DTI ECONOMICS PAPER NO. 9

The Benefits from Competition: some illustrative UK cases

BY PROFESSOR STEPHEN DAVIES, HEATHER COLES, MATTHEW OLCZAK, CHRISTOPHER PIKE AND CHRISTOPHER WILSON

CENTRE FOR COMPETITION POLICY, UNIVERSITY OF EAST ANGLIA

JULY 2004

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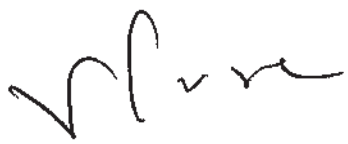
Foreword

This study provides a powerful demonstration of the real world impact of increased competition. By presenting six market case studies drawn from a variety of sectors it gives evidence of the type and magnitude of the benefits following market interventions to develop competition and free up the operation of these sectors.

In discussing the types and form such interventions take, whether competition policy, deregulation or liberalisation, this report explores market conditions before and after intervention, paying careful attention to both the envisaged benefits and the potential for negative side effects. Overall, the evidence suggests these benefits materialised, and in a number of instances proved more sizeable than anticipated. Concerns about harmful side effects have proved unfounded, with market stimuli impacting not only on the price and range of goods available but also acting as a motivating force to product and process innovation.

As Professor Davies points out, although active competition policy proves an important component in the competitive process, it is not sufficient in its own right. In order to deliver greater productivity, of which competition is a key driver, the UK needs a pool of resourceful entrepreneurs able to exploit changing market conditions. In order to give these people the best chance of success the framework conditions need to be correct with strength in the complementary capabilities of innovation, investment, skills and enterprise.

Ensuring the competition framework is world class is central to the DTI's strategy. The most recent peer review of the UK competition regime demonstrates that the UK is a strong performer, ranked third in the 2004 study, with the US first and Germany second. This study provides further evidence of the important role played by that framework in delivering tangible benefits to consumers.



Vicky Pryce
Chief Economic Adviser and Director General, Economics. DTI

Executive Summary

Purpose

The purpose of this report is to assemble a small number of case studies which illustrate, in a non-technical way, the benefits of introducing competition into UK markets in which, previously, it had been absent or muted. We are asked to present sufficient evidence to assess the types and magnitudes of benefits (e.g. price reductions, innovation and choice) which had accrued from increased competition, but also to acknowledge any harmful side effects.

This summary first briefly describes the six cases, and then lists our main findings, before drawing some research lessons.

The Six Case Studies

As explained in the introductory chapter, this particular sample was never designed to be random. Rather, it is a series of cases each of which might be thought of, at least *ex-ante*, as 'success stories' for competition. That is, cases in which there is a shared perception[1] that the introduction of competition has led to significant improvements. Here, we introduce each case with a brief paragraph, and summarise the key features and findings in tabular form.

RETAIL OPTICIANS (1984)

This is an example of deregulation, in which there was the removal of professional restrictions on advertising and entry into a retail market. It was hoped that this would lead to more competitive pricing, and perhaps wider choice, but there were fears that professional standards might be jeopardised, and that advertising might be misleading.

INTERNATIONAL TELEPHONE CALLS (1996)

Deregulation of the market for international telephone calls came towards the end of a decade of liberalisation of the telecoms industry. The process had started with the privatisation of BT, and continued through the 1990s with the gradual controlled emergence of new entrants. It was also against a backcloth of rapid technological change.

NET BOOK AGREEMENT (1995)

The Net Book Agreement was a long-standing example of resale price maintenance on the retail sale of books. Following intervention by the OFT, this agreement was ended in the mid 1990s, with hopes that this would free up price competition by retailers and

1 More accurately, both ourselves, and officials within DTI, considered that they would be good examples to use. Moreover, as explained in chapter 1, they were selected from a longer list compiled from suggestions of senior colleagues employed in academia and competition authorities.

publishers. However, there were fears that fiercer competition might lead to the demise of the smaller bookshop, reduced stockholdings and ultimately fewer books being published.

PASSENGER FLIGHTS IN EUROPE (1997)

There was a progressive liberalisation of European air routes by the European Commission throughout the 1990s, notably facilitating the entry of new firms. During this period, a number of low cost carriers emerged, notably Ryanair and EasyJet. Significantly, these new entrants operated a very different business model from that of the traditional scheduled carriers. It was anticipated that fierce price competition would ensue.

NEW CARS (2000)

This case involves a Competition Commission Report, against a backcloth of public concern, pending a change in European legislation, with respect to the vertical restraints imposed by car manufacturers on retailers. It was claimed that this was a major reason for large price differentials between the UK and continental Europe. It was hoped that this pressure (and the expectation that the vertical restrictions would eventually be relaxed) would lead to the erosion of the differentials and a sharp reduction in UK prices.

REPLICA FOOTBALL KITS (2002)

This is a, very recent, antitrust intervention by the OFT, which found evidence of price fixing of replica football kits by manufacturers and retailers. Financial penalties were imposed under the new UK competition legislation, and it was hoped that the outlawing of this collusion would lead to large reductions in price.

The table at the end of this summary provides an abbreviated checklist of characteristics and our key findings. The first two rows provide the case settings. As can be seen from the first row, with the exception of retail opticians, all cases relate to changes within the last 15 years. This reflects our desire to be topical, but also to ensure accessibility to useful sources. However, a downside of this is that we will be largely unable to explore the very long-term impacts. The first row also shows that all the cases can be related, to some extent, to explicit intervention in a market by government, or its competition agencies, or the European Commission. Row 2 shows the nature of these interventions: we have three cases of deregulation/liberalisation and three examples of antitrust intervention.

In all cases, it was hoped that the intervention would remove a market imperfection and thereby lead to significant price reductions. Rows 3-5 summarise our findings on price and market structure: the third row shows how far the expected price reductions actually materialised; the fourth row identifies the key price diagrams within each chapter; the fifth row summarises our findings on entry and changes in market structure.

Rows 6-8 refer to other consequences: row 6 points to apparent beneficial consequences, while rows 7 and 8 summarise any adverse consequences (row 7 lists those that were feared at the time of the intervention, and row 8 records those for which the fears were realised).

Finally, the last two rows are more of a questioning nature: in row 9, we refer to plausible alternative explanations of the causes of increased competition; and row 10 highlights any 'health warnings' that should be attached to our conclusions.

Main Findings

1. **The introduction of competition can sometimes lead to substantial reductions in price.** For both international telephone calls and European economy airfares, average price was comfortably more than halved within a decade. In two other cases (new cars and replica kits), very significant reductions (10%+) were observed. On the other hand, in neither book retailing nor (particularly) retail opticians is the evidence entirely conclusive[2].

2. **Competition can be enhanced in a number of ways.** This certainly includes competition policy *per se* (e.g. replica kits, NBA, new cars), and deregulation/ liberalisation (e.g. airlines, international telephone calls, opticians), but also the market itself can throw up new opportunities (e.g. rapid technological advance in telecoms).

3. Although **government policy may often be important and necessary for change, it is rarely sufficient.** We also need a pool of resourceful entrepreneurs, capable of exploiting changed market conditions (e.g. Ryanair, Specsavers, OneTel).

4. **Competition is not just about price, it is typically multi-faceted.** Sometimes freeing up a market stimulates new ways of doing things (e.g. new business practices by low cost airlines, changing retail book outlets, spectacles as a fashion item). These are generally unpredictable *ex-ante*, but may ultimately be worth more than just lower price.

Qualifications?

Throughout this report we caution against an unthinking acceptance that competition is always a 'good thing'. Typically, the policy interventions examined here were to remove a market imperfection. However, this raises the possibility of harmful side-effects, because imperfections were sometimes put in place in the first place to help protect some other desirable objective. (Examples in this sample include: protection of professional service standards amongst opticians, the stocking of minority taste books by booksellers, safety in the skies by regulating air travel.) Even where the imperfection is the result of strategic behaviour by incumbent firms, rather than government imposed, it might sometimes be justified in 'efficiency' terms, broadly defined. (Examples here might be reduced transactions costs between manufacturer and retailer of cars, or protection of brand image for football club shirts.)

5. Nevertheless, in this particular sample, **we find little conclusive evidence, so far, that any such harmful side effects actually materialised.** Perhaps the one exception is a once-for-all reduction in the number of eye tests[3].

2 But in both of these cases, no totally satisfactory price indices were available.

3 But even this was not a direct consequence of deregulation *per se*, but rather the simultaneous government policy decision to reduce the provision of free eye tests.

Overall Conclusion

6. **So are these really six 'success' stories? We believe the overall answer is yes** – given the often large price reductions, innovation and product improvement, typically achieved with little evidence of harmful side effects. The one exception might be retail opticians.

Policy implications

We should first stress that this report was not meant to be an assessment of competition policy *per se*. Nevertheless, we do have some observations.

7. **Our sample includes successful examples of competition policy.** The replica kit case vindicates the additional powers bestowed on the OFT by recent revisions to UK competition law. Rather less certainly, in new cars, a combination of the Competition Commission report and anticipated changes in the European legislation seems to have helped hasten competitive pricing. In the European airlines case, the fact that liberalisation was fastest in the UK appears to have helped low-cost carriers, such as Ryanair and EasyJet, gain a competitive advantage over rivals in international markets.

8. It should always be remembered that **markets rarely stay the same for ever.** So, just because a competition problem has been removed at one point in time, this does not necessarily mean that vibrant competition is then assured for ever more.

This rather cryptic observation requires a brief explanation. It is always important to view **competition as a long run process and not just a short run consequence.** Entrants today can soon become tomorrow's leaders (as in retail opticians, booksellers, and arguably air travel.) Competitive change often leads to structural shake-up with significant exit of smaller (perhaps less efficient) firms. These two effects can often mean that, following deregulation in particular, new concentrated market structures will emerge (e.g. book and optician retailing). This is not necessarily a matter of concern – theory tells us that **increased concentration is often the consequence of tough competition.** However, as concentration increases, there is a possibility of a new dominance emerging, with perhaps a return to softer competition. On this possibility, we have little or no evidence, mainly because most of our cases are too recent[4], but continued monitoring of all markets is surely prudent.

4 Again, the one exception may be retail opticians, for which it appears that price may have risen sharply in the last few years.

Research lessons

Finally, we would like to add four other remarks, more to do with the research process itself than the substantive findings.

First, we were surprised by how little had previously been written about some of the cases. All are reasonably well known, but academic economists (and perhaps competition authorities too) do not seem to devote much attention to following up 'what happened next?' This is, of course, a generalisation, which is not always true – for example, the regulation literature includes many studies of the consequences of privatisation. We should also acknowledge that a number of our cases are very recent.

Second, and notwithstanding the previous remark, it is possible for an enthusiastic research team to find out quite a lot in a fairly short time period. The legwork for this project was undertaken largely by 'starting-out' researchers (i.e. 2nd year PhD students), in a very short period of time, i.e. 2-3 months. Many of the relevant facts are publicly available, if dispersed, on the internet, in official reports or from trade associations. This suggests that future studies of this type, but perhaps on a grander scale, may be feasible within a reasonably tight budget.

Third, we were sometimes frustrated by the absence, or unavailability, of official price series. This means that some of our conclusions are uncertain, most obviously for spectacles and books.

Finally, our present research brief precluded the possibility of in-depth rigorous academic study, based on formal theoretical modeling and econometric testing. The time constraints were too tight. Nevertheless, in more than one of the cases, we see the possibility for further in-depth analysis.

Case	Opticians	International calls	Net Book	European flights	New Cars	Replica Kits
Event & Year	Sale of Optical Appliances Order, 1984	Throughout 1990s, government/OFTEL	Ruling by RPC of illegality of NBA (fully anticipated by 1995/6)	3rd package of liberalisation (1993-7)	Competition Commission (2000) but see below.	OFT (2002/3) finds evidence of price fixing
Nature of change	Deregulation, allowing entry and advertising	Deregulation of price, entry permitted	Removal of vertical restraint (RPM)	Deregulation allowing entry, removed international price setting	Reduced price discrimination, consequence of vertical restraints	Removal of price fixing/RPM agreements
Price effects	Short run: none Long run: perhaps rising	Reduced by up to 90% through decade up to 2002	Real price either fell by up to 6% in 4 years, or remained constant; in 4 years prior to abolition, price rose by 7%. Larger reductions in price of popular titles	Economy class: large reduction by BA etc., 1992-2002, approx 66% (nominal prices). Moderate reductions in real price for business class	Nominal price falls by about 10% in the 3 years following report	Almost immediate reductions in nominal price of about 15% on average
Key figure(s)	2.1	3.5	4.1 & 4.2	5.3 & 5.4	6.1 & 6.2	7.5 & 7.6
Entry & effects on market structure	Major entry, but market more concentrated	Major entry, but incumbent (BT) still largest share	Entry/growth of chain stores & supermarkets	Significant low-cost entry, most routes now less concentrated	Too soon to say, early evidence of reduced shares for market leaders	None yet; fears that small outlets may cease to stock; supermarket entry.
Other beneficial effects	Perhaps improved quality and choice	Increased choice of operators	More choice of type of retail outlet	Greater frequencies, new choice of carrier	Too soon to say	
Any harmful effects? **(a) feared**	Lower professional standards, fewer eye tests		Reduced production & stockholding of minority books; loss of small bookshops	Safety?	Quality of service provision	Less availability of kits of less popular clubs
(b) materialised	Fewer eye tests	None	None	None	None to date	Too soon to say
Alternative explanations		Cost-reducing technological change		Innovation: new business model of entrants	Political pressure, public opinion; anticipated reform of block exemption	
Data limitations?	No hard evidence on quality adjusted price		No definitive price index available			

1. Introduction

1.1 Competition is a 'good thing'?

> "The natural price, or the price of free competition ... is the lowest which can be taken...[It] is the lowest which the sellers can commonly afford to take, and at the same time continue their business."
>
> "In every profession, the exertion of the greater part of those who exercise it, is always in proportion to the necessity they are under of making that exertion... and, where competition is free, the rivalship of competitors, who are all endeavouring to justle one another out of employment, obliges every man to endeavour to execute his work with a certain degree of exactness."
>
> **Adam Smith, The Wealth of Nations (1776), Book I, Chapter VII**
>
> "Our mission is to deliver a competitive framework for the growth of successful businesses and a fair deal for consumers. We want to help UK consumers and businesses enjoy more choice, better service, safer products and competitive prices."
>
> **DTI's Competition and Consumer Policy Directorate (http://www.dti.gov.uk/ccp/)**

Almost from their (academic) cradle, economists learn the virtues of competition. Whether couched in the elegant prose of Georgian English, or in the more direct style of the 21st century, the message is the same. Competition is a good thing; it makes markets work well, and is in society's interests.

1.2 Our research brief: a more precise statement of objectives

In this respect, the authors of this report are no different. We start with the presumption that competition is, indeed, a good thing, and it is for that reason that we took up the challenge posed by the DTI.

The challenge was, quite simply, to assemble a small number of case studies, and to illustrate, in a reasonably non-technical way, the benefits of introducing competition into UK markets in which, previously, it had been absent or muted. In these cases, we are asked to present sufficient evidence to assess both the types and magnitudes of benefits (e.g. price reductions, improvements in quality and choice) which had accrued from that increased competition. But we were also asked to identify and acknowledge any harmful side effects (e.g. reduced choice, deterioration in professional standards, safety etc).

In fact, we believe that studies such as this one are rather scarce[5]. The academic literature, in particular, overflows with analyses of markets which are not working well,

5 Related literature includes some assessments of the success of competition policy, e.g. Clarke, Davies and Driffield (1998) and Blois *et al* (1975). But these are not directly comparable.

with suggestions of why this might be, and of how it might be rectified. Similarly, as academics, we are always ready to run a critical eye over the interventions of competition agencies, and to explain why they got it wrong, and what they should have done. But, arguably, we are less ready to 'look at yesterday's news' – cases where effective competition was introduced successfully, and where it should be possible to make an assessment of the gains (and, perhaps, losses) which ensued.

We should stress at the outset, however, that this was not meant to be a major research exercise. We were asked to report back within 3-4 months, the research was to be conducted largely by drawing on secondary sources, and the project team was to be a group of four doctoral students, led by a Professor with some experience in the field.

So this is certainly not meant to be a grand overarching study of the current state of competition in the UK economy. It is not a full scale statistical study, and no claims are made for it being comprehensive. Rather, it is based on a very small number of cases, which were certainly not chosen as a random sample (see below).

Nor is it an overall assessment of the efficacy of UK competition policy or competition authorities. Not only would that be way beyond the means of a small project such as this, but also it would miss an important point: enhanced competition is often the result of developments in the market place – the consequence of the competitive process itself, rather than from intervention from outside.

Given these qualifications, what do we hope to achieve? The emphasis is on the word 'illustrative' in our title. We hope to illustrate:

- What happens when a market is exposed to an extra dose of competition – the effects on price, quality, choice etc; and
- What can be achieved (in research terms) by a small-scale project, conducted within a relatively short period of time, using secondary sources already in the public domain.

In these senses, it might be considered as a sort of pilot study[6].

1.3 Theoretical perspectives

This report is intended to be accessible to the lay-reader, and, as far as possible, we shall avoid technical jargon and abstract theory. Nevertheless, we believe that it is helpful to start with a brief 'academic' discussion of two key issues – the meaning of competition itself, and the significance of what economists refer to as 'market imperfections'. The main points are summarised non-technically at the end of the section.

(I) WHAT IS COMPETITION?

