



Market Investigation References:
Competition Commission Guidelines
June 2003

This is one of a series of documents which the Competition Commission is required to publish under the Enterprise Act 2002

Market Investigation References: Competition Commission Guidelines

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Part 1: Introduction

Purpose of guidance

- 1.1 This guidance forms part of the advice and information published by the Competition Commission (“the Commission”) under section 171(3) of the Enterprise Act 2002 (“the Act”).¹ It explains the Commission’s approach to the questions to be answered in respect of market investigation references made to it by the Office of Fair Trading (OFT) or by certain sectoral regulators with concurrent² powers under section 131 and by Ministers under section 132.
- 1.2 Information on procedural aspects of the Commission’s investigation can be found in the Commission’s *Rules of Procedure* (“the rules”)³ and *General Advice and Information*. Information about these and other publications of the Commission and the Office of Fair Trading (OFT) relevant to market investigation references can be found in the Annex to this document. A separate document *Merger References: Competition Commission Guidelines* (the merger guidelines) covers similar ground in respect of merger investigations.
- 1.3 This guidance reflects the views of the Commission at the time of publication. Markets, economic theory, legal thinking and best practice evolve. This guidance may be revised from time to time to reflect such change or in the light of the Commission’s experience in applying the new market investigation regime and new guidance may be published. The latest version is always that appearing on the Commission’s website.
- 1.4 In addressing the questions the Commission⁴ must consider in respect of references made under sections 131 and 132, a group will have regard to this guidance and will apply such of the methodology and analysis summarised in it as it considers appropriate. However, the Commission will consider each reference with due regard to the particular circumstances of each case including the information that is available and the time constraints applicable to the case.⁵ Accordingly, whilst aiming to use a systematic approach to investigations, the Commission will apply the approach described in this guidance flexibly and may, if it considers it appropriate to do so, depart from that approach.

The competition questions

- 1.5 On receipt of a market investigation reference, the Commission is required 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 goods or services in the United Kingdom or a part of the United Kingdom.*⁶

If any feature, or combination of features, of a 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, under the Act this constitutes an ‘adverse effect on competition’.⁷ In this guidance we therefore refer to this question as the AEC test.
- 1.6 The phrase ‘prevents, restricts or distorts’ is familiar from the complex monopoly provisions of the Fair Trading Act 1973. (Similar phrases are also used in Chapter I of the Competition Act 1998 and Article 81 of the EC Treaty).

¹ Except when otherwise indicated, all references to sections and to Schedules are references to sections and Schedules in or to the Act.

² Director General of Telecommunications, the Gas and Electricity Markets Authority, the Director General of Water Services, the Director General of Electricity Supply for Northern Ireland, the Director General of Gas for Northern Ireland, the Rail Regulator and the Civil Aviation Authority.

³ Reference in the guidance to the rules are references to the proposed rules published on 1 March 2003.

⁴ In respect of each reference a group is appointed to carry out the Commission’s functions. For further information about the appointment of groups and the procedures that apply see *General Advice and Information* and the rules.

The Commission will interpret this phrase broadly using its ordinary and natural meaning so as to include any adverse effect on actual or potential competition. In particular, the Commission will interpret this phrase to include one circumstance in which several features create a situation in which the suppliers do not compete to the extent they would in a fully competitive market.

1.7 Section 131(2) of the Act states that, for the purpose of a market investigation reference, a feature of a market in the United Kingdom shall be construed as:

- (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.*

Conduct includes any failure to act, whether intentional or not and any other unintentional conduct.

1.8 Where the Commission decides that there is an adverse effect on competition, it is required to decide the following additional questions:⁸

- (a) *whether action should be taken by [the Commission]... 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;*
- (b) *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 customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and*
- (c) *in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.*

1.9 A detrimental effect on customers is defined as one taking the form of:⁹

- (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.*

Overall framework

1.10 Market investigation references to the Commission will be made where the OFT (or, in some circumstances, a Minister or sector regulator)¹⁰ has reasonable grounds for believing that competition is not working effectively (see OFT 501 *Market Investigation References*). The reference will describe the goods or services (referred in this guidance as products) and the OFT (or Minister, if appropriate) will indicate the feature or features that relate to the product that it (or he) believes have adverse effects on competition. The reference may require

⁵ For further information about the statutory period and the circumstances in which the inquiry may be extended see *General Advice and Information*.

⁶ Section 134(1).

⁷ Section 134(2).

⁸ Section 134 (4).

⁹ Section 134(5). The reference to customers includes future customers.

¹⁰ References in this Part to the OFT include references to the sectoral regulations having concurrent powers (see Footnote 2).

the Commission to confine its investigations to the effects of features on markets in the United Kingdom in connection with a specified description of supply or acquisition.¹¹ The OFT's views (or those of the Minister, if appropriate) will provide the natural starting point for the Commission's own investigation. But the Commission must reach its own conclusions on the effects of any features of the market subject to investigation. The Commission may, however, when deciding whether there is an adverse effect on competition, base its decisions on different features from those identified by the OFT (or Minister, as appropriate). It is entirely for the Commission to decide how any adverse effects on competition or detrimental effects on customers should be remedied.

- 1.11 The Government's intention is that market investigation references will focus upon the functioning of a market as a whole rather than the conduct of a single firm in a market. If the OFT has concerns about the conduct of a single firm, its first response is to consider whether the prohibition of the abuse of dominance in the Competition Act 1998 (the Competition Act) has been infringed. Similarly, if it suspects that firms have engaged in anti-competitive agreements it will first consider whether these infringe the prohibition of such agreements. However the Competition Act does not necessarily cover all types of competition concern. If, for example, anti-competitive conduct of a single firm is associated with structural features of a market, such as regulations or Government policies, it may be more appropriate for the OFT to make a market investigation reference than to take action under the Competition Act. Similarly, competition concerns may arise in oligopolistic markets even though no anti-competitive agreements exist between firms (as explained in paragraphs 3.58 to 3.67), hence triggering a market reference. More generally, OFT guidance (*OFT Market Investigation References*) indicates that it will consider whether to make a reference if it has reasonable grounds to suspect that there are market features which may prevent, restrict or distort competition, but does not believe there is evidence to establish a breach of the Competition Act. It may also consider whether to make a reference when action under the Competition Act has been or is likely to be ineffective to deal with the adverse effect on competition identified.
- 1.12 The European Community has revised the main regulation implementing Articles 81 and 82 of the EC Treaty (Regulation 17/62/EEC) with effect from 1 May 2004.¹² From that date Member State national competition authorities and courts have the responsibility, shared with the European Commission, for the application of Articles 81 and 82. National competition authorities and national courts will be obliged to apply Articles 81 and 82 where they apply national competition law to agreements or practices which may affect trade between Member States.
- 1.13 In the context of a market investigation, the obligation to apply Articles 81 and 82 in parallel with national competition law will arise only at the stage where remedies are imposed by the Commission. The obligation does not affect the exercise by the Commission of its powers of investigation.
- 1.14 If during the course of its investigation the Commission uncovered a potential breach of Article 81, it would consider the application of the modernisation regulation and whether the agreement, decision or concerted practice should be remitted back to the OFT for further consideration of the application of

¹¹ Section 133.

¹² Council Regulation (EC) No 1/2003 of 16 December 2002, "the modernisation regulation".

Article 81. The Commission might, for example, continue with its investigation but take the application of the modernisation regulation into account when determining whether to take remedial action (including whether it is prevented from taking action in respect of the agreement) and if so what action to take. If during the course of its investigation the Commission found evidence suggesting a breach of Article 82, it would normally continue with its investigation and, when appropriate, implement remedies under the Act. The OFT would then take such action into account when carrying out an Article 82 investigation.

Adverse effects on competition

- 1.15 Whilst market investigation references to the Commission will be made where the OFT (or, in some circumstances, a Minister or sector regulator) has reasonable grounds for believing that competition is not working effectively, it will be for the Commission to reach its own conclusions on whether there are any adverse effects on competition.
- 1.16 In doing so, the Commission sees competition as a process of rivalry between firms or other suppliers (hereinafter referred to as firms) seeking to win customers' business over time.¹³ This rivalry may occur in a variety of ways. In some cases the emphasis will be on achieving the lowest level of costs and prices in order to undercut competitors. In other cases, firms may go well beyond this, using entrepreneurial and innovative skills to develop new products and services, exploit particular strengths, abilities or other advantages held by a firm and, by these means, meet consumer needs more effectively than competitors. Where these factors are important, competition will often be characterised by uncertainty, turbulence and change. Amongst other things, therefore, this process of rivalry may be illustrated by changes in market structure, the pattern of pricing over time or the extent of product innovation, for example. Whatever forms the process of rivalry takes, the Commission will consider its effects over time and how it may be expected to develop.
- 1.17 Rivalry has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the quality and, more generally, the diversity of choice available to customers. Further, markets that are competitive generate feedback from customers to firms who, in consequence, direct their resources to customers' priorities. In addition firms are encouraged to meet the existing and future needs of customers as effectively and efficiently as possible. It is where this process is hampered, or otherwise hindered, by features of the market that competition may be adversely affected. The degree of rivalry between firms or other producers for customer business and the threat of entry faced by incumbents are the main competitive constraints on firms, although other constraints such as buyer and/or supplier power may also, in some cases, be significant.
- 1.18 As part of a market investigation, the Commission must consider how the competitive process in the relevant market is affected by any features of the market as described in the Act. Structural features include not only market shares, concentration, buyer power and entry barriers, but also less obvious aspects of market structure such as information asymmetries and government regulations. Conduct features include the conduct of buyers and sellers, of the

¹³ Other producers from which firms face competition need not be simply other commercial firms but might include government for example.

firms in the market and of customers. Each of these features may have effects on competition, in both its more static sense of price, cost and profit levels and its longer term dynamic sense of experimentation with new ideas, innovation, differentiation and development of products and markets through time. In its analysis, therefore, the Commission will consider the extent to which the process of rivalry in the market will ensure that all firms in the market are open to challenge, that no firm's position or market share is insulated from competitive pressure and that none can exert market power.¹⁴

- 1.19 In some market investigation references the Commission may find that for certain aspects of the market, or in some parts of the market, there is effective competition, but less than fully effective competition elsewhere in the market (possibly creating scope for cross-funding of some activities). In such instances the Commission will address the less competitive areas of the market, normally with the aim of securing effective competition in all areas of the market.
- 1.20 Inevitably a degree of judgement is involved in deciding whether there are adverse effects on competition. Where the line is to be drawn has to be judged in each individual case in the light of all the evidence that has been assembled in the course of the investigation.

The Commission's approach

- 1.21 The Commission's approach to market investigation references will normally be framed in terms of two related issues. The first concerns the identification of the relevant market (or markets) for the goods or services concerned (hereafter referred to as products). The relevant market may not coincide with the particular goods or services that are described in the reference. The reference will have outlined the market definition that OFT believes to be relevant to the investigation, but as OFT's Guidance indicates, the OFT does not have to reach a conclusive view on market boundaries.¹⁵ The second concerns the Commission's assessment of competition in the market and whether any features of the market adversely affect competition.
- 1.22 In practice the analysis of market definition and the assessment of competition will overlap significantly, with many of the factors affecting one being relevant to the other. For instance, in contemplating the extent of supply-side substitution for the purposes of identifying the relevant market, it is likely that the potential for entry and expansion, a key issue in the assessment of competition, will also be considered. Therefore, market definition and competition assessment should not be viewed as two distinct chronological stages – rather they should be viewed as two overlapping analyses. Market definition can be thought of as a framework within which to analyse the effect of features of the market on competition.
- 1.23 Part 2 looks at market definition and Part 3 considers the assessment of competition within the relevant market. Therefore, these two Parts focus on the key issues that are considered in an analysis of whether any features of a market have an adverse effect on competition. Part 4 describes the factors the Commission takes into account when deciding on the remedy questions. Part 5 relates to public interest cases.

¹⁴ Market power may be described most simply as the ability to raise price consistently and profitably above competitive levels (or where a buyer has market power, the ability to obtain prices lower than their competitive levels).

