Market inquiry into Classified Directory Advertising Services

Emerging thinking

Introduction

1. On 5 April 2005, the Office of Fair Trading (OFT) referred the supply of classified directory advertising services (CDAS) in the UK to the Competition Commission (CC) for investigation. Classified directory advertising services are defined in our terms of reference as 'the undertaking and performance of engagements to publish advertisements in printed directories which show suppliers of goods and services classified by reference to the goods or services supplied; and are distributed wholly or mainly to consumers'.

2. In line with the terms of reference we use the term 'classified directories' to refer to printed classified directories. However, we also discuss online classified directories (described in paragraph 37) most notably in consideration of the relevant markets.

3. Our inquiry into CDAS is a market inquiry under the Enterprise Act 2002 (the Act). Section 134(1) of the Act requires us to consider whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK'. 'Feature' means:

   (a) the structure of the market concerned or any aspect of that structure;

   (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or

   (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

   The process which our inquiry is following is explained in Annex A.

4. In the statement of issues,[1] we set out what we considered to be the most important issues relating to competition for CDAS in the UK. This document sets out our emerging thinking on these issues on the basis of the evidence so far presented, gathered and analysed. We invite parties' additional views and evidence on the matters raised in this document and intend to explore these issues further during hearings which will be held in February and early March.

Emerging thinking

Background

History of the reference

5. Our current inquiry follows a previous investigation. In March 1996, the Monopolies and Mergers Commission (MMC, now the CC) reported on the supply of CDAS.[2] It found that a monopoly situation existed in favour of British Telecommunications plc (British Telecom) in the supply of CDAS in the UK.

6. Following that report, in July 1996, undertakings were given under section 88 of the Fair Trading Act 1973 by British Telecom in regard to its classified directory advertising business, Yellow Pages (BTYP). The key undertakings included a price cap on advertising rates[3] and a restriction on the publication of overlapping directories.

7. A review of the undertakings was announced by the OFT in May 2000 and a report published in May 2001. This review found that effective competition was absent from the market and that effective competition from new entry was not likely in the foreseeable future. The OFT concluded that the lack of competitive constraint meant

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[1]Published on 31 August 2005 on http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/issues_statement.pdf.
[2]http://www.competition-commission.org.uk/rep_pub/reports/1996/383classified.htm#full.

that the adverse effects identified by the MMC in 1996 would continue to exist without effective regulatory intervention. The OFT noted the growth in Internet advertising services but found that there was no strong evidence that these sources offered strong competition to printed directories and that it remained to be seen how much they would constrain market power in the provision of CDAS in the future. As a result of the review, the price cap was strengthened by the Secretary of State to RPI–6 per cent and certain obligations in relation to discount schemes were relaxed.

8. In June 2001, BT sold the whole of the BTYP business (including the Yellow Pages brand), to a consortium of investment funds called Castaim Ltd which subsequently became Yell Ltd and which was listed, in July 2003, on the London Stock Exchange as Yell. Castaim Ltd agreed to comply with the undertakings that BT had given to the Secretary of State. We refer to these as the 'Yell undertakings'.

9. In its statement of reasons for referring the supply of CDAS in the UK to us, the OFT stated that while the undertakings given in 2001 were appropriate for the market conditions at that time, it was not clear that they remained appropriate to the market. In addition the OFT had reasonable grounds for suspecting that there were features of the supply of CDAS which prevent, restrict or distort competition.[4]

The Yell undertakings

10. The Yell undertakings relate to a number of areas including the preparation and publication of separate accounts for the CDAS business, the publication of rate cards (described in paragraph 72), prices to be charged to advertisers and directory areas. The effects are discussed in paragraphs 72 to 83.

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[3] Rates were capped at the lower of (a) the rate as set out in the July 1995 rate card, and (b) the immediately preceding rate adjusted by a factor of RPI–2 per cent

[4] The OFT's reasons for making the reference are published at: http://www.oft.gov.uk/NR/rdonlyres/A9B3409E-5D42-499C-BF18-06C9BA415373/0/oft787.pdf

Rate card

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

12. Yell provides the OFT with a master rate card upon each update (eg in 2005 copies were supplied in April, June and October). The master rate card contains different rates for each directory and different rates for different types of advertisements. Actual rates for each area come into effect at different times, depending on when the directory in question is published. The date of publication is indicated on the rate card.

Prices

13. On the basis of a like-for-like comparison, starting from the base level of prices in effect as at 1 December 2001, Yell's rate card prices for advertisements in classified directories have been required to decline, relative to the RPI, by at least 6 per cent each year.[5]

14. If Yell alters the distribution area for a directory, prices for advertisements featuring in the first edition of a rescoped[6] directory should not exceed the average of: prices charged for advertisements in the five directories with immediately larger guaranteed minimum circulation (GMC, see paragraph 30) and the five directories with immediately smaller GMC. Certain rates are excluded from the calculation. If Yell

[5] Rate card rates were capped at the lower of (a) the applicable rate for the same category of advertisement as set out in the December 2001 rate card, and (b) the immediately preceding rate adjusted by a factor of RPI–6 per cent
[6]Rescoping is described in paragraph 31.

extends the size of an area in which a directory is distributed, it must not increase the rates for advertisements in that directory as a result.

