

## Summary

1. On 5 April 2005, the Office of Fair Trading (OFT) referred the supply of classified directory advertising services (CDAS) in the UK to the Competition Commission (CC) for investigation and report. CDAS are defined in our terms of reference as referring to advertising in printed classified directories. The CC is required by section 137 of the Enterprise Act 2002 (the Act) to prepare and publish its report within a period of two years, that is, by 4 April 2007. This is a summary of our provisional findings. We will reach a final decision after hearing further evidence and representations from the parties affected.
2. This is not the first time the CDAS market has been investigated. Following an inquiry by the Monopolies and Mergers Commission (MMC) in 1996, undertakings were given by British Telecom,<sup>1</sup> the then owner of *Yellow Pages*, the leading classified directory.<sup>2</sup> Those undertakings included a price control on advertising rate card prices. The present inquiry has, however, involved a completely fresh evaluation of the market for CDAS, independent of the work previously carried out.
3. Advertising in classified directories is generally intended to direct consumers, who have already decided that they need a certain product or service, to a specific supplier. This type of advertising is often referred to as directional advertising and includes media such as classified directories, classified advertisements in newspapers, online directories and certain forms of Internet advertising.

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<sup>1</sup> British Telecommunications plc

<sup>2</sup> In line with our terms of reference we use the term 'classified directories' to refer to printed classified directories.

4. The three largest directory publishers—Yell,<sup>3</sup> Thomson<sup>4</sup> and BT<sup>5</sup>—together account for 98 per cent of UK CDAS revenues.
5. Kingston<sup>6</sup> and Trinity Mirror<sup>7</sup> are important directory providers in Kingston-upon-Hull and parts of Scotland respectively. There are also a number of publishers of small local directories and their products vary widely in size and sophistication.

### **The Yell undertakings**

6. In June 2001, BT sold its classified directories business (including the Yellow Pages brand) to a consortium of investment funds called Castaim, which subsequently became Yell. In June 2001 Castaim gave undertakings to the Secretary of State; we refer to these as the ‘Yell undertakings’.
7. The Yell undertakings cover a number of areas. The most significant aspects relate to prices and directory areas described below.

### **Prices**

8. On the basis of a like-for-like comparison, starting from the base level of prices in effect as at 1 December 2001, Yell's rate card prices for advertisements in classified directories have been required to decline, relative to the retail price index (RPI), by at least 6 per cent each year. Yell may not charge higher prices than those shown on the rate card.

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<sup>3</sup> Yell Group plc

<sup>4</sup> Thomson Directories Ltd

<sup>5</sup> BT Group plc

<sup>6</sup> Kingston Communications (Hull) PLC

<sup>7</sup> Trinity Mirror plc

### **Directory areas**

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

### **Market definition**

10. We analysed the scope for substitution between CDAS and other services in order to define the relevant market for our analysis. We used the hypothetical monopolist framework in line with our guidelines.
11. We obtained data from a variety of sources. These included a quantitative survey we commissioned by BMRB, a qualitative study by Andrew Irving Associates (AIA) and evidence submitted by CDAS providers.
12. We paid special attention to the role of the Internet, which is increasingly being used to search for supplier information.
13. We found that:
  - (a) The directories provided by Yell, Thomson and BT have high usage and benefit from strong brand images. In addition, certain other directories, notably that of Kingston in Kingston upon Hull, and those of Trinity Mirror in parts of Scotland, also appear to have relatively high usage in their distribution areas and are comparable to the directories provided by Yell, Thomson and BT.
  - (b) Classified advertising in local newspapers has historically been the closest alternative to advertising in classified directories, but such advertising tends to fulfil different functions from directory advertising (for example, recruitment and sales of cars), is much more expensive on an annualized basis and there has been limited past switching between classified directories and newspapers.

