



Market Investigation References: Competition Commission Guidelines

Consultation Document

This is part of a series of guidance documents which the Competition Commission is required to publish under the Enterprise Bill

September 2002

MARKET INVESTIGATIONS: COMPETITION COMMISSION GUIDELINES

Contents

Part 1: Introduction	3
Purpose of Guidance	3
Part 2: The statutory framework and the “adverse effects on competition” test	4
Overall framework	5
Market definition	9
SSNIP test	10
Product market	10
• Demand-side substitution	12
• Supply-side substitution	14
Geographic market	16
Other aspects relevant to market definition	17
• Temporal markets	18
• Upstream and downstream markets	19
• Market segments	19
• Chains of substitution	19
Part 3: Assessment of competition	21
Introduction	21
Intra-market rivalry	22
Market shares and concentration	22
Other structural factors	24
Non-price factors in competition	25
Barriers to entry, expansion and exit	27
Natural or intrinsic barriers to entry	29
Regulatory barriers to entry	31
Strategic barriers to entry	32
Effects of entry	33
Countervailing buyer power	34
Supplier power	35
Vertical integration	35
Switching costs	36
Information asymmetries	37
Conduct of firms	40
Conduct of oligopolies	40
Other market-wide horizontal conduct	45
Vertical agreements	47
Indicators of the extent of competition	47
Prices	47
Profitability	48
International price comparisons	49
Other indicators	50

Part 4: Remedial Action

Introduction	51
Consideration of appropriate remedies	53
The cost of remedies	54
Proportionality	54
Effectiveness of remedies	55
Types of remedy	56
Choice of remedy	58
Relevant customer benefits	59
Possible relevant customer benefits	61
Relevant customer benefits and remedies	63
Undertakings and orders	64
Procedural and other aspects of undertakings and orders	64
Part 5: Public Interest Cases	65

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 clause 166 (3) of the Enterprise Act (the Act). It explains how the Commission intends to address the questions to be answered in respect of market investigation references made to it under clauses 126 and 127.
- 1.2 A list of other advice and information and of other publications of the Commission and the Office of Fair Trading (OFT) relevant to market investigation references can be found at ****.
- 1.3 This guidance reflects the views of the Commission at the time of publication. Markets, economic theory 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 markets regime and new guidance may be published.
- 1.4 In addressing the questions the Commission¹ must consider in respect of references made under clauses 126 and 127 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.² Accordingly the Commission will apply the approach described in this guidance flexibly and may, if it considers it appropriate to do so, depart from the approach described in this guidance.

¹In 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, which apply, see General Advice and Information and the Commission's Rules of Procedure.

²For further information about the statutory period and the circumstances in which the inquiry may be extended see General Advice and Information.

Part 2: The statutory framework and the “adverse effects on competition” test

2.1 On receipt of a market investigation reference, the Commission is required³ 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 in a part of the United Kingdom.*” There is such an adverse effect on competition 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.⁴

2.2 Clause 126(2) of the Act states that, for the purpose of a market investigation reference, a feature of a market 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, in the course of business, 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, in the course of business, supplies or acquires goods or services.”*

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

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

“(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;*

³Clause 129(1).

- (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.”*

2.4 A detrimental effect on customers is defined⁵ as:

- “(a) higher prices, lower quality or less choice of goods or services in any market in the U.K. (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

2.5 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 (see section [2] of OFT *Market investigation references*). The reference will indicate the feature or features of the market that the OFT believes have adverse effects on competition, and will describe the goods or services (hereafter referred to as products) to which the relevant features relate. The reference 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, and it is entirely for the Commission to decide how any adverse effects on competition or detrimental effects on customers should be remedied.

⁴In this guidance, we refer to such adverse effect as the AEC and to the test above as the AEC test.

⁵Clause 129(5).

- 2.6 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. Where the conduct of a single firm raises competition concerns, the usual and first response of the OFT will be to consider whether the conduct amounts to an abuse of a dominant position and an infringement of the Competition Act 1998 (the Competition Act). However, there may be occasions when the behaviour of a single firm has a significant impact on a market (for instance where it has a dominant position, or where its conduct appears to establish a market wide pattern of behaviour that leads to anticompetitive outcomes) such that the Commission will wish to investigate the behaviour of that firm in more detail.
- 2.7 The Commission's approach to market investigation references will normally be in two stages. First, it will identify the relevant market (or markets). 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.⁶ Thus, before the Commission can reach its own conclusion on any adverse effects of a feature or features of a market, and proceed if appropriate to the consideration of remedies, it will need to reach a view on how the relevant market is to be defined.
- 2.8 With the market defined, the Commission will move to the second stage, namely a competition assessment. 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. 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

⁶OFT Guidance, Market Investigation References, para [4.12], [3.11-3.12].

