92 per cent of advertisers with the main CDAS providers advertise with Yell, and that about half of all current CDAS advertisers consider Yellow Pages as essential to advertiser in for their business, against only 5 per cent who consider Thomson as essential.

Comparison of return on assets (measured as truncated IRR or ROCE) with our calculation of the appropriate cost of capital

7.41 Our usual preference is to value intangible assets on a cost-based approach for each category of intangible asset (hence avoiding the inclusion of future profits in the valuation) and to add these valuations of intangible assets obtained to the balance sheet value (adjusted if required) of other net assets. This seemed impractical in this case given the fact that most assets in this industry were intangible, and that the relevant expenditure which built up those assets would be impossible to identify. We therefore estimated asset values in total (that is, tangible and intangible) using transactions in this sector. Such an approach may overstate asset valuations (and thus understate estimates of profitability) by including assets we would have excluded on a line-by-line basis.

7.42 In order to estimate the opening and closing asset values for the truncated IRR calculations and year-end asset values for each year to calculate ROCE figures, we used purchase multiples derived from various transactions in this sector. These IRR and ROCE figures estimated are for five years. In the case of Yell, this is the five years to 31 March 2005, and for Thomson, the five years to 31 December 2004.¹²⁶

7.43 In order to estimate values of net assets to use in these calculations, we have looked at values paid for other CDAS businesses to estimate asset values, and then scaled the results to the size of Yell's or Thomson's businesses using various parameters. The aim of this approach was to take figures from CDAS businesses that operate in less concentrated markets, or that are not the incumbent provider in CDAS markets that remain highly concentrated.¹²⁷

¹²⁶We propose to update these calculations to include the December 2005 figures for Thomson and the March 2006 figures for Yell in our final report following full-year results recently announced by Yell.

¹²⁷There may also be the issue that non incumbents might benefit from the incumbent's market power.

7.44 We used a sample of CDAS businesses recently acquired both by Yell and by third parties and examined their purchase values. From these, we were able to calculate multiples¹²⁸ based on various scaling factors including EBITDA, turnover and costs.¹²⁹ We then applied these multiples to the appropriate figure for Yell or Thomson (of EBITDA, turnover and cost respectively) to estimate net asset value (assumed equal to capital employed) for the start and end of the period for the IRR calculations and for the ROCE calculations for the ends of the intervening years.

7.45 We have chosen the multiples which we consider to be the most representative by excluding the more extreme multiples. It is possible that some of these may be considered outliers. The range of multiples shown in the results Table 20 takes the three multiples from the middle of the range.¹³⁰

7.46 The results of these calculations for Yell and Thomson are shown in Table 20 and in Figure 1, together with our estimated pre-tax nominal WACC.

TABLE 20 Results of truncated IRR and ROCE

		<i>Yell—five years to March 2005</i>		<i>Thomson—five years to December 2004</i>	
	<i>Multiple</i>	<i>IRR (%)</i>	<i>ROCE (%)</i>	<i>IRR (%)</i>	<i>ROCE (%)</i>
EBITDA multiples	14 to 10	8.6 to 11.4	6.7 to 9.7	(✂)	
Turnover multiples	4 to 2	14.5 to 24.6	8.8 to 21.3		
Cost multiples	8 to 4	14.8 to 23.4	7.0 to 19.1		

Source: CC calculations from Yell and Thomson data and data from other CDAS providers.

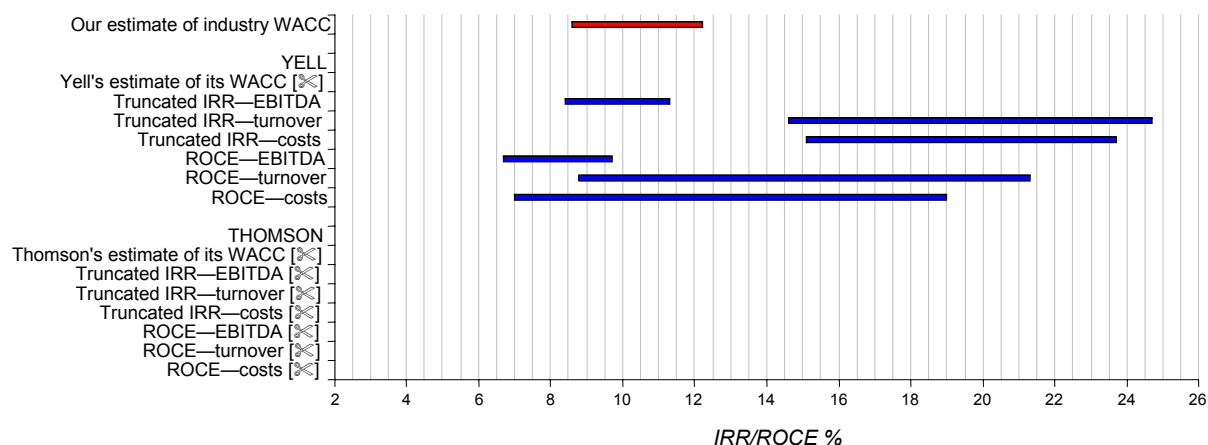
¹²⁸See comments below at paragraphs 7.55 to 7.57 on the relative merits on these various multiples and our particular concerns about EBITDA multiples in this instance.

¹²⁹The EBITDA multiple was defined as purchase value/EBITDA; the turnover multiple was defined as purchase value/turnover; and the cost multiple was defined as purchase value/cost where cost was the difference between turnover and EBITDA.

¹³⁰This means that 60 per cent of the results calculated are shown. All the results are shown in Appendix 7.1.

FIGURE 1

Results of truncated IRR and ROCE



Source: CC calculations.

7.47 Thomson also estimated a truncated IRR calculation for its business¹³¹ over five years to 31 December 2004. It derived an estimate of its opening and closing asset bases using only EBITDA multiples. These multiples were chosen by reference to other similar companies that were publicly-quoted and for which the multiple could be obtained. It considered a range of estimates for the asset values, from 9 to 12 times Thomson's EBITDA, taking 11 times as the central estimate. Assuming 11 times EBITDA for both opening and closing asset values and applying actual cash flows from 2000 to 2004, Thomson estimated a truncated five-year IRR of [X] per cent on a pre tax nominal basis.