Directory areas

15. Yell must ensure that a map showing the area in which each directory is to be distributed is included in each directory (this is referred to as a ‘distribution area’).

16. Yell must not distribute a directory outside its distribution area, unless this is specifically requested by a user; or unless the distribution is to a neighbouring distribution area which represents less than 5 per cent of the whole of that neighbouring area (calculated by reference to the directory circulation by number of households) where it can show that 55 per cent of households in that part of the neighbouring distribution area want that directory.

17. With some exceptions,[7] Yell must ensure that the distribution areas for its directories do not overlap. This has the effect of preventing Yell from publishing more than one directory in any area.

Yell Accounts

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

[7]There are exceptions for (i) overlapping directory distribution areas that existed when the undertakings were imposed, (ii) areas in which there was no supplier other than Yell in 2003 and (iii) areas in which users have requested a second directory in accordance with a mechanism set out in the undertakings.

Providers of CDAS

19. Yell is the largest provider of CDAS in the UK, followed by Thomson[8] and BT.[9] A recent report published by the Kelsey Group (the Kelsey Report), an industry commentator, estimated the UK shares of 2004 CDAS revenues for Yell, Thomson and BT to be 77.2 per cent, 13.8 per cent and 6.9 per cent respectively, with other providers totalling 2.2 per cent.[10,11] These three businesses each cover most of the UK and are the only national or near national providers. However, there are many other providers of directories, some of which have significant regional or local presence.

20. Yell publishes 102 classified directories covering the whole of the UK. Yell's UK revenues for the year ended 31 March 2005 for the CDAS business were £612.1 million. Yell also offers a telephone-based, operator-assisted classified directory service (118 24 7) and an Internet-based classified directory service, which combined contributed a further £50.5 million in revenues for that year.

21. Thomson has historically been the second largest CDAS provider (although much smaller than Yell) and has been owned since August 2000 by SEAT Pagine Gialle, a leading European publisher of telephone directories, and the leading provider of CDAS in Italy. Thomson publishes 173 Thomson Local directories, covering about 90 per cent of all homes and businesses in England, Scotland and Wales; sparsely populated areas are not covered. Thomson publishes other database products and services, including an Internet-based classified directory service.

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[8] Thomson Directories Ltd.
[9] BT Group plc.
[10] *Global Yellow Pages 2005: The Kelsey Group's Outlook & Forecast*—May 2005.
[11] BT's business has grown significantly since 2004.

22. BT, having sold its classified directories business to Yell in 2001, re-entered the CDAS market in 2003, by including a classified advertising section in its existing A to Z directory, called the Phone Book. It publishes classified directories within each of the 171 combined Phone Books covering the whole of the UK. Its Phone Book business is part of BT Retail's Directories unit (BT Directories), which includes operator services (118 500), telephone directories and an Internet-based classified directory service. Further information on BT and its combined Phone Book is set out from paragraph 39.

23. There are a number of smaller providers of classified directories which do not have a national presence. Trinity Mirror,[12] the UK's largest newspaper publisher, launched The One Directory in Edinburgh and Glasgow in 2004. The group published a further three directories in Scotland in 2005 bringing the total number of directories published to five.

24. Kingston Communications[13] is the independent communications company which serves the Hull area. It publishes classified directories for the areas of Hull and the Isle of Man. It also has an Internet based classified directory.

25. There are other smaller providers of classified directories which serve a local area only, such as Dentons,[14] which provides a number of classified directories, mainly in the West Country, and Capital Directories,[15] which produces a range of local classified directories covering parts of London. Dentons and Capital Directories also have Internet based classified directories.

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[12]Trinity Mirror plc.
[13]Kingston Communications (HULL) PLC.
[14]Dentons Directories Ltd.
[15]Capital Directories Ltd.

Industry background

26. The Kelsey Report[16] estimates that in 2004 about £757 million was spent on classified directory advertising in the UK, a figure that has been growing steadily for many years. Directory advertising is aimed at drawing the user's attention to potential suppliers or supplying details of these suppliers, in most cases after the user has decided to purchase particular goods or services. This type of advertising is sometimes described as 'directional' to distinguish it from advertising to create awareness or promote a brand.

27. The user's requirement of a directory is that it has a sufficient list of relevant suppliers and enough information about their services to enable him or her to make a selection of suitable contacts, as well as suitable contact details. The advertiser's requirement of a directory is that its advertisement should generate enough new business leads to cover at least the cost of advertising. The demand for advertising in classified directories by advertisers will be influenced by their expectation of the number of calls they would receive as a result of use of the directory; this in turn depends on the amount of useful information users find in directories. This interaction of usage and advertiser demand creates a 'network effect', by which more advertising attracts more usage which in turn attracts more advertisers (see also paragraph 84). This effect has been described to us by CDAS providers as a 'virtuous circle'.