Economists differ in their understanding of the word 'competition'. Divisions of opinion are most conspicuous between broad schools of thought: although the Neo-classical School is by far and away the dominant voice, significant dissonant voices include the Neo-Austrian and Marxists. This is not the place for a lengthy academic

6 It should be stressed, however, that neither we nor DTI envisage that the current exercise is a forerunner to a much larger scale study with more ambitious aims and coverage.

treatise on the history of Economic Thought[7]; suffice to say that the authors of this report are writing from a largely neo-classical perspective, albeit aware of Neo-Austrian warnings that: competition should always be seen as a process, and not just a static state; true competition requires entrepreneurial initiative; and barriers preventing new entry are invariably the consequence of government intervention.

This apart, our main purpose in this section is to elaborate what we mean by a 'Neo-classical perspective' in this context. We do this, for the sake of brevity and accessibility, in a highly truncated and stylised way[8].

First, elementary microeconomic theory characterises perfect competition as a state in which a very large number of small firms supply a homogeneous product at a price equal to marginal cost (MC). The polar opposite is monopoly, in which price is set (perhaps considerably) in excess of MC. In between these extremes is oligopoly; intermediate price theory teaches us that there is an almost infinite range of alternative models of oligopoly, and general predictions are hard to come by, but they tend to tell us that price will be nearer to the monopoly level, the fewer sellers inhabit the market[9].

Second, the 'structure-conduct-performance' (SCP) paradigm, dominant in the 1970s and 1980s, continued to emphasise the significance of the number of sellers, focusing on the degree of oligopoly, empirically operationalised by the notion of seller concentration. Basically, the prediction was that price will tend to be higher in more concentrated markets because firms tend to act less aggressively towards each other (or even collude, either tacitly or explicitly), the fewer rivals they face. Barriers to entry were also brought to centre-stage: concentration would only lead to sustainable higher prices if incumbents were protected by barriers which made new entry more difficult. Moreover, high concentration was more likely to evolve in the first place with high entry barriers.

Thus far, we can summarise by saying that competition was seen from a largely static perspective, and that it was thought likely to be less intensive when there were only a few sellers, protected by high entry barriers. The emphasis was very much on price, and the size of the price-marginal cost margin.

However, in the last 20-25 years, Industrial Economists have made significant advances in their understanding of the competitive process by applying and developing game-theoretic perspectives. Again for the sake of brevity, we simplify and describe this with something of a caricature.

In any market, firms compete with each other, using potentially a variety of competitive weapons, and in ways which may differ between the short-run and long-run. This can be captured by thinking of competition as a three-stage game[10]. In the first stage (corresponding to the long-run), firms decide whether or not to enter/exit/remain in the market. In the second stage, those who have chosen to enter or remain in the market make decisions about medium to long run strategic variables (i.e. those entailing some sort of investment decision). These variables will differ between different types of market, but will variously include R&D expenditures, product positioning and design, outlays on advertising and marketing, physical capacity etc. Then, in a third stage, in

7 See chapter 1 of Davies, Lyons *et al* (1988) for a brief informal survey.

8 And, therefore, with apologies to fellow economists for cutting corners and over-simplifying.

9 This is certainly true for the much-loved Cournot model.

10 See Tirole's (1988) seminal textbook for example.

the light of those investment decisions, firms compete by deciding what price to set, or what output to supply – these are typically seen as short-run decisions. Now, although the three stages are, in a stylised sense, sequential, a crucial insight is that there are also important feedbacks. For example, when deciding whether or not to enter in stage 1, or how much to advertise in stage 2, firms anticipate the type of competition which will likely ensue in stage 3. Similarly, decisions in, say, stage 2, might be motivated by a desire to affect rivals' decisions in stage 1, e.g. advertising, R&D etc might be employed as entry-deterring tactics.

It would be wrong to exaggerate the differences between the 'new' game-theoretic insights and 'old' oligopoly theory and SCP. There is still much common ground, but, as a general proposition, the newer insights tend to warn against simplistic generalisations. This is probably best illustrated by focusing on how we should interpret concentration and market shares.

In many circumstances, most theory, old and new, shows that more concentrated markets, with a few firms with large market shares, will mean less intensive competition, and this will result in higher price-cost margins and lower consumer surplus[11]. But high concentration does not automatically signal absence of intense rivalry – effective competition can sometimes be achieved with just two rivals. Without entry barriers, the threat of new competition deters incumbents from pricing above costs[12]. Moreover, newer theory repeatedly reminds us that concentration in stage 3 is very much an endogenous variable, i.e. itself determined by the nature of competition. On this issue, the picture is particularly complex. On the one hand, incumbent firms may actively strive to increase concentration by investing strategically to make entry more difficult. On the other hand, high concentration may sometimes be the 'innocent' consequence of intense price competition which forces all but the most efficient out of the market.

In other words, concentration and market shares remain potentially useful indicators of the nature of the competitive process, but they should always be viewed in a wider perspective. Precisely what they reveal will differ very much on a case-by-case basis, and we need to remember that the competition is, in fact, multi-faceted. Competition is a process, in which the long-run and short-run may look very different, and in which firms use a variety of weapons – not just price – with which to compete.

MARKET IMPERFECTIONS

When talking of a 'perfect market', economists have in mind an ideal which is rarely if ever attained in practice. Nearly every real world market will, in fact, exhibit some characteristics which prevent it from being perfect – so-called market imperfections. For the Competition Policy economist, the natural emphasis is on one particular type of imperfection – market power (on either the seller or buyer sides). More generally, however, markets may be imperfect for a variety of other reasons which are often bundled loosely under catch-all terms such as transactions costs, imperfect information and externalities.

11 For example, the repeated game is now commonly used to model the circumstances under which tacit collusion is more likely in more concentrated markets.

12 In the terminology of Contestable Market Theory, concentration is usually irrelevant if the market is contestable.

Importantly, these imperfections are often the result of government intervention[13]. Sometimes that intervention may be simply misguided, but in many cases it is because society may have concerns wider than just ensuring intensive competition. For instance, competition amongst doctors is constrained by professional barriers as to who can practice medicine. This can be justified, in broad terms, by the necessity of ensuring professional standards. Similarly, environmental concerns may persuade a government to 'manage' the energy sector in a variety of ways which dampen competition or drive a wedge between selling and buying prices. Closer to home (as far as Industrial Economists are concerned), patents bestow monopoly power on an inventor, in order to sustain incentives for invention. Moreover, in some circumstances, we must choose between market imperfections. For example, very often, the existence of a middleman (e.g. Estate Agents) may be a solution to one sort of imperfection (imperfect information), but only at the cost of introducing another sort (a transactions cost).

When seen in the wider perspective of society's overall utility function, it need not always follow that market imperfections are a 'bad thing', and certainly, the discussion of their rights and wrongs is not the sole prerogative of competition economists.

The relevance of this to the present project is that, in some cases, markets may be largely uncompetitive because of a deliberate, government imposed, regulation or restriction motivated by concerns other than competition. Equally, many examples of deregulation (including privatisation) reflect changes in government policy (and perhaps public opinion) on the continued importance of those non-competition concerns. In such cases, the liberalisation of a market implies a downgrading (either perceived or actual) in those concerns. It follows that, in principle at least, any liberalisation may have deleterious 'side effects' – competition may be enhanced, but only at a cost in terms of other objectives (e.g. environmental, health, equity etc).

NON-TECHNICAL SUMMARY

The natural starting point in assessing the state of competition in any market is to focus on the price, relative to the marginal cost of producing the product or service concerned. Intuition, and basic economic theory, suggests that price will tend to be lower the more sellers there are, competing for the buyers' custom, and (where that market is open to the discipline of new entry), should incumbents fail to compete with each other.

However, there are a number of major qualifications and caveats to be made:

- it is too simple to focus exclusively on price, and to become obsessed with the number of sellers (concentration). Competition is not just about price. In many (indeed, most) markets, products are differentiated, and consumers also care about product quality and choice. Because of this, innovation, product design and variety are often important parts of the competitive game between firms;
- high concentration (fewness of sellers) does not always signal the absence of competition; sometimes it can reflect the success of leading firms in providing better quality products, more efficiently, than their smaller brethren;

13 Some economists, particularly from the Neo-Austrian school, might argue that nearly all imperfections are government imposed. We prefer a less doctrinaire line.

- especially where entry of new firms is feasible, it is better to view competition as a process which evolves over time. It follows that a snap-shot picture, viewed at any particular point in time, may not be a sound basis on which to assess the long-run competitiveness of that market over time.

Turning to policy, it is a generally desirable objective to aim for markets which are as free as possible: as a general proposition, market imperfections are undesirable. An absence of competition is one type of market imperfection. However, we must always acknowledge the possibility that there may be harmful side effects of competition, especially when we remember that governments have wider objectives than low price. Sometimes, it may be desirable to restrict competition to protect those other objectives. By the same token, policies designed to remove barriers to competition, imposed perhaps by previous generations, may jeopardise those other objectives which may still be desirable today.

This last observation has, to some extent, guided our choice of case studies in this project, and the way we consider the evidence. In all six cases, one can identify some sort of initial market imperfection. Amongst these imperfections, we are interested particularly in two broad types: deliberate strategies pursued by incumbent firms, designed to create, protect and abuse their market power; and government imposed restrictions.

Ultimately then, each market must be analysed on the basis of case-specific detail, and not with some broad-brush one-size-fits-all approach: competition is not unidimensional, and not even, always, desirable in an unqualified way.

1.4 Selection of cases

The first part of our research brief was to select (in collaboration with the DTI) a small number of case studies, each of which we anticipated could be shown to be 'success stories'. Obviously, any small sample is not necessarily representative of the population as a whole, but we have tried to include some examples which were the direct consequence of competition policy *per se*, some which resulted from deregulation/liberalisation, and some in which the market was undergoing significant technological change. Bearing in mind the discussion of the two previous sections, the market imperfections which were 'removed' include some cases where this resulted from strategic market power-enhancing activities of incumbent firms, but also other cases where the imperfection resulted from government imposed restrictions (perhaps from an earlier era, when they were designed to ameliorate anticipated harmful side effects of competition). While our focus was to be on the UK, we wanted to include some cases with an international (at least European) angle.

In deciding the make-up of our sample, we undertook a small scale survey of about a dozen friends and colleagues from academia and the UK competition authorities. They were asked to suggest what they thought might be 'success stories'. The cases we eventually selected were those most commonly cited by respondents[14].

14 Thanks are due to these individuals, all of whom replied and mostly within the same day! We would like to thank them by name, but this would be inappropriate, given some of their affiliations. This project is in no way associated with any competition authorities, all suggestions were made on a personal level, and not as representations from these individuals' organisations.

The cases eventually chosen are shown in Table 1.1. As can be seen, all but one occurred within the last decade. The changes in the nature of competition resulted from a mix of deregulation and liberalisation (UK and European), mainstream competition policy, new technology, and new business practices. The next six chapters describe each case in turn (in no particular order). The final chapter summarises and draws together some common threads.

Table 1.1 The six case studies

Case	Year*	Nature of change
Retail Opticians	1984	Removal of restrictions on advertising and entry
International Telephone Calls	1996	Deregulation and subsequent entry; New technology
Net Book Agreement	1995	Effective end of vertical restraint agreement
Passenger Flights in Europe	1997	Liberalisation of European aviation; New business model of low-cost entrants
New Cars	2000	Competition Commission Report; public concern; pending change in European legislation
Replica Football Kits	2002	Removal of price fixing following OFT investigation

* In most cases, it is difficult to uniquely date the time of the change – there is usually a sequence of events. Therefore, these dates are indicative, rather than definitive. See case study chapters for more detail

2. Retail Opticians' Services

2.1 Introduction

Up until the mid 1980s, the UK retail market for spectacles and related services was heavily regulated: competition was restricted in terms of who could supply, and how they could compete. However, a number of investigations by the MMC, the Price Commission, and then the OFT, culminated in 1984 in the Sales of Optical Appliances Order. Amongst other things, this allowed advertising and facilitated new entry. It was hoped that this would lead to fiercer price and non-price competition, but concerns were also voiced with regard to the lowering of professional standards, choice and quality. Similarly, the subsequent abolition of universal free sight tests raised additional fears that general eyecare would suffer, with some consumers opting to have their eyes tested less frequently.

Although nearly 20 years have elapsed since these reforms, we believe that the available evidence on price and quality is inconclusive on whether they have proved successful.

2.2 The Market

There are three types of opticians: ophthalmic opticians, dispensing opticians, and ophthalmic medical practitioners. Ophthalmic opticians conduct sight tests and then prescribe and dispense spectacles and contact lenses. Dispensing opticians purely dispense spectacles and contact lenses from an existing prescription. Ophthalmic medical practitioners conduct sight tests but rarely dispense. Spectacles comprise two distinct parts: lenses and frames. Prior to deregulation, lenses and frames could be either private or National Health Service (NHS), or a hybrid of NHS lenses and private frames. Contact lenses have also since become an important substitute for spectacles and now represent an increasing (but still fairly small) proportion of the market. However, as they are a post-deregulation innovation, we focus primarily on the spectacles segment of the market[15].

2.3 Deregulation of the market[16]

Very briefly, the key dates, prior to deregulation, can be identified as follows.

- **1900s** Opticians demanded a legal recognition of their status.
- **1948** Provision of spectacles included in the NHS.

15 However much of the following evidence, on retail competition and concentration for example, applies equally to the contact lens segment of the market. FODO report that 3% of eye examinations result in the patient choosing to purchase contact lenses.

16 This, and the following, sections draw heavily on information provided by Fulop and Warren (1993).

- **1958** The Opticians Act established a legal monopoly for sight tests and the dispensing of spectacles, and prohibited most forms of advertising.
- **1960/70s** Restrictive Practices Legislation led to the removal of restrictions on trade in many industries. This opened a debate as to whether this should also apply to the professional service industries.
- **1970** The Monopolies Commission (MC) investigated Restrictive Practices in the professional service industries[17], and concluded that advertising prohibitions will tend to increase prices and that their removal would likely encourage entry and increase efficiency.

In **1976 and 1979,** two Price Commission (PC)[18] reports found a lack of competition in the opticians industry and suggested removing restrictions on advertising and a separation of the provision of sight tests and prescriptions from the retailing of spectacles. This was followed in **1982** by a comprehensive Office of Fair Trading (OFT) investigation[19] of the industry. This came to the conclusions that (i) unregistered retailers should be permitted, in order to encourage entry and decrease prices, (ii) advertising restrictions should be removed to aid entry, stimulate innovation and increase choice for consumers. Based on the OFT's recommendations, in 1984, the Sale of Optical Appliances Order, removed advertising restrictions and allowed unregistered suppliers to supply spectacles. Subsequently, in 1986, NHS spectacles were abolished and replaced by a voucher scheme, and, in 1988, the Health and Medicines Act abolished universal free sight tests and allowed the supply of ready-made reading spectacles without the need for a prescription. In addition VAT was introduced on spectacles.

To summarise, deregulation involved four significant changes:

i) All restrictions on advertising removed (before 1984 only directory enquiry listings, reminder cards and some window displays were allowed);

ii) Unregistered suppliers were allowed to enter the market;

iii) NHS spectacles and free universal sight tests were abolished;

iv) Ready-made reading spectacles became available without a prescription[20].

2.4 Arguments for and against deregulation

Inevitably there was a conflict between the major parties involved, concerning the potential effects of deregulation. As described above, the parties in favour of deregulation were the competition authorities (the OFT, PC and the MC), and they were supported in the main by the retailers. The opposition came from the opticians' professional bodies for example, the General Optical Council (GOC). The remainder of this section discusses the arguments given by both sides; where the arguments are for deregulation it can be assumed these were given by the competition authorities and the arguments against by various opticians' professional bodies.

17 Monopolies Commission (1970).

18 Price Commission (1976) and (1979).

19 OFT (1982).

20 Despite these changes, opticians maintained their monopoly position on sight tests, the supply of contact lenses and the provision of spectacles for children.

The opticians' bodies were primarily concerned with maintaining the professional status of their service, and argued in favour of maintaining restrictions on advertising in order to avoid an over commercialisation of the industry and an undermining of the professional nature of the service. Advertising, it was also argued, would provide consumers with misleading and over complicated information. More generally, they feared that greater competition could lead to a fall in the quality of their service due to pressures to reduce costs. Less time would be spent on conducting sight tests, and lenses and frames would be put together in a less careful manner. It was also suggested that, in the pursuit of cost cutting, unprofitable activities, such as home visits, would be discontinued. The necessity to compete by advertising, it was also claimed, would have a harmful effect on smaller independent opticians and potentially lead to large increases in concentration. If smaller opticians were forced out of business, this could leave some consumers with a poorer service, especially those living in rural areas.

In contrast, the competition authorities and the retailers stressed the beneficial effects advertising could bring to the industry: opportunities for consumers to search for high quality, low price products would be enhanced, and, in turn, the quality of service, and product range would be driven upwards, and prices could be expected to fall. Crucially, advertising was viewed as having a key role in facilitating entry.

While it was accepted that deregulation would indeed intensify pressure on margins, it was believed that efficiency could be dramatically improved by increasing the utilisation of opticians' premises, and increased sales volumes would compensate for reducing margins. The increased supply of spectacles from unregistered opticians would further reduce costs and this would be passed on to consumers in the form of lower prices.

The opticians' bodies were also concerned about the introduction of fees for sight tests and the provision of ready made reading spectacles without a prescription. They claimed that these two factors would lead to a significant reduction in the demand for tests and therefore prevent the detection and treatment of serious medical conditions. The contrary argument was that an ending of free sight tests should not lead to a high price, since opticians would still have an incentive to price low in order to stimulate demand for spectacles. Also, advertising campaigns by the opticians, possibly in conjunction with the government, could be used to maintain public awareness.