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, meeting 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 the process of rivalry, the Commission will consider its effects over time and how it may be expected to develop.⁷ Rivalry has numerous beneficial effects: prices and costs are driven down, and innovation and productivity increase, so increasing the range, quality and, perhaps, the diversity of choice available to customers. Further, markets that are competitive generate feedback from customers to firms who, in consequence, direct priorities for innovation. 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 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 power may also, in some cases, be significant.

- 2.9 The Commission must also consider how the competitive process in the relevant market is affected by any features that would fall within the scope of clause 126(2). The scope of the clause is wide. 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 firms in the market and of customers. The consideration of the conduct of customers is considered further in the sections on *Switching costs* and *Information asymmetries*. Each of these features may have effects on

⁷Other producers from which firms face competition need not be simply other commercial firms but might include government-for example.

competition, in both its more static sense of price, cost and profit levels but also its longer term dynamic sense of experimentation with new ideas, innovation, differentiation and development of products and markets through time. Where these characteristics prevail, the process of rivalry will ensure that all firms in the market are open to challenge, no firm's position or market share is insulated from competitive pressure and none can exert market power.

2.10 As part of its assessment of the relevant market, the Commission will usually wish to look at structural features of the market, the conduct of players in the market, and the outcome that is produced by each of these factors. The Commission's assessment is unlikely to focus solely on the effects of a single market feature on the competitive process. Rather it will consider all those features of the market that may contribute to a prevention, restriction or distortion of competition. Thus the Commission may want to investigate a range of structural features of a market to assess whether firms in that market have market power (as sellers or buyers). 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). The Commission may also examine the business practices used by firms in the market for evidence relevant to the question of whether competition is adversely affected and whether there are any detrimental effects on customers. Finally, the Commission may also examine information on price levels, changes in prices over time, costs, efficiency, innovation, productivity and profitability, for example.

2.11 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.

Market definition

- 2.12 An important first step in a market investigation will be 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.
- 2.13 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 analysing the competitive constraints present in the market. Other constraints include entry conditions and countervailing buyer power. There is inevitably an element of judgement in defining the market and the Commission will adopt the methodology most appropriate in the context of the investigation. However, 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.
- 2.14 The next section looks at how the SSNIP test can be used when considering the product market. In doing so it comments on the importance of 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 temporal markets and chains of substitution.

SSNIP test

Product market

- 2.15 In using the concept of the SSNIP test for product market definition the Commission will consider whether a hypothetical monopolist of a certain 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 collection of products, the supply of which can, hypothetically, be monopolised. The first stage of the test is to analyse the characteristics of the product including its intended use in order to establish possible substitutes that might be included in the relevant market definition. The second stage examines what happens when the relative price of these apparently substitutable products increases.
- 2.16 The application of the SSNIP test is an iterative process. It starts with a narrow group of products and asks the following question: if there were only one supplier of these products (a hypothetical monopolist), would it be able to sustain a SSNIP profitably? If the price rise is unprofitable, then the closest substitutes to which customers would switch are added to the group of products and the procedure is repeated. The relevant market is defined as the smallest group of products for which a hypothetical monopolist could sustain a SSNIP profitably.
- 2.17 The SSNIP test is usually conceptualised by assuming a price increase for the group of products in question in the range 5-10 per cent, whilst assuming all other prices remain unchanged. The absolute size of the price rise used in the test will depend on the circumstances of the investigation, but in general the Commission's practice will be to hypothesise an increase of around 5 per cent, whilst assuming all other prices remain unchanged, to last for at least a year. In many instances, an increase in the price of a product of around 5 per cent (with all other prices unchanged) might reasonably be expected to make customers

reconsider their purchasing decision and so provide an effective level at which to consider the test. 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.

2.18 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. For example, in markets where firms have been able to exercise their market power, prices are likely to be above the competitive level. In the extreme case, prices will have been raised to the level at which a further price rise would lead purchasers to stop buying, or switch to alternatives that would not otherwise have been regarded as reasonable substitutes. Therefore, using the prevailing price level could lead to a market definition that is broader than the true market. This is because a further price rise might well be unprofitable, and the SSNIP test might, therefore, suggest that other products should be included in the relevant 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. This problem is generally known as the "cellophane fallacy" after the Du Pont case in the US.⁸ The problem for the Commission is that at the outset of an inquiry it is unlikely to be in a position to be able to judge decisively on 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 recognises that using prices more indicative of the competitive level might be more appropriate in its analysis of market definition.

