

CHAPTER 9

Conclusions

The monopoly situation

9.1. Under the terms of our reference we are required to report whether a monopoly situation in the supply in the United Kingdom of contraceptive sheaths exist and, if so, by virtue of which provisions of section 6 of the Fair Trading Act 1973 and in favour of what person or persons.

9.2. Under section 6(1)(a) of the Act a monopoly situation exists if at least one-quarter of the contraceptive sheaths supplied in the United Kingdom are supplied by one and the same person. LRC Products Ltd (LRC) is the only United Kingdom manufacturer of sheaths, and it is clear that the company accounts for a very large proportion of the total supply in the United Kingdom. As we have explained in paragraphs 2.4 and 2.5, there is no means of arriving at a precise figure of the total of United Kingdom annual sales accounted for by imported supplies. It is therefore not possible to state precisely LRC's share of the market. However, Tables 2.1 and 2.2 indicate that in 1981 (and indeed in each of the three previous years) LRC's United Kingdom sales of sheaths, which in 1980-81 were £7.03 million, almost certainly accounted for at least 90 per cent of the total United Kingdom supply. In view of this, and of the fact that the company itself recently estimated its share at over 90 per cent (see paragraph 2.5), we consider LRC's share of the United Kingdom sheaths market can safely be put at between 90 and 95 per cent.

9.3. We conclude therefore that a monopoly situation under section 6(1) exists in relation to the supply of contraceptive sheaths in the United Kingdom in favour of LRC Products Ltd.

The public interest

9.4. Having concluded that a monopoly situation exists in favour of LRC, we are restricted by the reference to considering the public interest in relation to one point only—namely whether any action or omission on the part of LRC in respect of the prices charged, or proposed to be charged, for contraceptive sheaths operates, or may be expected to operate, against the public interest.

9.5. LRC said that in the period since the 1974 report there had been significant changes in the United Kingdom sheaths market (see paragraph 3.17). There had been a decline in the share of its sales through barbers and other small retailers and a rise in that through multiple chemists, mail order companies and family planning clinics. A higher proportion of sales was now through wholesalers. Nine customers now accounted for nearly half of LRC's United Kingdom sales of sheaths.

9.6. As we have explained in paragraphs 7.5 and 7.6, LRC maintained that these changes placed constraints on its pricing because its large customers were likely to resist any price increases which they regarded as unreasonable

and were able readily to switch to imported sheaths. In addition, there had been a decline in the usage of sheaths as a method of contraception, and high prices for sheaths would encourage consumers to switch to other forms of contraception from which there is already increasing competition, and would stimulate still greater research into other methods. A further restraint on price increases was the ability to obtain limited supplies free of charge from clinics.

9.7. We believe, however, that there are a number of factors which indicate that, in spite of the changes to which LRC drew our attention, the company still has considerable market power. Although the demand for sheaths in the United Kingdom has declined over the years and may continue to do so, and as a result LRC has a reduced share of the total contraceptive market, the company's share of at least 90 per cent of the sheaths market itself has not changed significantly, and a number of factors to which we have drawn attention in Chapter 2 lead us to believe that this share is unlikely to be much eroded in the future. Although sheaths manufactured in a number of foreign countries are readily available for import into the United Kingdom, no importer has been able to secure an important share of the market. As we have pointed out in paragraph 2.25, there appeared to be some possibility in 1974 that sheaths manufactured by Akwell in the United States of America, which had then recently begun to be marketed in this country by a subsidiary of Johnson and Johnson, might offer substantial competition to LRC; but the product was withdrawn in 1976.

9.8. Since then Chefaro has begun to market sheaths made by Akwell (see paragraph 2.27); but its share of the market is small and we do not expect it to be able to capture a substantial share. Moreover, that company's sheaths are products selling at higher prices than those of LRC's principal brands, and we consider that its presence in the market is unlikely to impose much restraint on LRC's prices.

9.9. No other importer of sheaths has achieved a significant share of the market, even when the products sell at lower trade prices than Durex, and because of the great strength of the Durex brand name and the difficulty of advertising sheaths (which we have referred to in paragraphs 2.16 and 2.20-2.21) we think it unlikely that any will do so.