Commentary on the Results

Yell

7.48 The truncated IRR results for the five years for Yell were greater than both our estimate and Yell's estimate of the relevant WACC when either cost or turnover is used to calculate the multiples used. When EBITDA multiples were used, which we

¹³¹Financial data for the complete UK business, rather than CDAS alone, was used by Thomson in order to simplify the analysis. Thomson argued that the whole-business IRR is likely to be higher than the CDAS IRR would be. We find this explanation plausible. This is explained further in Appendix 7.1.

place little weight on (see paragraph 7.55), this produced ranges that were within our WACC range.

7.49 The results of the ROCE produced ranges that overlapped with our range of estimates for the WACC. Looking at the results based on turnover and cost multiples, about half of the estimates exceeded our WACC range; this was the case for ROCE figures calculated using lower multiples, for example using a turnover multiple of two or a cost multiple of four. Detailed results showing the ROCE for each year using each multiple are set out in Table 10 in Appendix 7.1. This shows that for each multiple used, the estimate of ROCE declines each year over the five years¹³² and is therefore lowest for the most recent year of the calculation (year ended 31 March 2005). The declines are fairly steady. Results calculated using EBITDA multiples¹³³ produced ranges within our estimate of the range for WACC.

Thomson

7.50 All our estimates of the truncated IRR for Thomson [X]. The truncated IRR results for Thomson [X] except when EBITDA was used as the scaling factor.

7.51 The ranges of our ROCE estimates for Thomson [X].

Limitations of the approach used above to estimate truncated IRRs and ROCE figures in this case

7.52 This approach had its limitations, which we set out below.

7.53 Both the ROCE and the truncated IRR figures are very sensitive to which type of multiple is used and value of the multiple used. In the case of the truncated IRR

¹³²This results from the fact that we have estimated asset values as a multiple of turnover or costs and both turnover and costs have increased over the period while profits have remained virtually flat.

¹³³Again, see our comment in paragraphs 7.55 to 7.57.

figures, this is due to the fact that over relatively short time periods, the influence of the values of the opening and closing asset value on a truncated IRR is large, relative to the influence of the cash flows.

7.54 The result of a truncated IRR calculation can also be very sensitive to the choice of the opening and closing years. This was significant in the case of Thomson as the cash flows fluctuate markedly and, hence, also the EBITDA figures used to derive the opening and closing values by them and also our EBITDA-derived results. We looked at the results of using different opening and closing years. The IRR increases significantly when the opening year was changed from 1997 to 1998. This was due to Thomson's EBITDA falling from £[X] million in 1996 to £[X] million in 1997.¹³⁴

7.55 There were also issues as regards which was the best approach to multiples to derive the opening and closing asset values. Using EBITDA multiples may not be a good measure of business size. Further, if a firm has market power, its EBITDA will tend to be higher, hence an approach based on EBITDA multiples could overstate the value of assets. While profit multiples are frequently used in valuation, given that our purpose is to draw conclusions about profits, we consider that very limited weight can be placed on a calculation that is derived from a profit-related number. Turnover is likely to reflect business size better than EBITDA, but is still likely to reflect market power, because higher prices would be reflected in turnover figures.

7.56 Cost,¹³⁵ calculated as turnover less EBITDA, is likely to be a better indicator of business size. Also any market power effect that results in higher prices would be included in both turnover and EBITDA, would be eliminated and consequently, any distortion due to market power is likely to be less. However, when the transactions

¹³⁴The opening asset value was calculated using the previous year's EBITDA.

¹³⁵That is, the total cost base of the business.

used to obtain the scaling factors involve acquisition of targets that themselves have market power (and therefore command a high purchase price), the multiples themselves are inflated. Applying these multiples to Yell's or Thomson's costs will then lead to an overestimate of asset values.

- 7.57 We believe that the multiples calculated by reference to cost are more appropriate, as any distortion due to market power that the firm may possess is likely to be less. Accordingly we put more weight on figures derived using cost as the scaling factor.

'Lifetime' internal rate of return

- 7.58 In addition to considering truncated IRRs over five years, we also looked at IRR calculations over longer periods. Calculating a truncated IRR over a much longer period has the advantage of the result being less dependent on the value of opening and closing asset values used. We estimated such an IRR for Yell, and Thomson similarly provided an IRR estimate for its business from inception to 2004.

- 7.59 Our 'lifetime' IRR for Yell for the period 1978 to 2004,¹³⁶ which was based on values in 1977 prices, produced a real IRR of between [x] and [x] per cent.

- 7.60 We estimate that the pre-tax real WACC for the period 1978 to 2004 was between 7.0 and 10.4.

- 7.61 Thomson's estimate of its IRR from inception to 2004, which was in 2004 prices, showed that on a 'lifetime basis', its pre-tax IRRs ranged from [x] to [x] per cent,

¹³⁶Using a multiple of two or three times cost in calculating the opening intangible asset value. The basis for this is explained in Appendix 7.1.

depending on the EBITDA multiple¹³⁷ used for the closing asset value (shown in Table 21).

TABLE 21 Thomson's estimates of its 25-year pre-tax IRRs using 2004 prices

	<i>per cent</i>			
<i>EBITDA multiple used to value closing assets in 2004</i>	9	10	11	12
IRR	[%]	

Source: Thomson.

7.62 This compares with Thomson's own estimates of the pre-tax real WACC over the period, which were [%] per cent for the period 1980 to 1999 and around [%] per cent for the period 2000 to 2004.

Limitations of the approach used to estimate 'lifetime' IRRs

7.63 When we put the various approaches set out above and the resulting estimates of its profitability back to Yell for comment, it queried whether anything meaningful could be learned from the 'lifetime' IRR analysis because for most of the period 1978 to 2004 the business was part of BT and bore little relationship to Yell's business today. It also stated that, as the CDAS business was part of BT, transfer prices would be an issue which would need to be considered when analysing business unit accounts.