28. Classified directories differentiate themselves in various ways, including the size and shape of the geographic area ('footprint') served, layout and physical design, brand image and editorial content. Directory providers have to establish classification systems (the term 'classification' is used to describe the heading under which an advertisement appears) and systems for sequencing the advertisements within

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[16] *ibid*.

classifications (an important issue for advertisers as many have strong preferences to have their advertisement positioned at or towards the beginning of a classification).

29. As well as deciding in which directories and which classifications they wish to appear advertisers have various advertising choices relating to the size of advertisement and the use of colour. In addition special options may be available such as spine advertising, inside front cover or 'filler' space which utilizes gaps in the run of advertising that have resulted from the page composition process.

30. Providers describe the advertising audience of specific directories by reference to the number of copies they guarantee to distribute; this is known as the guaranteed minimum circulation or GMC. The cost of advertising is often expressed in terms of cost per thousand, based on GMC, relating the cost of advertising to the number of potential users addressed.

31. The geographic footprint of a directory is an important feature. A larger footprint will bring a greater GMC and more advertisements for the user; however, some users may consider those advertisers that are further away to be less relevant and dislike the physical size of very large directories. Thomson publishes directories with a smaller geographic footprint than Yell's and positions its product as a 'more local' directory. BT's directories also tend to have a smaller footprint than those of Yell. Yell has moved towards smaller footprints in many areas by subdividing directories, a process known as 'rescoping'.

32. Many advertisers measure performance by asking callers where they saw an advertisement but there is also widespread use of more sophisticated methods such as using dedicated telephone numbers for each advertisement. The most sophisticated advertisers, typically those operating at a national level, will measure

the cost of each lead generated from a particular advertisement relative to the value of that lead. This will be a function of the rate at which leads can be converted into sales, the value of the initial sale and the subsequent ('lifetime') value to them of the user.[17]

33. In order to compile a classified directory it is necessary to have a list of businesses and their telephone numbers. The major directory providers obtain business listings from a sub-division of BT, known as BT Wholesale Directory Solutions, which operates the Operator Services Information System (OSIS) database, although other sources are also used to supplement this data. It is a requirement of the OSIS licence that consent is obtained before a directory publisher uses this data. The publisher's staff contact each business concerned and confirm its name and address, whether the business wishes to appear (as a line entry, free of charge) in the directory and under which classification it wishes to appear. Sales staff will subsequently contact those businesses which have confirmed that they wish to appear in the directory and seek to sell them an enhanced entry. Potential accounts likely to have low value will normally be handled by telesales, although a new directory provider might make greater use of face-to-face contact in order to maximize its sales impact. Higher potential value accounts will be contacted by a field sales executive. Very high potential value accounts will normally be dealt with by a separate team, for example a national sales team.

Recent developments

34. The two most significant recent developments affecting the supply of CDAS have been the increasing use of the Internet and BT's re-entry into the supply of CDAS.

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[17]See the summary of evidence from insurance companies on the CC web site: http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/third_party_submissions_insurance_companies.pdf.

Use of the Internet

35. Much of the information provided by classified directories can now also be found using the Internet. Use of the Internet has grown rapidly and continues to grow, particularly with the increased adoption of broadband, and the greater use of handheld, portable devices (including Internet enabled mobile phones) for Internet access.

36. To obtain information on businesses via the Internet, users may also search for a supplier using a search engine. Search engine providers offer 'paid search' products (such as Google's Adwords) to advertisers; these enable links to advertisers' websites to be prominently positioned alongside the search results. This can be an important form of advertising for businesses that have web sites.

37. Information on businesses is also available via the Internet through online classified directories. Yell, Thomson and BT, along with a number of other providers such as Google.[18] Yahoo!,[19] 192.com[20] and upmystreet.com[21] provide online classified directories that enable users to search their database by business type or name and geographic location. Google, for example, has introduced a product (Google Local) designed to meet the needs of users looking for a supplier in a particular locality, using content made available by Yell. Yahoo! has a similar arrangement with Thomson.

38. Thomson has entered into an agreement with Google to act as a reseller of its AdWords product.

[18] Google Inc.
[19] YAHOO! INC.
[20] i-CD Publishing (UK) Ltd.
[21] uSwitch Limited.

Re-entry of BT

39. Following the expiry of a one-year non-compete agreement with Yell, BT re-entered CDAS supply in 2003 by introducing a classified section to its Phone Book and promoting it as a ‘3 in 1’ product offering alphabetically sequenced (A-Z) residential and business listings and classified business listings. The three sections of the Phone Book share common production and distribution facilities. By combining its CDAS product with its A to Z Phone Book, BT appears to enjoy substantial economies of scope, particularly in its directory distribution costs.

40. As a communications provider, BT has a regulatory obligation[22] to provide to BT telephony subscribers, on request, a printed directory containing A-Z listings of directory information. Any such directories produced must be updated at least once a year. It also took the decision to distribute this combined Phone Book not only to BT subscribers but to materially all businesses and households in the UK.