¹⁵ OFT guidance, *Market Investigation References*.

Part 2: Market definition

Introduction

- 2.1 An important element in a market investigation is to define the market (or markets) relevant to an assessment of the effect of market features. There are normally two dimensions to the definition of a market: a product dimension and a geographical dimension. The products that should be included in the relevant market, and the geographic boundaries of that market, are determined by the extent to which customers can readily switch between substitute products, or suppliers can readily switch their facilities between the supply of alternative products. The key to market definition is substitutability.
- 2.2 As noted earlier, the Commission does not regard market definition as an end in itself, but rather as a framework within which to analyse the effects of market features. The definition of the relevant market is a useful tool for identifying the competitive constraints present in the market. There is inevitably an element of judgement involved in defining the market and the Commission will adopt the methodology most appropriate in the context of the investigation. The generally accepted conceptual approach to market definition, used in many jurisdictions, is the SSNIP test (also known as the hypothetical monopolist test). The Commission will adopt this approach wherever it is feasible to do so.
- 2.3 The next section looks at how the SSNIP test can be used when considering the product market. In doing so it considers both demand-side and supply-side substitution. It then explains how the SSNIP test might be used when defining the geographic market before considering some other aspects related to market definition, for example chains of substitution.

SSNIP test

(a) Product market

- 2.4 In using the concept of the SSNIP test for product market definition, the Commission will consider whether a hypothetical monopolist of a certain product or set of products, which might constitute a market, could profitably impose a small but significant non-transitory increase in price (SSNIP). The principle behind the test is that a market is defined as a product, or collection of products, the supply of which can, hypothetically, be monopolised profitably.
 - 2.5 The application of the SSNIP test is an iterative process. It starts by considering each product (narrowly defined) in the market reference. The following question is then asked: if there were only one supplier of the product (a hypothetical monopolist), would it be able to sustain a SSNIP profitably? If the price rise is unprofitable, because consumers would switch their consumption to other products, then the closest substitutes are added to the product group and the procedure is repeated. Some analysis of the characteristics of the product including its intended use may, therefore, be necessary in order to establish possible substitutes that might be included
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in the group of products to be used in the SSNIP test. The relevant product market is normally defined as the smallest group of products for which a hypothetical monopolist could sustain a SSNIP profitably.

- 2.6 Occasionally the process of market definition may not give a clear-cut or unique answer. Whilst in most instances the Commission will want to be clear as to its preferred market definition, its duty is to decide whether any features of a market adversely effect competition. As a result, it will not devote disproportionate resources to determining exactly whether a particular competitive constraint results from within the market (and so should be included in the market definition) or from outside the market, provided that the alternative market definitions do not make a substantial difference to the analysis.
- 2.7 Commonly, the concept behind the SSNIP test has been to assume a price increase for the group of products in question in the range 5 –10 per cent, whilst all other prices remain unchanged. Whilst the absolute size of the price rise used will depend on the circumstances of the investigation, the Commission will normally hypothesise an increase of around 5 per cent, whilst assuming all other prices remain unchanged. This price rise is assumed to last for the foreseeable future and the Commission will typically consider the extent of response which is likely to occur within a year of the price rise (although the exact time period will depend on the nature of the market considered).
- 2.8 The Commission will normally use 5 per cent for the SSNIP test, rather than the more common 5 – 10 per cent, because in many instances an increase in the price of a product of around 5 per cent (with all other prices unchanged) might reasonably be judged to have a significant effect on customers' expenditure on that product and so provides an appropriate level at which to consider the test. In addition, a 5 per cent increase in price might also be expected to have an appreciable effect on a firm's profit margin, the main issue then being whether demand would be reduced to such an extent as to offset the effects of the higher margin. However, in some cases 5 per cent might be an inappropriate level at which to conduct the SSNIP test and in such cases the Commission will use a more suitable figure given the nature of the market in question.
- 2.9 One difficulty in considering the SSNIP test is that the existing price may be significantly above (or below) the price level that would result from a fully competitive market. This might be the case, for example, where a market is already to some extent monopolised, or where for some other reason prices are above competitive levels (for instance, see the section on coordinated effects, paragraph 3.58 to 3.67). In some cases, prices will have already been raised to the level at which a further price rise would lead a significant number of purchasers to stop buying, or switch to alternatives that would not otherwise have been regarded as reasonable substitutes. As a result, a further price rise might well be unprofitable. The application of the SSNIP test might, therefore, erroneously suggest that other products should be included in the resulting product market even though they would not have been seen as substitutes had the competitive price level been used as the starting point for the test.¹⁶

¹⁶ This problem is generally known as the "cellophane fallacy" after the Du Pont case in the US (US v El Du Pont de Nemours & Co, [1956] 351 US 377).

- 2.10 The problem for the Commission is that at the outset of a market investigation it is unlikely to be in a position to be able to judge decisively whether the existing price level is competitive or not, or indeed whether the prices of possible substitutes are at the competitive level or not. Therefore, in practice, the Commission will most likely use existing prices in its initial consideration of market definition. However, where the Commission's subsequent understanding of the market leads it to believe that prices are substantially above the competitive level, the Commission would normally wish to use prices indicative of the competitive level in its analysis of market definition.
- 2.11 Another difficulty is that it is generally not possible to apply the SSNIP test in any direct sense, that is to say actually observing a 5 per cent price increase across the products concerned and identifying the consequence for demand and for the profitability of the products concerned. Given this, it is usually necessary for the Commission to infer, from whatever information is available or can be collected, what the likely outcome of the SSNIP test would be. This can then be used to determine market definition.
- 2.12 The overall effect of the SSNIP on profit will depend on the net effect of three factors:
- the decline in the quantity sold as customers switch to other products;
 - any change in the costs of production, as the quantity produced decreases; and
 - the margin earned on each unit sold.
- 2.13 The first effect, substitution, is often a key focus of the Commission's analysis of market definition and is considered below. In order to measure the second and third of these effects the Commission would need information on actual costs and margins and how they change with the amount produced. This would provide direct information on whether any price increase would be profitable or not.
- 2.14 The effect of customers switching to substitute products following a SSNIP is called demand-side substitution and is considered in the following section. The effect of other suppliers commencing or increasing the supply of the products whose price rises following a SSNIP is called supply-side substitution. New suppliers commencing production (of the products whose price rises) might be considered, in some instances, as new entry and the distinction between supply-side substitution and new entry is considered after the section on demand-side substitution.
- (i) Demand-side substitution**
- 2.15 Demand-side substitution occurs because an increase in price makes a product less attractive to customers who therefore decide to purchase less of it and more of substitute products. A measure of demand-side substitutability, known as the elasticity of demand, looks at the responsiveness of demand to changes in price, with all the other prices remaining unchanged. Own-price elasticity measures the responsiveness of the demand for a product to a change in its own price; cross-price elasticity measures the responsiveness
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of demand for a product to a change in the price of a different product.¹⁷ Estimates of such measures, where they are available, may be considered when defining the market.

2.16 The following are examples of the types of information that can be useful, when available, in the analysis of demand-side substitution:

- product characteristics such as physical properties and intended use;
- responses from customers, competitors and interested and informed third parties to questions about customer behaviour and the SSNIP test;
- information enabling the estimation of “switching costs” that customers might incur in changing from the product of one supplier to that of another. These may be monetary or non-monetary, eg the time, effort, uncertainty etc involved in switching suppliers;
- past and future business decisions. This may include documents such as marketing studies, consumer surveys, market analyses prepared for investors, and internal business analyses (eg board papers, business plans and strategy documents). The Commission will also consider any similar types of studies, such as surveys, that have been prepared specifically for the inquiry;
- available information on the extent to which variations in price differentials, over time or across different areas, have occurred and their impact on sales;
- estimates of own-price, and cross-price, elasticities of demand, for example from econometric studies, sales data etc.

This information may be supplemented with two calculations:

- estimates of the sales that must be lost before a given price increase would be unprofitable (sometimes referred to as ‘critical loss’). This would then have to be judged against the likelihood of such a loss occurring;
- estimates of the maximum own-price elasticity of demand that would still make an increase in price profitable (sometimes referred to as ‘critical elasticity’).

Such calculations may help the Commission to judge how likely it is that a SSNIP would be profitable.

2.17 Various types of evidence on the responsiveness of customers to price changes may therefore be available to the Commission. Econometric estimates can provide information on elasticities, but their value depends on the robustness of the economic models used and the quality of the underlying data. Any econometric estimates submitted to the Commission should be supplemented by the full data set used, as well as a detailed description of each of the steps taken in the course of the estimation. This will help the Commission to understand fully the methodology used and allow it to replicate and assess the results.

2.18 Defining the market on the demand side focuses, as described above, on products rather than the firms that produce the products. However, as part of its wider assessment of competition the Commission will consider the separate

¹⁷ An own-price elasticity of -1 means that a 5 per cent increase in the price of the product results in a 5 per cent decrease in the quantity sold of that product. Demand is said to be elastic when the own-price elasticity is less than one and inelastic when the elasticity is greater than one (ie closer to zero). Similarly a cross-price elasticity of +1 means that a 5 per cent increase in the price of product A results in a 5 per cent increase in the quantity sold of product B. For substitutes we would expect a positive cross-price elasticity (as an increase in the price of one good leads consumers to substitute to the alternative good). For complements we would expect a negative cross-price elasticity.

issue of who produces the products included in the market. For instance, the importance of the market to a particular firm's sales or profits may affect that firm's attitude to, or strategy in, the market and may, therefore, be a matter the Commission will want to consider. In addition, the competitive strength of a particular firm may be related not only to its share of a market but to its overall size and financial strength.

(ii) Supply-side substitution

- 2.19 In defining the product market, the Commission will consider the potential for supply-side substitution, which occurs when a price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will usually come from firms with existing facilities, providing similar products and/or operating in adjacent areas. Imports might be another source of supply-side substitution.
- 2.20 It is not always straightforward to distinguish supply-side substitution from potential new entry. The difference is typically one of timing and/or investment: supply-side substitution occurs in the short-run with little or no investment required, whereas new entry is likely to occur over a longer period and may require more significant investment. Therefore, any significant investment or set-up costs, especially those which firms consider are unlikely to be recoverable, will reduce the likelihood of supply-side substitution. In order to consider a competitor's response as supply-side substitution, therefore, the response should, normally, be likely to occur within a year of the price rise (although the exact time period will depend on the nature of the market considered) and should not involve significant investment in plant, equipment, skills or marketing.
- 2.21 While the Commission will usually consider the extent to which supply-side substitution acts as a possible competitive constraint, and hence should be taken into account in defining the market, and will normally attempt to adjust market shares accordingly, it may not always be practicable to do so. The Commission will consider whether it is feasible to incorporate supply-side substitution into its calculation of the size of the market or whether it will calculate the size of the market based on the demand side only whilst incorporating in its assessment of competition in the market the fact that supply-side substitution imposes an effective competitive constraint on the incumbents.
- 2.22 The following are examples of the types of information that can be useful, when available, in the analysis of supply-side substitution:
- information on past supply-side substitution (for example, information on the extent to which supply-side substitution has resulted from variations in price differentials);
 - information on the willingness of customers to switch to new suppliers following a SSNIP;
 - information on the size of adjustment costs¹⁸ for potential suppliers;
 - information on the production processes involved;

¹⁸ Adjustment costs are costs incurred in adjusting to the supply of the new product. For instance, they might include the costs of altering the production process or establishing the distribution of the product.

- the extent of spare capacity within the industry;
- the business plans of potential suppliers and the assessment of their competitive threat by firms in the market;
- assessment by independent technical consultants and interested third parties of the likelihood and feasibility of supply-side substitution; and
- information on supply-side substitution in similar markets in other countries.