7.64 We consider that the 'lifetime' IRR measure has the advantage that, because it considers a long time period, relatively more weight is given to actual cash flows and relatively less to opening and closing asset valuations. Although the "lifetime' IRR reflects cash flows from a much earlier period, it may still be possible to draw useful inferences about more recent performance. In this case the 'lifetime' IRR is significantly in excess of the relevant WACC and the cash flows in the later years are

¹³⁷See paragraph 7.55 regarding our views about the disadvantages of using EBITDA multiples in this context.

substantially greater than those in the early years; the IRR would tend to be higher were it not for the inclusion of the early years. Consideration of the 'lifetime' IRR therefore suggests that overall returns, and also returns in recent years, have been greater than the WACC. However, given our interest in current and recent profitability, it would not be appropriate to consider only 'lifetime' IRR calculations.¹³⁸ We have therefore also considered the five-year truncated IRRs (in paragraphs 7.41 to 7.49).

Comparison of accounting ratios for Yell and Thomson with various comparators

7.65 We also compared the profitability ratios of Yell and Thomson with those of a variety of firms and sets of firms, as an alternative way of considering the profitability of the CDAS activities of Yell and Thomson. For the majority of the data used (both in terms of firms and measures), six years of data was available.¹³⁹ We compared measures of Yell's¹⁴⁰ and Thomson's ROS with those of the comparator companies. The results shown in this section are for comparisons of EBITDA margins. EBITDA is widely used in the CDAS industry and we considered it to be the most appropriate measure. We also considered other measures of return on sales.¹⁴¹

7.66 We took an average of five years, to 31 March 2005 for Yell¹⁴² and to 31 December 2004 for Thomson. We compared both Yell and Thomson's figures with:

- (a) a large set of more than 4,000 publicly-listed companies from the UK, other European countries and the USA;

¹³⁸This point was recognized by Thomson who stated that 'Notionally at least, there is a question whether an IRR calculation over such an extended period might mask excess profitability occurring only at the end of the period considered, as the IRR measures an average return over the entire period'.

¹³⁹Up to six years' of annual data for all indicators except EBITDA, for which up to eight years' of data was available, and beta, for which only the current value was reported. Availability varied between the firms in the sample. Yell Group data was extracted from this database. Yell UK CDAS data was not available from the database, but the comparable indicators were constructed from data extracted from Yell's submissions to the CC. Further detail on this is included in Appendix 7.1.

¹⁴⁰We considered both the return on sales of Yell's UK CDAS business and Yell's whole UK business. The figures given in this section are for the CDAS business. Both sets of results are shown in Appendix 7.1.

¹⁴¹The first measure was calculated as EBITDA, divided by net revenues which we called ROS1. We calculated ROS2 as EBIT divided by net revenues, and ROS3 as EBITDA less capital expenditure, divided by net revenues.

¹⁴²The measure ROS3 for Yell UK was an average of four years 2000/01 to 2004/05 as data for the first year was not available.

(b) a subset that represented firms that are active in similar types of business.

7.67 We also compared Yell's ratios with:

(a) several subsets that represent firms that have some characteristics similar to Yell in terms of cost structure and risk; and

(b) with Yell's operations in the USA, namely Yellow Book.

7.68 Each of the comparisons for Yell was also done comparing Yell's ratios both with the raw data set derived for a variety of firms and sets of firms, and also with the ratios of the firms based on a 'cleaned' dataset.¹⁴³ The results quoted below are those from the comparisons with the 'cleaned' dataset.¹⁴⁴ The results do not differ substantially from the ROS comparisons obtained from the whole sample.¹⁴⁵

Benchmarking of accounting ratios results

7.69 The results for the benchmarking approach set out above were as follows:

Large sample comparison

7.70 Yell ranked very highly in the comparison of the ROS ratio with the large sample, ranking in the top decile.

7.71 Thomson was in the [X] decile.

Subsample of firms in similar businesses

7.72 When compared with the publishing subset, an industry that we considered has some similarities with CDAS, Yell's ROS was again in the top decile.

¹⁴³This involved for example looking for any outliers and excluding observations with abnormal accounting figures, eg negative turnover. This process is explained further in Appendix 7.1.

¹⁴⁴The results of both sets of comparisons are included in Appendix 7.1.

¹⁴⁵We note that the comparison with the large sample places Yell in the top decile against the 'cleaned' data set whereas a comparison with the raw data set would place Yell in the ninth decile.

7.73 Thomson was in the [8] decile for the comparison with publishing firms.

Subsample comparison with subsets that represent firms that have some characteristics similar to Yell in terms of cost structure and risk

7.74 Within the subsamples of firms with similar cost structures, when we compared Yell's ratios with firms with similar operating and capital expenditure and fixed asset ratios, Yell's ROS ratios were consistently within the top decile.

7.75 Within the subsamples of firms with similar risk indicators, the results were as follows:

- (a) when compared with firms of similar turnover volatility, Yell's ROS was in the top decile;
- (b) when compared with firms of similar EBITDA volatility, the ROS of Yell's business was in the eighth or ninth deciles; and
- (c) when compared with firms of similar beta, the ROS indicators of Yell's UK CDAS business¹⁴⁶ ranked in the top decile.

Comparison with Yellow Book

7.76 Yellow Book, Yell's US business, is the largest of the so-called 'independent' print directories publishers in the USA, ie those not affiliated with telephone companies. Since the 1990s, independent providers have established themselves in a market previously dominated in each area by an incumbent provider (which owed its strong market position to current or former affiliation with a telephone company). Independent providers are currently estimated to have a combined market share in the whole of the USA of around 14 per cent. Yellow Book has significantly expanded since the 1990s, both internally and by acquisition.¹⁴⁷ The recent (July 2005) acquisition of TransWestern has established Yellow Book as the fifth-largest US

¹⁴⁶Beta was not available for Yell's whole UK business.

¹⁴⁷Source: The Kelsey Group, *Overview and Outlook: The US Independent Yellow Pages Market*, memorandum prepared for Yell Group.

directory publisher in revenue terms,¹⁴⁸ accounting for around 9 per cent of all sales in the USA.¹⁴⁹

7.77 Table 7.8 compares the ROS of Yell's UK business and Yellow Book.¹⁵⁰ We note that the ROS of Yell's UK business has been substantially higher than that of Yellow Book in each financial year for which we have data, although we also note that the ROS figures for Yellow Book are increasing and reducing the difference between the two sets of figures.

