

Classified directory advertising services

The OFT's reasons for making a reference to the Competition Commission

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OFT 787

- 1 The Office of Fair Trading (OFT) has made a reference to the Competition Commission (CC) under section 131 of the Enterprise Act 2002 (the Enterprise Act) for an investigation into the supply of classified directory advertising services in the United Kingdom (UK). For the purposes of this reference, 'classified directory advertising services' means the undertaking and performance of engagements to publish advertisements in printed directories which: (i) show suppliers of goods and services classified by reference to the goods or services supplied; and (ii) are distributed wholly or mainly to consumers.
- 2 Under section 131 of the Enterprise Act, the OFT may make a market investigation reference to the CC where it has reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services 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.
- 3 The OFT believes that the test for a reference set out in section 131 of the Enterprise Act is satisfied. In addition, the OFT has considered the criteria set out in the OFT's guidance about making market investigation references and concluded that they are satisfied.¹ This paper sets out the reasons for the reference and is published in accordance with section 172(5) of the Enterprise Act.
- 4 Prior to the making of the reference the OFT consulted on its proposals as required by section 169 of the Enterprise Act. The consultation process did not yield any substantive evidence to change the OFT's view that there are

¹ OFT (2002), Market Investigation References: guidance about the making of references under Part 4 of the Enterprise Act, paragraph 2.1.

reasonable grounds for suspecting that there are features present in the supply of classified directory advertising services which prevent, restrict or distort competition. However, a number of issues arose as a result of the consultation process and they are considered in this document.

Background to the reference, investigation and consultation

- 5 In March 1996, the Monopolies and Mergers Commission (MMC, now the CC) reported on classified directory advertising services.² It found that a monopoly situation existed in favour of British Telecommunications plc (BT) in the supply of classified directory advertising services in the UK.
- 6 Following this report, in July 1996 undertakings were given under section 88 of the Fair Trading Act 1973 (FTA) by BT in regard to its classified directory advertising business, Yellow Pages. The key undertakings included a price cap on advertising rates (RPI-2%) and a restriction on the publication of local directories.
- 7 The BT undertakings were reviewed by the OFT in May 2001, as a result of which the price cap was strengthened by the Secretary of State to RPI-6%. The Secretary of State's press statement accepting the revised undertakings said that any further price cap, if still necessary, should be in place by 1 January 2006.
- 8 In June 2001, BT sold the classified directory advertising business (i.e. Yellow Pages) to a consortium of investment funds called Castaim Ltd which subsequently became Yell Ltd (Yell). As a criterion of the sale, BT procured from Castaim Ltd the same undertakings, to be given to the Secretary of State, as those BT had given.
- 9 The OFT is of the view that the existing undertakings given following the transfer of ownership of the Yellow Pages business to Castaim Ltd are non-statutory. Therefore, the OFT considers that statutory provisions relating to variation and enforcement do not apply to these undertakings.
- 10 While the undertakings given in 2001 were appropriate for the market conditions at that time (the OFT had recently completed a review of the previous undertakings and BT agreed to strengthen them) and Yell has continued to comply with them throughout, it is not clear that they remain appropriate.
- 11 The concerns set out in this document combined with this fact make a reference to the CC the most appropriate course of action.

² MMC (1996), Classified Directory Advertising Services, Cm 3171.

Features of the market that prevent, restrict or distort competition

- 12 The OFT has reasonable grounds for suspecting that there are features of the supply of printed classified directory advertising services which prevent, restrict or distort competition.
- 13 The following sections outline these features. A feature of the market may include any conduct of suppliers or customers, or the market's structure, or an aspect of its structure, including such matters as government regulations and any information asymmetries.³