41. BT Directories receives cost recovery income, via a recharge between BT Directories and other part’s of BT’s business, from BT’s line rental customers, intended to cover the cost of production and distribution of the A to Z listings in the Phone Book.

42. BT is also the main supplier of telephone number data, by means of the OSIS database, to CDAS providers (see paragraph 33).

Smaller providers of CDAS

43. We have invited and taken evidence relating to CDAS providers of all sizes. Most of the evidence submitted relates to large providers and we have received none that

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[22] Under the General Conditions of Entitlement set out in the Communications Act 2003

suggests any particular concerns relating to the supply of CDAS by small providers. Our analysis has therefore concentrated on the supply of CDAS by major providers.

The relevant markets

44. At the time of our issues statement, our working hypothesis was that the supply of printed classified directories, in the UK, could be regarded as the relevant market, that this market might also extend to certain online services, but that other forms of classified advertising, such as in local and regional newspapers, would not form part of the relevant market. Since then we have considered this subject in more detail and conducted a quantitative market survey and a qualitative study that focused on the highest-spending advertisers.[23] Market definition is considered in more depth in a working paper; this and other working papers will be published on the CC website.[24]

45. As our guidelines state, the key to market definition is substitutability. To test substitutability we have used the hypothetical monopolist framework (or SSNIP test),[25] so far as is feasible to do so in this industry, and have examined empirical evidence of substitution and substitutability.

46. There are two types of customer for CDAS, advertisers in and users of classified directories. However, classified directories are free to users and this is unlikely to change. We therefore apply the hypothetical price framework based on prices to advertisers. We consider two aspects of market definition: the product market and the geographic market.

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[23] The surveys are discussed in Annex A and the reports published on the CC website: http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/research_studies.htm.
[24] At http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/working_papers.htm
[25] Described in the CC market guidelines, CC3, paragraphs 2.4 to 2.25.

47. The most important characteristics of CDAS offerings to advertisers appear to be brand image, levels of usage by users, comprehensiveness of their business listings, and the geographic area covered by the provider.

48. We considered the factors that influence substitution between classified directories. Based on this, it seems appropriate to distinguish two broad types of offerings: (i) small local classified directories and (ii) larger, comprehensive, classified directories. This second type would include classified directories provided by Yell, Thomson and BT nationally, and may include certain local directories such as those provided by Trinity Mirror and Kingston Communications. We refer to providers of the second type of offering as the major CDAS providers. Although the offers of the more comprehensive classified directories are differentiated from each other, it appears to us that they each provide a similar service to advertisers and users. On the other hand, smaller classified directories do not generally offer similar levels of usage, such comprehensive classifications, or comparable brand image.

49. Respondents to our quantitative survey of advertisers indicated that a directory's brand image and number of users were particularly important. In local areas where there are strong well established small local classified directories (as characterized above), some advertisers may regard them as substitutes for the major classified directories, but overall our survey showed that only two to three per cent of those that advertised in the major classified directories had advertised in smaller, local directories in the past three years. This suggests that small local directories are not, in general, a sufficiently close substitute for the major classified directories to form part of that relevant market.

Other advertising media

50. We consider substitution between advertising in classified directories and advertising in other media. Particular attention is paid to potential substitution from Internet advertising and from local and regional newspaper advertising (the main other area of classified advertising), and these are discussed in detail below. We begin this section with some general observations.

51. Most evidence that we have received suggests that advertisers which use classified directories find them very valuable and that other media are not close substitutes. Our quantitative survey indicated that 81 per cent of local advertisers and 90 per cent of larger advertisers regarded advertising in classified directories as important to their business. Of these, 55 per cent considered that there was at least one directory in which they considered it was essential to advertise. About 60 per cent of advertisers would switch to another CDAS directory if their main directory were unavailable.

52. It was also clear from our qualitative study of larger advertisers, and from evidence given in hearings, that they generally found CDAS to be a highly cost-effective medium, the value of which was significantly greater than its cost.

53. Our quantitative survey showed there has been very limited switching (including partial switching or reweighting of expenditure) between CDAS and other media in the past. Our quantitative survey included lapsed CDAS advertisers, ie businesses that had advertised in CDAS but had then stopped. Most of these indicated that no price decrease would convince them to advertise in CDAS again, suggesting that the reasons for lapses were not generally related to price.

Online classified directories and Internet searches

54. There are various means of advertising on the Internet. We considered the most relevant to be the use of online classified directories (based on the directory concept but exploiting many features of the Internet) and the use of paid search products (see paragraph 36) from companies such as Google. These products are different in character, and their appeal will vary between advertisers; paid search will have less appeal to businesses currently without a website but more appeal to a business that wants to promote itself via its website and possibly transact business online.

55. While the amount of advertising on the Internet for purposes similar to that in classified directories is increasing, printed CDAS revenues have also grown by about 15 per cent in real terms over the past four years and are continuing to grow, albeit possibly at a slower rate. This suggests that substitution of Internet advertising for CDAS has been limited. Our analysis indicates that even in those classifications for which the Internet might have most appeal, the impact on CDAS revenues appears to have been very limited. In certain cases Internet advertising may have clear advantages to users or advertisers and therefore be a more appropriate product. For example, businesses such as hotels seek to appeal to users outside of their local area and may take bookings online; for them, online products have definite advantages over printed classified directories. In these circumstances a small change in the price of classified directory advertising would probably make little difference to advertising patterns.