- (c) Smaller local directories have much more limited usage, and only a small proportion of advertisers in the major directories also advertise in these directories. These directories appear unlikely to be effective substitutes to those provided by Yell, Thomson and BT.
- (d) Although usage of the Internet for directory-equivalent searches has increased over the past five years, this has not resulted in a decrease in CDAS revenues, which have been increasing in the past five years.
- (e) Up to now, there have been limited levels of switching between classified directories and the Internet. Yell, Thomson and BT have continued to grow revenues in many of the classifications where the Internet appears to be a very suitable advertising medium (for example, financial services and insurance). This suggests that the Internet, to date, has been used more as a complement than as a substitute to directory advertising.
- (f) The evidence received does not suggest that Yell's pricing policies have responded to the growth in Internet use.
- (g) We expect that advertising on the Internet will increase in the future, and CDAS advertising may decrease. It appears that these future trends will be driven primarily by the greater functionality of the Internet, rather than relative prices. We do not expect that directory providers would be able to retain many of the advertisers which were likely to adopt Internet advertising by lowering their prices, and therefore this switching would not act as a constraint on CDAS prices.

14. We concluded that there was a relevant product market for the provision of advertising services in major printed classified directories, with a set of characteristics that includes strong brand image, high levels of usage and comprehensive business listings. Other media (such as online directories and Internet advertising) are not part of this relevant market. The relevant product market

includes the directories provided by Yell, Thomson and BT nationally, and the local directories provided by Trinity Mirror and Kingston.

15. We considered that the relevant product market, from the perspective of small classified directories, is likely to be the provision of advertising services in printed classified directories (both large and small) and we considered the competitive issues in that context.
16. However, the directories of Yell, Thomson, BT, Kingston and Trinity Mirror account for almost all sales of CDAS in the UK (around 99 per cent); and we therefore focused our analysis mainly on these major classified directory providers.
17. While a number of factors point to the existence of local markets from the demand side, we analysed competition between the major classified directory providers mainly on a national basis because the three largest providers meet in almost every local market and because the competitive conditions are likely to be very similar in the different geographical markets.

### **Competition in the market**

18. Classified directory providers operate in a 'two-sided market', in which success depends on their ability to attract both users and advertisers to their directories. This interdependence of advertiser and user demand for directories gives rise to a network effect or 'virtuous circle'; a directory provider that has built up high levels of usage and advertising is more attractive to new advertisers and users than a competitor with less usage and less advertising whose offer, in terms of price, quality and service, may otherwise be the same.

### ***Market concentration***

19. We estimate that Yell currently has around 75 per cent of the UK advertising revenues for major CDAS and that Yell, Thomson and BT have, between them, around 99 per cent.

### ***Pricing***

20. We examined the pricing and revenues of the major classified directory providers giving detailed attention to the pricing of Yell, Thomson and BT.
21. Yell's rate card prices have fallen as required by the Yell undertakings. In addition, Yell has offered discounts, particularly to encourage new advertisers and to encourage existing advertisers to increase expenditure.
22. Thomson, BT, Kingston and Trinity Mirror also all offer discounts to encourage new advertisers and to encourage advertisers to increase expenditure. These schemes have several features in common with those offered by Yell.
23. Our pricing studies showed that the average realised price for Yell and Thomson advertisements fell year-on-year between 1999 and 2005, that Thomson's prices have fallen more than Yell's, and that, due to increased use of discounts, Yell's prices have fallen more than required by the price control.
24. There has been a tendency to purchase more expensive types of advertisement in Yell, Thomson and BT's directories, including more colour advertisements, so the average expenditure per advertiser has been broadly stable.
25. The Yell undertakings do not regulate the pricing of new products in the year of their introduction. This allowed Yell to introduce colour advertisements at prices that were

not constrained by the Yell undertakings. Yell's colour premium appears to be high compared to the incremental costs incurred.

### **Price competition**

26. Since 92 per cent of the advertisers in our survey used *Yellow Pages* and Yell has around 75 per cent of the revenues in this market, the determinants of Yell's pricing have been a key question for this investigation.
27. Yell told us that competition in the market was intense and that there was no scope for price increases since prices were constrained by competitive forces.
28. We considered whether Yell's rate card prices and realized prices are constrained by Thomson and BT. We analysed how Yell's rate card prices had moved, and the effects of Yell's discount schemes, for the year ended 31 March 2005.
29. Our analysis showed that the rate card price for 57 per cent of the advertisements sold in the year ended 31 March 2005 fell by no more than RPI-6%, the minimum rate required by the Yell undertakings. This 57 per cent includes advertisements that were sold at 'composite rates' (25 per cent of all Yell's advertisements were sold at composite rates without discounts); the composite rate is a mechanism available when Yell 'rescopes' (divides a directory area into two or more areas) that avoids disadvantaging advertisers who wish to have the same geographic coverage that was available before the directory was rescoped. In our view, composite rates are effectively required by a good faith provision within the Yell undertakings which provides that on the basis of a like for like comparison, prices paid for advertisements in classified directories published by Yell must decline by at least RPI-6% each year. Yell disagrees with this interpretation of the Yell undertakings.