(b) Geographic market

- 2.23 The SSNIP test, including both demand and supply-side substitution, is also considered when defining the geographic market over which firms supply. The geographic market may be international, national, regional or limited to certain localities.
- 2.24 In considering the geographic market, the test looks at whether a SSNIP of the products in the relevant product market in a narrowly defined region would be profitable. If a SSNIP would not be profitable, for instance because customers switch to products in neighbouring areas, then these areas are added to the market and the procedure is repeated. The relevant market is defined as the smallest area in which a hypothetical monopolist could sustain a SSNIP profitably.
- 2.25 Where available, similar information to that used to identify demand-side substitution in the product market can be used to assess the geographical boundaries of the market. In particular the Commission might consider the following:
- the cost to customers of switching to products supplied in other geographic areas and the cost to suppliers of supplying products to different areas (eg transport costs) in relation to the value of the products and the length of time taken to make the switch;
 - information on consumer preferences by area;
 - product characteristics such as perishability;
 - information on differences in pricing, sales, advertising and marketing strategies by area; and
 - information on flows of goods between regions or into the UK and any legislative, natural, strategically created or other barriers to entry.
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2.26 The potential competitive impact of imports can also be analysed in the consideration of the geographic market, in the same way as that of UK based suppliers or potential entrants. Where a proportion of purchases within the United Kingdom is accounted for by imports, the Commission will consider whether customers would increase their purchases from overseas suppliers consequent upon an increase in domestic producers' prices (perhaps suggesting that the market is wider than the UK). Even when imports account for a small proportion of UK consumption, it might be relatively easy for the proportion to increase in response to a SSNIP, and the Commission will need to consider this as a possible outcome of the SSNIP. In some cases, however, there may be obstacles to customers purchasing more from overseas, or to overseas producers increasing their UK supply, for example, trade barriers, national standards, regulations or just capacity constraints. Furthermore, imports controlled in any way by the firms in the industry are unlikely to be a source of competitive challenge to participants in the market.

(c) Other aspects relevant to market definition

2.27 The Commission recognises the methodological and practical difficulties in delineating markets. These can be particularly acute, for example, in markets subject to rapid change, in markets driven by new technology, or in markets with other distinctive characteristics such as "bidding markets" where suppliers bid for the right to supply customers. This section looks at such factors and some other issues, such as chains of substitution, which are of relevance to market definition.

2.28 Some markets are not characterised by usual market attributes. For instance, bidding markets tend not to have multiple buyers and multiple sellers over a continuous time period; competition for contracts occurs at particular times only. Applying the SSNIP test in this instance might lead the Commission to consider each contract as a market in itself. This may not, however, be very helpful in understanding the dimensions of the market within which rivalry between firms occurs. In circumstances where the usual method of defining markets does not work effectively it may be necessary to consider other factors to help inform on market definition; for instance, information on the firms bidding for contracts and how they bid may be considered. It may also be necessary to consider other factors; for instance information on the track record of firms in bidding for contracts may be more indicative of the significance of firms in the market than other measures such as market share which might be difficult to calculate and perhaps misleading in such markets.

(i) Chains of substitution

2.29 In the process of defining a market, two products that are not direct substitutes can at times be included in the same market. This happens when product B, for example, is a direct substitute to products A and C, but C is not a direct substitute to A and vice versa. There is then a 'chain of substitution' running from A to B to C. Despite not being direct substitutes, A and C may, in some instances, be considered to be in the same market if they are constrained by their common relationship with B.

2.30 In the presence of chains of substitution in the product market, consideration will be given to the extent to which there are breaks in the chain of substitution. Where, in using the SSNIP test, breaks in the chain of substitution are identified, it might be appropriate to define separate markets on either side of the break. In addition, consideration of the chain as a whole (and not simply each link) will be necessary in finally defining the market.

2.31 The concept of chains of substitution can also apply to geographic markets. The Commission will also consider possible breaks in the chain of substitution as well as the chain as a whole, in deciding whether separate regional or local markets should be defined. Where the concept of a chain of substitution leads to a wide geographic area, the Commission will also consider whether a hypothetical monopolist would be able to price discriminate between smaller areas, and if so, whether it is appropriate instead, to define a number of smaller geographic markets.

(ii) Different groups within a market

2.32 In many instances markets serve heterogeneous collections of customers, for example business and personal customers. Where this heterogeneity exists, and where suppliers can charge different prices to different groups, then depending on the market and the evidence presented, the Commission may choose to treat these different groups, for the purpose of assessing competitive pressures, as separate markets, or as one market whilst noting the scope for price discrimination between different groups within the market.¹⁹

2.33 As noted earlier (see paragraph 1.19), in some market investigation references there may be less than effective competition in certain aspects, or in some parts, of the market. This may divert competition into other areas of the market with firms using profits made in less competitive areas of the market to fund greater competitive effort elsewhere, for instance to sign up new customers. In some cases, if the less competitive area is sufficiently immune from competition elsewhere in the market, it may be, depending on the application of the SSNIP test, more appropriate to regard it as a separate market.

2.34 Temporal characteristics of demand may suggest that a market might be defined as comprising different groups of customers. When customers are not able to substitute products between periods, a temporal dimension may be added to the market, for example seasonality, peak and off-peak services. A typical example concerns commuters and leisure travellers on trains. Commuters constrained by their hours of work have less choice than other travellers and tend to travel at peak times. On the other hand, leisure travellers may be less sensitive to the time of travel and more willing to travel at off-peak times. Given this, train companies frequently charge higher prices during peak times than during off-peak times. In such instances, depending on the circumstances of the case, the Commission may decide to define two or more markets, or it may decide to define only one market and note the scope for price discrimination within the market, for instance identifying a market for rail travel with different prices charged to peak and off-peak travellers.

¹⁹ This scope for price discrimination over a narrow group of products within the market might allow a hypothetical monopolist to impose a SSNIP profitably over these products within a wider market.

(iii) Upstream and downstream markets

- 2.35 Some products are not sold directly to the final customer. They are first sold to an intermediary, who then either sells on directly to another customer (wholesaler) or reprocesses the products before resale (reprocessor). Markets for products at an earlier stage of production are generally designated as upstream markets; and those at a later stage, typically the retail stage, downstream markets. There may be a supply chain involving one or more upstream markets in addition to the downstream market where the final consumer purchases.
- 2.36 Where there are upstream and/or downstream markets the Commission will have regard to their impact on market definition and competition more generally. As well as considering which aspects of the supply chain should be included in the definition of the relevant market, the Commission will consider the potential for upstream and downstream markets to impact on the relevant market, and vice versa, in its wider assessment of competition in the market. This issue is considered in more detail in paragraphs 3.37 to 3.45.

Part 3: Assessment of competition

Introduction

- 3.1 Part 2 dealt with issues concerning market definition. This Part considers the assessment of competition in the market and whether there are any factors that might adversely effect competition. Factors that may have the effect of preventing, restricting or distorting competition can be structural features of the market, the conduct of firms whether as sellers or buyers, and the conduct of customers.
- 3.2 In the first instance, the Commission's analysis of competition in the market will typically include a consideration of rivalry from other firms within the market, the threat of entry and/or countervailing power of customers, but need not be restricted to these. The following section deals with structural factors relevant to intra-market rivalry before considering other competitive constraints on firms such as barriers to entry and countervailing buyer power. It then turns to other aspects of the market that might need consideration in a market inquiry such as vertical integration and the conduct of customers. It then looks at the conduct of firms and its impact on intra-market rivalry before considering some possible indicators of ineffective competition.

Intra-market rivalry

- 3.3 The process of intra-market rivalry is altered by both the conduct of firms in the market and structural features of the market. The following section considers the structural features pertinent to intra-market rivalry; a later section considers the conduct of firms.

(a) Intra-market rivalry: structural features

(i) Market shares and concentration

- 3.4 The market shares of firms in the market, both in absolute terms and relative to each other, can give an indication of the extent of a firm's market power. For instance, a firm with a large market share relative to other firms in the same market may have the ability to raise its price independently of other firms, at least to some extent. Further, a large market share may confer substantial advantages in bargaining with suppliers upstream, or buyers downstream, and a firm may be able to control prices in its favour or impose unreasonable restraints in the negotiation process. However, a firm with a large market share will not always be able to exert market power. Other features of the market, such as the extent of switching costs, threats of entry and countervailing buyer power, will affect a firm's ability to exercise its market power.
- 3.5 As noted earlier, it is likely to be unusual for market investigation references to be focused solely on a single firm. Nevertheless, there may be cases where the size and conduct of a large single firm has a significant impact on the market. In such instances the Commission might wish to investigate the firm's behaviour in more detail.
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- 3.6 More generally, changes in market shares over time may give some indication of the dynamics of the market and may be useful in assessing the nature and extent of competition in the market. When considering such changes, the Commission will aim to look at market shares over several years where the information is available. Volatile market shares may indicate the existence of effective competitive constraints against the exercise of market power in the form of, for example, successful entry, rivalry between firms and innovation. However, high and static market shares do not always indicate that a firm has market power: the firm may simply have competed successfully on a continuing basis.
- 3.7 In order to calculate market shares, the Commission may use information from a variety of sources including the main parties, other competitors, customers, buyers, suppliers, trade associations and market research reports. Market shares can be measured in terms of revenues, volumes, production capacities or inputs, depending on the markets concerned and the information available.
- **Concentration measures**
- 3.8 Normally the Commission will also look at measures of the degree of concentration of the market (which are primarily measures of the structure of the market). Concentration measures can be indicators of the ability of the leading firms in a market to exercise market power collectively, though other competitive constraints will need to be considered before finding that firms have such market power.
- 3.9 There are a number of possible ways of measuring the degree of concentration in a market. A straightforward count of the firms in a market is only a very basic measure of concentration because it does not convey much information about the structure of the market – it fails to take into account differences in market shares and the size distribution of firms. Two other measures that are commonly used are the concentration ratio and the Herfindahl-Hirschman Index (HHI).
- 3.10 The concentration ratio measures the combined market share of the largest firms in a market. For example, the ‘five firm’ concentration ratio is simply the sum of the market shares of the five largest firms in the market. As such, it does not provide any information on the relative size of the firms nor on the number, or size, of the smaller firms.
- 3.11 In contrast to the concentration ratio, the HHI potentially reflects both the number of firms in the industry and their relative size. It is defined as the sum of the squares of all the market shares in the market. In its guidelines, the OFT states that it is likely to regard any market with a HHI in excess of 1800 as highly concentrated, and any market with a HHI in excess of 1000 as concentrated. Where it uses the HHI, the Commission will have regard to the threshold levels set out above, but only as one factor in its wider assessment of competition.
- (ii) Other structural factors**
- 3.12 Whilst market shares and other measures of concentration may provide an indication of current competitive conditions within a market, the Commission will consider a number of other factors in its assessment of competition in the market. Future market shares might be very different, for example due
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to technological change, the existence of patents and the development of new products. Such factors may suggest that future competitive conditions are likely to be different from those suggested by simple market share or concentration measures.

- 3.13 Moreover, there are a number of other structural factors beyond market shares and market concentration that can affect the degree of intra-market rivalry in a market. For instance, the extent of intra-market rivalry may depend on whether firms' cost structures are very similar or not, and how low-cost firms utilise this advantage. In addition the degree of spare capacity in a market and the ease with which existing capacity can be expanded are two factors that might impinge on the degree of intra-market rivalry. Furthermore, the ownership and organisational form of firms might also affect the degree of intra-market rivalry.
- 3.14 Particular features can be important in some markets; for example, certain markets are characterised by network effects. Such effects arise when the value of a product to a customer increases with the number of other customers consuming the same good. As a result, incumbents with an existing customer base have an automatic advantage over entrants. Markets characterised by network effects may be prone to 'tipping'. That is, as one firm, or technology, gains an advantage in the market, in effect, the balance of power in the market 'tips' in its direction leaving it as the prevalent firm, or technology. An example of this was the emergence of VHS developed by JVC as the standard video technology over Sony's Betamax at the beginning of the 1980s. In these markets, competition takes place for the market as opposed to within the market, and traditional methods of analysis, such as market shares and market concentration, might not adequately convey the degree of competition in the market.
- 3.15 Two other factors that might impinge on intra-market rivalry are switching costs and information asymmetries. These factors along with their interaction with the conduct of customers are considered later (paragraphs 3.46 to 3.55).