9.10. While it is true that there have been changes in the pattern of distribution of sheaths, which have resulted in a substantial proportion of LRC's United Kingdom sales being to large buyers who might exercise their buying power to put pressure on LRC's prices, there is no evidence that any great pressure has in fact been applied and we think it unlikely that it will be. We note in particular that most supermarkets are not interested in selling sheaths. While LRC's major customers could switch to imported sheaths, the extent to which in practice they might do so would be limited by the extent to which imports were both cheaper and able to obtain the BSI Kitemark as well as to secure adequate consumer acceptance in place of the firmly established Durex brand. In any case, although there is some retail selling of sheaths at below recommended prices, the demand for sheaths, either in total or for particular brands, does not appear to be very price-sensitive, and retail price competition is not, in our view, an important

feature of the market. For this reason, and because they enjoy exceptionally high margins in sheaths, LRC's customers have little incentive to switch to imports. We believe therefore that LRC enjoys considerable freedom to determine its prices without coming under any significant pressure from its customers.

9.11. While we take note of LRC's anxiety not to provoke further complaint, still less a further reference to this Commission, we do not accept that there have been changes in market conditions such that LRC is no longer able to charge prices which might be held to be excessive.

9.12. As regards the present level of LRC's prices, we take account of the fact that over the period October 1975 until October 1981 they were subject to approval by OFT. We observe that, over the period covered by the company's financial years 1976-77 to 1981-82, its average realised prices rose at a somewhat faster rate than both the index of retail prices and the index of wholesale prices (see Chapter 5, Table 5.1). However, we also observe that during the first three years of that period, the company's return on capital employed was well below the figure of 30 per cent which it regards as a reasonable minimum target, and the rate remained below that level in the following year, although increasing to 26 per cent. The rate of return increased to 32.9 per cent in 1980-81 and was 31.8 per cent in 1981-82, but taking the period as a whole we consider that there is no satisfactory basis on which to form a firm view on the effect on the public interest of the company's present profits and prices. In saying this we do not imply any judgment on whether any particular rate of return, in a single year or on average over a period, is or is not generally acceptable.

9.13. In October 1981, when the current reference was made, LRC was released from the undertakings given to the Secretary of State for Trade in 1975 and is therefore free to increase its prices for sheaths as it considers appropriate. It was part of the case made to us by the company that a return of 30 per cent on capital employed is reasonable, and it might be argued that the implication of this is that the company will not charge prices which will raise its return above this level. However, the target rate of return is stated to be a minimum of 30 per cent and we note that for the year ending 31 March 1981 the company's return on capital employed was already 32.9 per cent as calculated for the purposes of our inquiry and 40.1 per cent as calculated on the basis used for reporting to OFT. The return for 1982 as reported to us was at about the same level.

9.14. We recognise that the company forecasts lower figures for the next two years; but, since we consider that the company's prices are not effectively constrained by market forces, and bearing in mind the history of very high profit levels as recorded in our 1974 report, we think it likely that in the absence of control the company's prices will in due course again become excessive.

9.15. We conclude that the pricing of contraceptive sheaths in the United Kingdom is an action on the part of LRC which may be expected to operate against the public interest, the particular effect adverse to the public interest being that its United Kingdom prices for contraceptive sheaths may be expected to become excessive.

Possible remedies

9.16. Since we consider that in the absence of control LRC's prices are again likely to become excessive, it follows, at least in principle, that some kind of control needs to be re-imposed. However, LRC's United Kingdom annual sales of sheaths, including its vending operations, amounted to only £7.241 million in 1981-82 and, apart from the effects of inflation, may well be less in future, and must therefore be regarded as a relatively unimportant part of the total business activity of the country. While we do not think that the prices of sheaths can be regarded as being of negligible importance and therefore not justifying any system of control, we think that there is a case for keeping to a minimum the resources needed to exercise control.

9.17. For this reason we considered that it might be inappropriate to reintroduce the system of control which, following our 1974 report, was used by OFT until 1981 and which involved prior consent for price increases on the basis of a maximum permissible rate of return on capital employed (see paragraphs 4.3 to 4.6).

9.18. The control of prices by this method has certain disadvantages which arise from the difficulty of ensuring that the relevant profit and the relevant capital employed are, and continue to be, calculated on an acceptable basis. The difficulty is particularly acute in this case since sales of sheaths represent a relatively small proportion of the total turnover of LRC. Moreover, for our purposes the company's United Kingdom sales of sheaths have to be segregated from its export sales, which though smaller, are a significant proportion of the total. As a result the allocation of costs and of capital which is necessary in calculating the return on capital employed on United Kingdom sales of sheaths will be imprecise. In Chapter 6 we have drawn attention to some of the particular areas in which these difficulties arise.

9.19. The problems of ensuring that LRC's relevant return on capital employed is calculated on a fair and acceptable basis and that, for purposes of price control, it continues to be calculated on the same basis are exemplified by the fact that in our 1974 report it was found necessary to show two different rates of return calculated on alternative bases and also by the fact that (for reasons which are explained in Chapter 6) the rates of return as calculated for the present inquiry are substantially different from those used by OFT during the period of price control.