The structure of supply and barriers to entry

- 14 The OFT is of the view that the supply of printed classified directory advertising services in the UK is the relevant market. A summary of the OFT's analysis on this is given in Annexe A.
- 15 On the basis that suppliers do not compete with suppliers of advertising in other media, the supply of classified directory advertising services is highly concentrated. The OFT estimates that the two largest suppliers, Yell and Thomson Directories Limited (Thomson), account for over 90 per cent of supply in the UK. Yell comprises the very large majority of this. Yell's and Thomson's shares are much the same as those reported by the MMC in 1996.⁴ This high concentration has been persistent and stable over the last decade. The little change in the two largest suppliers' shares of supply indicates that there has been little change in the competitive environment for the supply of these services.
- 16 The OFT believes that the stability in the structure of supply is aided to a substantial degree by significant barriers to entry. These come mainly in the form of branding and network effects.
- 17 Yellow Pages in particular, as well as Thomson Local, have strong brand names and large customer lists.
- 18 Yellow Pages is by far the most widely used printed classified directory in the UK. Many businesses advertise in Yellow Pages as they value the large number of consumers it attracts. Many consumers use the directory expecting to find what they want because of the many businesses which advertise in it. Therefore, the directory is the one in which many businesses consider they must advertise. This harmonious relationship enables Yellow Pages to benefit from

³ OFT (2002), paragraph 5.1.

⁴ MMC (1996), paragraph 2.7.

network effects (i.e. the value of advertising in Yellow Pages increases as more businesses advertise in Yellow Pages). This is a difficult barrier to overcome, especially in the supply of a suite of comprehensive directories distributed on a national scale.

19 However, entry to the market has occurred to some degree. It was put to the OFT during the consultation process that two new entrants had strengthened competition.

- In 2003, BT started once more to supply printed classified directory advertising services on a national basis as a part of its Phone Book which it publishes and distributes annually. Based on information provided to the OFT, BT is estimated to have a market share of less than five per cent.
- Trinity Mirror, a newspaper publisher, has also started to supply these services in 2004 on a small scale with two printed directories distributed in Scotland called The One Directory.

20 The OFT cannot be certain whether these recent entrants will strengthen competition in the years to come. However, the OFT does not consider that they currently provide effective competition to the leading suppliers for the following reasons:

- combined, the OFT estimates that they represent less than five per cent of supply
- from the information provided to the OFT, profits of the leading suppliers seemed not to have been significantly affected, and
- Trinity Mirror only has two directories, both in Scotland. Thomson has told the OFT that Scotland represents a very small proportion of its revenues.

21 Because of these reasons and the possibility that it may be a considerable amount of time before one or both of these entrants strengthens competition effectively (if they do), the OFT does not consider it appropriate to delay making a market investigation reference in order to assess what effect these entrants will have on the market. Furthermore, it is timely that the market is examined afresh given that it is not clear that the current undertakings are appropriate to today's market conditions.

Pricing and profitability

- 22 The pricing policies and profitability of the leading suppliers provide further evidence that the structural features of this market may restrict, distort or prevent competition.
- 23 The OFT has not been presented with any persuasive evidence that overall advertising prices in printed classified directories are constrained to any material degree other than by the price cap, despite the cap only applying to Yellow Pages. Competition between suppliers seems weak and concentrated on marginal customers.
- 24 Evidence presented to the OFT shows that suppliers do offer sizeable discounts targeted at persuading businesses not currently advertising in classified directories to do so. But once these become established customers it seems that these discounts cease. Discounts (for a limited period) may also be available to existing customers provided they increase their advertising spend.
- 25 Yell has told the OFT that each year it offers discounts from its rate card to a considerable proportion of its customers (around 50–60 per cent). However, many of these are customers who received a discount on re-scoped directories so that customers advertising in all the directories of a split directory area pay no more than they would have paid under the price cap formula if the area was not split.⁵ The OFT considers such discounts to be in effect a requirement of the undertakings and therefore not attributable to the effects of competition.
- 26 When these customers are omitted from the analysis a smaller proportion of Yell's customers and a much smaller proportion of revenue are affected.
- 27 The discounting by the two leading players is indicative of a degree of competition. However, it seems that the discounts are short term and do not represent a sustained fall in prices as a result of stronger competition overall. Despite submissions to the contrary, there is insufficient evidence to establish with any certainty that their discounting policies extend to lowering prices for existing customers below the level set by the undertakings (other than in the limited circumstances referred to above). In these circumstances, the OFT has concluded that competition is weak and unlikely to be sufficient to maintain pressure on prices in the absence of regulation.
- 28 The lack of any demonstrable material effect on the prices of the two leading suppliers for existing customers beyond that achieved by the current

⁵ A re-scoped directory area occurs when an area served by one directory is divided so that subsequently it has two or more directories servicing it.

undertakings indicates that the entry and potential expansion of BT and Trinity Mirror has not increased competition to any material degree.