56. In summary, our view is that much Internet advertising is likely to be complementary to classified directories, rather than a substitute, and that where there has been switching to the Internet this has been largely because of the additional or different

capabilities that it offers. This pattern does not suggest that Internet advertising should be considered to be part of the relevant market.

Local and regional newspaper advertising

57. The characteristics of local and regional newspaper advertising differ from those of CDAS advertising. In particular, the duration of a classified directory (typically one year) is much longer than that of a daily or weekly newspaper, so the cost of a CDAS advertisement is usually lower than that of a series of newspaper advertisements over the course of a year. Local and regional newspapers derive the vast majority of their classified advertising revenues from categories such as recruitment, property sales, sale of motor vehicles, and births marriages and deaths. In most cases such advertisements seek to create awareness of a temporary opportunity: a particular job vacancy, a house or car for sale. This type of advertising would not appear in a classified directory. There is some overlap in categories such as professional services, home services and emergency and repair services but regional newspapers have not been particularly successful in capturing a great deal of this business.

58. In our view, local and regional newspaper advertising is not a strong substitute for CDAS.

Scope for supply-side substitution

59. We considered whether there was any scope for supply-side substitution. This occurs when a small price rise prompts other firms to start supplying, at short notice, an effective substitute to the product in question. This would usually come from firms with existing facilities, providing similar products and/or operating in adjacent areas. However, as we discuss later, there are high barriers to entry into CDAS (see

paragraphs 88-95), so the potential for supply-side substitution from other media into CDAS is very limited.

Non-classified advertising in classified directories

60. Classified directories frequently carry some advertising which is not classified, such as advertising on covers and in various inserts. The revenue BT derives from advertising in its A to Z sections is of particular note since this represents a significant proportion of its Phone Book revenue. In our view this non-classified advertising serves a somewhat different purpose to classified advertising and our current view is that it does not form part of the relevant market.

Emerging thinking on product market definition

61. Our current view is that the relevant product market is for advertising services in major classified directories with a set of characteristics that includes strong brand image, high levels of usage and comprehensive business listings. Thus the relevant product market includes the directories provided by Yell, Thomson and BT nationally, and may include certain local directories such as those provided by Trinity Mirror and Kingston Communications.

62. We have not, so far, formed a view on the definition of the relevant product market that includes local directories which do not share these characteristics described above.

63. Although we currently consider that neither online classified directories nor other Internet advertising (such as ‘paid search’) form part of the relevant market, we recognize that Internet advertising for purposes similar to that in classified directories has been increasing, especially for certain classifications. This might reduce the total

demand for CDAS: our quantitative survey indicated that, over time, some advertisers are likely to commit relatively less of their advertising budgets to printed directories and relatively more to the Internet.

64. However, our current view is that this process is less the consequence of direct competition between the two media and more the effect of the long-term and general growth of Internet usage. The evidence of our quantitative survey and our qualitative study of high spending advertisers does not indicate that advertisers currently treat the two media as close substitutes. Although Internet advertising, for purposes similar to that in classified directories, may influence the providers of printed directories, the consequence is not sufficiently strong to include the Internet within our definition of the relevant market.

Geographic market definition

65. We have also considered the geographic scope of the market for advertising services provided by major classified directories. Although the products are intrinsically local, there are also factors that point towards a national market.

66. One major provider put forward the view that the markets were local because for most advertisers, the purchasing decision is mainly a local one. However, others put forward the view that this was a national market because of the existence of some large national advertisers and because the main suppliers were present on a national basis.

67. Our view is that from the advertisers' point of view the relevant geographic markets for major classified directories are local and that the prices outside a given locality are unlikely to constrain those within it. Nevertheless we consider it appropriate to

analyse competition between the main suppliers mainly on a national basis, because they meet in almost all the local markets and because the competitive conditions are likely to be similar across almost all the different geographical markets.

Characteristics of the market for major classified directories

68. We set out our emerging thinking on the characteristics of the market under the following headings:

(a) concentration in the market;

(b) pricing of advertisements and revenues including effects of the Yell undertakings;

(c) other aspects of the Yell undertakings;

(d) interaction between competition for users and competition for advertisers; and

(e) barriers to entry and expansion.

Concentration in the market

69. The market for major classified directories has historically been highly concentrated with Yell (and its predecessor, BTYP) having a very large and stable UK market share[26] and with Thomson having a much smaller, but significant, share.