2.5 Outcomes

MARKET STRUCTURE AND NEW ENTRY

Prior to deregulation, the retail market was unconcentrated. By far the largest firm was the Dolland & Aitchison Group (D&A) – established in 1750[21] – which comprised over 450 practices and accounted for 15% of all sight tests. The Group includes ophthalmic opticians, dispensing opticians and prescription houses. Apart from D&A, only one other chain had more than 100 practices, and five others had 50 or more practices. The five firm concentration ratio (in terms of practices) was only about 12%[22], with the large majority of the market being served by small independent firms.

21 Dolland and Aitchison website, www.danda.co.uk/html/about_us/company.asp, (20/10/2003).

22 OFT (1982).

As expected, deregulation was accompanied by significant new entry. Boots, an established firm in other markets such as over the counter medicines, opened its first optical services department in 1983 and established Boots Opticians in 1987[23]. Specsavers entered in 1983[24] and Vision Express followed in 1988[25]. Together with D&A, these firms are now by far the largest retail players: Boots has around 300 outlets, Vision Express 200, Specsavers more than 500 and D&A around 400[26]. Their market shares by turnover are shown in Table 2.1.

Table 2.1 Market Shares (by Turnover) of Leading Opticians 2000-01

Optician	%
Boots	32
Vision Express	22
Specsavers	17
D&A	10

No other firm has a share of more than 2%
Source: Keynote (2002), Market Review, Ophthalmic Goods and Services, (Turnover figures vary from the year ending 30/11/00 to 31/12/01).

While these figures probably overstate the absolute level of concentration[27], it is clear that deregulation has transformed the marketplace from being very fragmented into fairly heavily concentrated. At least in part, this is due to the major change in the form of retailing – following deregulation, a prominent high street location and well known brand name became increasingly important. The entry of new firms into the industry also forced a number of large firms to exit, for example following deregulation D&A took over Pearle Vision, which previously owned 57 stores[28]. Nevertheless, a significant proportion of the market is still covered by independent firms, suggesting that efficient independent firms have still been able to survive, perhaps by differentiating their product and service from the large multiple opticians and obtaining niche market positions. For example they may specialise in contact lens provision and/or offer a more personal and in depth service to customers willing to pay more for such service. Arguably, this has increased the choice available to consumers. Another important factor that has enabled some independents to survive is the establishment of buyer groups, allowing them to achieve a degree of buyer power and therefore to influence the prices charged by suppliers.

Total sales by the four leaders increased nearly four-fold from 1991-2000. Immediately following deregulation, it appears that Boots enjoyed a position as the market leader. This is perhaps attributable to its established position in other markets such as over the counter medicine, and success in transferring brand loyalty to its optician's services. Somewhat surprisingly, Boots quickly overtook the D&A group as the market leader in the years following deregulation. This perhaps suggests that D&A was slow to respond to the changes that occurred following deregulation or perhaps suffered from some form of incumbency disadvantage. However, by the year 2000, although Boots remained the market leader, the shares of the top four firms moved closer together, suggesting perhaps an increased intensity of competition between them.

23 Boots (2003).

24 Specsavers website, www.specsavers.co.uk/cgi-bin/strudwick.sh/s?langid=1&pfmt=1&sireid=22&p.

25 Vision Express website, www.visonexpress.com/opportunities/5-CompanyNews/OurCompany/ Main.

26 These figures are taken from the respective firms' websites.

27 The table is based on turnover figures for selected opticians and excludes a number of other small opticians and online retailers and supermarkets etc.

28 Fulop and Warren (1993).

ADVERTISING

As expected, deregulation heralded a dramatic growth in advertising expenditure (Table 2.2). It is clear that the vast majority of this was by the new entrants (defined as firms entering later than 1983[29]) as they attempted to establish their position in the market. This suggests that allowing advertising was essential in order to facilitate the entry on a significant scale of new firms without an established brand name in other markets.

Table 2.2 Advertising Expenditure (£000's)

	1985	1990	1995	2000
Total	1,674	5,352	22,785	37,030
Share of Entrants (%)	0	74	77	84

Sources: 1985 and 1990 from Fulop and Warren (1993). ((MEAL), Advertising Expenditure by Opticians (not comprehensive)); 1995 from Keynote (1995), Market Report, Ophthalmic Goods and Services, Main Media Advertising Expenditure by Opticians; 2000 from Mintel (2003), Main Media Advertising Expenditure by selected Opticians.

In the broader academic literature, there has been a large amount of theoretical and empirical work on the effect of advertising on prices and competition. On the one hand, the product differentiation which is established by advertising can raise prices and create barriers to entry. On the other hand, advertising can provide consumers with important information and therefore, aid product search and switching and may allow firms to take advantage of economies of scale[30]. Empirical evidence from Benham[31] and Kwoka [32] for the US opticians industry suggests that advertising led to lower prices, and the latter study also found no evidence of a decline in quality.

There is also an important link between the rapid escalation of advertising expenditure and the increases in industry concentration discussed earlier. It can be seen as an illustration of a process described by Sutton[33]. He distinguishes between industries with exogenous and endogenous fixed costs, and suggests that in industries with endogenous sunk costs, such as advertising or R&D, we do not observe market concentration declining as the size of the market increases. Rather, as the market size increases, so do the benefits from increasing expenditure on advertising and R&D. Consequently, the endogenous sunk costs increase and this allows the larger incumbent firms to increase their size, rather than leaving space for further new entry. This appears to be exactly what has happened in the retail UK opticians market.

Moreover, without advertising, it is unlikely that we would have seen the promotional activity that became commonplace in the industry. Casual observation suggests that these promotions often involve reduced price frames, two frames for the price of one and free sight tests. The apparently frequent use of such promotions appears to have been an important source of increased price competition, and is consistent with the results reported above for the US by Benham and Kwoka.

29 Following the approach of Fulop and Warren (1993).

30 Benham (1972).

31 Benham (1972).

32 Kwoka (1984).

33 Sutton (1991).

PRICES

In searching for a suitable price index with which to compare the pre- and post-deregulation periods, we have encountered no really satisfactory candidates. In the event, our chosen source is data published by the Federation of Optical Corporate Bodies (OPTA). In their annual short bulletin, they report the results from an annual survey on members concerning the average prices paid for spectacles. It is not altogether clear how comprehensive the survey is. Equally important, comparisons across years can not take into account any quality improvements, so this is very much a quality **un**adjusted price, estimated with an unknown degree of imprecision. However, in our judgement, it is the best source available.

We distinguish between private and NHS spectacles (from July 1986 onwards, more correctly defined as spectacles purchased using NHS vouchers).

Thus, Figure 2.1 shows the average 'real' price of **private** spectacles for 1982-2003. As can be seen, the price declined noticeably in the years immediately prior to deregulation. This is confirmed by Fulop and Warren (1993) who suggested that this was the result of 'backdated remuneration from the NHS' and to entry and price cutting by incumbents in anticipation of deregulation. But in the ten years after deregulation, this 'time series' appears to have remained fairly steady, albeit with a very slight upward drift[34]. However, from the end of the 1990s into the early years of the present decade, there appears to have been a distinct and persistent upward trend: in the five years up to 2002, its average annual increase in real terms is about 5%.

For the reasons already given, we believe that caution is needed in interpreting these data, hence our use of the word 'time series' in the previous paragraph. If one is prepared to accept the average real price paid as a meaningful measure of real price, the picture is simple:

- There is little reason for believing that deregulation had any discernible effects on prices in the decade following deregulation, but in the last 5-6 years, prices have risen quite steeply in real terms.

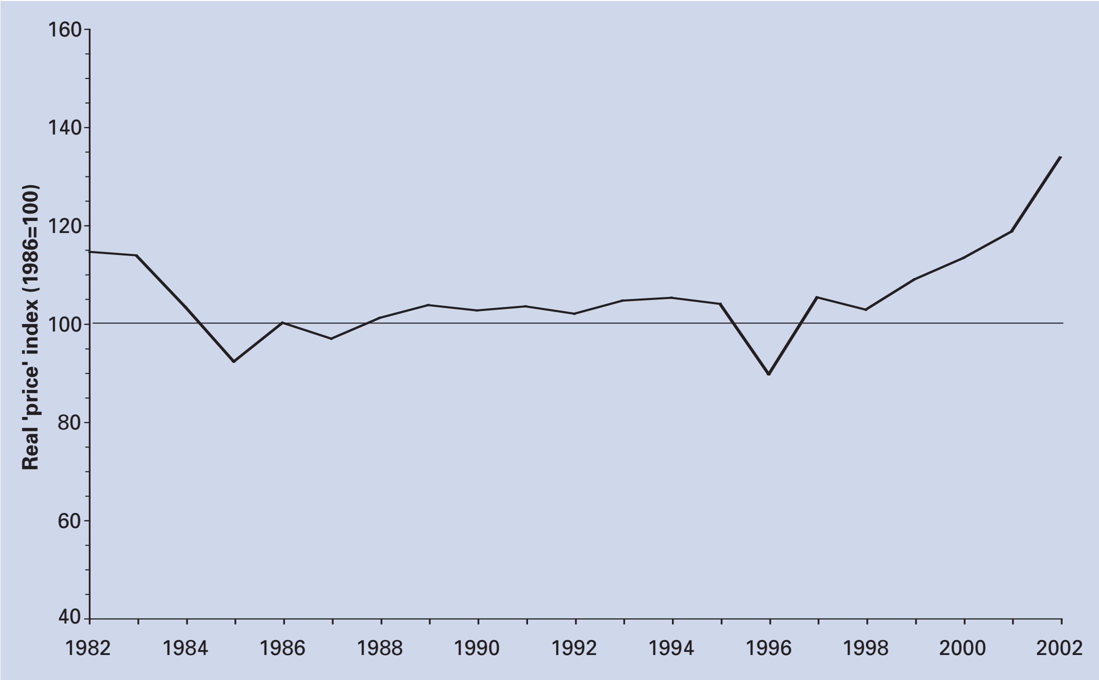
However, there are two reasons why 'average price paid' may give a misleading picture:

- as casual inspection of any retail optician's outlet will confirm, there is a wide range of spectacles on offer, at a correspondingly wide range of prices. It is possible that, as spectacles have become more of a fashion item, (some) consumers are choosing to move upmarket within that range. In other words, average price is a weighted average of all prices, and, over time, this may have increased simply because more consumers are choosing to buy higher priced models;
- over and above this, there may have been a general improvement in the quality of spectacles, with additional features added, such as anti-scratch coatings, tinted lenses, designer label frames, and these extra features have increased consumers' willingness to pay.

For both of these reasons, the average price paid may rise, although the price of any given standard pair has not. In principle, it would be possible to estimate the strength of these two effects, but, in practice, this is impossible without access to better quality data than we have available.

34 Discounting the exceptional year of 1996/7, which we presume to be a rogue observation.

Figure 2.1 Real 'Price' of Private Spectacles (net of VAT), 1982-2002 (1986=100)

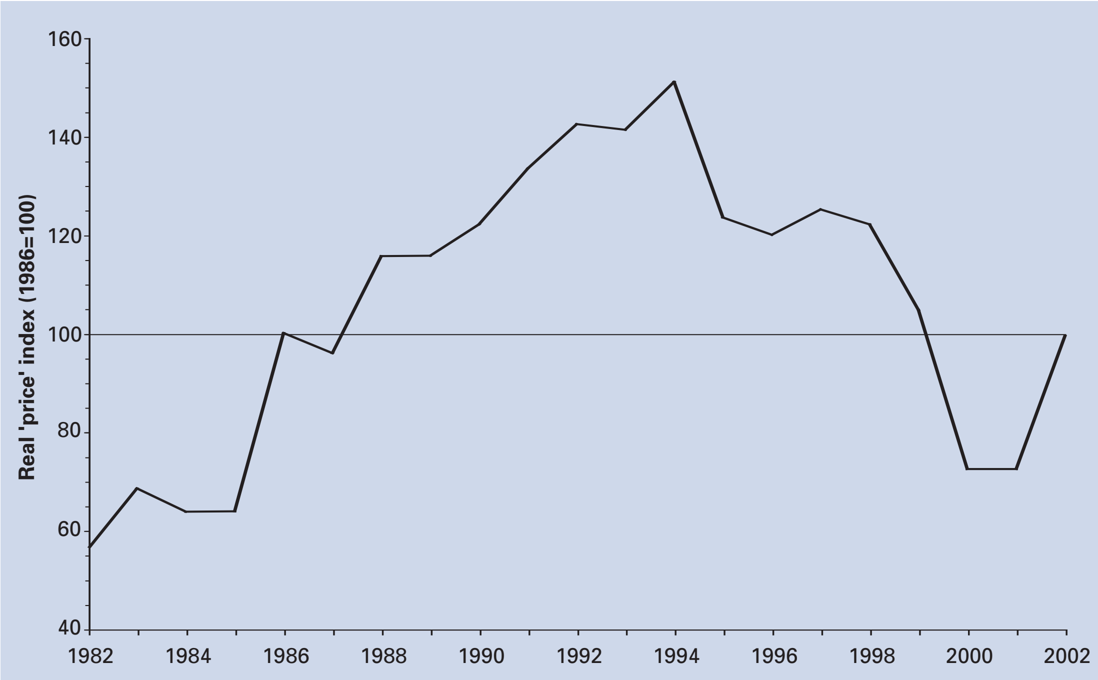


Source: Federation of Ophthalmic and Dispensing Opticians (FODO), Optics at a Glance, 1982-2003, deflated by the RPI (Office for National Statistics, www.statistics.gov.uk.) The FODO surveys cover year endings of end March; for brevity, we record these in this figure by the most corresponding calendar year, e.g. 2002 refers to the survey for 2002/3. We have also deducted VAT which was imposed at 15% from September 1988, and raised to 17.5% in April 1991.

Figure 2.2 plots the average price paid for **NHS spectacles**. This term merits close definition. Up until 1986, these were spectacles provided under the NHS. Following deregulation various groups of consumer (all children under 16, children under 19 in full time education, various benefit claimants, low income consumers and consumers prescribed complex lenses) qualified for NHS vouchers. These vouchers can be used to pay for, or contribute to payment for, any spectacles or contact lenses. Over time, the value of the vouchers have been changed. For example, in March 2003 it was £31.30, compared to £18 in 1990.

As can be seen, and in contrast to private spectacles, the average price paid for NHS spectacles increased rapidly in real terms in the first seven years after deregulation, before falling back in the next six years.

Figure 2.2 Real 'Price' of NHS/NHS Voucher Spectacles, 1982-2002 (1986=100)



Source: Federation of Ophthalmic and Dispensing Opticians (FODO), Optics at a Glance, 1982-2003, adjusted using RPI from Office for National Statistics, www.statistics.gov.uk. The FODO surveys cover year endings of end March; for brevity, we record these in this figure by the most corresponding calendar year, e.g. 2002 refers to the survey for 2002/3. We have also deducted VAT which was imposed at 15% from September 1988, and raised to 17.5% in April 1991.

However, three important caveats should be added. First, since deregulation, spectacles purchased using NHS vouchers have represented a declining segment of the market. While data on this proportion, from the FODO sample surveys[35], reveal apparently large year to year fluctuations, the broad trend is clear: on average, between 1989/90 and 1995/6, spectacles purchased with NHS vouchers accounted for 33% of the total; but between 1996/7 and 2002/3, this had fallen to 22%[36].

Second, the switch to a voucher scheme allowed consumers the option of choosing any available spectacles and then paying the extra. Figure 2.3 compares the average actual spend of consumers using NHS vouchers against the price of the least expensive pair of spectacles available[37]. This reveals quite clearly that, on average, they consistently chose to spend more than was 'necessary'. Nevertheless, it is also clear that in real terms the price of the least expensive pair increased consistently up until 2000.

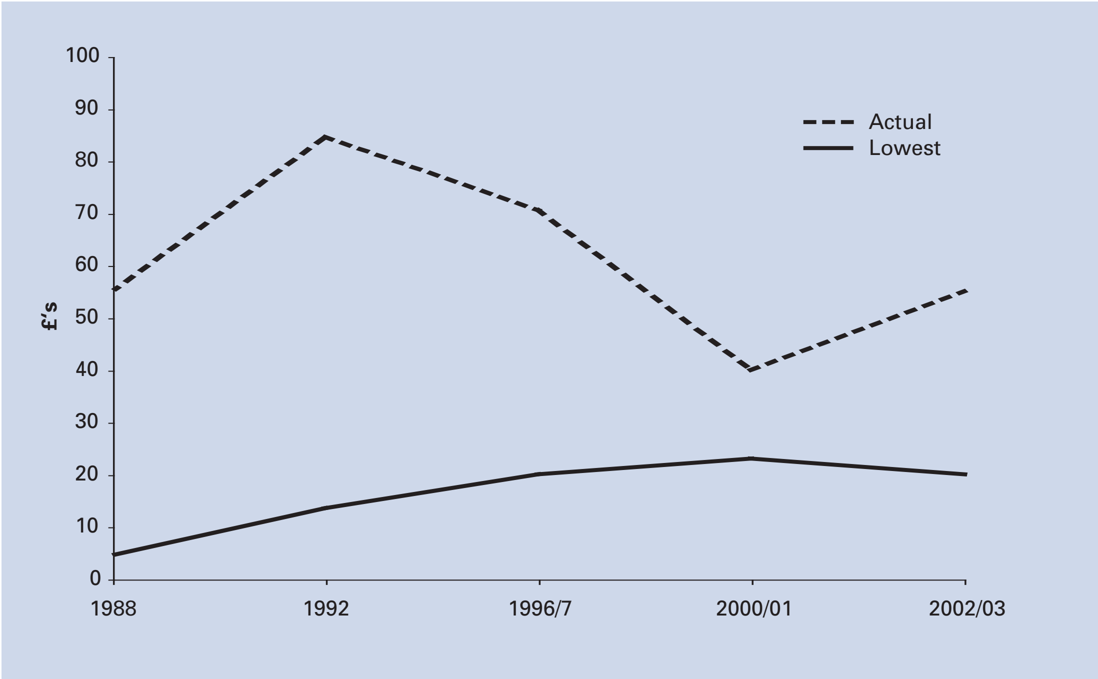
Third, the willingness to pay of NHS voucher patients obviously depends on the monetary value of the vouchers, and, as mentioned, this has been periodically increased over time.