9.20. In addition we accept that there is some validity in LRC's argument that limiting its return on capital employed tended to weaken the incentive to improve its efficiency and to make the best use of its resources, since reductions in costs or in the amount of capital employed might bring the rate of return up to or beyond the permitted limit. For a company in LRC's monopoly position, where the spur to increased efficiency is not provided by pressure from strong and effective competition, this point has some significance.

9.21. In principle we do not reject return on capital employed as an appropriate criterion for judging a company's profitability or for controlling its prices, even in cases where a substantial degree of allocation is necessary.

However, because of the problems to which we have referred, LRC's applications for price increases during the period of control placed a substantial burden on the company in presenting the necessary information and involved a significant amount of work on the part of OFT in checking the basis of the company's calculations. Because of this and bearing in mind the relatively small size of the United Kingdom sheaths market we consider that re-introduction of a system of price control on the basis of a maximum permissible rate of return on capital employed would not be justified in this case.¹

9.22. We note, however, that LRC emphasised to us that it did not foresee any significant changes in the level of its prices in the future apart from allowance for inflation (see paragraph 7.2). This reinforces our view that a preferable alternative to limiting the return on capital employed is to ensure that LRC's United Kingdom prices of sheaths are related to an appropriate index relevant to the input costs of the sheaths business. We believe that the incentive to increase efficiency, which the company said was removed by the method used during the last period of control, will be restored if control is exercised directly over its prices by reference to an appropriate index, rather than over its profits.

9.23. Since there appeared to be no single published index which was wholly suitable for this purpose, we invited LRC to suggest a composite index related as closely as possible to its known cost structure. The company's response, which is referred to in paragraph 7.14 and is set out in detail in Appendix 12, proposed an index of seven components, each of which is published and readily available, appropriately weighted in relation to actual costs, as follows:

<i>Component</i>	<i>Weighting</i>
Department of Employment's index of average earnings in manufacturing industry	45.4
Wholesale price index of industrial and special purpose paper	9.1
Wholesale price index of materials purchased by manufacturing industry other than food, drink and tobacco	9.1
Wholesale price index of imported crude rubber (natural rubber smoked sheet)	3.4
Wholesale price index of coal, gas and electricity purchased by manufacturing industry	4.5
The transport and vehicles component of the general index of retail prices	8.0
General index of retail prices—all items except certain food	20.5

9.24. We accept that this composite index, which we shall refer to as the special index, is appropriate for our purpose.

¹ Before reaching the conclusion that relating prices to a maximum rate of return on capital employed would not be appropriate in this case, we gave some consideration to the problem of determining what would be the maximum rate that was not incompatible with the public interest. In doing so we gave careful attention to the study which we commissioned from Dr Franks and Dr Hodges of the London Business School and the comments we received upon it (see paragraph 1.5). The authors of the study sought to compute a pre-tax annual accounting rate of return which would ensure that shareholders would continue to have an incentive to invest in the assets. This involved the use of the Capital Assets Pricing Model. LRC expressed reservations, which were not shared by the authors of the study, about the methods used and the way in which they had been applied. However, for the reasons described in paragraphs 9.16 to 9.21, we have reached the conclusion that it would not be appropriate to require that LRC's prices should be controlled by reference to the rate of return on capital employed.

9.25. However, one of the purposes of relating prices to such an index rather than to a maximum return on capital employed is, as we have said, to remove the disincentive to increased efficiency. We have no doubt that LRC has scope for increasing its efficiency, and we consider that some part of the benefits of any achieved greater efficiency on the part of the company should accrue to the public, as it would if the company were forced to seek cost savings by the pressure of effective price competition, and that not all of the benefit should be taken by way of additional profit. For this reason we consider that the company's prices should not be allowed to increase to the full extent of any rise in the special index representing its costs.

9.26. The general trend of improvement in labour productivity in manufacturing industry over the 18 years since the index of output per person was introduced, has been about 3 per cent per annum. We considered it reasonable to expect that LRC could achieve a similar rate of improvement in labour productivity over the next few years. Labour represents less than half of the company's total relevant costs, but, particularly in view of the company's acknowledgement that in recent years it has been discouraged from improving its efficiency, we consider that improvement in its overall efficiency at something approaching this rate should be possible. We calculated that if the special index rose by 10 per cent and if LRC's prices were increased by not more than 85 per cent of that rise (ie by 8.5 per cent) the company would need to increase its efficiency by about 1.5 per cent to maintain its 1981-82 rates of return on sales and on capital employed and that the benefits of any increase in efficiency in excess of this would be retained by the company. This calculation depended on a number of assumptions, but we considered that it gave a broad but sufficiently reliable indication of the extent to which LRC might be permitted to increase its prices. We accordingly put it to the company that any increase in the United Kingdom prices of its contraceptive sheaths should not exceed 85 per cent of any rise in the special index.