30. We consider that the Yell undertakings, rather than competition, effectively provided the binding constraint on Yell's prices for these advertisements. We consider that, even if Yell's interpretation of the undertakings was correct, these rates, which are designed to avoid disadvantaging advertisers, were not determined by competition.
31. A further 9 per cent of all Yell's advertisements were sold at rate card prices in rescoped directories where the new rate had been set below the maximum level permitted by the Yell undertakings (calculated in accordance with the rescoping formula). We do not think that, in general, the fact that prices were below the maximum permitted level was due to competition.
32. The remaining 35 per cent<sup>8</sup> all Yell's advertisements had been sold with discounts, bringing those prices below the rate card prices. We analysed the extent to which conditions of demand or competition provided the binding constraint on prices. While we consider that, particularly for some types of new advertisers, competition may influence the level and extent of discounts, Yell's discounts schemes appear to be those that a firm with market power would use; Yell's changes to its discount schemes indicate that competition has not been a significant factor in the setting of many of Yell's discounts.
33. We also found that Yell's colour prices are not significantly constrained by its competitors' prices: Yell was able to charge introductory prices that were higher than those of its competitors and it has been able to maintain high colour premiums in both absolute and percentage terms, over a period in which its competitors' colour premiums have fallen.

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<sup>8</sup> The percentages (57, 9 and 35 per cent) referred to in paragraphs 29 to 32 cover all of Yell's classified advertisements; the figures are rounded and for this reason appear to add up to over 100 per cent.

34. With regard to BT and Thomson, we found that both of these providers set their prices with reference to Yell's and are constrained by Yell's prices and each other's.

### ***Non-price competition***

35. There are a number of aspects of non-price competition within this market. Of these, the scoping (footprint) of directories and competition for users are the most significant, since they potentially alter the number, and targeting, of business leads generated by classified advertisements.

### **Barriers to entry and expansion**

36. Yell's CDAS business is the successor to British Telecom's 'Yellow Pages' business, the original major CDAS provider. As such, it benefits from a first-mover advantage which has helped it develop a high market share, strong finances and a long-established brand and reputation. It appears to have been very hard for other providers to erode this advantage.
37. The threat of entry or expansion can act as a constraint, preventing firms from exercising market power. Adverse effects on competition are thus less likely where entry is easy, provided that such entry is sustainable and likely to have an impact on the ability of existing firms to exercise market power.
38. We found the following barriers to the establishment of a major CDAS business:
- (a) overcoming the network effect to establish enough usage to offer a convincing product for advertisers; and
  - (b) the need to establish a strong brand identity.

39. These barriers to entry and expansion appear to be substantial, and apply both to first-time entry and to local classified directories aspiring to expand to a national scope.
40. Although BT and Trinity Mirror have entered the market, we find their entry consistent with our analysis of barriers to entry and expansion. BT enjoys considerable advantages compared with other potential entrants; while other companies may have some advantages, we have not identified any other potential entrant with comparable relevant strengths. Trinity Mirror entered the market exploiting particular local strengths in Scotland; however we consider it unlikely that Trinity Mirror will substantially expand its directory business further in other parts of the UK.

### **Buyer power**

41. We considered whether CDAS advertisers possess sufficient buyer power to enable them to constrain the prices of CDAS providers through bargaining. However, we do not consider that there is any significant buyer power in this market.

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

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

## **'Second tiering'**

43. The introduction of a second directory publication in a given geographic area is sometimes described as 'second tiering'. Yell is currently prevented from second tiering and we considered what the effect on competition would be if Yell were allowed to publish additional smaller directories. We consider that the publication of additional smaller directories by Yell has the potential to harm Yell's competitors by inducing advertisers to switch away from competitors' directories. However, we do not believe that damage to individual competitors would necessarily lead to less effective competition or hinder the development of competition. On balance we do not consider that the evidence submitted to date enables us to form an expectation at this stage in our inquiry that second tiering would prevent, restrict or distort competition or give rise to a detrimental effect on customers.