70. The 1996 MMC report estimated BTYP's 1994 share of CDAS revenues at about 84 per cent. The OFT's report published in 2001 estimated BTYP's share at 83 per cent. The Kelsey Report estimated Yell's share for 2004 at just over 77 per cent.[27,28]

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[26]The term 'market share' is used to refer to shares of advertising revenue (not to usage). The term 'UK market share' is used to describe the market share of the local CDAS markets aggregated across the UK.
[27]*ibid.*
[28]The CC is preparing its own figures, based on confidential data. The figures cited here are taken from public sources and should be regarded as indicative only. These figures are shares of total CDAS revenues for the UK, and so include small local CDAS; this is estimated at less than 2 per cent of the total. Certain revenues may be included which are not classified revenues, for example advertising outside the classified sections in Yell and Thomson's directories.

71. The pattern of market shares has somewhat changed with the re-entry of BT in 2003, and its growth in market share, but the market remains highly concentrated and Yell continues to hold about three quarters of the market revenues.

Pricing of advertisements and revenues including effects of the Yell undertakings

72. Advertisement prices are determined by a combination of rate card prices and discounts from these prices. Rate cards determine the price of an advertisement based on a number of factors including the directory it appears in, its size and the degree of colour used. Discounts are often offered.

73. Yell publishes a rate card setting out the prices for each classified advertisement type featuring in each directory. The Yell undertakings operate to prevent it from entering into individual price negotiations with advertisers but it offers discount programmes for some new advertisers, for some of those renewing for the first time and for some of those advertisers which upgrade their advertisement type. Some of the more recent versions of the discount programmes offered have been offered to particular classifications featured in the directory. The value of the discount offered depends on the classification that the advertisement is in, taking into account, as one factor, the value that advertisers in particular classifications are likely to obtain. Yell also offers a ‘composite discount’ (discussed in paragraph 78), which relates to rescoping and which is somewhat different to the schemes described above. Excluding the ‘composite discount’ we found that more than one-third of Yell’s advertisements (both by number and weighted by value) were sold at discounted prices.

74. Both Thomson and BT told us that they set their rate card prices with reference to those of Yell. They both also told us that they offered discounts within their rate cards; in addition Thomson said that it will enter into individual negotiations with

certain advertisers, while BT said that it offered discounts which were centrally determined. Our qualitative study of high spending advertisers confirmed this.

75. We are studying Yell's, Thomson's and BT's prices and revenues over time. We are working on price indices that show the average price change faced by an advertiser wishing to buy the same advertisement (or bundle of advertisements) in consecutive years. Our initial analysis suggests that the prices of advertisements in the classified directories of Yell and Thomson have fallen over the publishing cycles between 1999 and 2005, and that Yell's rate card rates have fallen in line with the undertakings. It also suggests that the price index for Yell has fallen by more than the price cap, due to the discount schemes that Yell has offered, and that the price index for Thomson has also fallen faster than the price cap.

76. Although the Yell undertakings do not directly apply to other market participants, Thomson and BT told us that they affect prices across the market as other providers set their prices based on Yell's. To the extent that the undertakings affect the revenues of CDAS providers, they may reduce the incentives for other companies to enter the CDAS market.

77. The price control may have discouraged Yell from lowering any of its rate card rates more than is required by the price control, because the reduced rate would become the base for calculating the reduced rate in the following years (and so on). In contrast, the base figure is unaffected by any discounts offered. Yell has reduced its rates by the amount required by the price control. One consequence of following this uniform pattern is that relative rates of different advertisements (whether comparing rates between different directories or between different types of advertisement in the same directory) have been unaltered over the period of price control.

78. When Yell undertakes rescoping (division of directories, described in paragraph 31) it determines the new rates in the rescoped areas by reference to similarly-sized directories. The rates for advertisements in the new smaller directories are lower in absolute terms, reflecting the smaller circulation. However, on a ‘cost-per-thousand’ basis (see paragraph 30) prices are generally higher, which reflects the historic pricing of Yell’s directories with smaller circulations. Yell has taken the position that if any new or renewing advertiser wishes to place the same type of advertisement in each of the new rescoped directories, then that advertiser will not have to pay any more for these advertisements as a result of the rescoping. The composite rate initially charged by Yell following rescoping is thereafter reduced in line with the Yell undertakings. Yell describes this provision as a ‘composite discount’.

79. Though the prices of advertisements in major classified directories have fallen, the revenues of the three largest CDAS providers have risen. This revenue growth has been possible since the average expenditure of advertisers has remained stable and the number of advertisers has risen. Expenditure per advertiser has remained broadly stable despite falling advertisement prices because advertisers are buying more advertisements and more expensive advertisement types.

80. New types of advertisement, and in particular colour advertisements which are typically priced at a premium, have been introduced. Although advertisers are not obliged to take advantage of these, the availability of colour and its use by rival advertisers may diminish the relative attractiveness of monochrome advertising in some classifications. As a result there has been a significant movement to colour advertising and a tendency for advertisers to trade up to the more expensive products.

81. In certain classifications, especially those for insurance, there has been a trend towards advertisers placing multiple advertisements within a classification to increase their prominence compared with rival advertisers.

82. The division or restructuring of some classifications appears to have led to some increase in the number of advertisements placed. (For example, Yell's insurance classifications have been restructured, resulting in a greater number of classifications. Major insurers will often now wish to advertise in more classifications.)