35 FODO (1982-2003).

36 Direct comparisons with the years before 1989 are complicated by the fact that consumers were able to mix NHS/Private lenses and frames. However, excluding these 'hybrid' spectacles, and as an illustration of how much more the shares have changed, we note that, in both 1983 and 1984, NHS spectacles accounted for a larger share of the total than did private.

37 This is the average least expensive pair of spectacles found to be available in the FODO yearly surveys (FODO (1982-2003). In some years at least initially proceeding deregulation, it was stated that some opticians provided spectacles at a price equal to the basic voucher value.

Figure 2.3 Average Spend on Spectacles Using NHS Voucher Compared to the price of the least expensive spectacles available (in 2002 Prices)



Source: FODO (1982-2003), Optics at a Glance. Adjusted using RPI from Office for National Statistics, www.statistics.gov.uk.

Overall, this evidence on price is inconclusive. Certainly, it offers no reason for believing that deregulation has had any major depressing effect on price. Making no adjustment for quality, if anything, the reverse would be true. However, in the absence of hard quantitative evidence on quality, we can not preclude the possibility that an hypothetical quality-adjusted price index might have shown a downward trend. Focussing on the small, and declining, proportion of the population entitled to financial support with spectacle purchase, it is even harder to argue that they have benefited (at least in terms of price) from deregulation: they were faced with consistently rising prices following deregulation, confirming earlier fears. However, again, it is possible that the quality of even the least expensive spectacles available was increasing during this period.

NUMBER OF SIGHT TESTS

As mentioned earlier, a major fear of the deregulation package as a whole was that consumers would be less mindful of eye-care because of the charges introduced in 1988 for sight tests for a significant proportion of the population[38].

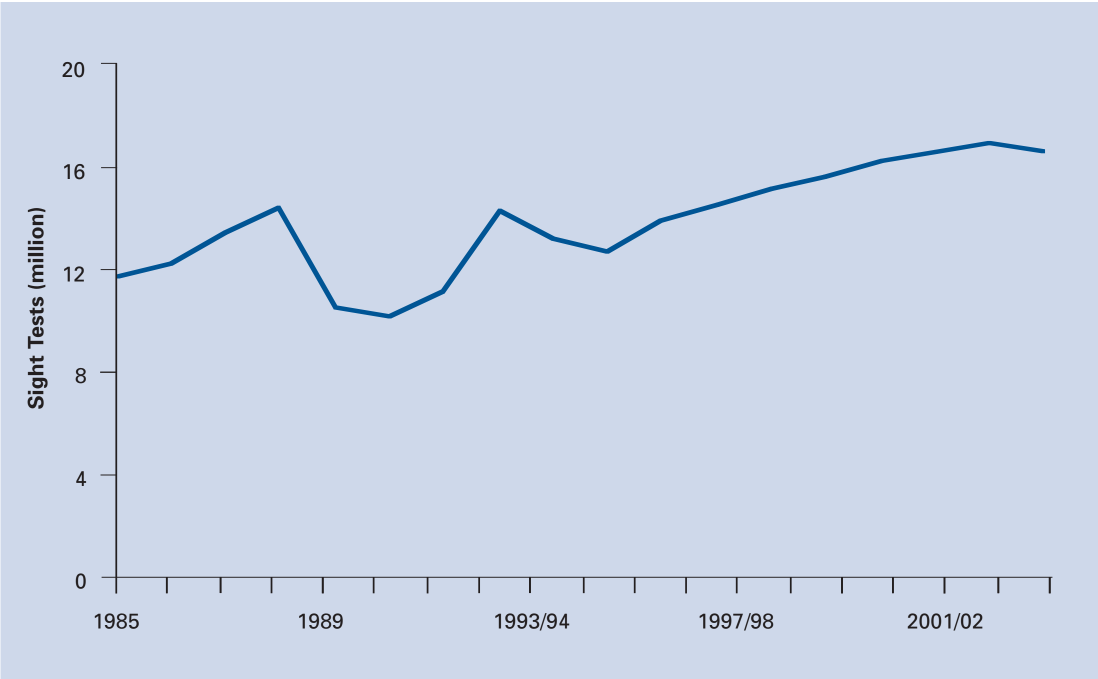
In fact, Figure 2.4 shows that, in the years immediately before this, there was actually a rapid increase in the number taking place. It is likely that this reflects a last minute rush to pre-empt the charges. (In fact advertising was used to encourage consumers to have sight tests done while they continued to be free[39].) This is confirmed by the subsequent sharp decline in 1989-90, before a partial recovery in 1992. A steady upward trend, year on year, was re-established from 1994 onwards, and, from inspection of the graph, it appears that the underlying trend growth rate is similar to that observed in the days of free tests. However, although the trend growth rate may be unchanged, the level is,

38 However, 40% of the population continued to be entitled to free NHS sight tests (children under 16, children under 19 in full time education, diabetics, glaucoma sufferers and their family over 40, the registered blind and partially sighted and low income consumers.)

39 Fulop and Warren (1993).

arguably, lower. Again, this interpretation cannot be conclusive because of the large fluctuations at the end of the 1980s and the start of the 1990s. Clearly, there was an anticipatory surge, and then a catching-up of sorts. But other short-term factors might also have been at play. For example, it was suggested that, at this time, GPs referred some patients for hospital treatment rather than to opticians thus avoiding the charges[40]. It is also possible that, initially, a significant proportion of the population who were, in fact, exempt from charges, were unaware of this. The evidence also suggests that charges varied substantially between opticians[41], and that low price and free sight tests were often (and still appear to be), used by opticians as promotional reasons.

Figure 2.4 Number of Sight Tests Conducted in the UK



Source: FODO (1982-2003), Optics at a Glance.

Having said this, the time path in the figure points in the direction of there being a lower level now than there would have been had there been no aberrations in the late 1980s. We certainly cannot exclude the possibility that some consumers, at least, now have less frequent eye tests, or in extreme cases, no eye tests, as a result of charges. In a survey, conducted in 1995, 35% of respondents agreed with the statement 'I would be more likely to go for eye tests were it not for the charges'[42]. Moreover, the generally ageing nature of the UK population would suggest that the counterfactual would actually involve an increase in the trend growth in the demand for eye tests[43].

THE NUMBER OF OPTICAL PRACTITIONERS

Figure 2.5 shows that the steady growth in the total number of registered Optical Practitioners continued more or less at the same rate post deregulation as it did in earlier years. The number rose from just over 10,000 in 1984 to just under 14,000 in 2002 – an increase of 36%. This can be interpreted as an, albeit crude, indicator of the quality of the with-sales service available.

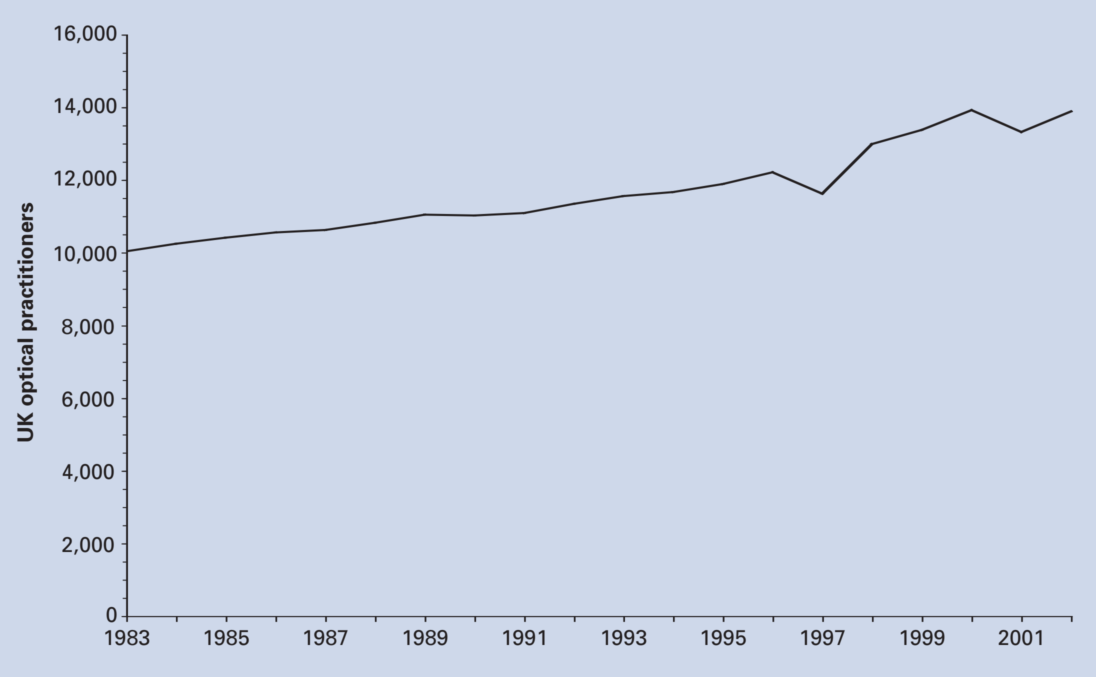
40 Fulop and Warren (1993).

41 Fulop and Warren (1993).

42 Keynote (1995), Market Report.

43 This is not to say that the demand from the elderly has declined – in 1998 the government announced free NHS tests for anyone over the age of 60 as from 1999 (FODO (1998)).

Figure 2.5 The Total Number of Optical Practitioners in the UK



Source: FODO (1982-2003), Optics at a Glance.

MISLEADING ADVERTISING?

One potential criticism of the (correctly anticipated) upsurge in advertising was that it might lead to misleading and over complicated information being given to consumers. It is difficult to find conclusive evidence of whether this has in fact occurred, although some insight is provided from complaints received by the Advertising Standards Authority (ASA). Inspection of their website for each of the years between 1995 and 2001 reveals that opticians never featured in their list of the top ten advertisers by number of complaints[44].

INCREASE IN CONSUMER CHOICE

Fulop and Warren (1993) suggest that, by the early 1990s, opticians were often stocking 3,000 or more frames, in contrast to only around 200 in 1986. They also report claims that the quality of service has increased dramatically (e.g. increased opening hours, speed of service and immediate consultations). Arguably, these improvements were made possible by the new form of retailing which developed following deregulation. This involved the leading firms establishing stores in prime high street locations. If deregulation has, indeed, meant a decline in the number of home visits conducted by opticians, as was claimed by those opposing deregulation, the prime high street location and extended opening hours have helped compensate, at least in part.

Similarly, with deregulation came the availability of ready-made reading spectacles without prescription. This should have benefited the consumer in that the product is now available from a wide range of outlets, not just opticians, and prices vary considerably[45] according to the consumer's willingness to pay. This should have enhanced price competition, although we have no hard evidence on this.

44 www.asa.org.uk – statistics – Top 10 advertisers by complaints, 1995-2001 (11/02/04).
45 Fulop and Warren (1993).

2.6 Conclusions

Of the six cases covered in this report, spectacles turns out to be the least conclusive. Without doubt, the reforms did lead to significant new entry, on the back of substantial advertising. However, the evidence on price is mixed. Superficially at least, there is no hard evidence that deregulation has helped force price downwards. Indeed, the price rises observed for private spectacles in the last two to three years suggest the opposite, albeit some 15 years after deregulation. For spectacles purchased with NHS vouchers, the evidence suggests that consumers paid considerably more, at least in the decade immediately following deregulation. However, there are signs that this was as much a matter of choice as necessity (consumers preferring not to buy the cheapest available option). But these conclusions refer only to the average prices actually paid for spectacles, and casual empiricism suggests that the quality of spectacles, whether actual or perceived, has improved significantly over this period. Ideally, these improvements should be factored into any satisfactory price comparisons. But unfortunately, there is no index available on quality adjusted price.

Conclusive hard evidence on non-price factors is even more difficult to establish. Again, casual empiricism might suggest that consumers now benefit from greater choice, higher quality products and, arguably, improved forms of retailing, but we have no objective evidence on this. There is certainly no evidence that advertising has misled consumers; rather, it was the means by which new retailers established and consolidated their market presence. There is also no evidence of a decreased quality of service and, since independent opticians are still in business (albeit in smaller numbers), consumers still have available the option of the arguably higher quality, more personal, service provided by such retailers.

It was feared that the discontinuation of free eye tests for the majority of consumers would reduce the aggregate amount of eye testing. While the data are not entirely conclusive on this either, our interpretation is that there was a once-and-for-all reduction, but that the underlying trend growth rate was unchanged (but now from a slightly lower level), as a consequence. This is, perhaps, one downside, although it should be stressed that the abolition of free tests is separable conceptually from deregulation: deregulation did not necessarily require abolition. Moreover, we have no evidence on whether this has actually led to a deterioration in standards of eyesight.

3. International Telephone Calls

3.1 Introduction

Until the early 1980s the telecommunications industry in the UK was a monopoly with British Telecom (BT) the sole provider. Following BT's privatisation in 1984, it has been progressively exposed to more and more intensive competition from new entrants. (Similar privatisation/liberalisation has since occurred in many other countries around the world.) In this chapter, we confine attention to the retail[46] market for international phone calls from the UK. In this case, after privatisation, BT was initially regulated on price, but as entry was permitted in the late 1990s, the market became more open, and competitive forces increasingly replaced regulation. Thereafter, price fell rapidly – partly as a consequence of liberalisation, but almost certainly due also to a period of rapid cost-reducing technical change. Either way, this is a case of a market undergoing fundamental structural change, and delivering impressive price reductions.

3.2 The market

A BRIEF HISTORY OF LIBERALISATION[47]

The first significant sign of the structural change which was to come was in 1982 when Mercury (owned by Cable and Wireless (C&W)) was licensed with mandatory interconnection to BT's public switched networks. This was followed, even more significantly, in 1984 by **The Telecommunications Act**, which led to the privatisation of BT, and the removal of BT's monopoly position. Initially, competition was to be muted, with controls on BT's prices for national and local calls. Although Mercury was allowed to enter, there was a guarantee that no further entry would occur for at least another seven years.

Moving on to the late 1980s, entrants were allowed, and they were to be free to lease lines from BT and Mercury and resell them within the UK without adding value. Then, in 1990, simple resale and interconnection for international telecommunications was initiated, therefore enabling a new entrant to 'piggy-back' on an established carrier. In 1991, the Government licensed entry into all markets except those for international services, and the control of BT's prices was extended to include international calls. Cable companies were now able to provide telecommunication services. In addition government regulation of BT and Mercury continued.

However, in the international market segment, it was not until 1996 that full liberalisation was close to being achieved with the ending of the duopoly period. C&W

46 Retail international direct dialled calls (IDD) are defined as calls made by end-users dialling directly to subscribers in other countries. This should be distinguished from wholesale, defined as termination of calls overseas by an international operator on behalf of another operator.

47 This is drawn from a number of sources, notably: Hooper (1990), OFTEL's five minute guide to the history of telecommunications regulation in the UK, www.oftel.gov.uk/publications/news/on61/5min0903.htm, (10/10/2003); Cave and Williamson (1996), Cave (1997).

merged Mercury into a new company with the local networks of three cable companies, with the objective of winning 25% of BT's market within the following five years. From 1997 onwards regulatory controls were gradually removed. In 2000/1, The Office of Telecommunications (OFTEL) concluded that competition was now sufficient for controls on BT and Concert[48] to be reduced on certain international routes[49]. 83% of IDD traffic was now on effectively competitive routes. Also in 2000 carrier pre-selection was first introduced: this allowed telephone calls (including international) to be made without requiring a box to be attached to the telephone, or an access code to be entered, but still continuing to use the same fixed line to access the services of an alternative supplier.

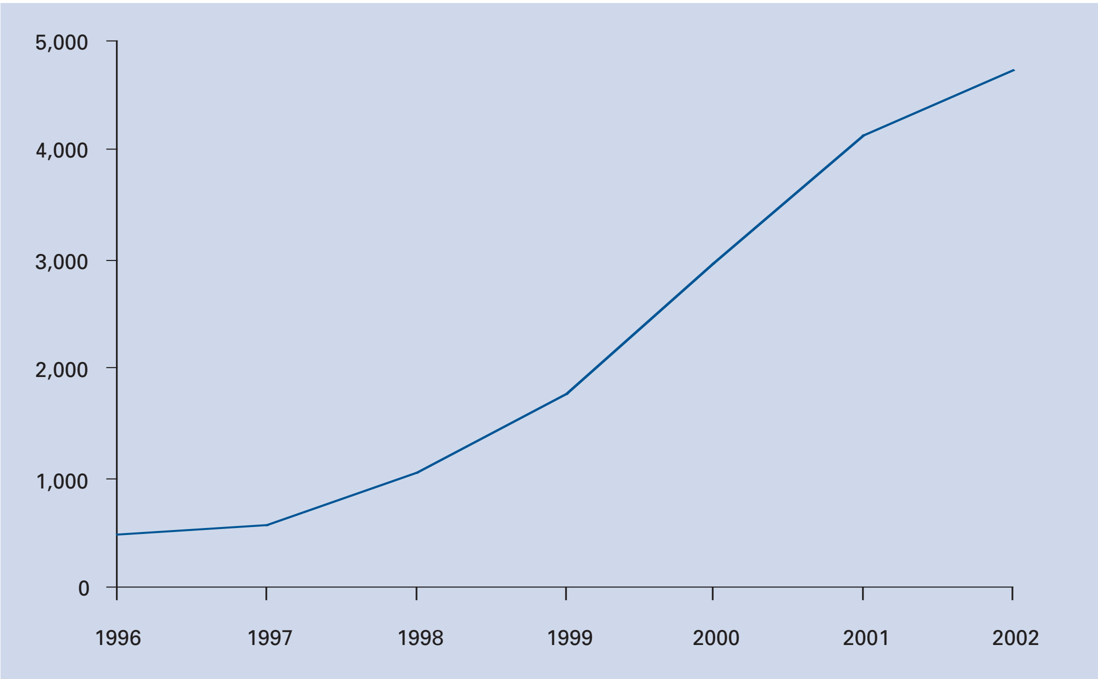
In 2002 the UK Telecommunications market was valued at £24bn and was expected to grow moderately to £25.3bn by 2003, this would continue the trend of slower growth in the last few years[50].