2.19 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 and producers of other products switch production;
- any change in the costs of production, as the quantity produced decreases; and,
- the margin earned on each unit sold.

2.20 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. The first effect, substitution, is often a key focus of the Commission's analysis of market definition and is considered below.

2.21 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 rise 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.

- *Demand-side substitution*

2.22 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 alternative substitute products. A formal measure of the demand-side substitutability, known as elasticity, 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 of demand

⁸US v El Du Pont de Nemours & Co, [1956] 351 US 377.

for a product to a change in the price of a different product.⁹ Such measures may be considered when defining the market.

2.23 It is generally not possible, in the context of a market inquiry, 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 what the consequence is 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 would be. This can then be used to determine market definition.

2.24 Types of information that can be useful in assessing the degree of demand-side substitutability include:

- product characteristics such as physical properties and including 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 the 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;
- information from the main parties and third parties used (or that could be used) to make 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,

⁹An 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 greater than one (ignoring for the purpose of exposition the negative sign) and inelastic when the elasticity is less than one. 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.

business plans and strategy documents). The Commission might also consider any similar types of studies that have been prepared specifically for the inquiry;

- available information on the extent to which variations in prices differentials through time have occurred and their impact on trends in sales;
- estimates of own-price, and cross-price, elasticities of demand, for example from econometric studies, sales data etc.

In some cases, it may be useful or necessary to supplement these with two other types of calculation:

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

This may enable the Commission to judge how likely it is that a SSNIP would be profitable.

2.25 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.

- *Supply-side substitution*

2.26 In defining the product market, the Commission will give due consideration to 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 in adjacent areas. Imports might be another source of supply-side substitution.

2.27 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, in order to consider a competitor's response as supply-side substitution, the Commission will want to be sure that any response is likely to occur within a year of the price rise and that it does not involve significant investments in plant, equipment, skills or training.

2.28 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 the fact that supply-side substitution imposes an effective competitive constraint on the incumbents.

2.29 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;
- information on the willingness of customers to switch to new suppliers

following a SSNIP;

- information on the size of adjustment costs¹⁰ for potential suppliers;
- 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.

Geographic market

2.30 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.

2.31 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.

2.32 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:

¹⁰Adjustment costs are those 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 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;
- product characteristics such as perishability;
- information on variation in prices and sales by area; and
- information on flows of goods between regions or into the UK.

2.33 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 and hence that the market is wider than the UK. 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. 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 test.

Other aspects relevant to market definition

2.34 The Commission recognises the methodological and practical difficulties in delineating markets. These can be particularly acute in markets subject to rapid change, for example, 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.

2.35 Some markets, such as bidding 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 considering 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 might 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 might be considered. Similarly, when assessing competition in the market 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.

- *Temporal markets*

2.36 In certain markets, time is a factor that needs to be taken into account for the purpose of market definition. Time-related characteristics include seasonality, peak and off-peak services. When customers are not able to substitute services between periods, a temporal dimension may be added to the market definition. A typical example is 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. Indeed, train companies frequently charge higher prices to those travelling during peak times than during off-peak times. In such a market, the

Commission might decide to define two separate markets, that is peak and off-peak markets.

- *Upstream and downstream markets*

2.37 Some products are not sold directly to the final customer. They are first sold to an intermediary, who then either sells directly on to another customer (wholesaler) or reprocesses the products before resale (re-processor). 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.

- *Market segments*

2.38 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 inquiry and the evidence presented, the Commission may choose to treat these different groups, for the purpose of assessing competitive pressures, as separate markets.

- *Chains of substitution*

2.39 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 a good 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. 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 breaks are identified it might be appropriate to define separate markets on either side of the break.

2.40 The concept of chains of substitution can also apply to geographic markets. The Commission will consider possible breaks in the chain of substitution, indicating that separate regional or local markets might 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 areas within the market and, if so whether it is appropriate, instead, to define a number of smaller geographic markets.