TABLE 22 Yell UK vs Yellow Book: ROS*

	Year ended 31 March					per cent
	2001	2002	2003	2004	2005	Average
Yell UK	37.2	36.2	36.2	32.9	36.2	35.7
Yellow Book	<u>12.1</u>	<u>12.2</u>	<u>19.5</u>	<u>23.0</u>	<u>26.1</u>	<u>18.6</u>
Difference	25.1	24.0	16.7	9.9	10.1	17.1

Source: Yell.

*Calculated as EBITDA/net revenue.

7.78 This may indicate the Yell's ROS in the UK is high. Yell told us that Yell US's margins are continuing to grow as it transfers best practice from its UK to its US operations and that Yellow Book's margins on established books are broadly comparable to Yell's printed directory margins in the UK. However, we are aware of significant differences¹⁵¹ between the US and UK markets, which may affect the comparability of these measures. We therefore place little weight on this comparison.

¹⁴⁸Source: Yell.

¹⁴⁹The 2004 turnover of the enlarged business has been estimated at \$1.31 billion (source: Yell), compared with a total US turnover of around \$14.37 billion (source: The Kelsey Group, *Overview and Outlook: The US Independent Yellow Pages Market*, memorandum prepared for Yell Group).

¹⁵⁰Separate accounting data for Yellow Book's print directories business was not available. We therefore compare Yellow Book with Yell's whole UK business.

¹⁵¹ For example, we are aware that classified directories profits in the US are high and that CDAS publishers affiliated to telephone companies use these profits to keep local telephone call rates down. See Rysman, M (2004) 'Competition Between Networks: A Study of the Market for Yellow Pages', *Review of Economic Studies*, 71, 483–512. Section 3.1 Industry characteristics.

Limitations of the benchmarking of accounting ratios approach

- 7.79 When we put the initial approach and calculations back to Yell for comment, it stated that the large sample of 4,000 (see paragraph 7.66) was absurd, by including companies not related to CDAS. Yell said the subsample approach was better, but also questionable.
- 7.80 It stated that the publishing subset was an improvement, but still had limited comparability with Yell; Yell criticized the inclusion of certain companies in the subset and stated that the CC should consider why it used Yell CDAS instead of Yell Group as a whole when it did not disaggregate results for other companies. We considered this point, but our purpose is to look at the profitability of Yell's UK CDAS business and we believe that it would be virtually impossible to disaggregate results for the other companies in the subset.
- 7.81 Yell suggested it would be appropriate to compare its profitability to CDAS firms in other countries, and considered that our concern that these companies are not appropriate benchmarks, because of possible possession of market power, was not justified. As explained in the context of asset valuation, we consider that when measuring profitability for competition purposes, such concerns are relevant. We wish to avoid, as far as possible, valuing assets in such a way as to capture 'excess profits' or value attributable to market power in the future (see paragraph 7.31). Similarly we wish to compare Yell's accounting returns to firms which as far as possible do not have market power. As set out in paragraphs 2.72 to 2.74, most European countries have CDAS markets dominated by one provider.
- 7.82 Thomson argued that comparisons of ROS figures with comparator firms as set out above, and as used by the OFT to measure its profitability, was not recognized as best suited for analysis in the context of competition policy. It stated that ROS was a

rough proxy measure of profitability appropriate only when data limitations precluded the use of more meaningful measures. Thomson's preference was for methodologies in which the truncated IRR was compared with an appropriate WACC to determine whether or not the activity is profitable.

7.83 We agree with Thomson in that we would, in general, prefer to measure profitability by comparing a return on capital (or truncated IRR) with an appropriate WACC. However, there are particular difficulties in this case and we note that the Guidelines mention the use of ROS specifically when there are difficulties measuring capital.¹⁵² We therefore believe it is worth considering ROS comparisons in addition in this case.

7.84 Further detail on the accounting ratios used, and the results, is set out in Appendix 7.1.

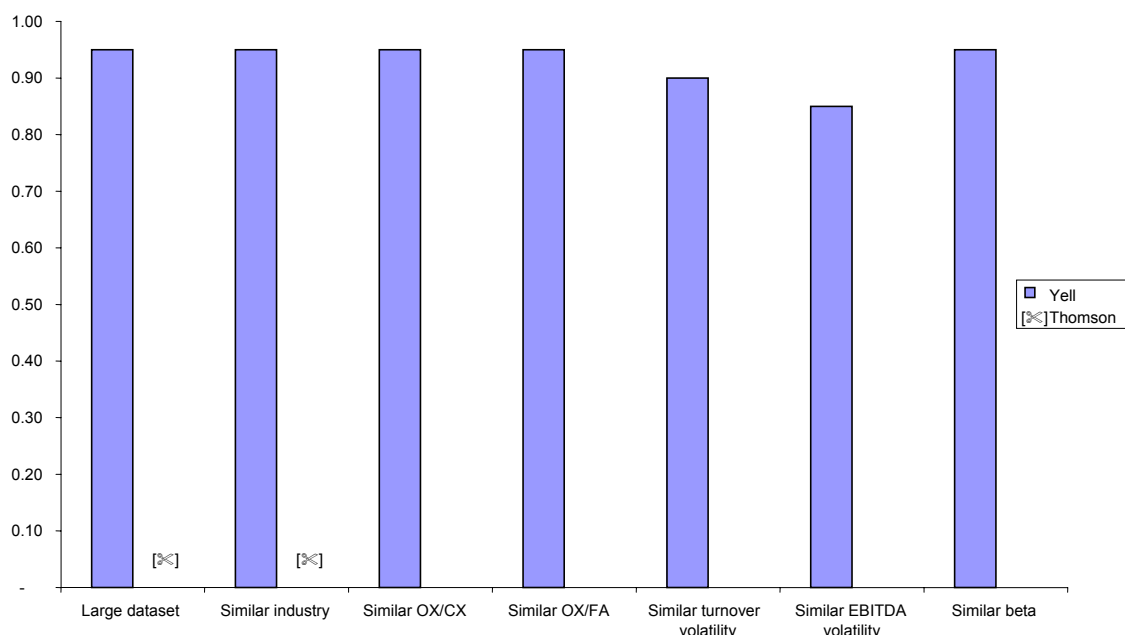
Benchmarking of accounting ratios: summary of results

7.85 Figure 2 illustrates the results of the analysis set out in paragraphs 7.65 to 7.75 for Yell and Thomson.

¹⁵²CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, states at paragraph 3.85 'In such situations the Commission may consider alternative measures, such as return on sales or other relevant financial ratios. For instance, comparisons with businesses operating in different but similar markets may on occasions be helpful, but will be of limited usefulness unless the Commission can confirm the validity of the comparison.'