- 29 It was put to the OFT during the consultation that yield per page for one supplier has been falling at a faster rate than RPI-6 per cent a year from 2001 to 2004, and that this is a better measure of the degree of competition in the supply of classified directory advertising services.
- 30 Although yields per page may fall under greater competitive pressure, such a decline may also result from other reasons not associated with the effects of competition such as changing the mix of advertisement types. Evidence submitted to the OFT tends to show that the size of advertisements has increased since 2001 and the revenues that are generated from a page of such advertisements are less than would be earned from a page of smaller adverts. For this reason the OFT considers that the evidence of falling yield per page is not sufficiently strong to dispel the suspicions raised by the pricing and profitability evidence.
- 31 Information provided to the OFT on profitability in the supply of printed classified directory advertising services indicates that profits by the two leading suppliers, especially Yell, are high and significantly more than profits earned by other firms selected as comparators. Rates of profitability have remained reasonably stable over recent years.
- 32 Yell's profitability in 2004 is actually greater than the level forecast for 2004 at the time of the imposition of the present price cap regime (2001). These estimates were made prior to the re-entry of BT into the market and the impact of this was not factored into the estimates at the time. This casts significant doubt on claims that competition in the market is increasing and that it is having an effect over and above the undertakings in pushing down prices and profitability.
- 33 The following table sets out profit rates earned by Yell and Thomson. Rates of profit were calculated using a return on sales (ROS) measure, which the OFT considers is the most appropriate measure.⁶ Yell's figures are for the printed

⁶ ROS was used to measure profitability in the OFT's 2001 review of the undertakings and in the 1996 MMC report (which also used the return on capital employed measure (ROCE)). ROS was calculated using operating profits before goodwill to avoid uncertainty inherent in valuing the Yellow Pages brand, to provide a base to compare changes in the profitability of Yell from previous OFT and CC reports and to ensure comparability between Yell and Thomson, and the comparator firms. The OFT considers it inappropriate to use a ROCE measure which incorporates the substantial goodwill on Yell's balance sheet as a portion of this may represent the discounted net present value of expected high profits.

directory business only. Thomson's figures include all lines of business. However, confidential information supplied by Thomson shows ROS for the printed directory business alone do not change our conclusions on profitability.⁷

RETURN ON SALES: YELL AND THOMSON (%)

	Yell ¹	Thomson ²
2000	42.7	16.8
2001	38.7	26.3
2002	38.3	28.8
2003	37.0	26.9

1 Yell's financial year ends on 31 March following the stated year.

2 Thomson's financial year ends on 31 December.

Sources: Information provided by Yell (as required by the undertakings) and Thomson accounts lodged with Companies House.

- 34 The OFT has compared the ROS earned by Yell and Thomson with that of other companies. Comparator firms were chosen either because they were involved in the similar activity of newspaper publishing and advertising, or because they had a similar ratio of tangible assets to turnover to Yell.
- 35 This methodology was similar to that used previously in the 2001 OFT review of undertakings and also in the 1996 MMC report.⁸ The major difference is that the comparator sample used this time includes firms in the newspaper publishing and advertising industry where previously the comparator sample included firms in printing and publishing and communications industry.
- 36 The ROS of the companies in the newspaper publishing and advertising group averaged two to six per cent over 2001 to 2003. During the consultation it was put to the OFT that it was inappropriate to include advertising agencies in the list of comparators because they do not receive their revenues from advertising. With these firms removed from the comparators, the ROS average increased to three to 10 per cent over the three years.
- 37 For the companies in the group which had a similar tangible assets to turnover ratio to Yell, the ROS average was two to five per cent over the same period.
- 38 The ROS for each of the two leading suppliers of printed classified directory advertising services is significantly above these averages, even when adjustments are made for advertising agencies. Moreover, these rates of profits are also higher than those found for some of the most profitable firms among both comparator groups.

⁷ Furthermore, Thomson provided to the OFT its printed directories business management accounts for 2004. The OFT took account of this confidential information in reaching its conclusions on profitability.

⁸ MMC (1996), paragraph 5.33.

39 During the consultation it was put to the OFT that an appropriate benchmark should be ROS earned by other European directory publishers. The OFT does not regard such international comparisons as a more appropriate measure than the comparators it has used. The OFT understands that the supply of printed classified directory advertising services in other countries generally have similar characteristics to those observed in the UK, including the dominant position of one supplier. Competition therefore may not be working well in those markets so that a comparison with the ROS achieved by overseas directory publishers could have misleading results.