OUTSIDE THE UK

Most of the world's industrialised nations started to liberalise competition in their telecommunications sectors during the 1990s. The UK was in the vanguard however. For instance, it was not until 1998 that it was decided that the telecommunication monopolies throughout the European Union (EU) should be ended.

The rapid increase in the number of international carriers world-wide is shown in Figure 3.1. Of the 10 largest companies by outgoing traffic, two are from the UK; BT (6th) and Cable & Wireless (7th)[51].

Figure 3.1 Number of International Telecommunications Carriers World-wide



Source: Telegeography website, www.telegeography.com/resources/statistics/telephony/growth_int_carriers.html, (11/12/2003).

48 A joint global venture between BT and AT&T, which was dissolved in 2001.
49 OFTEL (2001b).
50 Keynote website, Executive Summary, www.keynote.co.uk/kn2k1/11084_03//doc_8.htm?uni= 1066671299, (20/10/2003).
51 Telegeography website.

3.3 Dating the significant change in the competitive environment

Arguably, we could define our reference time period from the privatisation of BT in 1984. However, a brief review of the 'Duopoly Period', when price was still regulated, and entry was confined to just one firm, confirms that this would be premature.

The regulatory controls imposed on BT throughout this sub-period might have been expected to allow Mercury to encroach significantly on BT's market share. However, the evidence suggests that Mercury had only limited success. By 1991, Mercury had only achieved market shares of 2% for local calls, 8% for long distance calls and 17% for international calls[52]. In the markets for local and national calls there was evidence of BT acting as a price leader, in all but a few distinct market segments. Significantly, however, the one area in which Mercury appears to have the most success was the market for international calls. Overall, however, Mercury failed to meet its target of 25% of BT's market.

Of course, throughout the process of deregulation, OFTEL, the industry regulator, had a pivotal role. Gradually, it was repositioning itself as a competition authority with the aim of preventing anti-competitive behaviour, such as predatory pricing or collusion, rather than as an interventionist regulator using price controls as it had been initially[53].

In our view, the crucial change in the market, so far as international calls is concerned, occurred when the duopoly period for international calls was ended in 1996. This represented the removal of a government imposed restriction to competition.

3.4 The case for intervention

The case for opening up the market to competition is relatively straightforward. Allowing new entry should raise the prospect of lower prices and increased choice. It was, however, important that new firms were given a fair opportunity to compete. The potential danger was that simply promoting entry would merely lead to the establishment of a fringe of small firms and overall the industry would remain largely uncompetitive[54]. Regulatory controls including restrictions on the prices of the incumbent firms were initially used to aid entry and increase competition. It was also essential that new entrants were allowed access to the networks of the incumbent firms. However, at least initially, following the opening up of local and national markets to competition in 1991, OFTEL preferred competition to evolve by infrastructure competition i.e. the new entrants establishing their own networks e.g. cable companies[55]. However, a significant factor increasing competition in the market for international calls was the presence of new entrants simply providing services for international calls using the fixed line providers. This is particularly true following the establishment of carrier pre-selection. A final factor that was, and continues to be, essential in facilitating competition is the need for consumers to be aware of the services offered by the new suppliers, so that they can consider the possibility of switching from incumbent firms.

52 Cave and Williamson (1996). Figures based on estimates by NERA.

53 Cave (1997).

54 Cave and Williamson (1996), MacDonald (1986).

55 Cave and Williamson (1996).

56 Alternative methods for making international calls are also available including; pre paid phone cards, calling shops and pay phones. However, these are used by a relatively small segment of the market.

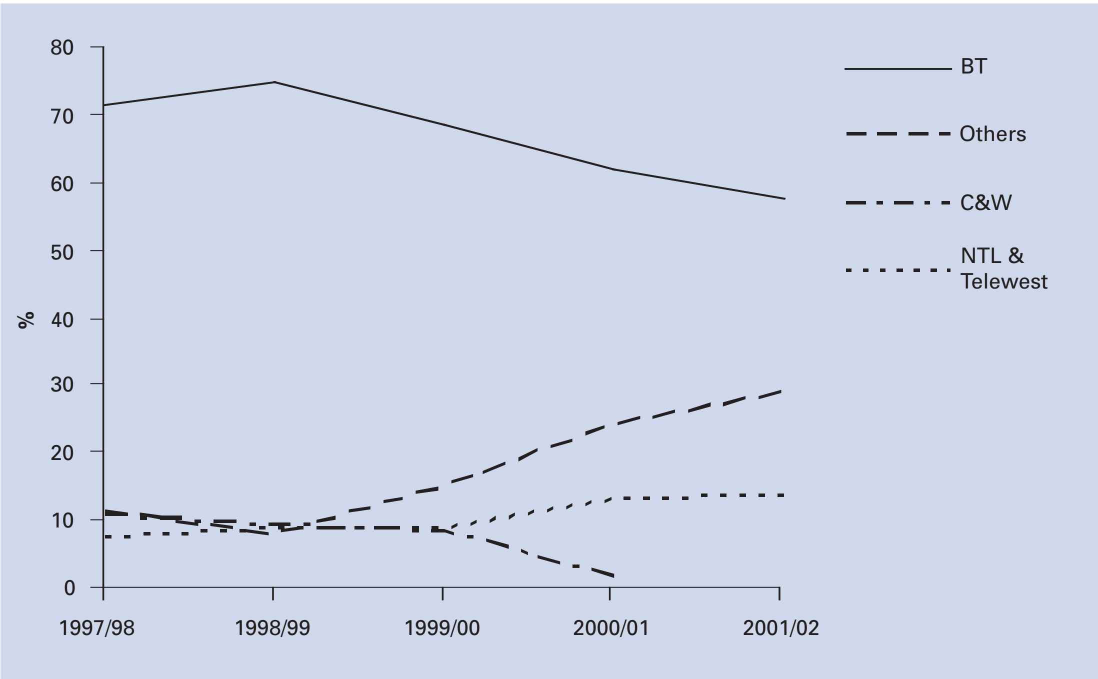
3.5 Outcomes

MARKET STRUCTURE

Following liberalisation, there are now two distinct types of supplier of international calls. The traditional, and still most common, method of calling abroad is via a direct access provider. Here, the provider of the fixed line into the house or business is also the provider of the calling facility. BT and the cable firms, NTL and Telewest, are direct access providers. An alternative form of supply which has emerged following deregulation is indirect access. In this case, the provider represents an alternative to using the provider of the fixed line for making international calls. Initially, an access code or box was attached to the phone line in order to connect to the indirect provider. Many indirect suppliers now also often supply local, national, mobile and internet telephone calls. However, the user is still required to pay line rental to the fixed line provider. Examples, of indirect providers are OneTel and Planet Talk. In recent years a further innovation, established in the market for international calls, is known as carrier pre-selection. This obviates the need for an access code or box for the use of indirect suppliers[56]. Indirect access providers currently account for 24% of the market by value and 38% by volume (OFTEL).

Figures 3.2 and 3.3 plot the changing market shares of the main players respectively for residential and business international calls. In the residential market, we can see that BT easily remains the leading firm. However, its share is declining gradually, suggesting that this segment of the market is gradually becoming more competitive[57]. In the business market, BT already had a much lower market share by 1997, mainly due to the inroads made by Mercury (C&W) during the duopoly period. Over time, BT's share has again declined, but at a slower rate than in the residential market. Clearly then, entrants have succeeded in making significant inroads, but BT's continued 'leadership' poses a question to which we return presently.

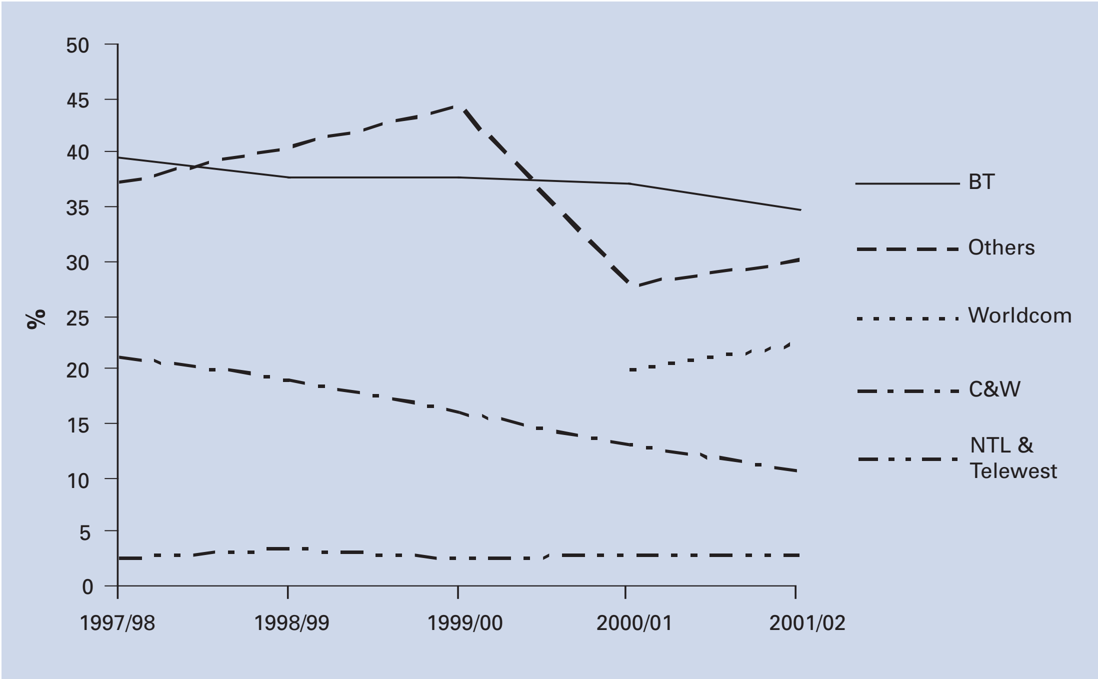
Figure 3.2 UK Market Shares by International Residential Call Revenues



Source: OFTEL, The UK Telecommunications Industry, Market Information 2001/02.

57 The disappearance of C&W in 2000 reflects a divestment to NTL.

Figure 3.3 UK Market Shares by International Business Call Revenues

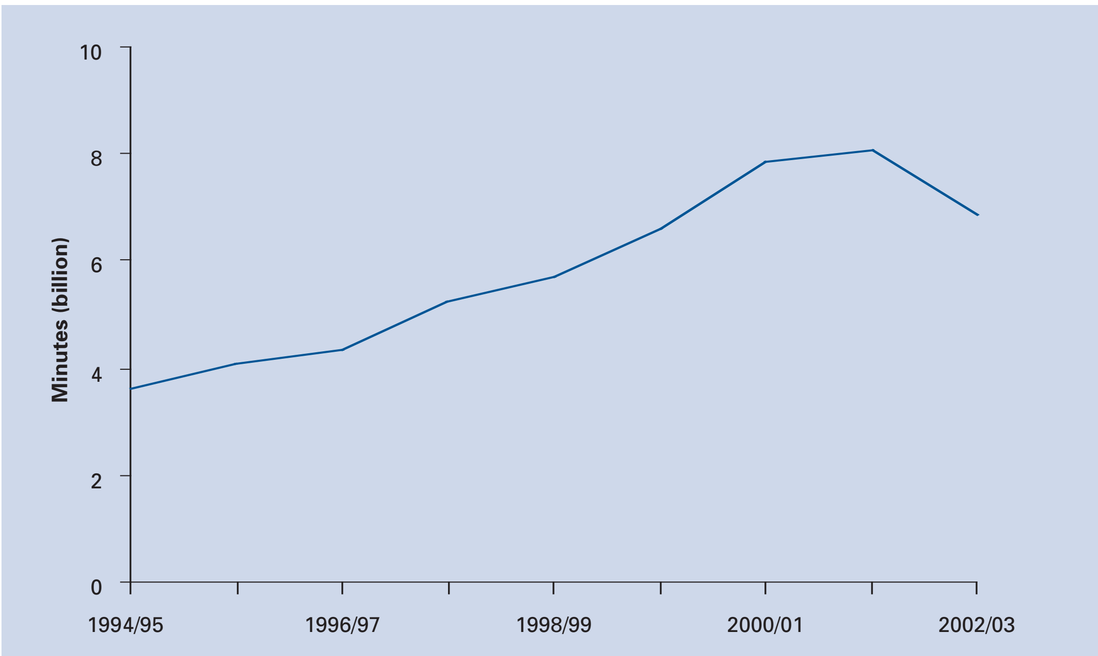


Source: OFTEL, The UK Telecommunications Industry, Market Information 2001/02.

PRICES

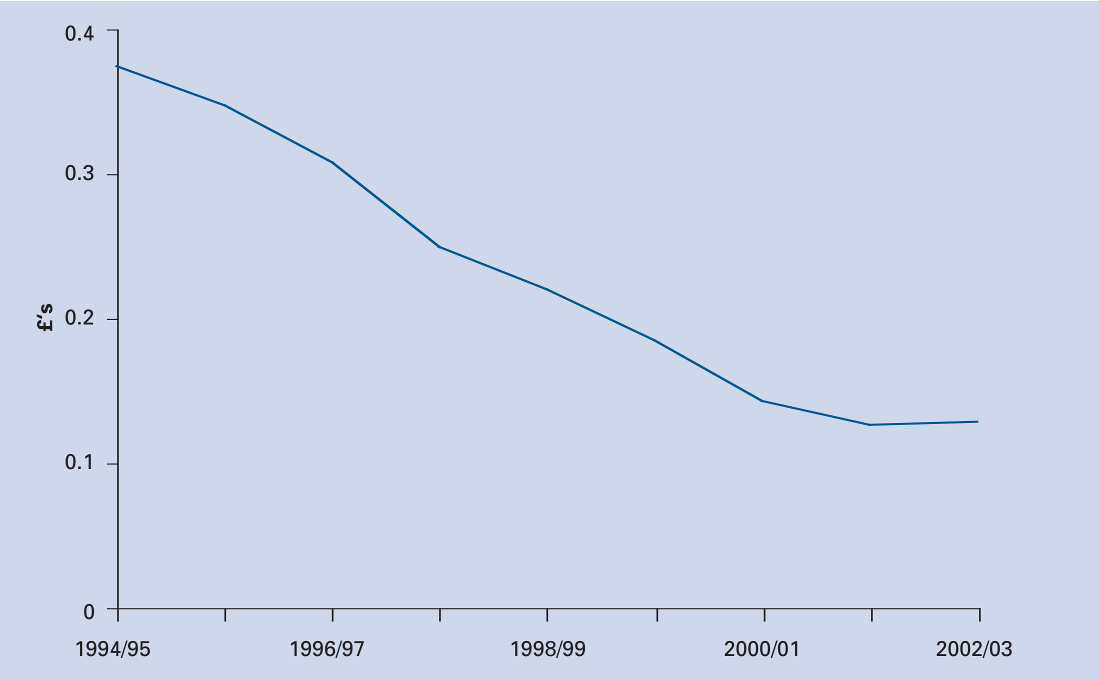
An initial indication of how prices have changed in the liberalisation era is provided by some OFTEL data on the volume and value of international calls from the UK. Figure 3.4 shows that the volume roughly doubled in the six years after 1994/5. Figure 3.5 shows that this was accompanied by a dramatic drop in price (more precisely, the unit price, derived by dividing revenue by volume): by 2002/3, it had fallen to roughly a third of the 1994/5 level. Of course, since price has fallen more than quantity has increased, total revenue has fallen (not shown here) – a suggestive indication perhaps of an increasingly competitive market.

Figure 3.4 Volume of UK International Calls



Source: Data supplied by OFTEL.