FIGURE 2

Benchmarking of accounting ratios: summary of results



7.86 The results of all our comparisons put Yell above the eighth decile and for almost all they are in the top decile.

7.87 The results put Thomson in the [X] decile for the large dataset comparison and in the [X] decile for the comparison with publishing firms.

7.88 Yell did not propose alternative methods of calculation to the methods set out above and in Appendix 7.1 or provide us with alternative calculations. Yell has told us that the reason that it did not provide us with alternative calculations of its historic ROCE or IRR is that it believes that the exercise of measuring historic profitability is of limited relevance given recent changes in the market. Yell stated that ‘Aside from the major practical difficulties associated with reliably measuring Yell’s historic profitability, what is relevant in the present case is whether—given the entry of BT and the increasing competition from the Internet—historic profitability can usefully

provide information relevant to future competition. Yell submits that measurement of its historic profitability cannot' The effect of the entry of BT and the Internet on competition in the CDAS market is considered elsewhere in this report (see sections 6 and 5 respectively).

Consideration of Yell's efficiency and innovation

7.89 The following paragraphs consider whether the high profits Yell has achieved over the last five years are the result of superior efficiency or innovation. The remainder of this section describes the projected future profitability of the UK CDAS operations of Yell, Thomson and BT.

7.90 Yell argued that its profits were derived from superior efficiency and innovations and not from market power. More specifically, it argued that introduction of colour advertising and initiatives targeted at increasing advertiser numbers were the two major areas that contributed to its high profitability. It provided us with workings, which sought to quantify, in terms of revenues and profits, the benefits arising from these two areas.

7.91 Yell claimed that the initiatives introduced over the five years to 31 March 2005 that contributed to the increase in advertiser numbers included the introduction of discounts, rescoping, and investment in its sales force. It also mentioned other innovations that were more difficult to quantify, including classification development and information tools for sales representatives.¹⁵³

¹⁵³These tools include 'proven value' programmes, which help sales representatives to sell the benefit of an advertisement to the final customer.

7.92 A summary of Yell's calculations of the impact on revenues and profits from colour and initiatives to increase advertiser numbers¹⁵⁴ is shown in Table 23.

TABLE 23 Yell's estimates of impact of initiatives on revenues and profits

	year ended 31 March 2005			£ million
	Full year results	Results excluding colour	Results excluding increase advertiser	Results excluding colour and inc advertiser
Net revenue	612			
Sales costs	[X]		X	
Other direct costs	[X]			
Indirect costs	[X]			
Total costs	-395			
EBITDA*	217	[X]	[X]	[X]
EBITDA margin (%)*	35.4	[X]	[X]	[X]

Source: Yell.

*IFRS adjusted.

7.93 Yell estimated that its EBITDA margin for the year ended 31 March 2005 would have been [X] per cent in the absence of colour, compared with the actual margin of 35 per cent. It also estimated that without both colour and the initiative targeted at increasing new advertisers, EBITDA for that year would have been [X] per cent. These two initiatives are discussed in turn below.

Colour

7.94 Colour advertising has contributed substantially to Yell's revenues and profits in recent years. Yell estimated that for the year ended 31 March 2005, colour contributed £[X] million in incremental revenue. This was made up of colour premium revenue of £[X] million, less an allowance of £[X] million for growth in

¹⁵⁴Yell stated that the calculation of the impact of increased customer numbers presented in Table 24 was an *incremental* calculation, designed to avoid double counting the effects of colour. It adds that the £[X] million (£[X] million to £[X] million) revenue associated with incremental customer numbers deducts the colour revenues. In the absence of this adjustment, the revenue figure would be £[X] million.

advertiser expenditure¹⁵⁵ (historically at [%] per cent per year). Yell deducted a further £[%] million to reflect its estimate of the associated production costs of providing colour, resulting in £[%] million of incremental EBITDA.

7.95 Yell provided further estimates for incremental colour revenues and profits for the two years ended 31 March 2004. We have applied the same methodology as Yell in estimating the incremental EBITDA associated from colour for the two years to 31 March 2002, ie assuming the same level of direct costs as a percentage of colour premium, and the same level of revenue growth each year (5 per cent of previous year's revenue). Our calculations, along with Yell's estimates, are shown in Table 24.

TABLE 24 Incremental EBITDA from colour advertising—years ended 31 March 2005

	CC calculation		(Yell estimate)		
	2001	2002	2003	2004	2005
Total colour premium (£'m)					
Allowance for revenue growth in absence of colour		✂		✂	
incremental revenue from colour					
incremental colour costs					
incremental EBITDA					
Total Yell CDAS EBITDA	227.8	222.3	227.3	227.7	225.5

Source: Yell and CC calculations from Yell data.

7.96 We consider that it is questionable to view colour advertising as an innovative product and whether this incremental profit represents a return on innovation by Yell. Innovation is reflected usually by the creation of new products and/or services by a company which gives it an advantage over its competitors. Yell was relatively late, and by no means an innovator, in introducing colour advertising nationally across all of its directories in 2001; full colour advertising was offered by Kingston in 1998;

¹⁵⁵This is Yell's estimate of expected growth in advertiser expenditure that might have occurred if colour had not been implemented.

Thomson followed, rolling it out across its directories between 1999 and 2004. The level of Yell's colour premium was a management decision, was not constrained by the Yell undertakings and, based on the figures provided, was not based on the incremental cost to Yell of providing colour. On the figures provided by Yell for the year ended 31 March 2005, the colour premium increased revenue by £[redacted] million when the incremental cost of providing colour was £[redacted] million. (See also paragraphs 6.36 to 6.44).