(b) Barriers to entry, expansion and exit

- 3.16 Where the Commission believes that intra-market rivalry is not strong, other possible competitive constraints on firms need to be considered. This section considers the potential for entry and expansion in the market. It looks at entry and expansion in general before focusing on different types of barrier such as natural or intrinsic barriers, regulatory barriers and strategic barriers. It then considers the effects of entry before turning to countervailing buyer power – another possible competitive constraint.
- 3.17 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.
- 3.18 Entry and expansion might take a number of forms including, for example:
- new firms building new capacity;
 - existing firms within the market building new plants or capacity;
 - forward/backward integration;
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- the entry of new firms into the market taking over existing capacity and using it in new, or more productive, ways; and
- new technology facilitating new production methods, potentially increasing entry possibilities.

3.19 In assessing the potential for entry to act as a competitive constraint, the Commission will consider available information on a number of factors including:

- the history of past entry and evidence of planned entry or expansion by third parties;
- the extent to which past entrants have successfully gained market share and, more generally, the cost of gaining a significant share of the relevant market (usually considered as 5 per cent);
- direct observations or statistical information on barriers to entry, expansion and exit;
- the costs involved in entry or expansion and in operating at the minimum efficient scale necessary to achieve a reasonably competitive level of costs;
- the likelihood of entry (from new entrants in related markets and/or from scratch) or expansion within such a timescale that it bears on the incentives and decisions of the existing firms in the market;
- the cost of exiting the market – if this is high it may deter entry by raising the cost of failure for new firms;
- the potential effect of technological change and innovation on barriers to entry or expansion; and
- the likely response to entry or expansion by incumbent firms.

3.20 In considering historical evidence, relevant factors include survival rates, ie how long any entrants traded in the market; the effects that entry or expansion had on competition in the market, in particular whether past entry or expansion modified the pattern of behaviour and competition; and if so, whether this would be relevant for the present analysis.

3.21 The effectiveness of any given set of barriers to entry or expansion will to some extent depend on other characteristics of the market. For instance, if growth in demand is likely to be large and/or rapid, then barriers to entry are less likely to have a lasting effect. Similarly, in markets characterised by innovation, product cycles are likely to be shorter, which may decrease the probability that some barriers to entry will have a lasting effect. More generally, therefore, the Commission will consider what other supply-side responses might be likely.

3.22 Barriers to entry are features of the market that may prevent or restrict firms from exploiting profitable opportunities in a market and hence enable existing suppliers to raise prices above costs persistently without significant loss of market share. Some barriers are described as “natural” or “intrinsic” in the sense that they are a function of the technology, production methods or some other factor necessary to establish an effective presence in the market. Some are “regulatory”, such as rules designed to provide safety, or other types of

consumer protection that may make it difficult for new firms to develop products. It should be noted that the concept of regulation in this case is broader than the conventional sense and includes things such as intellectual property law, the planning regime, voluntary or compulsory standards and codes of practice for example. Other barriers, termed “strategic”, are the result of existing firms in the market acting with the specific intention to deter entry or expansion. Each of these different types of barrier is considered in more detail in the following sections.

(i) Natural or intrinsic barriers to entry or expansion

- 3.23 Natural or intrinsic barriers to entry or expansion are the unavoidable costs necessarily incurred when setting up or expanding a commercial operation. These involve the cost of putting the production process in place, gaining access to essential facilities or inputs and the acquisition of any necessary intellectual property rights (IPRs). An important consideration in evaluating the effects of such barriers is the extent to which the costs associated with them are ‘sunk’.
- 3.24 Sunk costs are those costs that cannot be recovered fully upon exit, because they cannot be used to produce other goods and cannot be successfully traded. They include for example, some specific asset investments, advertising, and research and development (R&D). In some markets, a reputation for producing quality products is needed to attract customers: the costs of acquiring such a reputation can be a form of sunk costs. As noted earlier, the existence of high sunk costs is likely to deter entry by raising the costs of leaving the market. Non-sunk costs, in contrast, by definition are recoverable if production ceases, and do not therefore pose the same risk.
- 3.25 In industries where economies of scale are significant, entry or expansion on a small scale may not be economically feasible unless the firm is aiming at a differentiated ‘niche’ in the market or can develop a new production strategy which offsets the disadvantages of small-scale production. But entry or expansion on a large scale will often raise the risks because large-scale entry or expansion will generally be successful only if the firm can expand the total market significantly, or substantially replace one or more existing firms. Firms can also be at a disadvantage where production costs are reduced according to the cumulative quantity produced (ie through ‘learning by doing’). Similar considerations apply to economies of scope, which arise where producing two (or more) products is less costly for a single firm than for two (or more) firms each to produce the products separately. Where economies of scope are significant, a successful entrant might have to produce a range of products from the outset.
- 3.26 Where substantial financing is required for entry or expansion, the Commission might want to consider whether raising capital to finance the set up of a new operation is difficult and whether the actual cost of financing would be relatively high. Financiers might regard new entrants as especially high risk because they do not have a proven track record in the market and consequently provide higher cost finance to new entrants as opposed to incumbent firms.
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- 3.27 Existing firms within the market sometimes have access to superior or scarce resources to which entrants cannot gain access because the supply is limited, or the cost prohibitive. This might again act as a barrier to entry by, in effect, raising the input cost to entrants relative to existing firms.
- 3.28 Natural or intrinsic barriers to entry often accrue simply because incumbents are already in the market and as a result have a cost, or demand-side, advantage over entrants. Alternatively, incumbent firms may derive some benefit from simply being a known business in the market and as such there may be a reputational barrier that new entrants would have to overcome. In addition, a firm will often have to incur costs to launch a product in order to gain consumer awareness and this can act as a barrier to entry. The existence of switching costs may also increase the costs of entry, making it harder to gain customers from the incumbents' existing customer base. In some markets the first firm to innovate or introduce a product or create a substantial capital base will gain a competitive advantage which competitors can overcome only with difficulty.
- 3.29 Network effects (paragraph 3.14) may constitute an absolute barrier to entry as incumbents with an existing customer base have an automatic advantage over entrants. However, when demand is growing fast, or innovation is rapid, the barrier might not be as high as when demand or technological change is more static.

(ii) Regulatory barriers to entry

- 3.30 Regulations are beneficial for a variety of reasons ranging from ensuring the stability of the financial system to protecting the environment. Notwithstanding this, regulation may inhibit the extent to which competition can flourish in certain circumstances. Some types of regulations may concern the production process and the characteristics of the finished product, for instance health and safety standards. Others may limit the number of competitors in the market, for example by requiring that only firms with a licence or permit may operate in the market. A limitation on the number of licences and permits may act as an absolute barrier to entry. If licences and permits can be traded in a competitive market, then a potential entrant could enter the market by buying a licence, though this would depend on how frequently such opportunities arose.
- 3.31 Subsidies, tax relief and preferential purchasing may also raise barriers to entry in a market if potential entrants are not equally eligible for them. Similarly, planning policies and regulations can constitute a barrier or impediment to potential entrants into a market to advantage of incumbent firms. Intellectual property rights (IPRs) such as patents, trademarks and copyrights give the owners of such rights exclusive use of them and the ability to control their use by others, though the period of such exclusivity or control varies according to the nature of the property right. Whilst IPRs are a way by which firms and individuals are incentivised to invest and innovate they can also act as barriers to entry, as access to certain rights owned by an incumbent may be vital for entry. In some such cases it will be more appropriate to assess the impact on competition for the market rather than within the market.
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3.32 Quality, environmental, and health and safety standards that apply indiscriminately to all the firms in a market may on occasions adversely affect entry although they make no distinction between incumbents and new entrants. For example, they might favour the technology which the incumbent owns and in so doing raise the costs of a new entrant. Some regulations may give advantage to incumbents by not requiring them to comply with the same standards as new entrants. For example, existing high pollution factories often have grandfather rights to pollute, which are not enjoyed by entrants, because the factory existed before the relevant regulation came into force.

(iii) Strategic barriers to entry

3.33 Firms that are already operating in the market may sometimes have the ability to pursue strategies designed to deter entry through investing in excess capacity or launching predatory price or non-price initiatives targeted at entrants when they are most vulnerable. Switching costs, for instance, may be intrinsic to the market, but may also be affected by the actions of firms. The existence of significant switching costs may act as a barrier to entry, especially when there are economies of scale. Firms may act to increase such switching costs, so strategically raising barriers to entry, for example by offering fidelity discounts. Furthermore, existing firms may produce complementary goods and tie or bundle them together, which potentially raises the costs for an entrant who produces only one of the complementary goods.

3.34 Other forms of non-price competition, such as advertising, can have the effect of increasing sunk costs, and this will tend to disadvantage entrants. Even a low level of sunk cost may be enough to deter entry given that existing firms within the market have already incurred these costs. They may also be able to deter entry by signalling that they would respond aggressively to entry or seek to target entrants specifically to drive them back out of the market. Similarly, incumbent firms may seek to deter expansion by another firm in the market.

3.35 Sometimes firms may, through their conduct, increase barriers to entry even though that may not be the prime purpose of their conduct. Marketing or advertising, for instance, may be designed for inter-firm competition but may make entry more difficult. More generally, firms often seek to create a reputation for good service, quality and reliability and this may prove a further obstacle to new firms seeking to enter the market (with no track record to demonstrate their quality and reliability for example). In market investigation references, when applying the AEC test (paragraph 1.5), the Commission will take into account that firms may have built market share by successfully providing customers with good service, quality and value for money. It will, however, also have regard to the impact on competition and barriers to entry.

(iv) Effects of entry and expansion

3.36 The absence of significant barriers to entry and expansion will tend to constrain what might otherwise be scope for the exercise of market power by incumbent firms. However, the Commission will wish to consider not only whether entry or expansion can be expected to occur within such a time scale that it bears on the incentives and decisions of the existing firms in the market but also whether successful entry or expansion can be expected to be sustainable or provide an effective competitive constraint to firms in the market. In some cases entry on a

small scale may be relatively easy, for example using a small-scale technology, but there may nonetheless be considerable barriers to expansion to a scale that would significantly impact on competition. Similarly, entry of firms producing niche products will not necessarily constrain incumbent firms' ability to exercise their market power. In markets with differentiated products, entry at the fringe may be easy, but a niche product may not necessarily compete strongly with other products in the same market and so constrain incumbents effectively.

(c) Countervailing buyer power

- 3.37 In many markets buyers have some degree of market power. Prices will then be determined by their relative bargaining power. Buyers may have sufficient bargaining power to prevent the exercise of suppliers' market power. Much depends on the relative importance to each of its business with the other party. In retailing, for example, a supplier may well be more dependent on his sales to a large retailer than is the retailer on its purchases from that supplier, even if the supplier has a larger market share of its market than the retailer has of the retail market.
- 3.38 The fact that the market is characterised by buyers that are large relative to the size of the suppliers does not necessarily mean that there is countervailing buyer power in the market. For instance, factors that will affect the ability of buyers to constrain suppliers include:
- the buyers' ability to find alternative suppliers in the case of a price rise;
 - the ease with which buyers can switch supplier;
 - the extent to which buyers possess a credible threat of setting up their own supply arrangements;
 - the extent to which buyers can credibly threaten to stop purchasing other products sourced from the supplier; and
 - the extent to which buyers can impose costs on suppliers (for instance by delaying purchases).
- 3.39 While buyer power can offset the market power of suppliers, the benefits from the exercise of buyer power in lowering suppliers' prices are not necessarily passed on to their customers. Much depends on how effective competition is between the various buyers in the market that they supply. It follows that, in markets where buyers appear to have market power in their own right, the Commission's assessment of whether any market feature has the effect of preventing, restricting or distorting competition is likely to have to embrace the competitive process in both the upstream and the downstream markets.

(d) Supplier power

- 3.40 In some situations, the structure or behaviour of firms in upstream markets may have an appreciable effect on downstream markets subject to a market investigation. For instance, upstream suppliers may possess many of the characteristics of power outlined for buyers above. In such circumstances the Commission will have regard to the upstream market and its effect on the

market subject to the reference. Normally it would be for the OFT to consider whether any concerns arising in the upstream market itself were sufficient to justify a separate reference.