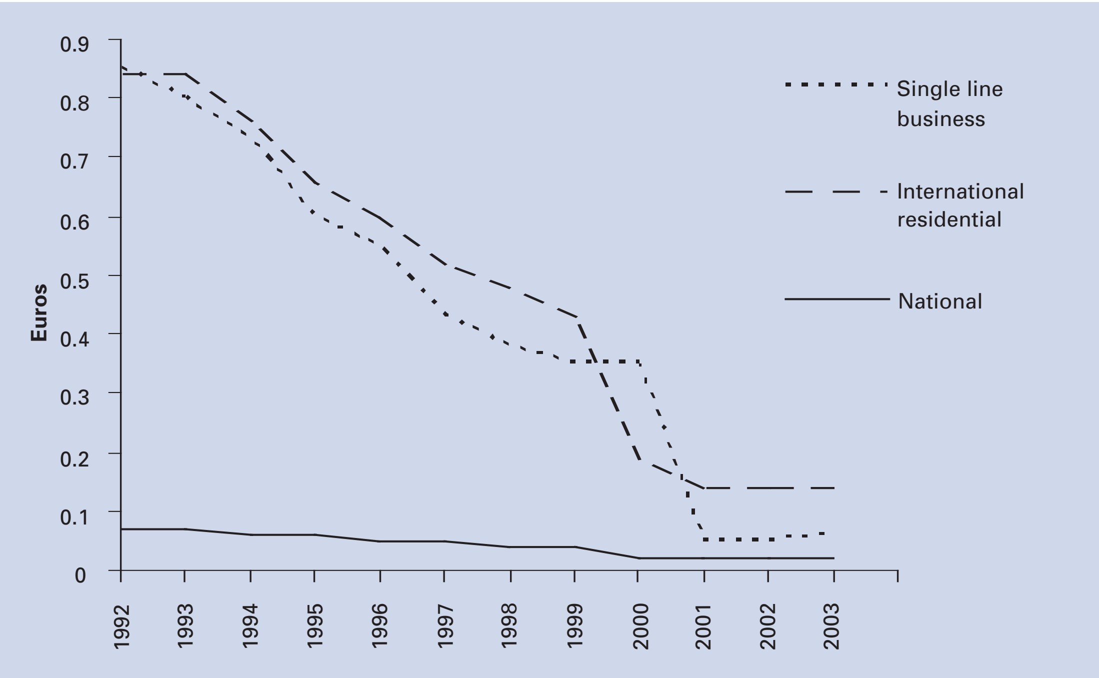
Figure 3.5 Unit price of UK International Calls



Source: Derived from data supplied by OFTEL.

Figure 3.6 provides confirmation of the dramatic fall in prices. In this case, the data are from direct observation on price, and distinguish between residential and business calls. This suggests, if anything, that the price reduction has been even bigger than shown in Figure 3.5. It also establishes similar time paths for residential and business. The figure shows national calls as a comparator: as can be seen, by the year 2000 prices for international calls were much closer to the lower prices of national calls.

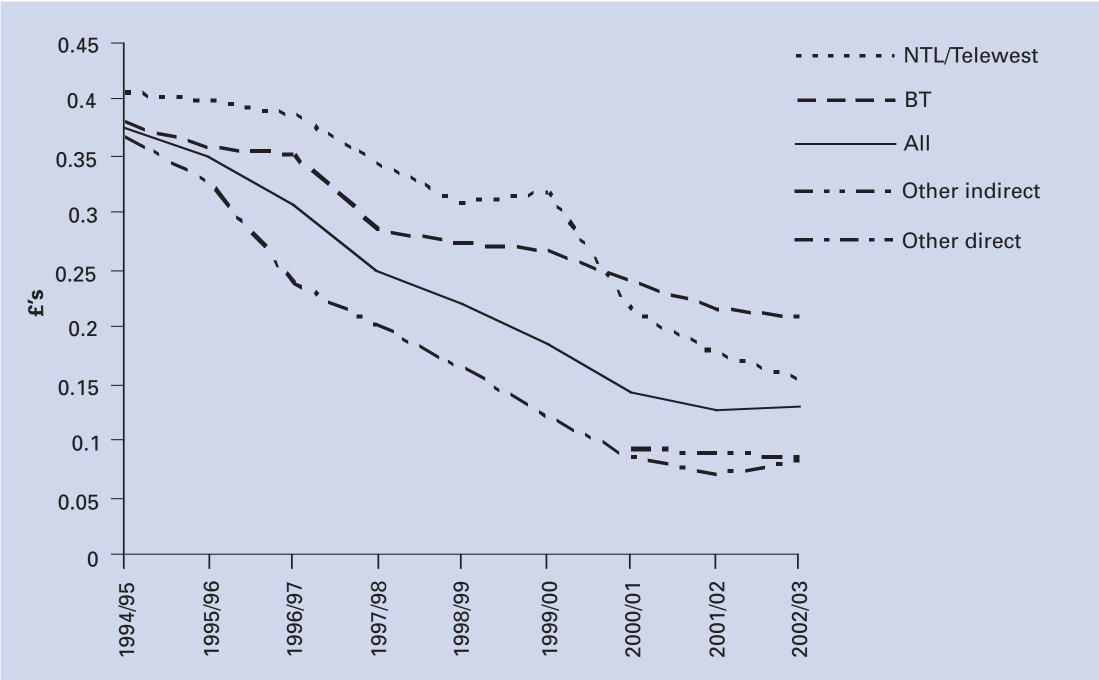
Figure 3.6 UK Prices of National and International Residential Calls



Source: Analysys website, http://www.analysys.com/default_acl.asp?Mode=article&iLeftArticle=1152& m=&n=, (13/02/2004).

Finally, Figure 3.7 compares the time paths of price between competing suppliers. This shows quite clearly that, with the initial exceptions of the cable companies, the other direct and indirect[58] suppliers have always tended to price below BT. The differential has narrowed noticeably in recent years, suggesting that the entrants have played a crucial role in forcing down the price of the incumbent. Nevertheless, it must be questioned why BT is able to retain its leading market share (Figures 3.2 and 3.3), whilst, at the same time, charging higher prices. The apparent explanation is the first mover advantages of the initial sole incumbent – the strong BT brand name, reputation and consumer inertia.

Figure 3.7 Prices for UK International Calls by Supplier



Source: Data supplied by OFTEL, prices calculated by Total International call revenues/Total International call volumes.

INTERNATIONAL COMPARISONS

To attribute these dramatic falls in UK prices for international calls solely to the effects of increased competition would be wrong. Undoubtedly another major contributor has been the rapid cost-saving technological progress in the sector over recent decades. Examples of this include the substantial investment in international submarine cables which occurred in the 1990s[59] and other possible improvements in telecommunications networks. More generally, there has been rapid growth in adjacent, but to some extent competitive, product markets, such as mobile telephones and the internet. Technological progress has also undoubtedly improved the quality of service provided. In a brief study such as this, it is difficult to undertake rigorous analysis to identify the relative contribution of technical advance, as opposed to increased competitive pressures. Nevertheless, one way of touching on this question is by making international comparisons. If we assume that technological progress impacts on countries at relatively similar rates, we might compare prices in countries with deregulated telecommunications sectors with those where the sector remain under monopoly provision, to attempt to establish the effects of competition[60].

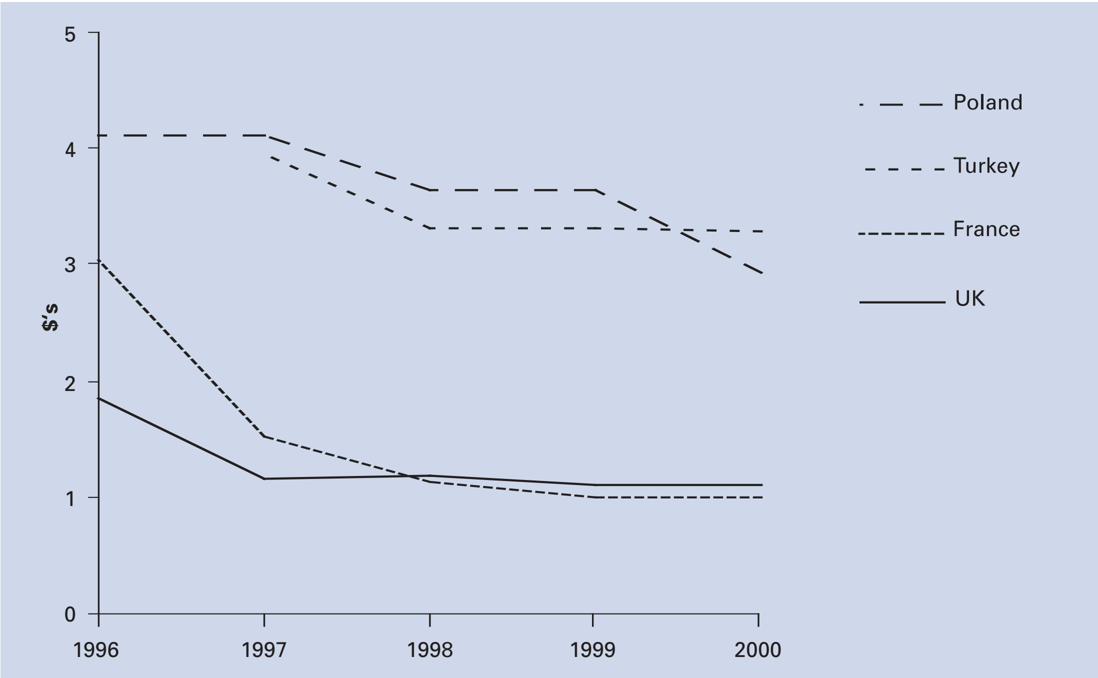
58 Data only available from 2000 for indirect access suppliers.

59 OFTEL (2001a).

60 An obvious limitation of this analysis is that it ignores the impact of differing regulatory reforms in different countries.

Unfortunately (for our purposes), there are now only a few other countries in which the sector remains monopolised: by 1999 only six Organisation for Economic Co-operation and Development (OECD) countries continued to operate telecommunications monopolies[61]. We have selected, almost arbitrarily, two of these six, Poland and Turkey, for comparison with the UK. We also include France in the comparison, as another country presumed to be more similar to the UK, in the sense that it, too, had opened up its telecommunication sector to competition. On the other hand, in 1998, in both Poland and Turkey, all local, national and international infrastructure and services were under monopoly provision. Poland aimed to have complete market opening for long distance and international services by 2003 and Turkey estimated complete market opening by 2006[62]. Figure 3.8 shows the comparison.

Figure 3.8 Cost of a 3 Minute Call to the US from France, Poland, Turkey and the UK



Source: World Bank, World Development Indicators, 1999-2002, (ITV (1999-2002)).

As can be seen, prices in the UK and France were significantly lower throughout the 1996-2000 period; whilst prices in Poland and Turkey had fallen over these years, their absolute levels were still very much higher than in the UK and France. This therefore suggests that a significant proportion of the fall in prices in the UK can indeed be attributed to the benefits of increased competition. However, it would be rash to read too much into what is only an illustrative and largely ad hoc comparison such as this.

CONSUMER EVIDENCE

Finally, we now explore a little more fully the important issue of consumer awareness and willingness to switch. Entry (whether actual or potential) is only a necessary condition for a more competitive market, it is not sufficient: if entry is to be effective, consumers must be aware (i) that it has occurred, (ii) that it might be in their interests to switch supplier, and (iii) to actually switch.

61 OECD (1999).
62 OECD (1999).
63 NOP (1999), OFTEL (2001a).

Important insights into this can be found from qualitative surveys of consumers. One such survey was conducted at the time when OFTEL reduced regulatory constraints on BT and Concert (see above)[63]. This established that, while relative prices are important, for many consumers they are not always the prime concern; when choosing an international call supplier, line quality and convenience are also important. In addition consumers calling only a single international destination were particularly aware of potential high costs, and therefore invested considerable time in searching for a low cost supplier. It was also found that there was very little knowledge of carrier pre-selection, and very mixed responses concerning its benefits. The majority of consumers continued to use a fixed line provider and there was often a lack of awareness concerning other options. However, evidence showed that consumers were prepared to try alternatives when approached, but not to actively search for alternative suppliers. Consumers were also generally satisfied with the service provided by alternative suppliers.

This research raises a number of important issues. Firstly, the fact that consumers are not just concerned with low prices may explain why large numbers have remained with BT despite the price differentials described earlier. If consumers are concerned with quality, then BT appears to have a significant advantage due to its prominent brand name. If this is the case, then it will be important for the future that consumers are satisfied with the service they receive from the new alternative suppliers, leading eventually to the entrants' own reputation for quality of service. It is also significant that the consumers who were most prepared to actively seek out alternative suppliers were those calling only a single destination, These are the consumers for whom the cost of acquiring information is lowest, and we would expect them to be the most likely to switch. But the other side of this coin is that consumers who call a number of different international destinations find it relatively more difficult to make systematic comparisons.

Some of the quantitative survey results[64] also make interesting reading: 61% of respondents used BT as their sole supplier of international calls, while 31% used BT plus one other company; 63% of those changing supplier within the last year had switched to a supplier other than BT; and 27% reported that they were likely to switch supplier within the next year.

Overall then, there is evidence that a significant proportion of consumers have taken a 'dual supplier' service, switched, or are willing to. Our earlier market share comparisons suggest, nevertheless, that they are probably in the minority – BT's share remains high, given that it appears to typically price higher than the competition. Of course, a significant benefit from increased competition is increased choice. In this case, if competition provides consumers with the choice of low cost suppliers, but many consumers choose to remain with an established firm, consumer sovereignty must be respected. But equally, it is important that consumers are genuinely informed, and have full information on the alternatives available. Tentative casual observations suggest that the advertising of alternative telecommunication suppliers such as television advertisements, posters, leaflets and sponsorship, has increased significantly in the last few years and consumers are becoming increasingly better informed.

64 Annex B NOP (1999).

3.6 Conclusion

As a matter of simple fact, there is no doubt that the cost to consumers of international phone calls has fallen dramatically in the years since full deregulation and significant new entry. It also true that, since the 1980s, the structure of the market has undergone fundamental change – where once there was a single provider, consumers now have the choice between a number of providers. Since the new entrants have gained significant market share, there is also evidence that consumers are exercising that choice, and presumably this is largely price-based. In that sense, we can confidently claim that 'competition is working'.

This does not necessarily mean, of course, that competition is working perfectly (many consumers have not been swayed by, or are unaware of, price differentials.) Nor does it mean that increased competition is the sole, or even necessarily the main, driver of lower prices. Rapid technological change has clearly been another important factor. Nevertheless, as a market delivering to consumers very significant price reductions, for whatever reasons, this is an excellent example.

4. The Net Book Agreement

4.1 Introduction

The history of the Net Book Agreement (NBA) is a long and remarkable one. Its effect on the book market in the UK and Ireland was profound from its beginnings in approximately 1900, until the competition authorities prompted its ending in 1995-97. This agreement amongst publishers was used to artificially constrain the retail price of book, by preventing any bookseller from selling a book under the publisher's chosen (net) price, without facing a publisher-wide refusal to supply future books. The collective nature of the NBA's enforcement constitutes an unusual example of 'collective resale price maintenance'.

The NBA and the wider issues surrounding it have remained highly controversial. The case is quite extraordinary when one considers that the arguments have endured for almost one hundred years, dividing and puzzling policymakers, economists and even industry members themselves. It is also noticeable how the arguments have evolved and changed over time, in line with the evolution of the industry. This chapter attempts to clear some of the confusion by assessing the relative success of the actions taken by the competition authorities to end the agreement. Although the evidence since 1995-97 is a little ambiguous, on balance, we suggest that the hoped for price reductions have materialised, without some of the feared adverse side effects (such as loss of choice and quality).

4.2 The Net Book Agreement

The NBA was a collective agreement among publishers to enforce a vertical restraint on book retailers, in the UK and the Republic of Ireland. Retailers had no active part in forming the agreement. Within the NBA any publisher was free to name any of its book products as a 'net book'. The agreement actually covered not just books, but maps, pamphlets and other printed materials and so 'books' are referred to in a loose sense. Having named the book as a net book, the publisher was then also free to name a 'net price'. Any retailer of the book was then restrained from selling the book at any price under the net price (except under some special conditions[65]). Any retailer who defied the publishers' rules by trying to price below the enforced price, would be collectively refused any future supply of books from all participating publishers.

The imposition of prices on retailers by manufacturers or in this case, publishers, is termed by economists as 'resale price maintenance'. However the NBA departs from the standard example of resale price maintenance due to the very rare feature of collective enforcement, rather than individual enforcement. Usually RPM is imposed

65 A retailer could price below the net price in three scenarios. i) An annual two-week National Book Sale allowed the retailer to undercut the net price on books which he had not ordered a copy of in the past 12months. ii) The retailer could also price freely if the book was second hand, and 6 months had passed since publication. iii) Any retailer sales to libraries were allowed a ten percent discount below the net price.

and enforced by a single manufacturer on the retailers of its product, but here it was enforced collectively as part of a formal manufacturer agreement. All publishers would punish any deviating retailer. In this sense the NBA provided a very strong weapon for publishers to control prices, and, as will be argued below, it may have also allowed publishers to collusively coordinate prices.

4.3 NBA and policy intervention

Without prejudging the motives, it is fair to suggest that the publishing industry has seemingly always aimed to constrain retail price competition. The NBA came into existence as long ago as 1900, having been approved by the Publishers' Association and the Association of Booksellers of Great Britain and Ireland. Previously in 1895, it was agreed that 16 books were to be 'netted'. Ironically one of these books was one of the founding books of modern economics – *Principles of Economics* by Alfred Marshall. In 1956 the government began a new more pro-active era on vertical restraints between firms, by introducing the 1956 Restrictive Practices Act. This act prohibited any collective enforcement of restrictive practices and the later 1964 Resale Prices Act went even further by forbidding any individual resale price maintenance. The NBA would seem to be in breach of both of these acts by collectively enforcing resale prices above the competitive level. In an attempt to seek exemption from these actions, the NBA was rewritten and formalised in 1957. In 1962 the Restrictive Practices Court considered the illegality of the NBA, and contrary to initial intuition, its judgement exempted the NBA, allowing it to continue. In the judgement, Mr. Justice Buckley famously emphasised that 'Books are different', and considered the NBA to be in society's interest. The NBA remained in this state until the mid-1990s.