Incremental advertisers

7.97 Yell argued that it was able to achieve a step change in the new advertiser acquisition rate. This was reflected in figures for new advertiser acquisitions for the year ended 31 March 2001, which show that the number of new advertisers increased from [redacted] to [redacted] new advertisers for that year. Yell attributed this mainly to pricing initiatives such as the 'First Steps' and 'Move-in' discounts.¹⁵⁶ It explained that the one-year lag between the introduction of the discount schemes and the step change in advertiser acquisition was due to the fact that new advertisers were recorded in its accounts when advertisements were published in directories and these were distributed, and not when advertisers were acquired.

7.98 Yell estimated the number of incremental advertisers attributable to its pricing initiatives, gained over the five-year period, that were retained in the year ended 31 March 2005. These estimates were based on the average first year and non-first year renewal rates for advertisers. Yell estimated that about [redacted] advertisers or [redacted] per cent (out of a total of 478,000) of advertisers in the year to March 2005 can be attributed to the initiatives mentioned above.

¹⁵⁶Yell stated that rescoping and sales force investment have also contributed to its customer acquisition success.

7.99 Yell provided an estimate of incremental EBITDA in 2005 associated with these incremental advertiser numbers of £[redacted] million.

7.100 We accept that Yell's introduction of the 'Move in' and other discount schemes have contributed to the increase in new advertiser acquisition. However, we do not believe that these can be categorized as superior innovation or efficiency. Superior efficiency and innovation usually arise when a firm introduces, or invests in, a product or operating method that cannot be easily replicated by its competitors. If they were easily replicated, then the benefits of these products and methods would be competed out promptly. We note that Thomson and BT have introduced their own discount schemes, as well as in the case of Thomson of rescoping of its directories, during the period in which we have evaluated Yell's profitability.

7.101 We accept that investments in initiatives such as computerized information and 'proven value' tools would have contributed to Yell's success in advertiser acquisition and to the relative efficiency of its sales force. However, it is difficult to quantify accurately advertiser gains that are attributable to these initiatives, given the degree to which market power can contribute to advertiser acquisition success. Although Yell's sales initiatives have contributed to the advertiser gains, we consider that its leading position in the CDAS market, and the advantages arising from network effects it enjoys over its competitors, have played a significant role in this success.

Yell: future profitability

7.102 In its five-year plan, Yell expects the financial performance of its UK CDAS business to [redacted] to the years ended 31 March 2010 as [redacted]. It has assumed the continuance of the RPI -6 per cent price control in preparing its forecasts.

7.103 Revenues and EBITDA for the printed business are forecast to [REDACTED]. Yell has assumed that costs will increase in line with inflation, and increasing levels of investment in advertising and promotion are required to promote directory usage and address increasing challenges in advertiser retention and advertiser acquisition.

7.104 [REDACTED] relative stability is forecast for the year ended 31 March 2007, [REDACTED]. We note that long-term forecasts are generally less reliable than short-term forecasts; however we do not believe that an assessment of Yell's forecasts is relevant to the assessment of Yell's current market position in this inquiry. It may be relevant to a consideration of remedies after we have provisionally found an adverse effect on competition and we will examine this issue during the final stages of our inquiry.

Thomson future profitability

7.105 Thomson provided a forecast for the three-year period 2006 to 2008,¹⁵⁷ which shows [REDACTED] in turnover continuing [REDACTED], and profit margins [REDACTED].

7.106 Thomson expects that the [REDACTED] revenue from [REDACTED]. Paper, printing and selling costs are expected to [REDACTED].

7.107 Thomson told us that the above forecasts were revised [REDACTED] to take into account [REDACTED].

BT CDAS future profitability

7.108 BT provided us with financial projections for the *Phone Book* for the five years to 31 March 2011.¹⁵⁸ CDAS revenues are forecast to [REDACTED], with profit margins [REDACTED] by 2010.

¹⁵⁷Thomson told us that it prepares its three-year business plans at entity level only. Consequently, a breakdown of profit forecasts by business area was not readily available.

7.109 BT's CDAS profitability is expected to [X] million as revenue [X]. BT also expects [X].

Conclusions on profitability

7.110 Based on the analysis in paragraphs 7.25 to 7.109, our provisional findings as regards profitability are as follows:

- (a) The estimated truncated IRRs for Yell for the five years to March 2005¹⁵⁹ were in excess of both our own and Yell's estimates of its WACC, and when we used lower multiples of turnover (three or less) or cost (six or less), were significantly so.
- (b) Our estimates for Yell's ROCE¹⁶⁰ for each of the five years produced ranges which overlapped with our estimated range for WACC. Around one-half of our estimates of ROCE exceeded our estimated range of WACC. For each method, the ROCE declined over the five years.
- (c) Our estimate of Yell's IRR over the period 1978 to 2005 ('lifetime' IRR) was significantly in excess of the relevant WACC for this period.
- (d) The comparisons of Yell's ROS with those of other companies whether looking at large numbers of companies, companies in similar sectors or with companies with similar characteristics, showed Yell on almost all occasions as being in the top decile, and otherwise as being in the eight decile or above.

7.111 Because of the issues we faced in asset valuation, our preferred measure for this investigation is the truncated IRR which gives less weight to asset valuations than ROCE. From the above results, we conclude, based on the truncated IRR estimates, that Yell's profits were high over the five years to 31 March 2005 and in excess of its

¹⁵⁸As explained in paragraph 7.18, BT does not show the A-Z listings and classified directory businesses separately in its management accounts. BT, at our request, prepared forecasts for its CDAS business based on three allocation methods for common costs (share of pages, share of usage, and share of revenues). For further information see Appendix 7.3.

¹⁵⁹Obtained using our preferred multiples (ie turnover and cost) in the calculation of the opening and closing assets.

¹⁶⁰Again, calculated using turnover and cost as the multiples.

WACC. This view is supported by the benchmarking we have done comparing Yell's ROS with various comparators.

7.112 While our preferred measure here is the truncated IRR over the five years, this measure does not show the trends over the period, nor is it suitable for focusing on the results of a particular year. For this, we need to consider our estimates of ROCE. Our range of estimates of Yell's ROCE calculated using turnover and cost multiples for each of the five years overlaps with our estimated range of WACC for the period and trends down over the five years.