Part 3: Assessment of competition

Introduction

- 3.1 Having defined the market, the Commission will move to its consideration of the features of the market and competition in general. 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. In a typical case, the Commission will be concerned about a combination of features though there may be cases where, in terms of the structure of the market, the situation is largely sufficient to establish that there is no adverse effect on competition. On the other hand, where the Commission believes that structural features might, of themselves give rise to an adverse effect on competition, it would normally go on to consider conduct of firms to see if that offset its concerns. It is unlikely that the Commission would reach an adverse conclusion about the structural features of a market and not also go on to consider the conduct of the firms engaged in that market. Any detrimental effects will usually arise from conduct of firms that is conditioned by the structural features of the market.
- 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 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, conduct of customers and firms. It then considers some possible indicators of ineffective competition before turning to the question of remedies in the next part.

Intra-market rivalry

3.3 When assessing the degree of competition in the relevant market, there are a number of measures and factors that the Commission will normally consider. Two commonly used measures are market shares and measures of concentration. We look at such measures before looking at other factors that may be relevant to investigating intra-market rivalry.

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 relatively large market share will not always be able to exert market power. Other features of the market will affect a firm's ability to exercise its market power, such as the extent of switching costs, threats of entry and countervailing buyer power. Market investigation references are unlikely to be concerned with firms that, individually, are in a dominant position in the market. This is more likely to fall under the scrutiny of the Competition Act. Nevertheless, market power can exist with market shares short of those that give rise to dominance. Furthermore, as noted earlier, there may be instances where, during the course of an inquiry, it becomes apparent that the behaviour of a 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.

3.5 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 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.

- 3.6 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.
- 3.7 The Commission will also normally 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: see the next section on other structural factors.
- 3.8 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 a very basic measure of concentration as it does not convey much information about the structure of the market - as it fails to take into account differences in market shares and the size distribution of firms. Two measures that are commonly used are the concentration ratio and the Herfindahl-Hirschman Index (HHI). The concentration ratio measures the combined market share of the largest firms in a market. For example, the 'five firm' concentration ratio measures the combined market share of the largest five firms in the market, and as such is simply the

sum of the market shares of the five largest firms in the market. It does not, however, provide any information on the relative size of the firms, nor on the number, or size of the smaller firms. The HHI, in contrast, takes account of all 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.¹¹ Other measures may be more appropriate in certain cases and will be taken into account by the Commission when relevant.

Other structural factors

3.9 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.

3.10 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

¹¹ The HHI for an industry with N firms and where s_i is the market share of firm i):

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 successfully illustrate the degree of competition in the market.

3.11 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 3.44-3.53).

3.12 There is more to the assessment of intra-market rivalry than purely structural factors. Markets with a similar structure can display different degrees of intra-market rivalry as a result of many factors. The conduct of firms and its effect on competition is described later but other non-structural factors that might affect the level of intra-market rivalry include the different ability of, and capacity for, firms to innovate. Other examples might include 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 might also be of interest. 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. In short, the Commission will seek to assess the process of competition and consider the kinds of factors that determine its effectiveness.

Non-price factors in competition

3.13 Competition encompasses both price competition and non-price competition, and the latter can in some markets be the more significant. Where applicable, the Commission will consider the effect of non-price competition in a market,

$$HHI = \sum_{i=1}^N s_i^2$$

for example product development, product range and quality, marketing, servicing and research and development (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 co-ordinated price behaviour is more difficult or impossible to achieve.

3.14 For example, oligopolistic firms may each face incentives 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 co-ordinated price behaviour 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 in terms of very similar products.

3.15 Whilst non-price competition that leads to product differentiation may make co-ordinated behaviour less likely, it may also segment the market facilitating price discrimination schemes that may act to the detriment of the consumer.

3.16 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.

Barriers to entry, expansion and exit

3.17 Where an assessment of intra-market rivalry does not illustrate a competitive market, 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.

3.18 Entry and expansion can include all the ways by which supply can be increased in a market. High costs of leaving (or exiting) a market might act as a barrier to entry for new firms by raising the cost of failure. Entry and expansion might take a number of forms including: new firms building new capacity; existing firms within the market building new plants or capacity; 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. Where there is a threat of entry or expansion, it 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.

3.19 In assessing the potential for entry to act as a competitive constraint, the Commission will consider 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) within such a time scale 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;
- the likely response to entry 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 had on competition in the market, in particular whether past entry modified the pattern of behaviour and competition and if so, whether this would be relevant for the present analysis.

3.21 The effects of any given set of barriers to entry will to some extent depend on other characteristics of the market. 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.