## **Assessment of competition**

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

## **Future developments**

45. Although the market has been, and remains, highly concentrated, it is clear that BT is becoming a more significant operator in this market. It appears likely that BT will become a stronger competitor, but the pace of its future growth is unclear and the extent to which it will become a significant constraint on Yell's prices is uncertain.
46. Competitive conditions could change substantially in the next few years, although we have no firm evidence on which to form a view as to the timing and speed of possible

changes. The effect of possible market developments will be more relevant to our consideration of remedies than to our assessment as to whether there is currently an adverse effect on competition.

## **Profitability**

47. We looked at Yell and Thomson's profitability as an indicator of the extent of competition in the CDAS market. Effective competition should put pressure on the profit levels of these companies so that they move towards their cost of capital in the medium to long run.
  
48. In comparing profits to the weighted average cost of capital (WACC) we applied two profitability measures; return on capital employed (ROCE) and internal rate of return (IRR). In order to capture intangible assets not recorded in their normal financial reporting, we estimated their capital employed using various methods including multiples based on turnover, cost and earnings before interest, tax, depreciation and amortization (EBITDA), calculated from transactions involving CDAS companies. We complemented these measures with an assessment of return on sales (ROS) measure, undertaking comparisons with various other companies.
  
49. Yell's truncated IRR results for the five years were greater than our estimate of the WACC when the turnover and cost multiples were used.
  
50. Yell's ROCE for the five years to 31 March 2005 produced ranges that overlapped largely with our range of estimates for the WACC. However, about half of the ROCE estimates, based on lower turnover and cost multiples, exceeded our WACC range. The ROCE declined steadily each year over the period and was lowest for the most recent year.

51. The results of our ROS comparisons place Yell above the eighth decile of the comparative group and for almost all comparator categories it was in the top decile.
52. Yell argued that its high profits could be explained by its greater efficiency and superior levels of innovation. We acknowledge that some of Yell's profits may have been the result of this. However, we considered that the incremental profit from colour was not an innovation that would enable Yell to continue to earn substantial profits in a competitive market. Rather, we see the level at which Yell was able to introduce and maintain the colour premium as an indication of market power.
53. The fact that Yell is subject to a price control means that our profitability assessment may in fact underestimate the true extent of Yell's market power in the absence of the undertakings. In light of these undertakings, lack of evidence of excessive profits is nevertheless consistent with the existence of market power.

### **Provisional findings**

54. Our competitive analysis led us to the provisional conclusion that Yell has market power. We would normally expect a detrimental effect on customers to arise in the presence of market power. In this market, we would expect Yell's market power to enable it to set prices profitably at levels that are higher than they would be in a well-functioning market.
55. We have identified the following features which prevent, restrict or distort competition in the market:
  - (a) the market for major CDAS is highly concentrated: Yell has a market share of around 75 per cent and between them Yell, Thomson and BT have a market share of around 99 per cent;

- (b) the market has been highly concentrated for a number of years: Yell had a market share of over 80 per cent until BT's re-entry in 2002 and between them Yell and Thomson had a market share of around 99 per cent until BT's re-entry. Since it re-entered the market, BT has grown its share rapidly but it is still very significantly smaller than Yell's;
- (c) entry barriers are high and include the network effect referred to above and the need to establish a strong brand identity;
- (d) the incumbency position of the largest player is reinforced by the network effects present in this market. Other providers wishing to expand have to build usage in order to attract advertisers. This requires investment, particularly in usage advertising, and acts as a barrier to expansion;
- (e) Yell has market power and is the price setter in the market; and
- (f) in general, Yell's prices are not constrained by those of its competitors; Yell does not compete on price in any significant way.

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

57. Accordingly, we provisionally find that there are features of the relevant market, either alone or in combination with each other, that prevent, restrict or distort competition in connection with the supply of CDAS and hence that there is an adverse effect on competition.

## **Remedies**

58. We will be issuing separately a notice of possible remedies. In considering appropriate remedies, we will have regard to expected changes in the market over the medium term.