(e) Vertical integration

- 3.41 A vertically integrated firm operates simultaneously at different levels of the supply chain for a particular product or service. Vertical integration thus modifies the structure of a market as it adds a dimension to the relationship between competitors. It may be distinguished from vertical agreements between firms, which are considered later as an aspect of firms' conduct. The effects of vertical integration can be ambiguous. It can lead to gains in efficiencies that would not be achieved without integration, but it may also lead to the foreclosure of supply to non-integrated firms and higher barriers to entry.
- 3.42 Examples of efficiency improvements from vertical integration include improved organisation between firms at different stages in the supply chain, resulting in, for instance, improved product design, lower transaction costs and removal of the 'double marginalisation' that occurs when two non-integrated firms both have significant market power.²⁰ Another potential benefit of vertical integration is that it can create greater confidence for specific investments when market contracts provide inadequate incentives and safeguards.
- 3.43 Vertical integration can also have anti-competitive effects, most notably if rival firms downstream are not supplied (known as 'foreclosure' of supply), for example, when retailers are integrated with manufacturers and only sell the goods of their parent company. Although this may reduce costs for the supplier because the manufacturer has to supply fewer retailers, it decreases inter-brand competition within each retail outlet.
- 3.44 Vertical integration can raise barriers to entry or expansion, for example by limiting, or foreclosing altogether, access to essential inputs or means of distribution to a non-integrated firm, or by requiring any entrant to consider entering at both stages.
- 3.45 The larger the share of either the upstream or the downstream market of the vertically integrated firm, or the more widespread the vertical integration in a market, the more significant the effects of vertical integration are likely to be.

(f) Switching costs

- 3.46 In some markets, customers face obstacles to switching between suppliers. These may take many forms including inconvenience, monetary costs, administrative hurdles or a lack of information about the products of alternative suppliers. The existence of switching costs may mean that suppliers can charge high prices to captive customers and this may have implications for market definition as well as for the assessment of competition. Against this, the presence of switching costs may intensify the competition for new customers, which may benefit new buyers, particularly if there is scope to charge rather different prices to new as opposed to existing customers. The overall effect on competition will depend on weighing up these effects. Much the same set of considerations applies where there are network effects, since these effectively give rise to collective switching costs, locking consumers into existing standards and the firms that control them.

²⁰ Double marginalisation may occur because, in the absence of price discrimination, each non-integrated firm has the incentive to raise prices above cost without taking account of the fact that this lowers the output of the other. The result is lower output and profits (and higher prices) than if the two firms pursued a policy of joint profit maximisation.

- 3.47 The Act explicitly includes the conduct of customers as a market feature that might potentially adversely effect competition. As indicated above, switching costs may decrease customers' incentives to search for, or switch to, alternatives that could meet their needs. Evidence that customers rarely switch suppliers, combined with evidence that significant switching costs exist, may suggest that competition is not effective.
- 3.48 Technical standards can lower switching costs, for example, by ensuring the compatibility of different suppliers' products. But they could have adverse effects on competition if they serve to discourage market entry. This may happen if the standards favour incumbents. For example, entrants may only be able to gain access at prohibitive cost to crucial patents or know-how held by incumbents.

(g) Information asymmetries

- 3.49 Customers' purchasing decisions are based on the information they have about products. Complete information would include knowledge of all available substitutes and their characteristics, their prices, and the switching costs that customers incur in changing suppliers. The characteristics of a product include all the things that the customer values such as durability, functionality, compatibility, etc. Firms in markets with well-informed customers have the incentive to supply goods that match the preferences of customers, as customers could take their business elsewhere if other suppliers were matching their preferences more closely.
- 3.50 In many markets, customers do not have adequate information: information may be unavailable or costly to acquire or customers may be unwilling or unable to get it. In such markets, customers can only compare prices or the quality of the products they know, or are aware of, and thus their perspective of the market is reduced. Firms may exploit this gap in knowledge and compete less intensively on prices or quality because, regardless of the actual number of suppliers in the market, customers are unlikely to switch to other products readily.
- 3.51 As noted in paragraph 1.18, the Act explicitly includes the conduct of customers as a market feature that might adversely affect competition. Information asymmetries may be one area where this issue is relevant as information asymmetries decrease customers' incentives to search for or switch to alternatives that could meet their needs. Evidence that customers do not search out alternatives effectively, combined with the evidence on the existence of information asymmetries may suggest that competition is not effective.
- 3.52 It is often the case that customers are unable to assess the quality of a product fully before making a decision to purchase. This can occur, for example, when products are complex, when the performance of a product is not easily determined prior to sale, or when products are purchased infrequently. In such circumstances, where purchasers have less information than sellers regarding the quality of the products, the competitive process can be significantly affected. Information asymmetries of this type can, in the absence of corrective measures, distort market behaviour. Indeed, in principle, such problems could lead to difficulties in even establishing a market for the product. In theory this
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problem could apply to any market where there are asymmetries in information, for example, many durable goods, insurance services, health services, legal services, estate agency services, and holidays. The effects of asymmetric information may, however, be mitigated in various ways. For example, in the case of holidays, suppliers might offer ‘satisfaction guarantees’ on their holidays, or produce more detailed brochures describing the accommodation. These ‘mitigating factors’ frequently become part of the process of competition, though they may not overcome the information problems entirely.

- 3.53 Advertising is often an important source of information for consumers, but can have an ambiguous effect on information asymmetries. Advertising and promotional offers increase the visibility of a product and provide information on price, where it can be bought and so on. However advertising may not necessarily be informative in terms of what consumers want to know about a product; rather it may contain only what firms feel consumers need to know in order to persuade more of them to buy the product.
- 3.54 Firms may engage in practices that increase search and switching costs by, for example, providing inadequate information about prices. Prices may not be clearly displayed, or firms may only refer to some prices (eg special offers etc) which are not always available to all customers. In some cases, a large amount of information may be made available but is complex or displayed unclearly so as to limit customers’ understanding of existing prices.
- 3.55 It is important to add that information asymmetries might have adverse effects on competition even when other structural features such as the number of firms and entry conditions suggest that the market may be competitive. This is likely to be the case in markets for services where customers are not able to gauge the quality of a service when acquiring it.

(h) Intra-market rivalry: conduct

- 3.56 As noted earlier, there is more to the assessment of intra-market rivalry than purely structural features. Markets with a similar structure can display different degrees of intra-market rivalry as a result of many factors. Non-structural factors that might affect the level of intra-market rivalry can include, for example, the different ability of, and capacity for, firms to innovate; the objectives and culture of the firms in the market, their views on the future development of the market and on the appropriate strategies to meet those developments; the history of pricing behaviour in the market and the extent to which transparent prices are available in the market. To the extent that these can be identified during the course of an inquiry, these factors might well provide additional insight to the more static analysis of market structure.
- 3.57 In short, the Commission will seek to assess the process of competition and consider the kinds of factors that determine its effectiveness. But it is to be emphasised that there can be no exhaustive or inclusive list of the types of conduct which might adversely affect competition, much less the assurance that a particular pattern of conduct will adversely affect competition in all market circumstances. The Commission will have regard to any conduct of the firms in a market (whether sellers or buyers) that could, in the circumstances of the particular market, have an adverse effect on competition (whether in the market in which the firms themselves are engaged or in some other market, for example,
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the market of the sellers' suppliers or customers). The rest of this section looks at the pricing strategies of firms and non-price competition before considering other conduct that can affect the extent of competition within a market.

(i) Pricing issues: coordinated effects

- 3.58 Where markets are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence. The interdependence of oligopolistic firms may lead them to anticipate competitors' responses to their own actions and take this into account in their own decisions. If, as will often be the case, this interdependence persists through time in such markets, the repeated nature of such decisions can have significant effects on business strategies and on competition. In particular, under certain conditions discussed below, it can become rational to refrain from initiating price cuts which would be unavoidable in more competitive circumstances.
- 3.59 If a reduction in price fails to achieve a significant volume response it will be unprofitable. However, if it does achieve such a response this will, in a sufficiently concentrated market, be likely to provoke a matching price reduction from the competitors who will necessarily have lost significant demand. In this instance, the price cut will again prove to be unprofitable. Recognition of this – namely that firms have a clear common interest in avoiding mutually destructive price cuts – may be sufficient to deter a cut in price.
- 3.60 Moreover, price increases by one firm to levels that might otherwise have been uncompetitive may well prove profitable. This is because, of the two possible responses by competitors – to follow or not to follow the price rise – the former will often be more profitable, as the latter is likely to force a reversal of the original price increase and hence eliminate the new profit opportunity. Recognition of this could then provide rational grounds for the initial price rise. Such considerations, whether explicit or implicit in terms of established pricing strategies, understanding of 'going rates' etc can result in oligopolistic firms tending to match each others' prices at a higher level than could otherwise be sustained.
- 3.61 This type of behaviour is sometimes referred to as 'tacit collusion' or 'conscious parallelism'. However, this behaviour does not require any type of collusion, in the usual sense of the word, between firms, or even any contact between them. Nor does any such parallelism of price necessarily have to be 'conscious' in the form of an explicit or documented analysis of interdependent price strategies. Instead, the behaviour can arise purely from firms' perception of interdependence, with the benefits of such behaviour accruing to all firms in the market. As a result, we term the effects of such behaviour coordinated effects, whilst noting that no explicit coordination between firms is necessarily required. Such behaviour is nonetheless capable of weakening competitive pressures on prices and, if so, is likely to be detrimental to both consumers and the extent of rivalry in a market.
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- **Conditions facilitating coordinated effects**

- 3.62 A number of conditions are necessary for such behaviour to occur and be sustainable through time. First, the market has to be sufficiently concentrated for firms to be aware of the behaviour of their competitors, and for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market. Where prices are transparent any deviation from the prevailing behaviour will be clear. However, even where they are not transparent, as is often the case in intermediate markets, any deviation from the prevailing behaviour by a competitor may nonetheless be readily apparent, because the essence of interdependence is that price cuts by one firm will have a significant impact on others' volumes.
- 3.63 Secondly, it must be clear that it will be costly for firms to deviate from the prevailing behaviour; so costly that it will be in a firm's interests to go along with the prevailing behaviour rather than seek to deviate from it. In many cases, the mere fact of the interdependence and hence the strong likelihood of a matching price cut may be enough to create such a disincentive. Timing will, however, be significant here. If prices can be adjusted quickly then such a response is very likely, but in markets where prices can only be set infrequently, the short-term gains from lower prices until a response is possible could outweigh the long-term gains of higher oligopolistic prices. If price setting is very infrequent then the basic perception of interdependence may cease to hold at all.
- 3.64 Thirdly, this type of parallelism can only be sustained in markets where there are relatively weak competitive constraints. If barriers to entry are low, then the threat of entry will tend to undermine such conduct. Alternatively, if there is a fringe of other firms in a market outside the core oligopolists, and if the competitive fringe firms have both the incentive to undercut and scope to attract significant volume away from the core oligopolists, then an uncompetitive price level is unlikely to be sustainable.²¹
- 3.65 The extent to which fringe firms act as a competitive constraint will in part depend on the number and size of such fringe companies and their cost and profit margins. It will also depend critically on their scope to expand output, first in relation to their current levels and secondly in relation to the output of the core oligopolists. To the extent that fringe firms can significantly expand their own output, their existence will provide a threat to firms considering pricing above competitive levels. If however this scope is limited then pricing up to the 'umbrella' price set by the core oligopoly may be more profitable. Even if a lower price strategy for the fringe firms is preferable (to pricing up to the 'umbrella' price) this will only tend to undermine the prevailing price level if the loss of output by core companies to the fringe is sufficiently large in relation to the output of the core oligopolists. It should be noted that such behaviour, and so coordinated effects, could also occur with non-price variables such as quality, variety and innovation.
- 3.66 The Commission will want to evaluate all the available information on the characteristics of the market that may facilitate, or may in other ways impinge upon, coordinated effects. These can include:
- a high level of concentration in the market;

²¹ The term "competitive fringe" is often used by economists to describe a group of relatively small firms in the market.