3.22 Barriers to entry are features of the market that prevent or restrict potential entrants 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 “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 to entry, termed “strategic”, are the result of existing firms in the market acting with the specific intention to deter entry.

Natural or intrinsic barriers to entry

3.23 Natural or intrinsic barriers to entry 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, specific asset investments, advertising and 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 on a small scale may not be economically feasible unless the entrant 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 on a large scale will often raise the risk of entry because large-scale entry will generally be successful only if the entrant can expand the total market significantly, or substantially replace one or more existing firms. Entrants can also be at a disadvantage where production costs are reduced according to the cumulative quantity produced (‘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 one of 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, 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 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.

3.27 Existing firms within the market sometimes have access to superior or scarce resources which entrants cannot gain access to 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 3,10) 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.

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.

Subsidies, tax relief and preferential purchasing may also raise barriers to entry in a market if potential entrants are not equally eligible for them. New entrants may also find it hard to receive planning permission. 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.

- 3.31 Quality, environmental, 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, because the factory existed before the relevant regulation came into force, which are not enjoyed by entrants.

Strategic barriers to entry

- 3.32 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. 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 then 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.

3.33 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). It should be noted that market investigations will not seek to penalise firms that have built market share by successfully providing customers with good service, quality and value for money, for example; rather the Commission will have regard to conduct that might have the, albeit unintentional, effect of increasing barriers.

Effects of entry

3.34 The absence of significant barriers to entry will tend to constrain what might otherwise be scope for the exercise of market power by incumbent firms. However, the Commission will wish to be satisfied not only that entry can occur within such a time scale that it bears on the incentives and decisions of the existing firms in the market but also that successful entry will 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.

Countervailing buyer power

3.35 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.

3.36 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. A large buyer will only be able to constrain firms if it is able to find an alternative supplier in the case of a price rise, if it can switch supplier relatively easily or if it possesses a credible threat of setting up its own supply arrangements.

3.37 While buyer power can offset the market power of suppliers, the benefits from the exercise of buyer power in lowering suppliers' prices do not necessarily get 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.

Supplier power

3.38 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 in some cases the concern may be sufficiently important as to merit a separate reference.

Vertical integration

3.39 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 non-integrated firms and higher barriers to entry.

3.40 Examples of efficiency improvements from vertical integration include improved co-ordination, for instance in product design and marketing between firms at different stages in the supply chain, lower transaction costs and removal of the 'double marginalisation' that occurs when two non-integrated firms both

have significant market power¹². Another potential benefit of vertical integration is that it can create greater confidence for specific investments when market contracts provide inadequate incentives and safeguards.

3.41 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.

3.42 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.

3.43 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.

Switching costs

3.44 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

¹² 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

presence of switching costs may intensify the competition for new customers, which may benefit new buyers. The overall effect on competition will depend on weighing up these effects. This in part will depend on whether there is scope to charge different prices to new as opposed to existing customers. Much the same set of considerations apply 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.

3.45 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.

3.46 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.

Information asymmetries

3.47 Customers' purchasing decisions are partly 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.

- 3.48 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.
- 3.49 The Act explicitly includes the conduct of customers as a market feature that might adversely effect competition. Information asymmetries may 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.
- 3.50 It is often the case that customers are unable fully to assess the quality of a product 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 markets where sellers have more information than customers regarding the quality of the products, the competitive process can be significantly affected (because of adverse selection). 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 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.

3.51 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 than what firms feel consumers need to know in order to persuade more of them to buy the product.

3.52 Firms may engage in practices that increase search and switching costs by deliberately providing inadequate information about prices. For example, prices may not be clearly displayed, or firms may only refer to some prices (e.g. special offers etc.) which are not always available to all customers. In some cases, a large amount of information may be made available but it is complex or displayed unclearly so as to limit customers’ understanding of existing prices.

3.53 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.

Conduct of firms

3.54 The structural features of a market determine whether or not firms in the market have market power and the ability to engage in conduct that adversely affects competition or which takes advantage of the absence of competition. As already explained, market investigation references will usually be concerned with the conduct of a number of firms in a market (other than conduct that amounts to an anti-competitive agreement or concerted practice prohibited by the Competition Act 1998) rather than the conduct of any individual firm. Where single firm conduct raises competition concerns, the usual and first response of the OFT will be to consider whether the conduct amounts to an abuse of a dominant position and an infringement of the 1998 Competition Act.

3.55 Where a market investigation reference is prompted by the conduct of firms, the Commission will look at a number of aspects of conduct. The following paragraphs indicate how various types of conduct are likely to be viewed by the Commission. 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 effect 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, the market of the sellers' suppliers or customers).