In August 1994, the Director General of the Office of Fair Trading announced a review of the NBA's legal status. At the time of this announcement, and for the period after the announcement, there was growing pressure to abolish the NBA. Within the industry itself large divisions of opinion began to appear. Some publishers (HodderHeadline, HarperCollins and Reed Elsevier) led protests for reform, which were echoed by some retailers. The retailer, Dillons[66] actually broke the agreement without authority and was prevented from further doing so, with a court injunction by the Publishers' Association. However other retailers (WHSmith and Waterstone's) always remained in favour of the agreement. The retail sector was rapidly changing and the enforcement of the NBA was beginning to be threatened. Most particularly, new forms of book retailing were making enforcement of the agreement more difficult. For example, the growing interest of supermarkets (e.g. Asda) in book selling brought in some new players with huge bargaining powers that threatened to break the agreement, and the increasing popularity of the internet and discount book clubs made enforcement even harder[67]. Further pressures mounted from overseas: the European Commission judged the NBA to be in breach of Article 85 of the Treaty of Rome in 1988, because of the cross border considerations between the UK and Eire, and this alone resulted in the NBA's collapse in Eire in 1992. Eventually, the pressures became too strong and the Publishers' Association disbanded the NBA, making it effectively inoperable for publishers, in September 1995. This occurred before the government's review of the exemption, and it was not until March 1997 that the Restrictive Practices Court formally outlawed the NBA, under the 1976 Restrictive Practices Act.

66 Now added to the Waterstone's collection of stores within the HMV Media Group.

67 Utton (2000, p.119) reports in the mid 1960s there were 3000 book club associates, but over 2 million in the mid 1990s. Figures for bookselling on the internet are scant, but would probably show huge growth.

BOOK INDUSTRIES ABROAD

Systems of RPM or equivalents of the NBA do exist elsewhere in the world's book markets. Germany has a strongly enforced system, as does France. In France a bookseller can discount only up to 5% of the publisher's price. RPM was abolished in 1979, but then reinstated in 1981, despite reports suggesting it was contrary to consumer interest. In 2001 the European Court of Justice rejected a claim by a French discounter that the system resulted in price fixing (Keynote (2002)). Other systems of RPM exist in Australia, Denmark, Greece, Italy, Spain and Holland (booksellers.org.uk). The US market has never had any maintenance due to the Sherman Act, and despite this, is considered a healthy book market (Allen and Curwen (1991, p.63)).

4.4 Arguments for and against

As stated above, in 1962, the NBA was granted an exemption from usual legislation, after a long, complicated hearing. In 1997 the second judgement made a policy 'u-turn' by removing the exemption, in a hearing that was far briefer and more straightforward than in 1962. Many of the arguments seen in 1962 became a lot simpler in 1997 because the industry's structure and practices had dramatically changed, and notably, the NBA had already collapsed in 1995. The 1997 hearing actually had to ask for volunteers to defend the NBA. OFT argued that 14 material changes had occurred since 1962, and that these changes were such that the NBA no longer benefited society. The Restrictive Practices Court accepted 11 of the 14 points, and as a consequence, the Court's decision to abolish the NBA became a clear one. It is the aim of this section to understand the arguments made in each hearing, and to assess why the reversal in policy was needed. The validity of each argument will also be assessed in the light of modern economic theory. Economics has much to say on the impact on society of RPM schemes such as the NBA. We shall see that if one were to jump back to 1962 using the ideas we have today, some of the 1962 arguments seem ill founded.

At a first glance, it would seem the NBA would artificially sustain retail prices, be anti-competitive and directly harm the interests of the consumer. Unfortunately the NBA's effects upon the book market and consumers are not so clear-cut as one might imagine. The 1962 Judgement lasted twenty-four days, and eventually suggested the agreement was in society's interests (see Allen and Curwen (1991)). The Judgement famously viewed books as being a special kind of market, above common law, "...the production and marketing of books involve problems that are different from those which are in connexion with most other commodities." (The 1962 Judgement, see the transcript in Barker and Davies (1996, p.4)). The 1962 exemption was founded on three negative effects that were predicted if the NBA were to be abolished. These have formed the basic points of contention in the debate ever since[68]:

(i) The retail price of books

(a) Retail competition

(b) Publisher collusion

(ii The survival of (small, independent) booksellers, and booksellers' stockholdings.

(iii) The production/authorship of books.

These will now be discussed in turn.

68 Effect i) has been split into two for expositional purposes.

EFFECT IA): RETAIL PRICE OF BOOKS – RETAIL COMPETITION

With the removal of NBA, retailers would become free to price books as they wished, and one would imagine that this would inevitably lead to price competition and a downward pressure on prices. However in 1962, the Court agreed on the opposite effect. Book prices, in general, were predicted to rise. At the time, it was thought that the downward pressure on prices following the end of the NBA would be most noticeable in the form of heavy, select discounts on popular books (as we have indeed seen since 1995). In modern terms, it was thought that loss leader pricing would prevail, without much change in other book prices. The effect of loss leader prices can be seen as depending on how much consumers search different stores to find the lowest price. If consumers search around town, then a very low loss leader price will attract a lot of revenue from other stores. The possible loss in revenue due to other firms' pricing would increase the volatility of individual demand for a store. This introduction of uncertainty and risk into stores' revenues would not be welcome, and in 1962 it was argued that firms would respond by ordering fewer copies of books, in fear of not being able to sell any excess stock. This reduction in order size would make publishers' print runs a lot smaller, reducing their cost efficiency. Larger print runs can produce cheaper books, due to economies of scale, but reductions in orders would prevent this, increasing the cost of books. As a consequence, in 1962 it was thought that these increases in book production costs would offset any reductions in price from increased retail competition, making the general prices of books increase.

A modern theoretical view of this argument could possibly agree with the Court's prediction, but not necessarily agree with its conclusion. Yes, reductions in orders may have increased prices, but this may have been, in some sense, 'correct' for society, as it is a product of market forces. Artificially maintaining larger orders through the NBA to keep lower costs would disgruntle many economists who would think such an action to be unnatural, inefficient and damaging to society outside of the book market.

In 1997, the second hearing was easily able to reject the 1962 arguments. Book production now involved new information technologies that made smaller print runs far cheaper, and economies of scale were not such an important issue. Reductions in orders would hardly affect efficiency or costs. Further, new business practices such as 'sale or return' where retailers can order as many books as they wish and simply return them if unsold, and quicker delivery times from wholesalers, both vastly reduce the inventory risks that were so feared in 1962. The introduction of price competition would not reduce ordering and increase costs, and so the only remaining price effect would be the downward pressure from competition, benefiting the consumer. The predicted effect was that book prices would be free to fall, and this effect was the primary reason for the 1997 decision to end the NBA.

EFFECT IB) RETAIL PRICE OF BOOKS – PUBLISHER COLLUSION

A second strand of the effects on price, which is often neglected, concerns the possible collusive implications of the NBA. Many of the other academic studies, and even the 1997 judgement, barely dwell on the collusive aspects of the NBA, despite, in our view at least, being an important aspect of the NBA.

Economic theory could argue that the NBA allowed publishers to coordinate prices and anti-competitively sustain high wholesale prices, across the market to increase their profits. However, in 1962 the Court judged "...the Agreement is not a price fixing agreement ...Net prices are fixed by publishers in conditions of free competition." (Judgement, Barker and Davies (1966, p.27)). It viewed the NBA not as a collusive device, but a device for purely maintaining price stability, ensuring predictable demand for sellers as described in effect ia).

While it certainly cannot be proved that the NBA was collusive, many economists would now agree that the reasoning of the Court seems plainly incorrect. It stressed the voluntary nature of the NBA: a publisher could choose a book to be net or non-net, and choose the level of its net price. The Court thought this was consistent with free competition. However this misses the point in many ways, and the Court ignored a possible argument that would imply that the NBA was a device to sustain collusive price fixing – the opposite of free competition. Despite having voluntary choices, a publisher would ideally participate in a collusive ring if at all possible, in order to achieve higher profits. To do so, publishers would have to fix wholesale prices across the market, and attempt to sustain this agreement by preventing any publisher from cutting its price below the agreed level. If book prices were indeed fixed, then one would expect prices to follow certain conventions and patterns. The circumstantial evidence supports the existence of such conventions. Wholesale book prices were often set at common levels across publishers by setting common net prices, and then offering the wholesale price as a common percentage off the net price. For example fictional works in 1962 were priced at 15,16 or 18s, with a common wholesale discount of 33%. (Judgement, Barker and Davies (1996, p.7-9)). The conventions continued over time. For example, Allan and Curwen (1991) present some prices of hardback fiction in 1991 across publishers (p.41, Table 10), showing all 18 selected prices, sharing a uniform price of £13.99.

Thus, although prices were in principle voluntarily set, the publishers could have had incentives to collude and voluntarily co-ordinate their prices and discounts. The Court conceded, "It may rightly be said that the adoption of such conventional prices ...tends to inhibit competition ...but these conventions are not imposed by the Net Book Agreement" (Judgement, Barker and Davies (1966, p. 8)). This last point is a fair one. The NBA itself has not played a part in creating or maintaining these pricing conventions. However one less standard view of resale price maintenance could be used to argue that the NBA did indeed help to sustain these common prices, by dissuading publishers from cutting their prices below the common levels. In technical terms, the NBA may have been a facilitating device for a collusive agreement.

Telser (1960) argued that a set of manufacturers (publishers) could use RPM to enforce a collusive agreement. If the manufacturers could easily monitor each other's net prices, then the only way for a manufacturer to try and profitably deviate from the agreement would be to reduce its wholesale price. However, under RPM, any cut in wholesale price would be ineffective in generating profit, as the retailer cannot pass the cost reduction onto the consumer to create further demand. RPM neutralises any manufacturer's incentive to break the collusive agreement, which makes collective price fixing a very feasible possibility. A wholesale price reduction could only be profitable if it was low enough to persuade retailers to only sell the manufacturer's product, while stopping the selling of rival products. This however seems unlikely in the market for books. Telser provided an example case where he thought this story was likely, in the market for tungsten filament lamps, US Vs General Electric, Westinghouse and others (1926). With Telser's argument, the NBA could easily have been thought, but not proved, to be a device for helping the publishers to artificially maintain high prices in a collusive agreement. Ending the NBA would then suggest that prices would be allowed to fall.

EFFECT II): SURVIVAL OF (SMALL) INDEPENDENT BOOKSELLERS, AND BOOKSELLERS' STOCKHOLDINGS.

Recall that it was predicted in 1962 that the introduction of price competition discussed in effect ia) would reduce the stock orders and stockholdings of book retailers. The increased uncertainty of demand following the end of the NBA would cause booksellers to reduce their stockholdings. It was also thought that the increased competition would cause many of the smaller, independent, perhaps more inefficient stores to lose large amounts of revenue to the bigger stores offering lower prices. These two effects would be damaging to the consumer because stockholdings and easier access to stores were important aids in purchasing, as book buying often requires the browsing and physical inspection of books. "Stockholding booksellers are the shop window of the book trade", "The existence of stockholding bookshops ... is undoubtedly a powerful influence promoting the sale of books" (Judgment, Barker and Davies (1966, p.9)). The defence of the NBA in regard in to effect ii) in 1962, was often motivated by protection of small businesses and consumers. The defence in terms of booksellers seems a little curious, as the NBA was never an agreement involving the consensus of retailers, only publishers.

In modern terms, this argument was most probably correct in predicting the outcomes of price competition. It is true, that the introduction of price competition could result in a fall in the number of booksellers, and it is possible that the level of stockholdings would fall too. However, the Court's conclusion that this was undesirable for society may have been a little misguided.

One can re-assess the 1962 arguments into a more modern theoretical context of the desirability of the effects of RPM upon retail service provision. One can classify a store's stockholdings and the number of stores within the book market as part of the services that an industry offers to its consumers. It could be argued that the provision of these services may perhaps suffer if prices were allowed to be set freely. The effects, though sometimes quite complex, are commonly discussed in economics textbooks[69]. Here we attempt an intuition in the context of the book trade. In essence, under the NBA, retailers only competed upon services (non-price competition). This could entail competition on the adequacy of book ordering services or advice, but to keep in line with the original argument, let us assume this meant competing on the location of bookstores, and the level and range of stockholdings at each store. Retailers would aim to provide the best range of services in order to survive within the market. The NBA ensured high prices, and by preventing price competition also ensured stores offered high services too. Without the NBA, prices would be freely set and price competition could ensure prices were lower. Further, as suggested above, the level of service (number of stores, and stockholdings) would fall also. Therefore, one can think of the effect of the NBA, and the effect of more general RPM, as artificially distorting the retail sector towards supplying high prices and high service provision. The crucial issue is whether or not this distortion is in society's interest: a question that has provoked a long debate in economics with no clear answers.

69 See for example Tirole (1988), Scherer and Ross (1990), Church and Ware (2000) or Martin (2002).

Under free competition, without a NBA, the retail sector could fail to provide the optimal levels of service for society. This is not always true and depends on technical issues[70], but it can be true for the following intuitive reason (see Telser (1960)). If an example retailer tried to hold a huge amount of stock to attract lots of customers then the retailer would have to charge quite a high price to cover the costs of all the stockholding. A wise consumer could simply go to this store, browse for and inspect the books he wanted, and then visit another cheaper store to buy them. The retailer would then find all its stockholding costs went unrewarded, and would choose not to provide the high level of services in the future. In this sense a retail sector may be unable to provide the desirable levels of service. How can this problem be alleviated? Could the retailer above simply charge consumer for access to its large stockholdings? This seems impractical, and the 1962 Judgement recognised this (Judgement, Barker and Davies (1966, p.12)). Could the publisher pay a retailer to hold more stock, if it were in the publisher's interests to do so? The problem with this argument is that it may be very difficult for the publisher to monitor what the retailer's stock services are, and so the retailer may be hard to control. Thus, there remains one possible way to ensure that the optimal levels of service are provided – RPM. By restricting price competition, the NBA could allow retailers to be better rewarded for stockholdings. The NBA, while universally increasing prices, may have provided the conditions needed for retailers to provide optimal services, such that the NBA enhanced net social value. This is really a modern formalisation of what the Judgement suggested.

This has been shown to be theoretically correct, but only in certain market conditions. In other conditions, the effects of RPM, may harm the consumer. Theory has shown it depends on the conditions of the market, and it is not clear which is the correct prediction for the book market[71]. While confirming that service provision will fall, economics is unsure whether the end of the NBA would have been in society's interests or not, in this specific context.

However once again, in 1997, the argument became a lot simpler. The new practices such as 'sale or return' discussed in effect i) largely neutralised any ideas of reductions in stockholdings. Many of the hypothesised risks of stockholding were simply not an issue in 1997. In regards to the survival of the independent stores, several new features of the market also weakened this argument. The Court argued that consumers' search activity was actually quite small so that smaller stores would not lose such large amounts of revenue to bigger, cheaper stores. Another argument suggested that smaller stores could compete on back listed books that would not be part of leader pricing. This actually makes up a significant part of the market (80% of Waterstone's sales are back lists (see Utton (2000, p.121)). This part of the market would also provide predictable demand patterns reducing the impact of uncertain stockholding costs. Further arguments in direct respect to the first prediction of store bankruptcy suggested that retailers were in a much better shape to take on any new risks, or increased competition. The retail sector has vastly increased in concentration since 1962, with the emergence and growth of many large chain stores (see section 4.5). Consequently, although the theoretical arguments of effect ii) are a little ambiguous, the changes in the industry made the concerns of 1962 seem quite out place in the 1997 book market.

70 A competitive retail sector will engage in competition to maximise the surplus of the average consumer. This can actually supply too little service in some instances when compared to a less competitive retail sector where the surplus is maximised with respect to the marginal consumer. It depends on the relative valuations of the service increase between the average and marginal consumers. (See the references in the previous footnote for more detail.)

71 Again, as noted earlier, an RPM scheme may be able to improve the levels of service compared to that provided by a competitive retail sector, depending on the relative valuations of the average and marginal consumer. See Scherer and Ross (1990) Ch.15 for a nice explanation.

EFFECT III): PRODUCTION OR AUTHORSHIP OF BOOKS.

In 1962 a final argument over the NBA concerned the protection of author incomes, in order to ensure high levels and quality of writing, which was of value for society. The increased costs and increased retail competition resulting from the end of the NBA would make publishing less profitable. The returns from writing and publishing a new book would fall, and the Court argued that this would reduce the number of titles published each year, damaging society's creative and educational sources.

From a theoretical point of view, once again the 1962 judgement's prediction, but not the conclusion seems correct. The returns from publishing would fall as predicted but this does not always imply that fewer books are written and published. As every undergraduate would know, a fall in a wage rate (for an author) would on the one hand make writing less profitable and so the author would write less, but on the other hand the author would have to write more to maintain a standard of living. Either of these effects could be larger, and so book authorship need not fall. In 1997, the Court viewed this effect to be a minor one.

SUMMARY

To summarise, in 1997, the Court made the NBA illegal for the following reasons. It was hoped that increased price competition would have beneficial effects on the retail price. This was the headline argument, but there were also three feared side effects: falling numbers of independent stores, retail stockholdings and published titles. However, all three side effects were expected to be small in magnitude. In fact, we have argued that the possible fall in stockholdings and independent stores may actually be optimal, if the NBA was inefficiently distorting the retail sector. Thus effect ii) may actually be a beneficial effect. The 1997 decision to end the NBA seemed quite clear cut, yet it differed from the view in 1962. This difference was due to perhaps a misguided theoretical view of the NBA in 1962, and most noticeably the drastic changes in the book industry since 1962.

The 1997 decision could be thought of as rather trivial, as the agreement had already broken up some two years before, but it was the threat of the review of the exemption in 1994 that really initiated much of the pressures that led to its break up. The question we now move onto is whether the 1997 decision was the correct one by looking at the evidence of the years which followed.