- the existence and significance of entry barriers;
- evidence of a long-term commitment to the market by firms;
- a high degree of homogeneity of the firms' products;
- a high degree of homogeneity of firms (ie the extent to which firms are similar, for instance, with respect to their size, market shares, cost structures, business strategies and attitudes to risk);
- a high degree of market transparency (the more transparent the market the easier it is for firms to see each other's actions);
- the existence of institutions and practices that may aid coordination, for example information sharing agreements, trade associations, regulations etc;
- the existence of switching costs. (However, in some instances, switching costs might increase competitive pressure so destabilising any coordination);
- the degree of excess capacity in the market (for instance a high level of excess capacity might make coordinated behaviour more difficult as other firms might enter and use the excess capacity. However, in other instances, excess capacity may make coordination easier because firms could use the spare capacity as a credible threat to other firms thinking of deviating from the prevailing behaviour);
- the stability of demand and costs (unpredictable changes in demand or costs might make it more difficult for firms to decipher whether a change in volume sold, for instance, is due to the actions of another firm or due to demand changes in the market as a whole);
- the stability of market shares over time;
- short-term financial pressures on firms (short-term financial pressures may encourage firms to depart from any common pattern of long-term behaviour);
- the extent to which small firms on the fringe of the market, for example, producing specialist 'niche' products might embark on large scale or more developed production.
- The extent to which there is strategic intervention by interested third parties (buyers and suppliers for example);
- The scope for, or pressure on, firms to bring new products into the market.

The Commission will seek to assess how in the circumstances of the investigation, the factors above interact to make coordinated effects more or less likely.

3.67 One problem in identifying such conduct is that similar or identical prices can also result from intense competition. Therefore, the observation that prices are similar, and even that they tend to move together, does not of itself demonstrate oligopolistic pricing of the type described above. Indicators or ways of distinguishing intense competition and oligopoly pricing include, first, the level of profitability generated by the price levels established. If profits are

excessive then this might be an indicator of oligopoly pricing. A second indicator might be that prices in competitive conditions, though tending to the same level, are, over time, likely to exhibit significant variation as they respond to changing supply and demand conditions. This is less likely to be the case with oligopoly pricing, because the incentive not to depart from an established level of high prices will to some extent dampen the responsiveness of prices to costs and demand changes. Indicators of the extent of competition are considered in more detail in paragraphs 3.78 to 3.90.

(ii) Non-price factors in competition

- 3.68 As noted earlier, rivalry encompasses both price and non-price competition, and the latter can in some markets be more significant than the former. Where applicable, the Commission will consider the effect of non-price competition in a market, for example product development, product range and quality, marketing, servicing, and R&D. An emphasis on non-price competition may reflect the characteristics of the product or customer, but may also result from incentives not to compete on price alone or a desire to raise barriers to entry. Equally, if strong non-price competition in the relevant market leads to substantial product differentiation, then this may mean that coordinated price behaviour is more difficult or impossible to achieve. Separately, strong product differentiation may facilitate price discrimination.
- 3.69 However, just as there may be factors reducing the level of price competition, there may be similar or other ones that reduce the extent of non-price competition. Oligopolistic firms may each have an incentive to delay introducing new product developments if this would precipitate equivalent development from competitors, thereby undermining the profitability of the existing product range. However, as in the case of coordinated price effects, the strength of this incentive will generally depend on how quickly it is anticipated that competitors could respond. If a long time-lag is envisaged then the threat to existing profitability is more likely to be discounted. Firms may also avoid competing in the same geographic markets, or refrain from competing with very similar products.
- 3.70 Whilst non-price competition that leads to product differentiation may make coordinated behaviour less likely, it may also segment the market, facilitating price discrimination schemes that may act to the detriment of the consumer.
- 3.71 Advertising is a significant form of non-price competition and in many instances may act to increase information about products for consumers. However, notably in concentrated markets for consumer goods, the Commission will consider whether advertising is excessive and whether it is simply being used to support brands at high prices (or margins) and/or with the possible effect of increasing entry barriers. In this instance the Commission will consider whether the resources used in advertising might better serve competition through other means, for instance direct price cuts.

(iii) Other market-wide horizontal conduct

- 3.72 There may be other market-wide practices that are adopted as custom and practice in a particular market and without agreement, communication or contact between competitors. Examples include manufacturers' recommended retail prices and fees

charged by underwriters of new issues on the capital market. Another example is the widespread adoption of tying practices in a number of markets ranging from computers and office equipment to the insurance and travel trades. There may be objective justifications for such practices, but any common policy among competitors will raise the question of whether competition is adversely affected.

- 3.73 Market-wide practices may also be the result of adherence to the recommendations of a trade or professional body or indeed to Government regulations. Again such conduct could be investigated for possible adverse effects on competition.
- 3.74 Competition may also be adversely affected in a market as a whole where information asymmetries, switching and search costs are important. Such market features will tend to give suppliers a degree of market power. Suppliers may also reinforce the impact of such features by providing misleading product or price information or by limiting information that would be useful to customers' decision-making.
- 3.75 The Commission may assess the effects on competition of certain forms of discounts and rebates. In many cases, discounts and rebates are normal components of the competitive process and will, in general, not be a cause for concern. However, where a firm, or group of firms, has market power then the Commission will consider whether any discounts or rebates offered might have adverse effects on competition. It is unlikely that, for example, short-term discount programmes and cost-based volume discounts open to all customers will raise concerns. In addition, discounts may be one way in which coordinated behaviour between firms might be broken down. However, there could be circumstances where the opportunity to negotiate an individual discount provides a way of responding to pressure for lower prices from particular buyers and hence of maintaining coordinated prices across the rest of the market. In addition, other forms of discounts such as fidelity (or loyalty) discounts, which directly disadvantage other suppliers, may hinder competition.

(g) Vertical agreements

- 3.76 Vertical agreements such as exclusive dealing arrangements or selective distribution arrangements may have beneficial or adverse effects on competition depending on the specific circumstances of a market. One beneficial effect can occur where a supplier wants distributors to provide advice, stock spare parts, or make investments, whether in facilities, equipment or marketing which will promote the product. This may enhance competition and consumer satisfaction, but represent too costly a commitment by distributors without some assurance of adequate sales.
- 3.77 Against this, such agreements have the effect of foreclosing access by other manufacturers to the part of the market covered by them. The effect of this will depend in part on the proportion of the market foreclosed, the length of time before such agreements are renegotiated, and the scope for other distributors to enter the downstream market and provide alternative outlets to other manufacturers. The effect of selective distribution arrangements will also depend on the criteria used to select distributors and whether there is a quantitative limit on the number permitted.
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Indicators of the extent of competition

3.78 The Commission will often not reach a conclusion on whether there are adverse effects on competition or whether there have been detrimental effects on customers solely from the investigation of structural and conduct features of a market. It will normally be helpful to the Commission's assessment to consider the effectiveness of competition by examining the outcome of the competitive process in the particular market. To do this the Commission will consider various other indicators of the extent of competition.

(a) Prices

3.79 One such indicator is the pattern of price changes over time. For example, as mentioned in the context of oligopoly pricing, evidence of parallel movements in prices may, where other market characteristics are conducive to such behaviour, indicate coordinated behaviour and an absence of effective competition. Prices in competitive conditions, though tending to the same level, are, over time, likely to exhibit significant variation as they respond to changing supply and demand conditions. This is less likely to be the case with oligopoly pricing, because the incentive not to depart from an established level of high prices may to some extent dampen the responsiveness of prices to costs and demand changes.

3.80 Of particular interest will be evidence of how prices adjust to changes in cost and demand conditions, and any evidence of competition in net prices (after discounts etc) notwithstanding that list prices may move in parallel.

(b) Profitability

3.81 Profitability is the crucial incentive and signal in a market economy and high profits by individual companies at various times are fully consistent with competitive markets. More generally, 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 the firms involved. At points in time, the profits of some firms may exceed what might be termed the '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 and, the fact that some firms may be earning profits gained as a result of past innovation. However, in nearly all cases competition should result in pressure on profit levels towards the cost of capital in the medium to long run.

3.82 However, 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. For instance, in some cases a high level of profitability could be indicative of significantly coordinated behaviour. Therefore, in the context of a market reference, the Commission will normally consider profit levels, usually in terms of rates of return on capital in the market or markets concerned,²² as a further indicator of competitive conditions.

²² The Commission will normally consider returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate. Such profits could be significantly different from profits reported in statutory accounts which are usually on a historic cost (or modified historic cost) basis.

- 3.83 Low profits, on the other hand, may conceal ineffective competition if firms with market power are able to operate with higher costs than would be sustainable with keener rivalry in the market. Therefore the Commission may also look at data on costs and compare actual costs with efficient costs in addition to looking at profits. This highlights that the Commission will not consider profitability in isolation, but only in the context of its overall assessment.
- 3.84 Normally in measuring profitability the Commission's approach will be to start with accounting profit produced in line with UK generally accepted accounting practice and then make adjustments. Cost allocation issues will often be significant as frequently the Commission will be investigating a market which does not represent the whole of the firm's business and may not correspond to the corporate or management structure.
- 3.85 In assessing levels of profitability the Commission will have regard to its view of firms' cost of capital, though it would not normally expect to apply this as a rigid benchmark. The Commission will generally look to the Capital Asset Pricing Model (CAPM) when considering the cost of capital, but will have regard to alternative models where appropriate. Moreover, the Commission recognises the difficulty in measuring the cost of capital and its limited applicability to some industries, such as some markets for services and products with a high intellectual property value. In such situations the Commission may consider alternative measures, such as the 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.

(c) International price comparisons

- 3.86 International price differences may be an important indicator in deciding to refer a case to the Commission. The scope to use them as a definite indicator of a lack of competition is likely to be much more limited.
- 3.87 In order to make the comparison meaningful, a number of factors need to be taken into account. At the product level, product names and pack sizes, for example, may differ from one country to another. There can be quality differences between countries for similar products, and difficulties in establishing which products are comparable, notably for retailers' own-label brands. A product may be more popular (and a more important item in consumers' budgets) in one country than another, and its price in that country may benefit from economies of scale. On a broader level, other factors independent of the products themselves need to be taken into account. Prices will tend to reflect potentially very different costs of land, capital, employment etc, in different countries and, where there is limited international trade, such price differentials may persist indefinitely. However, where international trade is relatively easy, the Commission would regard persistently large price differentials as one indicator of less than fully effective competition. International price comparisons reflect the exchange rate used to make the comparison; fluctuations in exchange rates can have a crucial effect on international price comparisons, as well as on trade flows. Different tax regimes can also contribute to differences in prices between countries.
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3.88 Although the inherent difficulties in drawing firm conclusions from international price comparisons limit their value, there may be market investigation references where such issues can be allowed for, so that comparisons can provide useful supporting evidence for the Commission's assessment whether structural or conduct features of a market have adverse effects on competition.

(d) Other indicators

3.89 When relevant and feasible, the Commission may also consider other evidence, for instance, customer behaviour, the rate of innovation, product range, and product quality in the relevant market. Comparisons may be made with the performance of the market in the past, internationally, or in other markets with similar characteristics. For instance, focusing solely on prices and profits may give an incomplete picture of the nature of competition in a high technology market, where competition is usually characterised by, amongst other things, new product introduction. In such a market it will be important to consider the factors outlined above, alongside more traditional factors, for a full assessment of the competitive pressures in the market to be made.

3.90 The Commission may also consider evidence on the efficiency of firms. Measuring efficiency is often particularly difficult but there may be instances where it is possible and relevant for the purpose of the assessment. Measures of efficiency include productivity measures, unit labour costs, unit costs and total factor productivity.

Part 4: Remedial action

Introduction

4.1 This Part considers remedies, starting with the statutory questions the Commission has to answer for each market investigation reference if it has decided that a market feature, or any combination of market features, has an adverse effect on competition. It then describes the various factors that may be relevant to the Commission's decision on the appropriateness of taking remedial action and the action to take, including the effectiveness of different types of remedy, costs and proportionality. It then considers different types of remedy before describing finally how the Commission will take relevant customer benefits into account when deciding on appropriate remedial action.