7.113 It is therefore not possible to conclude from the available evidence that Yell's profits at the end of the period were in excess of its WACC, although a number of factors suggest that they may have continued to be so. These include the fact that while our estimated ROCE figures were declining over the period, so was our estimate of the WACC, and the likelihood that the measures we have used will have tended to overstate the value of Yell's assets, and hence understated its profitability.

7.114 We have considered whether Yell's high profits can be explained by its greater efficiency or superior levels of innovation. We acknowledge that some of Yell's profits may be the result of superior efficiency or innovation. However, we consider that the incremental profit from colour which, in the year ended 31 March 2005, based on Yell's calculations, accounted for around 40 per cent of its EBITDA (£89.9 million out of £225.5 million), is not an innovation that would enable Yell to continue to earn substantial profits in a competitive market. Rather, we see the level at which Yell was able to introduce and maintain the colour premium as an indication of market power.

7.115 We consider that Yell has made high profits over the last five years as a whole, although the evidence as to whether its profitability was in excess of its WACC at the

end of the period was unclear. As explained earlier, however, profitability measurement is unlikely to capture the extent of Yell's market power because of the constraints imposed by the Yell undertakings. In light of these undertakings, lack of evidence of excessive profits is nevertheless consistent with the existence of market power.

7.116 As regards Thomson, its profits were [redacted]. [redacted] the truncated IRRs, calculated using our preferred multiples in the calculation of opening and closing assets, produced a range of results that [redacted]. We therefore considered that it is likely that Thomson's profits over the last five years were not in excess of its WACC.

8. Provisional findings

8.1 In this section, we summarize the key elements of our findings. We assess which of the structural factors and aspects of conduct identified in section 6 can be regarded as features of the market which prevent, restrict or distort competition in connection with the supply of CDAS in the United Kingdom.¹⁶¹

Market definition

Relevant product market

8.2 We found in section 5 that the provision of CDAS in printed directories with a set of characteristics that includes strong brand image, high levels of usage and comprehensive business listings forms a relevant economic product market. We refer to these as major CDAS. Yell, Thomson and BT publish such directories. Certain other directories, notably that of Kingston in Kingston upon Hull and those of Trinity Mirror in parts of Scotland, share key characteristics with the directories published by Yell, Thomson and BT.

¹⁶¹See section 131(2) of the Act and paragraph 1.3.

- 8.3 As we explained in section 5, the Internet does not form part of the market for major CDAS identified above. The Internet offers new opportunities to advertisers and users; while it can perform the role of directories, it has many additional capabilities and can be seen as a new product which will naturally take business from existing products such as CDAS. The evidence we have received does not suggest that Yell's pricing policies have responded to the growth in Internet use. We believe that the current trend for businesses to advertise increasingly on the Internet will continue and that there is little that CDAS providers can do in terms of pricing to influence this trend.
- 8.4 Other media, including various forms of newspaper advertising, do not form part of the same market as major CDAS.
- 8.5 Providers of CDAS in major classified directories constrain the prices set by providers of CDAS in smaller classified directories; however, the converse is not true. We do not consider a separate market for small classified directories in detail. There are two main reasons for this: (a) the major classified directories account for almost the totality of the reference services in the UK; and (b) we have not received any evidence to suggest that the structure of the supply of CDAS in small directories or the conduct of small directory providers raises any particular competition concerns.

Relevant geographic market

8.6 Several factors point to the existence of local markets from a demand-side perspective. We have analysed competition between the major CDAS providers mainly on a national basis, however, because the three largest classified directory providers meet in almost every local market and we found the competitive conditions to be very similar in each geographic market. In addition, pricing policies are set centrally.

Assessment of competition

8.7 In section 6, we considered the extent of competition for the supply of CDAS in the UK. As explained in paragraphs 3.6 to 3.15, Yell is currently subject to undertakings and this has impacted on our analysis both of competition and of competitive outcomes. Our provisional conclusions on the extent of competition for the supply of CDAS in the UK are summarized below.

Market concentration

8.8 In section 6, we describe the market as highly concentrated. We estimate that between them, Yell, Thomson and BT have around 99 per cent of UK advertising revenues for major CDAS, and 98 per cent of all UK CDAS revenues. We estimate that Yell currently has a high market share, of around 75 per cent, over five times that of its nearest competitor.

8.9 We recognize that Yell's market share has declined somewhat in recent years, and may do so further, but consider that in the short to medium term, Yell will continue to be by far the largest provider of CDAS in the UK.

8.10 We consider the recent re-entry of BT to be important and we examine, in particular, whether BT has affected pricing in the supply of CDAS below.

Pricing behaviour

8.11 In general, Yell's pricing does not appear to be affected by that of its competitors. We found that the majority of Yell's advertisements were sold at the maximum permitted by the Yell undertakings and consider these prices to be constrained by the Yell undertakings, rather than its competitors' prices.

8.12 In section 6, we considered the constraints on the prices Yell's advertisements that were sold at prices beneath the maximum permitted by the Yell undertakings. We analysed the extent to which Yell's discount schemes may be a response to increasing competition and concluded that competition has not been a significant factor in the setting of many of Yell's discounts. Rather, Yell's discount schemes appear to be aimed mainly at increasing the demand for CDAS, independently of the pricing of its competitors.

8.13 We noted that the Yell undertakings do not regulate the pricing of new products in the year of their introduction. This allowed Yell to introduce colour advertisements at prices that were not constrained by the Yell undertakings. Yell's colour premium appears to be much greater than the incremental costs incurred.

8.14 Yell's main competitors, Thomson and BT are constrained by Yell. Both set their prices with reference to and at a discount to Yell's prices.

Non-price competition

8.15 In section 6, we found that there was some non-price competition in the supply of CDAS. We consider scoping (footprint) of directories and competition for users to be the most significant, since they potentially alter the number and targeting of business leads generated by classified advertisements.

Switching patterns

8.16 We explained in sections 5 and 6 that it is relatively easy for advertisers to switch between the products of CDAS providers, but levels of switching (both full and partial) are limited.

Buyer power

8.17 We considered whether CDAS advertisers possess sufficient buyer power to enable them to constrain the prices of CDAS providers through bargaining. As explained in section 6, however, we do not consider that there is any significant buyer power in the supply of CDAS.