Scope of the reference

- 40 During the consultation process some concerns were raised about the scope provided by the draft terms of reference for the CC to investigate issues such as BT's responsibility for the A–Z listings in its Phone Book and its use of the Phone Book in relation to its classified advertising, its administration of the OSIS database, and its leading position in the telecommunications market.⁹
- 41 It was argued that a narrowly defined reference would limit the investigative and remedy making powers of the CC and therefore prevent these issues from being addressed.
- 42 The OFT has undertaken a study of the market for classified directory advertising services and identified competition concerns in that market. It did not consider a wider study to be necessary.
- 43 The power under section 131 of the Enterprise Act to make a market investigation reference does not require the OFT to identify all the features of the relevant market that may prevent, restrict or distort competition and the CC is not confined in its investigation to those features that the OFT has identified.
- 44 The definition of a feature of a market for the purposes of Part 4 of the Enterprise Act is broad. For example, it includes any conduct of a supplier or buyer of goods or services in the market concerned, including conduct in another market, which prevents, restricts or distorts competition.
- 45 In view of these considerations the OFT considers that the CC would be free to investigate the interaction of classified and non-classified directories and it could take action to regulate that relationship if it considered it necessary.

⁹ OSIS (Operator Service Information System) is a database of BT subscriber telephone numbers.

Conclusion

- 46 The OFT considers it has reasonable grounds for suspecting that there are features present in the supply of printed classified directory advertising services which prevent, restrict or distort competition.
- 47 Its concerns are predominantly about the structure of supply, which is highly concentrated. Barriers to entry are significant. The two leading suppliers account for the large majority of advertising revenue and their shares have not changed significantly over the past decade.
- 48 The pricing policies and profitability of the leading suppliers, especially the largest supplier Yell, provide evidence of limited competition in the sector which the OFT suspects results from these structural features.
- 49 Prices do not generally seem to be subject to competition below the level set by the undertakings. Discounts offered are aimed at capturing new business. Given that longer term customers are not generally offered these lower prices, it is difficult to conclude that the discounts have been driven by more effective competition overall.
- 50 Profit levels on printed directories of both Yell and Thomson also seem to be well above the levels of comparator companies.
- 51 Overall, the consultation process did not yield any substantive evidence to change our view that there are reasonable grounds for suspecting that there are features present in the supply of classified directory advertising services which prevent, restrict or distort competition.

Appropriateness, proportionality and remedies

52 OFT guidance says that it will exercise its discretion to make references to the CC when the reference test set out in section 131 of the Enterprise Act and, in its view, each of the following criteria, has been met:

- it would not be more appropriate to deal with the competition issues identified by applying the Competition Act 1998 (CA98) or using other powers available to the OFT
- it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference
- the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it, and
- there is a reasonable chance that appropriate remedies will be available.¹⁰

53 The following sections discuss these criteria.

Appropriateness of a reference

54 OFT guidance says that, as a general rule, single-firm conduct will, where necessary and possible, be dealt with under CA98 and that 'it is not the present intention of the OFT to make market references based on the conduct of a single firm, whether dominant or not, where there are no other features of a market that adversely affect competition'.¹¹

55 The OFT suspects that there are structural features in this sector which lead to a lack of effective competition in the market as a whole and not the conduct of a single firm. Accordingly, this is not a case where action under CA98 would be more appropriate.

56 As already noted, the OFT considers that undertakings given by Yell following the sale of the business by BT are non-statutory and not enforceable as such.

57 The OFT considers that the current approach to regulation should be reassessed. There is no doubt that the existing undertakings have reduced advertising prices in printed directories. The OFT has been told that this applies to customers of Yellow Pages and other printed directories. However, although undertakings

¹⁰ OFT (2002), paragraph 2.1.

¹¹ OFT (2002), paragraph 2.7.

have been in place since 1996, there has been no material change to the structure of supply within that period. Furthermore, although the price cap was tightened significantly in 2001, this does not appear to have had a material impact on the profitability of Yell in particular, and Thomson.

Undertakings in lieu of a reference

58 Section 154 of the Enterprise Act allows the OFT to accept undertakings instead of making a market investigation reference to the CC. None of the three suppliers contacted during the consultation offered undertakings in lieu of a reference.