The remedy questions

4.2 If the Commission has decided on a market investigation reference that a market feature, or any combination of market features, has an adverse effect on competition, it then has to decide whether any action should be taken (or whether it should recommend action be taken by others) in order to remedy the adverse effect on competition and, if so, what action should be taken (see paragraph 1.8).

4.3 Action can be taken by the Commission itself through exercising its order making powers or accepting undertakings from the parties (see paragraphs 4.42 to 4.45). Alternatively, the Commission may recommend that remedial action should be taken by others, such as government, regulators and public authorities, to remedy the adverse effects on competition or any detrimental effect on customers resulting from the adverse effect on competition. Such recommendations could not bind the person to whom they are addressed. They can be additional or alternative to remedial action taken by the Commission. The third question asks the Commission to state the action that should be taken and what it is designed to address.

4.4 The Act requires the Commission, in considering these questions:

*in particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition and any detrimental effects on customers so far as resulting from the adverse effect on competition.*²³

4.5 The paragraphs that follow describe various factors that may be relevant to a case and which, if so, will be taken into account when deciding on the appropriateness of taking remedial action and the action to be taken. In practice, these can rarely be considered in isolation from each other and key to the Commission's choice of remedy will be its duty to remedy the adverse effect on competition and any detrimental effects on customers.

²³ Section 134(6).

- 4.6 It is important to note that the remedial action can be directed at the adverse effect of a market feature on competition or the detrimental effects on customers of the adverse effect on competition. In other words, remedial action may deal with the source of the problem or with its consequences. In general, the Commission will seek to implement (or recommend) remedies that address the cause of the problem. It may also choose to address the detrimental effect on customers in addition or as an alternative. However, it is prevented from taking action to address future detrimental effects on customers if no detrimental effects on customers currently exist and the Commission is not remedying the adverse effect on competition (that is, the source of the problem).²⁴ In practice, the Commission will seek remedies that would both ameliorate the competition problem and mitigate its effects on customers. A remedy that significantly and rapidly increased competitive pressures in a market would normally have these desirable properties.

Remedies

(a) Consideration of appropriate remedies

- 4.7 Although the Commission must always consider the appropriateness of any remedial action, it is unlikely that the Commission, having decided that there is an adverse effect on competition, will decide that there is no case for remedial action, at least before it has given attention to any relevant customer benefits that may accrue from the market features. Examples of exceptional circumstances where the Commission may conclude that no action is appropriate might be where the costs of any practicable remedy seem disproportionate in the light of the size of the relevant market or where the only appropriate remedial action would fall outside the United Kingdom's jurisdiction. However, even in these circumstances, the Commission, having decided that no action should be taken by it, may recommend action by others; for example, if the matter were of sufficient concern that the OFT or other body with appropriate powers might keep the future conduct of the firms in the market under review.
- 4.8 The Act also enables the Commission to take into account any relevant customer benefits that arise from one or more features of the market when deciding whether, and if so, what action should be taken. This consideration too may lead to the decision that no action should be taken. The circumstances in which customer benefits can be considered, and what constitutes a relevant customer benefit are explained later in this Part.
- 4.9 The remedial action that the Commission will decide should be taken will always depend on the facts and circumstances of the case. When deciding what is an appropriate remedy, the Commission will consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality. These are discussed in the next sections.

²⁴ Section 138(6).

(b) The cost of remedies and proportionality

- 4.10 The Commission must have regard to the reasonableness of any remedy and will aim to ensure that no remedy is disproportionate in relation to the adverse effect on competition and any adverse effects on customers. Part of its consideration will include an assessment of the costs of implementing a remedy, for example in disbanding or modifying a distribution system; and the costs of complying with a remedy, for example, providing the OFT with periodic information on prices or margins. However, the Commission must consider the wider picture. Adverse effects on competition are likely to result in a cost or disadvantage to the UK economy in general and customers in particular. Where significant, these costs might usually be expected to outweigh the costs incurred by any person on whom remedies are imposed. If the Commission is choosing between two remedies which it considers would be equally effective, it will choose the remedy that imposes the least cost or that is least restrictive.
- 4.11 Other costs such as environmental costs or the social costs of unemployment will not be assessed by the Commission in its consideration of remedies which are intended to address the adverse effects on competition or any detrimental effects on customers.
- 4.12 The Commission will endeavour to minimise any ongoing compliance costs to the parties, subject to the effectiveness of the remedy not being reduced, and will have regard to the OFT's costs in monitoring compliance, with any remedies that the Commission may put in place.

(c) Effectiveness of remedies

- 4.13 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.
- 4.14 First, a factor bearing on the effectiveness of any remedy is whether it is clear to the persons to whom it is to be directed and also to other relevant interested parties, for example, the OFT, which has responsibility for monitoring, compliance, and other regulators. Other examples include competitors, suppliers and customers, each of whom may have an interest in ensuring compliance and may bring to the OFT's attention any concern that a remedy is not being complied with. This consideration can be particularly relevant to remedies concerning ongoing behaviour and the Commission will consider whether it is possible to devise a remedy that is both clear and not overly intrusive in its regulation of a firm's behaviour.
- 4.15 A second consideration is the prospect of the remedial action being implemented and complied with. Some remedies are in effect a commitment as to future behaviour or a standard as to acceptable future behaviour. There may be less certainty with some remedies compared to others that the remedies will have the desired effect. A relevant factor will be the ease of monitoring and enforcing compliance notwithstanding the possibility of setting a compliance programme. The effectiveness of any remedy may be reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One advantage of one-off remedies that change the structure of the market (so-called structural remedies) when compared with some remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) is that
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they address the competition concern directly and will require comparatively little, if any, monitoring or enforcement of compliance. However, when deciding upon the action to take, and having considered all other relevant factors, this factor alone may not be decisive.

- 4.16 A third consideration is the timescale within which the effects of any remedial action will occur. Some remedies will have a more or less immediate effect while the effects of others will be delayed. There may be particular uncertainty about the timescale within which results can be expected when the remedy calls for action by some other person, for example a recommendation to government to change regulations. The Commission will tend to favour a remedy that can be expected to show results in a relatively short time period – so long as it is satisfied that the remedy is both reasonable and practicable and has no adverse long-run consequences.
- 4.17 In their consideration, the Commission must have regard to the relevant statutory functions of the sector regulator concerned.²⁵

(d) Types of remedy

- 4.18 Except for the statutory limits on the content of orders, there are no formal restrictions on the remedial action that the Commission can take or recommend. However, possible remedies can be categorised as follows:
- (a) remedies designed to make a significant and direct change to the structure of a market by a requirement, for example, to divest a business or assets to a newcomer to the market or to an existing, perhaps smaller, competitor;
 - (b) remedies designed to change the structure of a market less directly by reducing entry barriers or switching costs, for example, by requiring the licensing of know-how or intellectual property rights or by extending the compatibility of products through industry-wide technical standards;
 - (c) as a particular category of (b), recommendations for changes to regulations found to have adverse effects on competition or detrimental effects on customers, for example, by limiting entry to a market;
 - (d) remedies directing firms (whether sellers or buyers) to discontinue certain behaviour (for example, giving advance notice of price changes) or to adopt certain behaviour (for example, more prominently displaying prices and other terms and conditions of sale)
 - (e) remedies designed to restrain the way in which firms would otherwise behave, for example, the imposition of a price cap;
 - (f) monitoring remedies, for example, a requirement to provide the OFT with information on prices or profits.
- 4.19 Most of the examples above are remedies that would fall to the Commission itself to impose. Examples of remedies that would require action by other persons or bodies such as government, regulators and other public bodies include changes to regulations and measures to increase market transparency.

²⁵ Section 168.

- 4.20 The Commission will also consider whether to recommend that action be taken by others. This could be action aimed at encouraging increased competition in the market(s) affected. For example, it might recommend action by government to change legislation or regulations that limit or control entry. Alternatively action could aim to prevent or limit potentially anti-competitive behaviour.
- 4.21 It will, of course, be for the government or other person to whom action is recommended to decide whether to act. However, the government has given a commitment to consider any Commission recommendation and to give a public response within 90 days of publication of the Commission's report.²⁶ The response may set out the changes it proposes to make in the light of the report or options on which it proposes to consult. Inevitably, as it falls to others to make a decision on the recommendation, there will be uncertainty over whether the recommendation will be accepted and, if so, over the time period before which it will be implemented. It will be necessary to take this inherent uncertainty into account when deciding whether to make such a recommendation.

(e) Choice of remedy

- 4.22 In deciding what remedy or remedies would be appropriate, the Commission will first look for a remedy that would be effective in dealing with the adverse effects on competition of the market features rather than seeking to deal with any detrimental effects on customers. Clearly, what type of effective action to increase competition can be taken will depend on the nature of the feature or features concerned. For example, if the feature was a widespread practice of recommending resale prices in a market with plenty of suppliers, it is likely that competition would be stimulated, either between those suppliers or between their (retail) customers, or between both, by a remedy that prohibited the practice.
- 4.23 In looking for remedies that would be likely to increase competition in the relevant market(s), the Commission will give attention to the time period within which the remedy can be expected to show results. If the remedy is not likely to have speedy results, the Commission may choose an alternative remedy or implement additional remedies such as those to remedy the detrimental effects on customers during the interim period. Otherwise, not only might there be uncertainty as to whether the effects would ever materialise, but in the meantime customers would continue to suffer from the consequences of the adverse effects on competition.
- 4.24 Remedies that increase the effectiveness of competition may include behavioural as well as structural remedies. Where, in particular, the conduct of firms has given rise to adverse and detrimental effects, it can be expected that the Commission will consider behavioural remedies. These can take many forms but can have a number of shortcomings. They can involve detailed prescription of rules of conduct, for example relating to the terms of trade with customers and suppliers, though there may, in some cases, be a danger of restraining legitimate competitive behaviour and otherwise being overly intrusive. They can require detailed monitoring by the OFT or the sector regulator. Notwithstanding the ability to vary any remedy imposed, behavioural remedies can be difficult to

²⁶ A World Class Competition Regime July 2001 DTI paragraph 4.15.

keep in tune with developing market conditions and might introduce their own distortions of competition. Nevertheless, behavioural remedies of one kind or another are a likely outcome of some market investigations.

- 4.25 Remedial action may also be required to address the adverse effects on competition directly, for example where remedies aimed at correcting the features which have caused those effects will not bear fruit for some time. Price restraints are the most obvious example, though there may be others. However, they are not likely, by their nature, to provide a solution to the underlying problem, that is, the market features that adversely affect the process of competition, and on that account are less preferable.

Customer benefits

(a) Relevant customer benefits

- 4.26 The Commission may in deciding the question of remedies:²⁷
- in particular, have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned.*
- 4.27 It would not normally be expected that market features that adversely affect competition could have beneficial rather than detrimental effects on customers. The usual consequence of a failure of competition is that prices will be higher not lower than they would be with more competition. Nevertheless, the alternative possibility is recognised in the legislation.
- 4.28 The Commission will disregard any benefits that might arise from commitments that the parties may wish to offer but that do not meet the criteria of a relevant customer benefit. That is, the benefits must clearly result from one or more features and be unlikely to have come about without the feature or features concerned.
- 4.29 Relevant customer benefits are limited to benefits to relevant customers in the form of:²⁸
- (a) *lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom (whether or not the market to which the feature or features concerned relate); or*
- (b) *greater innovation in relation to such goods or services.*
- 4.30 The Act provides that a benefit is only a relevant customer benefit if the Commission believes that:
- (a) *the benefit has accrued as a result (whether wholly or partly) of the feature or features concerned or may be expected to accrue within a reasonable period of time as a result (whether wholly or partly) of that feature or those features; and*
- (b) *the benefit was, or is, unlikely to accrue without the feature or features concerned.*²⁹
- 4.31 In considering potential relevant customer benefits, the Commission will need to ascertain that market features with which it has been concerned do indeed lead to lower prices, higher quality, wider choice or greater innovation, and that

²⁷ Section 134(7).