Conduct of oligopolies

3.56 Where markets are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognise their interdependence (oligopoly). 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. If a reduction in price fails to achieve a significant volume response it will be unprofitable; but 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, with the prospect that 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. Moreover, price increases by one firm to levels that might otherwise have been uncompetitive may well prove profitable because, of the two possible responses by competitors – to follow or not to follow the price rise—the belief that the former will be more profitable may lead to a reasonable expectation that the original price rise will be matched. 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 all matching each others’ prices at a higher level than could otherwise be sustained.

3.57 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 this will be clear. However, even where they are not, as is often the case in intermediate markets, such action 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.

3.58 Second, it must be clear that it will be costly to firms to deviate from the prevailing behaviour. In many cases, the mere fact of the interdependence and hence the strong likelihood of a matching price cut may well be enough to create 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 basis perception of interdependence may cease to hold at all.

3.59 Third, 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 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. This will largely be a factual matter, depending on the number and size of such fringe companies, their costs and profit margins. It will also depend critically on their scope to expand output a) in relation to their current levels and b) in relation to the output of the core oligopolists. To the extent that fringe firms can significantly expand their own output, there will be an incentive to undercut the existing price level. 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 is preferable 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 co-ordinated behaviour could also occur with non-price variables such as quality, variety and innovation.

3.60 The type of behaviour discussed in the above paragraphs is sometimes referred to as ‘tacit collusion’ or ‘conscious parallelism’. However, it does not require any type of collusion, in the usual sense of the word, between firms, or even any contact between them. Nor, as noted above, does any such parallelism of price necessarily have to be ‘conscious’ in the form of an explicit or documented analysis of interdependent price strategies. The outcome described can emerge purely from the independent recognition of the interdependence of conduct and the gains from anticipating the rational but independent responses of competitors¹³. It 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.

3.61 In its consideration of conduct the Commission will want to evaluate characteristics of the market that may facilitate co-ordination. These can include:

- A high level of concentration 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 others actions);
- The existence of institutions that may aid co-ordination, for example information sharing agreements, trade associations etc;
- The existence of switching costs;

¹³ Such outcomes are often described as ‘non-cooperative’ to distinguish them from ‘co-operative’ ones where companies do, formally or otherwise seek to reach.

- 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);
- 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);
- Limited 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 production¹⁴;
- 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 degree of buyer power;

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

3.62 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

¹⁴The term “competitive fringe” is often used by economists to describe a group of relatively small firms in the market.

then this will 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 volatility 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.

3.63 Tacit collusion may, if such collusion is by firms in a collectively dominant position, be prohibited by, and investigated under powers relevant to, Chapter II of the Competition Act or Article 82 of the Treaty of Rome. This is recognised by the OFT in its draft guidance on *Market investigation references*, but that guidance goes on to explain why, nevertheless, a market investigation reference might be the more appropriate way of investigating suspected tacit collusion. The Commission can therefore expect to receive references of oligopolistic markets where the possibility of tacit collusion is the OFT's main concern.¹⁵ Tacit collusion amounts to a restriction of competition between oligopolists that is likely to have detrimental effects on customers. Because oligopolistic behaviour does not always take this form, however, it is useful to say something in these guidelines on the Commission's approach to the identification of tacit collusion.

Other market-wide horizontal conduct

3.64 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 cited in the OFT draft guidance are manufacturers' recommended retail prices and fees charged by underwriters of new issues on the capital market.¹⁶ Others that can be thought of are the widespread adoption of tying practices in a number of markets ranging from

¹⁵OFT Guidance Market Investigation references paras [2.2-2.5].

computers and office equipment to the insurance and travel trades. There may be objective justifications for such practices, but any common policy among competitors is bound to raise questions whether competition is adversely affected.

3.65 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 assuming that no anti-competitive agreement or concerted practice is involved, such conduct could be investigated for possible adverse effects on competition.

3.66 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.

3.67 The Commission may assess the effects on competition of certain forms of discounts and rebates. In many cases, discounts and rebate are normal components of the competitive process. 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 collusion (either explicit or tacit) might be broken down. However, other forms of discounts such as fidelity discounts, which disadvantage other suppliers, may hinder competition. Nonetheless, such discounts are likely to be detrimental only when offered by a firm possessing market power.

¹⁶OFT Guidance, Market Investigation References, para [6.12-6.13].