Proportionality

59 OFT guidelines state that it will not make a market investigation reference to the CC if it suspects that the effect on competition and the detriment to customers are not significant enough to justify the burden on business and public expenditure involved in a CC market investigation.

60 The OFT estimates that the supply of printed classified directory advertising services in the UK was worth over £700 million in 2004.

61 Furthermore, the features which the OFT suspects prevent, restrict or distort competition are persistent features in the industry. Accordingly, the OFT considers that a market investigation is justified.

62 The OFT acknowledges that a reference will place a burden on business. However, none of Yell, BT or Thomson is a small company. The smallest of the three, Thomson, has an annual turnover of £90–110 million. Accordingly, the OFT does not consider that the burden is disproportionate generally nor in relation to any of the main players individually.

Remedies

63 When making a reference the OFT must consider whether there is a reasonable chance that remedies to address any adverse effects will be available to the CC.

64 To achieve this, the CC has powers to accept requisite undertakings from appropriate persons. The content is not limited to the provisions contained in Schedule 8 of the Enterprise Act. Additionally, section 161 of the Enterprise Act gives the CC the power to make an Order to remedy any adverse effects that it finds. Such an Order may contain anything permitted under Schedule 8 of the Enterprise Act. The OFT considers that remedies that have been suggested as potentially appropriate fall within the CC's powers.

65 Likewise, and as noted above, the OFT considers that the CC would be free to investigate the interaction of classified and non-classified directories and it could take action necessary to regulate that relationship if it considers it necessary.

ANNEXE A

The OFT's view of possible market definition

A.1 Since the MMC reported in 1996 there have been a number of developments surrounding the supply of printed classified advertising services. Some or all of these may have impacted on the nature and strength of competition. They include:

- technological changes, including the growth of the internet
- the deregulation of telephone directories
- the sale of Yellow Pages by BT
- the re-entry of BT, and
- the increasing demand for local and micro directories.

A.2 The OFT has been told that as a result of these developments, advertising in media other than printed directories (i.e. online directories, telephone enquiry services, newspapers and on the internet via search engines) do provide effective competition to the supply of printed classified directory advertising services.

A.3 But there is some disagreement among suppliers about this. For example, the OFT has also been told that the characteristics of a printed directory – having a single source of comprehensive listings showing all types and listings of businesses (whether they have a website or not), classified by good and service type – still make it difficult for advertising in other media, including internet search engines, to be effective substitutes.

A.4 Evidence provided to the OFT indicates that customer switching from printed directories to other media is not particularly significant and the OFT considers that switching is unlikely to be prevalent enough to have an effect on overall pricing. Customer retention rates seem high for both Yell and Thomson.

A.5 The majority of those customers who do not renew appear to be: new customers who will try out a printed directory for one or two years before deciding whether to continue with it; customers who have switched to another printed classified directory supplier; and those who have experienced business failure. The OFT has been told that less than a third of those who do not

renew, representing less than ten per cent of all customers, do so because other media better meet their advertising needs.

- A.6 Further, pricing information provided to us by the leading suppliers indicates that prices for printed directories, online directories and telephone directory enquiry services are set independently of each other, suggesting that these services are not in the same product market.
- A.7 In any case, whether online directories and telephone directory enquiry services are included in the relevant market does not much change the overall structure of the market and the position of the leading suppliers in it.
- A.8 The OFT has not been made aware of any developments in advertising in local newspapers since 1996 which would make us reconsider the MMC's market definition (which did not include advertising in newspapers).
- A.9 Despite printed directory advertising being done on a regional and local basis, the MMC considered the market on a national basis. At the time, BT Yellow Pages and Thomson were national brands offering national coverage and competed for national customers and advertised nationally. This seems to remain the case today. The OFT's view is that the relevant market is a national one.
- A.10 Printed classified directories still form the large majority of revenues for the main printed directory suppliers.
- A.11 The evidence provided to the OFT does not demonstrate that developments in online directories, internet advertising and in telephone directory enquiries have progressed to the point where they are able to constrain prices charged for advertising in printed directories. Therefore, the OFT's view is that the market definition has not changed since the MMC's 1996 definition. However, it will be for the CC to undertake further analysis and define the relevant market.