²⁸ Section 134(8).

²⁹ Section 134(8).

they are both attributable to the market features and not attainable in any other way. The Commission will tend to disregard benefits that are purely speculative, or would only arise at some time in the distant future.

(b) Possible relevant customer benefits

- 4.32 It is not possible to give detailed guidance on particular benefits that may be relevant customer benefits in market investigations, as this will tend to reflect the characteristics of a particular market. However, in the following paragraphs, examples of possible relevant customer benefits are given. In all instances the Commission will need to consider whether the criteria set out in paragraph 4.30 above are met.
- 4.33 Features of a market structure that could adversely affect competition, such as a high level of concentration, might enable economies of scale to be obtained that would not be available if there were a larger number of firms in the market. Scale economies would only be a customer benefit if they meant that prices would be lower than if there were more firms competing in the market. Whether scale economies could be a relevant customer benefit would therefore depend on whether there was sufficient pressure on the firms in the market, perhaps as a result of potential competition from new entrants, or countervailing buyer power, for any cost economies to be substantially passed on as lower prices.
- 4.34 Another potential benefit from high concentration is innovation. The riskiness and cost of R&D in many industries is such that in many instances it will only be undertaken by firms of some size and with a degree of market power. Prices may be higher than they would be with a more competitive market structure but the pace with which commercially successful new products or methods are introduced may well be faster. Again some continuing competitive threat is likely to be necessary if the incentive to innovate is to be maintained.
- 4.35 Customers are unlikely to enjoy any relevant benefits as a direct result of entry barriers, although some entry barriers may secure other kinds of benefit, for example regulations that limit entry to persons of proven competence or with adequate capital resources. The Commission will have regard to the wider purpose of such regulations in determining whether they have an adverse effect on competition. Generally, customers might be expected to benefit from any reduction of entry barriers.
- 4.36 Vertical integration and vertical agreements can have beneficial effects through the better coordination of activities at different stages of the supply chain and savings in transaction and inventory costs. With vertical integration, this is achieved by internalising activities which would otherwise be carried out in separately owned businesses. With vertical agreements it is achieved by a closer alignment of the incentives of, say the supplier and his distributor, towards the achievement of complementary objectives. Vertical restrictions within the supply chain may also help to resolve the free rider problem³⁰ in markets where suppliers need their distributors to incur certain necessary costs if advice and other pre-sale services are to be provided on a sustained basis.
- 4.37 Where vertical integration or vertical agreements enable a firm in a competitive market to increase its business at the expense of its rivals, the vertical arrangement is likely to be beneficial. It is where one of the firms concerned

³⁰ Free rider problems exist where other parties benefit from the provision of a good or service without paying for its provision.

has market power, or where vertical arrangements are widespread in a market, that the foreclosure effects and a possible increase in entry barriers, leading to a dampening of competitive pressures, can outweigh any efficiency benefits.

- 4.38 Many forms of business conduct can similarly have ambiguous effects. Tie-in sales or product bundling, for example, can be convenient to customers, reduce transaction costs and provide quality assurance. When practised by firms with market power or when the conduct is widespread in a market, however, these practices can adversely affect the competitive process by disadvantaging competitors supplying only one of the tied or bundled products.

(c) Relevant customer benefits and remedies

- 4.39 If the Commission is satisfied that there are relevant customer benefits deriving from a market feature that also has adverse effects on competition, the Commission will consider whether to modify the remedy that it might otherwise have imposed or recommended. When deciding whether to modify a remedy, the Commission will consider a number of factors including the size and nature of the expected benefit and how long the benefit is to be sustained. The Commission will also consider the different impacts of the features on different customers. It is possible that the benefits are of such significance compared with the effects of the market feature(s) on competition that the Commission will decide that no remedy is called for. Given, however, that the Commission will have found adverse effects on competition this is not likely to occur frequently.
- 4.40 Alternatively, the Commission, as a result of identifying relevant customer benefits, may choose a different remedy, for example a behavioural remedy rather than a structural remedy. In this situation, the Commission will have to weigh the disadvantage of a less effective remedy to the competition problem against the benefits that result from the feature concerned.
- 4.41 The Commission may also consider whether to impose a monitoring remedy to give some assurance that the expected benefits would be forthcoming. Monitoring alone does nothing to deal with the competition issues raised by a market investigation. But it may enable the competition authorities and regulators to decide whether any further action is called for.

Undertakings and orders

- 4.42 As far as its own actions are concerned, the Commission will have the choice of seeking undertakings from the persons that are to be the subject of the measures or making of an order. In general, the Commission's decision as to which form to use will be determined by issues of practicality such as the numbers of parties concerned, and their willingness to negotiate and agree undertakings in the light of the Commission's report. Another consideration will be the scope of the Commission's powers and whether the remedy that it considers appropriate falls within those powers.
- 4.43 The Commission's order making powers are set out in the Act. Schedule 8 sets out the types of provisions that could be included in an order and Part 1 of Schedule 9 enables the Commission to modify, by order, licence conditions in various regulated markets. While the content of any orders made by the
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Commission is limited by the Act, the subject matter of an undertaking is not similarly limited.³¹ The process of negotiation that is involved with undertakings and the fact that their content is not limited to the matters contained in Schedule 8 may be advantageous in terms of flexibility and suitability.

- 4.44 The essence of market investigations is that they are likely to be market-wide rather than focused on the conduct of one firm, and a remedy may be more effective if imposed by order than sought through undertakings. For example, because of the need to negotiate undertakings it may take longer to implement a remedy if undertakings are used instead of an order, particularly if many parties are involved. This can complicate the process of negotiation of effective undertakings. When the particular circumstances of the case point to the need for action to be taken speedily, the Commission may decide to implement the remedy by way of order to avoid delay while undertakings are negotiated. But any generalisation has to be qualified: which is the better approach must depend upon the facts of the particular case. However, in regulated sectors, if the Commission decides to modify licence conditions in connection with Part 1 of Schedule 9 to give effect to or take account of any provision of a proposed remedy, it will make an order.

(a) Procedural and other aspects of undertakings and orders

- 4.45 For more information about undertakings and orders, and the procedures that will apply when remedies are being considered, see *General Advice and Information* Part 6 and 7.

³¹ Section 164(1).

Part 5: Public interest cases

- 5.1 If the Secretary of State believes that one or more public interest considerations is relevant to a market investigation she may intervene by serving an intervention notice under section 139 of the Act. The notice may be given up to four months from the date of the reference provided the reference is not finally determined.³² Intervention by the Secretary of State is likely to occur only exceptionally. The interests of national security is a public interest consideration but the Secretary of State may, by order, specify new public interest considerations.³³
- 5.2 In public interest cases, the Commission will have to decide the first of the questions that apply to all other market investigation references, namely, 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 United Kingdom or a part of the United Kingdom. The considerations explained in Parts 2 and 3 will be relevant to the Commission's consideration of this question.
- 5.3 If the Commission has decided that there is an adverse effect on competition, it must decide a number of questions concerning the taking of remedial action. There are two different sets of questions which are set out in paras 5.4 and 5.5. The first set of questions relates to the action the Secretary of State might take. The second set relates to the action the Commission might take in the event that the case reverts back to the Commission. The case will revert to the Commission if the Secretary of State fails within 90 days of receipt of the Commission's report to make and publish her decision as to whether any eligible public interest considerations are relevant to any action mentioned in the Commission's report in its decision on the second type of question or if the Secretary of State decides that no eligible public interest consideration is relevant to any such action. An eligible public interest consideration is one which was mentioned in the intervention notice given by the Secretary of State and which the Commission is not required to disregard.³⁴ Whether the action identified in response to those questions is the action to be taken will ultimately depend upon the decision of the Secretary of State and whether the case reverts to the Commission under section 148 of the Act.³⁵
- 5.4 The first set of questions is:³⁶
- (a) *whether action should be taken by the Secretary of State under section 147 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;*
 - (b) *whether the Commission should recommend the taking of other action by the Secretary of State or action by persons other than itself and the Secretary of State for the purpose of remedying, mitigating or preventing the 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; and*

³² The circumstances in which a case is finally determined are set out in section 140(5) and include when the period for the Commission to prepare its report and for action to be taken has expired.

³³ The public interest considerations are specified in section 153 of the Act. The Secretary of State may by order specify other considerations and may remove or amend any specified considerations.

³⁴ Section 145(3) and (4) provide that the Commission must disregard a public interest consideration which has not been finalised before the giving of its report and must disregard a public interest consideration which was not finalised on the giving of the intervention notice and has not been finalised within the period of 24 weeks beginning with the giving of the notice concerned.

³⁵ See Part 4 of *General Advice and Information*

(c) in either case, if action should be taken, what action should be taken and what it is to be remedied, mitigated or prevented.

5.5 The second set of questions is:³⁷

(a) whether action should be taken by [the Commission] 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;

(b) whether the Commission should recommend the taking of action by other persons 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; and

(c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.

5.6 In deciding both sets of questions the Commission must, as is the case in general market investigation references (in which public interest considerations do not arise), have particular regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers so far as resulting from the adverse effect on competition. Similarly, the Commission may have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned. In respect of both sets of questions, the factors mentioned in Part 4 will be relevant to the Commission's consideration when deciding these questions. In addition, when deciding the first set of questions, the Commission will have regard to the matters mentioned in paragraphs 5.7 to 5.9.

5.7 When answering the questions set out in paragraph 5.4, the Commission will have regard to section 147 of the Act which applies if the Secretary of State has decided that one or more eligible public interest consideration is relevant and has published her decision within the period of 90 days beginning with the receipt of the report from the Commission. In particular, this gives the Secretary of State the power in relation to any adverse effect on competition identified in the Commission's report to take such action as she considers to be:³⁸

(a) reasonable and practicable –

(i) to remedy, mitigate or prevent the adverse effect on competition concerned; or

(ii) to remedy, mitigate or prevent any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and

(b) appropriate in the light of the eligible public interest consideration concerned or (as the case may be) the eligible public interest considerations concerned.

³⁶ Section 141(3).

³⁷ Section 141(4).

³⁸ Section 147(2).

- 5.8 The Secretary of State is required to have regard to:³⁹
- (a) *the need to achieve as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers so far as resulting from the adverse effect on competition; and*
 - (b) *the report of the Commission.*
- 5.9 The Secretary of State may have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned. The Secretary of State is prevented from taking action to address future detrimental effects on customers if no detrimental effects on customers currently exist and the adverse effect on competition is not being remedied.
- 5.10 If the case reverts to the Commission, the Commission must obtain the Secretary of State's agreement if it proposes to depart materially from the course of action set out in its report. However, the Secretary of State may only withhold her agreement if she believes that the Commission's new proposed course of action would operate against the public interest. The alternative course of action would so operate if any eligible public interest considerations outweigh the considerations that have led the Commission to propose the alternative action. In making her decision, the Secretary of State must accept the Commission's view of what would be the most appropriate action to take to remedy the adverse effect on competition and any resulting detrimental effects on customers.⁴⁰
- 5.11 Further information about public interest cases may be found in *General Advice and Information*, Part 3.

³⁹ Section 147(3).

⁴⁰ Section 148.

Annex

Information relevant to the Enterprise Act

Competition Commission publications

www.competition-commission.org.uk

CC1 Competition Commission: Rules of Procedure

CC2 Merger References: Competition Commission Guidelines

CC3 Market Investigation References: Competition Commission Guidelines

CC4 General Advice and Information

CC5 Statement of Policy on Penalties

CC6 Chairman's Guidance to Groups

CC7 Chairman's Guidance on Disclosure of Information in Merger and Market Inquiries

Competition Commission Annual review and accounts

OFT publications

www.oft.gov.uk

OFT 508 Overview of the Enterprise Act

OFT 506 Mergers: Substantive Assessment

OFT 526 Mergers: procedural guidance

OFT 501 Market Investigation References

Competition Appeal Tribunal publications

Competition Appeal Tribunal Rules *www.catribunal.org.uk*

Department of Trade and Industry information

See DTI website *www.dti.gov.uk/ccp*