Vertical agreements

3.68 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.

3.69 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 of 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.

Indicators of the extent of competition

3.70 The Commission will often not be able to arrive at a conclusion on whether there are adverse effects on competition or there have been detrimental effects on customers from the investigation of structural and conduct features of a market alone. 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.

Prices

3.71 One such indicator is the pattern of prices 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 volatility 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.

3.72 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.

Profitability

3.73 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. In contrast, persistently high profitability across a substantial part of a market is likely to be more indicative of limitations in the competitive process. In some cases the level of profitability may be the only way to distinguish whether a pattern of similar prices across a market reflects intense competition or significantly coordinated behaviour. The Commission, therefore, will normally seek to identify profit levels, usually in terms of rates of return in the market or markets concerned, as a further indicator of competitive conditions. The Commission will normally seek to identify returns on the depreciated replacement cost of assets, unless there are specific reasons why this is inappropriate.

3.74 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 costs with prices 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.

- 3.75 In assessing levels of profitability the Commission will have regard to firms' cost of capital, where identifiable, though it would not normally expect to apply this as a rigid benchmark. 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 and identify the competitive conditions in the other market.

International price comparisons

- 3.76 International price differences may be an important indicator in deciding to refer a case to the Competition Commission. The scope to use them as a definite indicator of a lack of competition is likely to be much more limited.

- 3.77 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 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.

3.78 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.

Other indicators

3.79 When relevant and feasible, the Commission may also consider evidence on 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, for example, 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.

3.80 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 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 matters the Commission takes into account when determining the appropriateness of remedies, including the effectiveness of different types of remedy, costs and proportionality. It then considers different types of remedy before closing with a description of 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 the following questions:

- “(a) whether action should be taken by it under section 133 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.”*

4.3 Detrimental effects on customers are defined in the Act, and limited to:

*“(a) higher prices, lower quality or less 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) less innovation in relation to such goods or services.”*

4.4 The first question asks whether the Commission itself should take remedial action. This would take the form of either using its order making powers or accepting undertakings from the parties (see paragraph 4.40 below). The second question asks whether the Commission should recommend that remedial action should be taken by others, such as Ministers, 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 specifically asks the Commission to address what the remedial action to be taken is designed to address.

4.5 In deciding these questions, the Act requires the Commission *“in particular to have regard to the need to achieve as comprehensive a solution as is reasonable and practicable to the SLC and any adverse effects resulting from it.”*

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. However the Commission may not take remedial action to address the detrimental effect on customers if it is the only detrimental effect on customers resulting from the adverse effect on competition and the adverse effect on competition is not being remedied, mitigated or prevented. 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 have this desirable property.

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 would 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 might conclude that no action was appropriate might be where the costs of any practicable remedy seemed disproportionate in the light of the size, or expected decline, 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 might recommend action by others; for example, that the OFT or other body with appropriate powers might keep the future conduct of the firm in the market under review.

4.8 The Act also enables the Commission to modify a decision about remedial action after taking into account any relevant customer benefits that arise from one or more features of the market. This consideration too might 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 commented on 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 have regard to such aspects as costs, proportionality and effectiveness of remedies. These are discussed in the next

sections.

The cost of remedies

4.10 Since the Commission must have regard to the reasonableness of any remedy, it will consider the costs of any action it might decide is appropriate. Costs will include 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 regular periodic information on prices and margins. However, the Commission must consider the wider picture: its function is to deal with those costs to society of a failure of a market to work effectively and these costs might usually be expected to outweigh the costs of remedies to firms in the relevant market.

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 unless the Commission is required to do so by the Secretary of State through a specified public interest consideration; see part 4 of General Advice and Information.

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 costs to the OFT in monitoring compliance with any remedies that the Commission may put in place.

Proportionality

4.13 The Commission will abide by the principle of proportionality in determining the appropriate remedy. For example, if the Commission were choosing between two remedies which it considered would be equally effective, it would choose the remedy that imposed the least costs or that was least restrictive.

Effectiveness of remedies

- 4.14 Before the several types of remedy are considered in more detail, a few general observations can be made about the effectiveness of remedies.
- 4.15 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.
- 4.16 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 notwithstanding the possibility of setting a compliance programme. Another is the willingness of the parties to implement and adhere to the remedy. The effectiveness of any remedy is reduced if elaborate, and possibly costly, monitoring and compliance programmes are required. One-off remedies that change the structure of the market (so-called structural remedies) are likely to be preferable to remedies that impinge upon the behaviour or conduct of firms (so-called behavioural remedies) as they directly address the competition concern and will require little, if any, monitoring or compliance.