Other aspects of the Yell undertakings

83. The Yell undertakings prevent Yell from distributing more than one directory in any one area, subject to certain exceptions. Yell may not distribute overlapping classified directories or classified directories designed to complement its main product, such as 'micro' classified directories covering very small geographic areas (a process sometimes known as 'second tiering'). Some competitors have told us that this has been helpful by preventing Yell from introducing additional products that might exploit its strong position to the detriment of its competitors, for example by creating classified directories that cover a smaller area within the footprint (see paragraph 28) of an existing directory, and selling advertising in these at very low rates.

Interaction between competition for users and competition for advertisers

84. An important characteristic of the CDAS market is the network effect arising from the interaction between competition for users of classified directories and competition for advertisers:

- the value of a directory to advertisers depends on the level of usage of the directory; and
- the usage of a directory depends on the number of relevant advertisers.

Thus success with users and success with advertisers are mutually reinforcing; by the same token it is hard for a directory provider with low usage to attract or retain advertisers.

85. Competition for users is a vital part of the competition for advertisers and advertising revenues. The following factors appear relevant in attracting users:

(a) the number of relevant advertisements;

(b) the quality of the directory, including production values, usability, and editorial content such as the NHS Direct self-help guide in Thomson's English directories;

(c) the footprint of the directory (see paragraph 28);

(d) established preferences of existing users and branding; and

(e) advertising and promotion.

86. As the number of advertisements in a classification increases, individual advertisements of a particular format in a classification may be less likely to produce results for advertisers. In addition, beyond a certain point, additional advertisements may not make a directory more attractive to users. Thus, as classifications become large the network effect described above may be at least partially offset by advertisers' concerns about the competition between advertisements in the classification (diminishing 'share of voice').

87. It is also relevant that whereas for users the opportunity for choice of classified directories and indeed other media is daily and continuous, decisions about directory advertising are taken only at yearly intervals, when each new edition is compiled. In consequence, the choices of directory and media made by advertisers, though responsive to user preferences, may lag behind them. However, advertisers may be

persuaded to anticipate developments in usage; indeed without this new directories could not be introduced.

Barriers to entry and expansion

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

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

90. We are considering the potential for entry and expansion in the relevant market. We believe there are the following barriers to the establishment of a major CDAS business:

(a) Overcoming the network effect to establish enough usage to offer a convincing product for advertisers

The network effect appears to give Yell a significant advantage over smaller providers and any new entrant. It is difficult for a new provider to compete for users—it cannot introduce a directory at a discounted price to users, since the product is already free for them. It is not clear how rapidly and at what cost a new entrant, intending to gain national coverage, could persuade users to use, or increase use of, its directory. Very high levels of advertising and marketing expenditure would probably accelerate the process. It took Thomson a considerable time to establish its business. BT appears to have grown more rapidly and its entry is discussed below (see paragraphs 92 to 95).

(b) Need to establish a strong brand identity

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

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

92. The two companies (BT and Trinity Mirror) that have entered this market in recent years have had significant brand and operational synergies with their existing businesses. It is too early to assess the long-term significance of Trinity Mirror's The One directory.

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

94. BT enjoys considerable advantages compared with other potential entrants. Whilst other companies may have some advantages, we have not identified any other potential entrant with comparable relevant strengths. We therefore do not consider

that BT’s re-entry necessarily gives any indication of the feasibility of any other company entering the CDAS market or expanding to national scope.

95. In addition, we observe that BT’s strengths could act as an additional disincentive to any business considering entry into the market.

Future development of the market

96. The CDAS market has grown significantly in recent years, in terms of the advertising revenues generated, even though usage appears to be declining.

97. We recognize that the Internet is becoming a more important advertising medium, particularly with increased use of broadband. This appears likely to take some business from classified directories, as discussed in paragraph 63, although it is not clear whether this would, at some future time, lead to a broader definition of the relevant product market or reflect a move from one product to another.

98. As described above, BT is now a significant provider of CDAS, but its CDAS business is nevertheless much smaller than that of Yell. It is not clear how and with what effect its growth strategy will be pursued and what impact it might have on competition within the relevant market.

Key points arising

99. The key points arising from our emerging thinking are set out below.

100. It is likely that, at present, advertising services in major printed classified directories with a set of characteristics that includes strong brand image, high levels of usage and comprehensive business listings, can be regarded as the relevant product market. The relevant geographic market appears to be local; however, we consider it

appropriate to analyse competition between the major CDAS providers mainly on a national basis.

101. While there is increased advertising on the Internet for purposes similar to that in classified directories, we do not consider Internet advertising to form part of the relevant market for CDAS at present. The Internet appears likely to take some business from classified directories, but it is not clear whether this would, at some future time, lead to a broader definition of the relevant product market or reflect a move from one product to another.