9.27. LRC pointed out, however, that with a formula of this kind the increase in efficiency necessary to maintain profitability depended on the extent of any rise in the special index, and argued that it would be wrong to link efficiency improvements to the rate of inflation. The company also claimed that, while it could envisage some cost savings, the scope for such savings would in course of time be reduced and would ultimately be insufficient to prevent a decline in profitability. The company therefore proposed that if such a formula were used, prices should be permitted to increase by one percentage point less than any rise in the special index (eg a rise of 10 per cent in the special index should permit a 9 per cent increase in prices, or a rise of 7 per cent in the special index should permit a 6 per cent increase in prices) for three years and that thereafter for a further three years prices should be permitted to increase by one-half a percentage point less than any rise in the special index (eg a rise of 10 per cent in the special index should permit a 9.5 per cent increase in prices).

9.28. Having considered LRC's arguments we accept that price increases should more appropriately be kept to a flat rate below any rise in the special index rather than to a percentage of it. However, we calculate that over

five years, regardless of the rate of rise in the special index, LRC would need improvements in efficiency in respect of the costs concerned of only between 1 and 2 per cent per annum to maintain its current level of returns if its prices rose by 1.5 percentage points less than any rise in the special index.

9.29. We think therefore that price rises should be limited in this way for a period of five years, and that thereafter the matter should be reviewed. If, during that period, there were a major change in circumstances such that the special index ceased to be adequately representative of the company's costs, we consider that the index should be examined by the Director General of Fair Trading in consultation with the company with a view to making any adjustments he might consider necessary.

Summary of conclusions and recommendations

9.30. We have concluded that:

- (a) a monopoly situation under section 6(1) of the Fair Trading Act 1973 exists in relation to the supply of contraceptive sheaths in the United Kingdom in favour of LRC Products Ltd (LRC) by virtue of the fact that the company's share of the United Kingdom sheaths market is between 90 and 95 per cent (paragraphs 9.2 and 9.3); and
- (b) the pricing of contraceptive sheaths in the United Kingdom is an action on the part of LRC which may be expected to operate against the public interest, the particular effect adverse to the public interest being that its United Kingdom prices for contraceptive sheaths may be expected to become excessive (paragraph 9.15).

9.31. We recommend that:

(a) LRC should be invited to give an undertaking:

- (i) that the United Kingdom average realised prices of its contraceptive sheaths (ie the total United Kingdom sales of sheaths divided by the grossage) shall not increase above their level in the company's financial year 1981-82 at a greater annual rate than 1.5 percentage points less than any percentage rise in the special index;
 - (ii) that, for the purpose of enabling the undertaking to be monitored, the company will provide the Director General of Fair Trading annually with figures of its total United Kingdom net sales of sheaths by value and volume, and with details of price changes of each of its brands of sheaths as and when such changes are made; and
 - (iii) that, to enable the undertaking to be reviewed or the special index to be examined, as in (b) below, the company will provide the Director General with such additional information as either the company or the Director General considers necessary.
- (b) That the undertaking should be reviewed after five years, and that if necessary during that period the special index should be examined and adjusted as described in paragraph 9.29.

(c) In the event of the company failing to give or failing to abide by the undertaking the company should be required to make no price increases without the prior approval of the Director General. In that event we consider that approval should be given only if the company has satisfied the Director General in advance that a proposed price increase will, having regard to any previous price increases, be consistent with the principle of the proposed undertaking.

9.32. The undertakings given by the company in 1975 included provisions that it should specify maximum retail prices for its principal brands of sheaths and that its discounts to its customers should not depart from certain specified rates. We believe that in the event the maximum retail price provision may to some extent have come to be regarded by retailers as establishing a fixed price rather than a maximum price and that the fixed discount provision may have provided LRC with some protection against pressure for more favourable net prices which might otherwise have been exerted by its larger customers. We think therefore that these provisions may have introduced some undesirable rigidity into both retail and wholesale pricing of sheaths, and as the company is no longer bound by them we see no reason to renew them.

J D ECCLES (*Chairman*)

B C OWENS

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4 August 1982