4.17 A third general 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.

Types of remedy

4.18 Except for the statutory limits on the content of orders, there are no 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 reducing switching costs, for example, by requiring the licensing of know-how or intellectual property 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.

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 Ministers to change legislation or regulations that limit or control entry. Alternatively it could be aimed at preventing or limiting potentially anti-competitive behaviour, for example, a modification to a licence condition or inclusion of a new licence condition.

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. The response might set out the changes it proposes to make in the light of the report or options on which it proposes to consult. For the Commission, there will inevitably 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 making such a

recommendation.

Choice of remedy

4.22 In deciding what remedy, or remedies, are needed in any particular case, 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. Clearly, it will depend on the nature of the feature(s) concerned as to the type of effective action to increase competition that can be taken. 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 to 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 will continue to suffer from the consequences of the adverse effects on competition. This may well lead the Commission to consider further remedies to deal with that problem.

4.24 Remedies that increase the effectiveness of competition may include behavioural as well as structural remedies. Particularly where it is the conduct of firms that 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 keep in tune with developing market conditions. For example, cost or demand structures might be changed by technological developments with the consequence that the remedy might introduce its 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.

Relevant customer benefits

4.26 The Commission may in deciding the question of remedies¹:

“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 effect competition could have beneficial rather than detrimental effects on customers. The usual consequence of a failure of competition is that prices will be higher

¹ Clause 129(7)

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 customers in the form of:

*“(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
a. greater innovation in relation to such goods or services.”*

4.30 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.”*

4.31 In considering potential 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 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 distant time in the future.

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 paragraphs below, 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 directly 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 problem in markets where suppliers need their distributors to incur the costs necessary 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 unambiguously beneficial. It is where one of the firms concerned 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.

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 firms that are to be the subject of the measure or making an order. In general, the Commission's decision as to which form to use will be determined by issues of practicality. Orders are limited in their scope to the matters set out in Schedule 8 of the Act. However there is no such constraint placed upon undertakings that can therefore have the advantage of flexibility. The disadvantage of undertakings in the context of market investigations is the large number of persons to which any remedial action may need to be directed. This can complicate the process of negotiation of effective undertakings and their subsequent monitoring by the OFT, or sector regulator. The essence of market investigations is that they are 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 persons are involved. When the particular circumstances of the case point to the need for action to be taken speedily, the Commission may choose 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.

Procedural and other aspects of undertakings and orders

4.43 For more information about undertakings and orders see General Advice and Information Part 7.

Part 5: Public Interest Cases

5.1 If the Secretary of State believes that one or more public interest considerations is relevant to a case she may intervene by serving an intervention notice under clause 134(1) of the Act. This is likely to occur only as a matter of exception. National security is a public interest consideration.

5.2 In such cases, the first question the Commission will have to decide will be the same question as applies 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 part 3 above 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 the questions:

“(a) whether action should be taken by it under section 133 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 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 it is to be remedied, mitigated or prevented.”

5.4 In deciding the questions the Commission must, in particular, have 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. As is the case in market investigation references in which public interest considerations do not arise, 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. Similar considerations to those explained in Part 4 will be relevant to the Commission's consideration of these remedy questions. 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 is reverted to the Commission under clause 143 of the Act.¹⁷

5.5 If the Commission has decided that there is an adverse effect on competition, it must also decide the questions:

- “(a) whether action should be taken by the Secretary of State under section 142 for the purpose of remedying, mitigating or preventing any of the effects adverse to the public interest which have 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*

¹⁷See 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.”*

5.6 When answering the questions set out in paragraph 5.5, the Commission will have regard to clause 142 of the Act which applies if the Secretary of State has decided that one or more eligible public interest consideration is relevant. In particular, this gives the Secretary of State the discretion in relation to any adverse effect on competition identified in the Commission’s report to take such action as she considers to be:

- “(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 resulting 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.”*

5.7 Clause 142 also requires the Secretary of State to have regard to:

- “(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.”*

5.8 The same clause permits the Secretary of State to have regard to the effect of any action on any relevant customer benefits of the feature or features of the market concerned.

5.9 The Commission will take these matters into account when deciding the questions set out in paragraph 5.5 and, to the extent they are appropriate, the considerations referred to in Part 4 of this guidance.

5.10 Further information about public interest cases may be found in General Advice and Information, Part 3.