Profitability analysis

8.18 We found Yell's profitability to be high for a five-year period to March 2005, both compared with its cost of capital and when its return on sales was compared with other companies. It is not possible to conclude from the available evidence that Yell's profits at the end of the period were in excess of its WACC, although a number of factors suggest that they may have continued to be so. While Yell submitted evidence to support its argument that these profits were due to efficiency and innovation and not to market power, we do not consider that these factors explain the full extent of Yell's profitability. The fact that Yell is subject to a price control means that our profitability assessment may in fact underestimate the true extent of Yell's market power in the absence of the undertakings. In light of these undertakings, lack of evidence of excessive profits is nevertheless consistent with the existence of market power.

Competition within CDAS

8.19 The factors set out in paragraphs 8.8 to 8.17 lead us to the provisional conclusion that Yell has market power, and competition in this market is deficient. We proceeded

to consider whether potential entry could act as a competitive constraint on Yell and our provisional conclusions on this issue are set out below.

Analysis of potential entry as competitive constraint

- 8.20 We consider barriers to entry to be high. Key barriers include the network effect referred to below. Economies of scale of existing providers and the need for a relevant brand are other key entry barriers. We consider that, although small scale local entry is possible, growing a local CDAS business to become a national provider is difficult.
- 8.21 As we explained in section 6, the supply of CDAS is a two-sided market and the success of CDAS providers depends on their ability to attract both users and advertisers to their directory. This creates a network effect, which operates in such a way that success with advertisers and with users are mutually reinforcing. A directory provider that has built up high levels of usage and advertising is more attractive to new advertisers and new users than a competitor with less usage and less advertising whose offer, in terms of price, quality and service, may otherwise be the same. Thus it is difficult to enter this market—advertisers will only advertise if they can expect there to be a high number of users; users will only use a directory if there is a worthwhile number of advertisers. We regard this network effect as a major barrier to entry and to expansion.
- 8.22 We have considered entry by BT and Trinity Mirror. We consider that BT has a unique set of advantages, including ownership of a strong and relevant brand and being the publisher of the *Phone Book*, which has national coverage. We do not consider that BT's entry indicates that other entrants would be able readily to overcome the entry barriers related to this market. Trinity Mirror entered the market exploiting particular local strengths in Scotland; however we consider it unlikely that Trinity Mirror will substantially expand its directory business further in other parts of

the UK. Thus, we do not consider the threat of new entry to constitute a competitive constraint.

Provisional conclusions on competitive analysis

8.23 Our competitive analysis has led us to the provisional conclusion that Yell has market power. We would normally expect a detrimental effect on customers to arise in the presence of market power. In this market, we would expect Yell's market power to enable it to set prices profitably at levels that are higher than they would be in a well-functioning market. We have observed that Yell has made high profits over the last five years and has charged a premium for colour which is not cost reflective. We consider that the Yell undertakings have had an effect both on Yell and its competitors and have reduced prices and profits to a lower level than they would have been in the absence of the undertakings.

Publication by Yell of local directories

8.24 As explained in section 6, we expect that in the absence of the undertakings, Yell would be able to publish additional small directories in areas where it also publishes a main directory and we consider it may find doing so financially worthwhile. On balance, we do not consider that the evidence submitted to date enables us to form an expectation at this stage in our inquiry that the publication by Yell of additional small directories would prevent, restrict or distort competition or give rise to a detrimental effect on customers.

Features which prevent restrict or distort competition

8.25 Paragraph 1.3 contains the statutory definition of the term 'features'. Although the Act sets out three types of feature that could have an adverse effect on competition, in practice there is no clear divide between features relating to structure and features relating to conduct. For example, difficulty in switching from one supplier to another could be considered as a structural feature and a lack of switching could be

considered as a feature relating to conduct. In this section, we indicate how particular features interact with other features in this market. The Act does not require us to identify the category or categories into which a feature falls.

8.26 We identify below the features which prevent, restrict or distort competition in the market. The combination of these features leads to a deficit of competition which leads us provisionally to conclude that were it not for the Yell undertakings, Yell's prices would be higher than in a well-functioning market.

(a) The market for major CDAS is highly concentrated: Yell has a market share of around 75 per cent and between them Yell, Thomson and BT have a market share of 99 per cent (see paragraph 6.4).

(b) The market has been highly concentrated for a number of years. Yell had a market share of over 80 per cent until BT's re-entry in 2002 and between them, Yell and Thomson had a market share of 99 per cent until BT's re-entry. Since it re-entered the market, BT has grown its share substantially.

(c) Entry barriers are high and include the network effect referred to below and the need to establish a strong brand identity (see paragraph 6.113).

(d) The incumbency position of the largest provider is reinforced by the network effects present in this market. Other providers wishing to expand have to build usage in order to attract advertisers. This requires investment, particularly in usage advertising, and acts as a barrier to expansion (see paragraph 6.113).

(e) Yell has market power and is the price setter in the market (see paragraph 6.127).

(f) In general, Yell's prices are not constrained by those of its competitors; Yell does not compete on price in any significant way (see paragraph 6.126).

8.27 The detrimental effect on customers that we have identified is that Yell's prices would be higher than in a well-functioning market, were it not for the Yell undertakings.

8.28 Accordingly, we provisionally find, on the statutory questions we have to decide pursuant to section 134(1) of the Act, that there are features of the market for the supply of CDAS in major classified directories, either alone or in combination with each other, that prevent, restrict or distort competition in connection with the supply of CDAS and, hence, that there is an adverse effect on competition within the meaning of section 134(2).

9. Remedies

9.1 Having provisionally found there are adverse effects on competition arising from the features of the markets listed above, we are required to consider whether action should be taken by us, or whether we should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition. For this purpose we have issued separately a notice of possible remedies.

9.2 As we explained in paragraph 6.134, it appears likely that BT will become a stronger competitor, but the pace of its future growth is unclear and the extent to which its future presence will become a significant constraint on Yell's prices is uncertain. We expect that advertising on the Internet will increase in the future, and CDAS advertising may decrease (see paragraph 5.77 (d)). In considering remedies, we will take these points into consideration.