102. The market is highly concentrated with Yell having a very high and stable market share. Yell has a strong brand, and benefits from certain network effects. Whereas average prices for advertisements in major classified directories have been falling, the revenues of Yell and other CDAS providers have risen. This appears to be due to an increase in the number of classified directory advertisers and to advertisers maintaining their level of expenditure by choosing more expensive advertisement types and placing multiple advertisements.

103. There appear to be substantial barriers to entry and expansion in this market. The existence of a network effect which is generated by increasing numbers of advertisements in directories attracting increasing numbers of directory users which in turn attracts more advertisers, appears to operate in favour of existing players such as Yell and against new entrants and smaller existing providers. An additional entry barrier appears to arise from the support that a strong brand identity provides to the usage of directories.

104. There is little history of entry to the relevant market. BT has recently re-entered the market and it appears to enjoy particular and strong advantages compared with other

potential entrants which we are continuing to examine. It is too early to assess the significance of Trinity Mirror's entry; however, at present its UK share of supply of CDAS is very small.

105. We currently consider it likely that in the absence of the price cap the prices offered to a significant number of advertisers, across the market, would be higher than they are at present.

106. It is our emerging view that Yell's strong position and the existence of substantial barriers to entry may give it market power. We are examining the extent to which such market power might affect the level of prices.

Principal areas for further investigation

107. This emerging thinking document puts forward the preliminary views of the inquiry group based on evidence received and analysis completed so far. We are continuing to examine and evaluate the areas discussed, and will hold further hearings and take account of evidence submitted. We have begun to consider the nature of competition in the market and will proceed to analyse this further. The Yell undertakings are an important characteristic of this market, impacting on the way in which Yell and other parties operate their classified directory businesses and we will continue to examine their effects. We are also considering industry profitability, to assess whether or not this is consistent with the preliminary views reported above. We are also considering the position of small local classified directories and whether there are specific issues associated with these providers.

The inquiry process

Events leading to reference

1. On 5 April 2005, the OFT referred the supply of classified directory advertising services (CDAS) to the CC.[29]

2. The statutory deadline for completion of the CC's inquiry is 4 April 2007.

Conduct of CC inquiry

Prior to Emerging Thinking

3. The CC sought initial background information and submissions from CDAS providers and from interested third parties (both advertisers and users). All documents published by the CC in relation to CDAS can be found on the CC website.[30] At the request of respondents, some submissions were anonymised and/or excluded sensitive material.

4. In July 2005 the CC published a note on the scope of the reference setting out its thinking that a publication is of the type described in the terms of reference if it is a printed publication; it is a directory; it contains advertisements; it is distributed wholly or mainly to consumers; and it covers a range of goods and services.

5. The CC published a statement of issues in August 2005. Its aim was to highlight issues which appeared relevant in deciding whether features of the supply of CDAS

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[29] The OFT's reasons for referral can be found on: http://www.oft.gov.uk/NR/rdonlyres/A9B3409E-5D42-499C-BF18-06C9BA415373/0/oft787.pdf

[30] http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/index.htm

prevent, restrict or distort competition. Following the publication of the issues statement, the CC inquiry group held hearings with CDAS providers .

6. The CC commissioned research to explore advertisers' perceptions and experiences of classified directory advertising services. Two complementary studies were carried out; one was among the very largest CDAS advertisers and conducted by Andrew Irving Associates (AIA), while the other was a survey of all other CDAS advertisers by BMRB International. For the first study, AIA conducted in-depth interviews with executives responsible for CDAS advertising in 40 of the 400 highest spending users of CDAS. BMRB conducted 2,200 computer assisted telephone interviews with other CDAS users, broken down as follows. 1,500 were advertisers with Yell, Thomson or BT and 200 were advertisers who had apparently ceased to use these providers. A further 200 were advertisers with Kingston, 100 advertised in *The One* (supplied by Trinity Mirror in Scotland) and 200 advertised in other, local ,directories. The results of these studies are published on the CC's website.[31]

Publishing the Emerging Thinking document

7. Since publication of the issues statement, the CC has considered further written and oral evidence. In the light of this, it has begun to focus its thinking. Emerging Thinking explains the inquiry group's current views.

What happens next?

8. As part of its consideration of responses to Emerging Thinking, the CC will hold further hearings in February and March. Written responses to the Emerging Thinking should be submitted by 48 hours before a hearing or by 15 March 2006.

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[31] http://www.competition-commission.org.uk/inquiries/ref2005/classdirec/rsearch_studies.htm

9. The CC will use the Emerging Thinking document and any further evidence as the basis for its provisional findings. This is expected to be published in April 2006 and will, in accordance with the CC's rules, be followed by a further consultation period. If the provisional findings were to point towards an adverse effect on competition, then the CC would consider whether action should be taken by it, or others, for the purpose of remedying, mitigating or preventing the adverse effect on competition or any detrimental effect on consumers arising from it. It would publish a notice of proposed remedies at about the same time as the provisional findings. Hearings would be held to discuss proposed remedies. Interested parties would have the opportunity to convey their views on proposed remedies.

10. We currently expect the CDAS final report to be published at the end of the summer of 2006.

11. We would like to thank all those who have assisted in our inquiry to date.