4.5 Outcomes

There have been several previous studies of the effects of ending the NBA. Fishwick and Fitzsimons (1998) provide a very detailed analysis with aggregate data and large survey findings of customers and book industry members. They conclude, "the disadvantages for the general public expected to follow the end of the NBA have been less evident than the 1962 Judgement predicted" (p.139). They did stress however that more evidence is needed as time passes since abolition. More recently, Dearnley and Feather (2002) conclude in a similar fashion: "The UK book trade has both retained its essential fabric and adapted to fresh challenges...there is little compelling evidence that the abrogation of resale price maintenance in 1995 intrinsically harmed the UK bookselling trade." (p.30). Here, we will review some of the evidence from these studies and provide some newer data from the UK book market in order to understand the impact since 1995.

RETAIL PRICES

One very obvious effect has been the startling drop in the price of popular paperback fiction. Chart-topping books are regularly discounted and priced with multi-buy offers such as ‘two for one’. For an arbitrary example, see Table 4.1, which shows some prices of the top five best sellers in early March 2003.

Table 4.1 Prices (£’s) for the Top 5 Paperback Fiction Books on March 01, 2003

	1	2	3	4	5
RRP	6.99	6.99	6.99	5.99	6.99
Firm					
WHS	4.99	4.99	5.24	3.99	4.99
Waterstone’s	5.43	5.36	5.27	4.69	5.30
British Books	4.99	4.99	4.99	3.99	4.99
Asda	3.84	3.84	3.84	3.84	3.84
Tesco	3.51	3.84	3.84	3.84	3.84
Sainsbury’s	6.99	6.98	6.99	5.99	6.98
Amazon	5.59	5.59	3.49	4.79	3.49

Source: Publishers’ Association (2003), compiled by Nielsen Bookscan, using the Bookseller bestseller list. The five bestsellers referred to are 1. Bad Boy, Jack Josephine Cox 2. Girl From The South, Joanna Trollope 3. The Summons, John Grisham 4. The Wind Off The Sea, Charlotte Bingham 5. 2nd Chance, Patterson/Gross

Note how the prices are consistently and significantly lower than the publishers’ recommended prices, where the recommended prices could be interpreted as the prices that would have obtained under the NBA, with discounting forbidden. Another recent example is the price war which accompanied the release of the fifth instalment of the Harry Potter books. Table 4.2 shows the extreme discounting used by some retailers.

Table 4.2 Prices (£’s) for ‘Harry Potter and the Order of the Phoenix’, June 2003

RRP	Amazon	John Lewis	Tesco	Safeway	Sainsbury’s	WHSmith
16.99	8.49	9.95	9.97	9.99	11.99	11.49

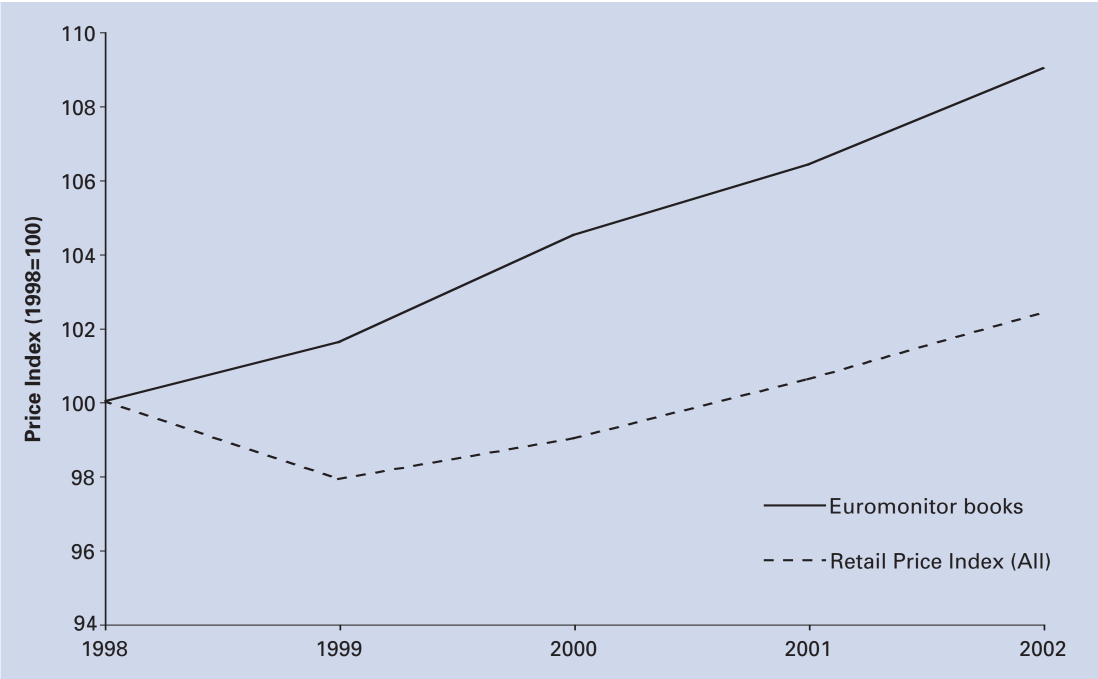
Source: John Ezzard, The Guardian, June 20 2003

However for a fuller picture of how book prices in general have behaved since 1995 we must look for more aggregate data on book prices as a whole.

Unfortunately, finding a measure to adequately and accurately characterise the average price of books is notoriously difficult, and there are many alternative indices, which in some cases differ quite substantially. Consequently, there is an inherent ambiguity in measuring price changes. Allen and Curwen (1991, p.60) point out , “..available statistics on book prices are to a greater or lesser extent flawed.” The problems include the following. One cannot simply take an average of a sample of book prices, as with all goods, the average should reflect the volume sold of each individual good. Thus if a Harry Potter book sells a million copies and another book sells one hundred, more weight should be given to the price of Harry Potter, yet the volumes sold change continuously. One must also consider not just quoted prices, but retailer discounts and actual selling prices. Account must also be taken of the multi-buy style offers that are commonly used such as 'two for one'. Moreover, consideration must also be given to the presence of quality changes. These prove particularly difficult to factor in/incorporate.

With this caveat, Figure 4.1 shows an index from Euromonitor, which maps prices from 1998. This suggests that book prices have only grown by 2.8% over the period 1998-2002, while retail prices in general grew by 9%. This would imply that increased competition has dramatically reduced the real price of books.

Figure 4.1 Euromonitor Book Price Index 1998-2002 (1998=100)

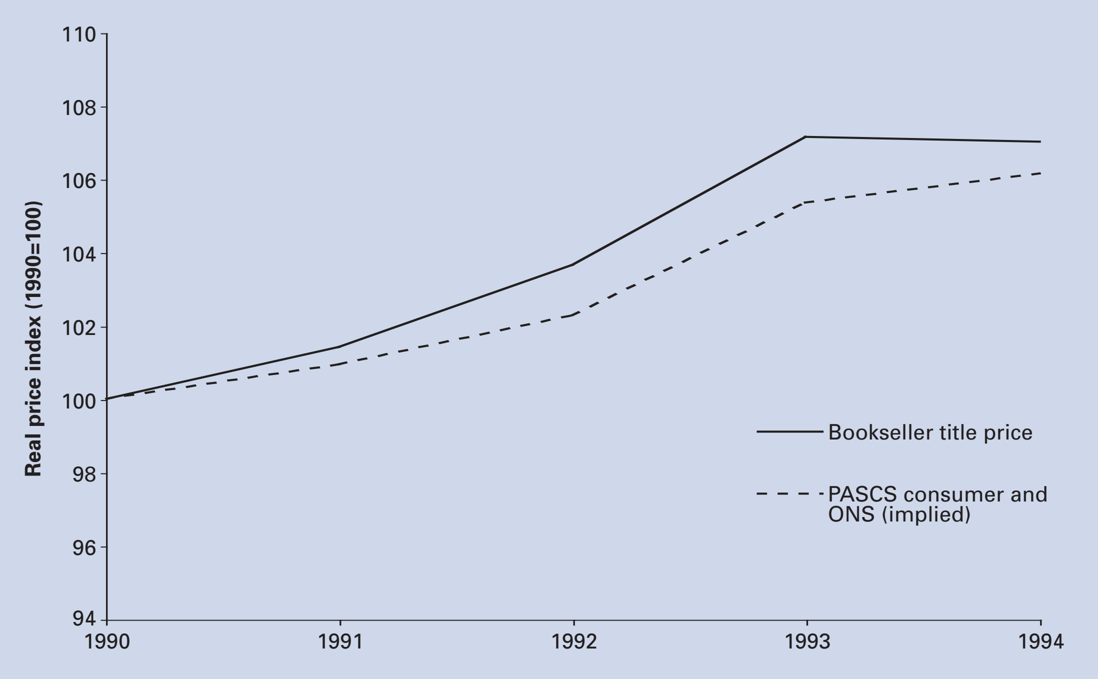


Source: Euromonitor (2003, p.55)

However other indices of book prices are not quite so clear cut. Figures 4.2a and 4.2b are derived from information provided in Dearnley and Feather (2002). They both map three alternative book price indices. We have re-indexed their data and re-expressed relative to the aggregate retail price index, first for the years 1990-1994 (before the ending of the NBA), and then for the period 1996-1999, without the NBA. The three measures are: the Bookseller title price index, which takes no account of seller discounts or volume effects, an approximate measure from the Office of National Statistics, and the PASCS measure from the Publishers' Association Statistics Collection Scheme which uses average invoice prices, and takes into effect the problem of weightings but does not reflect retailer discounts. Consequently all three measures are by no means accurate and are likely to overestimate book prices. Unfortunately more recent value of these indices are limited in availability, but the two parts of Figure 4.2 can still provide us with some interesting evidence. Figure 4.2a shows all three measures[72] of real book prices trending upwards – in the last years of the NBA, real book prices were increasing rapidly. Although not shown, this pattern was seen for most of the NBA's history. One could argue that this was due to the anti-competitive effects of the NBA.

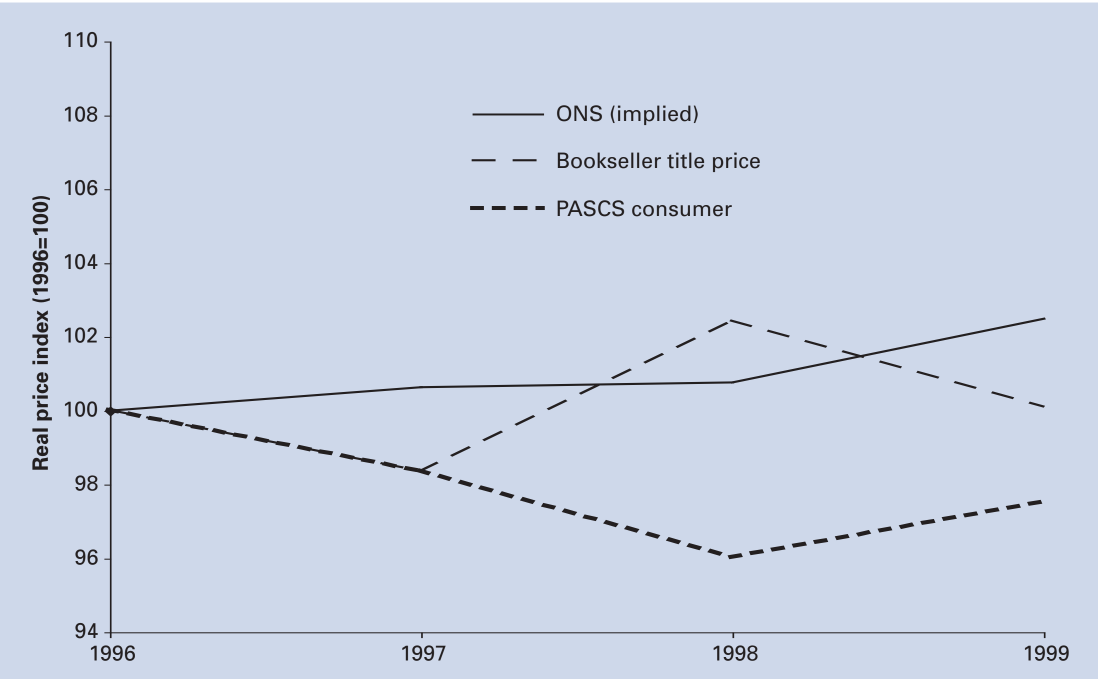
72 In this sub-period, PASCS and ONS are consolidated into a single line.

Figure 4.2(a) Real Book Price, 1990-1994, before Abolition of the NBA (1996=100)



In Figure 4.2(b), however, the picture is quite different. The year 1995 is left out as there was a small blip in prices, which can be accounted for by adjustments within the industry and a rise in the cost of printed matter at this time. However since 1996 we can see that the real price of books has by no means continued its upwards trend. Indeed the PASCS measure, in line with Figure 4.1's evidence, shows a fall in real prices. The ONS measure shows a reduced rate of increase of real prices, while the Bookseller title price index lies between the two. The two trends in Figures 4.2(a) and 4.2(b) are quite different, and provide strong support for a change in pricing behaviours within the industry between these two periods as the NBA broke up.

Figure 4.2(b) Real Book Price Measure, 1996-1999, with no NBA (1996=100)



Source: Figures 4.2(a) and 4.2(b) have been reconstructed from Dearnly and Feather (2002).

The two figures are not conclusive proof that the ending of the NBA has decreased prices, but if we bear in mind the measurement problems, there is fairly strong argument that book prices have become more competitive.

A final indication of the effect on pricing can be gained by examining the percentage of books that are discounted below the publisher's recommended price. Although we have no figures for the period under the NBA, one would expect virtually no discounting. Table 4.3 shows how this has changed.

Table 4.3 The Frequency of Book Prices that are Discounted

1997	1999	2003
41%	49%	52%

Source : DTI – Pira International (2002), Publishers Association (2003)

Again this adds weight to the argument that prices have decreased since the end of NBA.

SMALL, INDEPENDENT BOOKSELLERS, AND BOOKSELLERS' STOCKHOLDINGS

One of the feared side effects from abolition was that there might be a reduction in the number of independent book retailers, and a possible reduction in the stockholdings of booksellers. For a first piece of evidence we can look at how market shares by type of store have developed since 1955 (Table 4.4).

Table 4.4 – Retail Sales by Firm Type 1995-2002

Firm Type	1995	2002
Large/Multiple Stores	31.0	57.3
Independent Stores	27.8	11.7
Grocery multiple	1.1	5.2
Book Clubs	9.0	20.7
Internet	-	5.1
Other	31.1	-

Source: Euromonitor (2003b, p.74), * 1995 Figures spliced from different measures, www.euromonitor.com, www.booksellers.org.uk)

Since the 1995 figures are not perfectly comparable to those for 2002, the Table should be treated with care. However it is easy to see the trends. Independent market share has fallen significantly as feared, as the large and multiple stores have grown. The growth of supermarket and internet activity is also clear, but has levelled off at a low level. The supermarkets concentrate on selling very popular books at very low prices, and actually account for 50% of sales in this category (The Bookseller (2003b)).

However we should not jump to conclusions: the market share of independent stores may have fallen, but what has actually happened to the number of independent stores? Figure 4.5 shows the membership figures from the Bookseller's Association, and this confirms that the number of independent small businesses has indeed fallen since 1995, but in fact the loss in small businesses is perhaps smaller than the market share figures may have indicated. Further the fall has been a lot smaller than many commentators predicted.

Table 4.5 Bookseller's Association Members by Firm Size 1995-2001

Year	Total	Independents (1-5)	5+	10+	Multiples/Chains	(Warehouse)
1995	3333	1894	81	-	-	-
1996	3280	1846	85	-	-	-
1997	3281	1839	87	-	-	-
1998	3277	1798	83	694	702	
1999	3257	1774	81	744	638	20
2000	3204	1714	74	766	630	20
2001	3141	1669	57	768	629	18

Source: Dearnley and Feather (2002)

We can find a fuller picture of what has happened to booksellers with some more recent evidence. Table 4.6 represents a similar pattern to table 4.5, showing the fall of independent stores, and the rise in the number of chain store branches. This perhaps indicates a larger fall in the number of independents, but it is still less than what we would expect from the market share data.

Table 4.6 – The Number of Independent and Chain Store Branches 1998-2002

Year	Independents	Chains	Totals
1998	21257	1854	23111
1999	20334	1867	22201
2000	19638	1875	21513
2001	19175	1896	21071
2002	18735	1923	20658

Source: Euromonitor (2003b, p.76)

This may indicate that some independent stores have unfortunately been squeezed out since 1995, but much of the transfer in market share has been not due to involuntary shifts due to closures of small stores, but voluntary transfers to the emerging big stores. If so, the changes in the market have been of value to the consumer who has preferred the emerging big stores. The loss of some smaller stores may not have been too costly for the consumer.

For more evidence of the growth of the chain stores we can analyse the floor space owned by some of the chains over time. Table 4.7 seems quite astonishing; it not only shows the growth of the chain bookstores but also presumably can give some indication to the level of stockholdings. The level of stockholdings was expected to fall, but clearly one may conclude from table 4.7 that the consumer will have access to a plentiful stock selection as a result of the huge growth of the larger businesses. We must be careful to say that this does not mean the diversity of books has not fallen since 1995, and we must moderate the growth in floor space by remembering that many increases in shop space have included widening of aisles.

Table 4.7 Retail Space 1993-2002 (000's of Square Feet)

	1993	1998	1999	2002
Ottakar's	37	164	263	360
Borders	56	145	301	650
Waterstone's	500	125	1334	1295
WHSmith	700	1300	2290	3300

Source: www.publishingnews.com, www.booksellers.org.uk

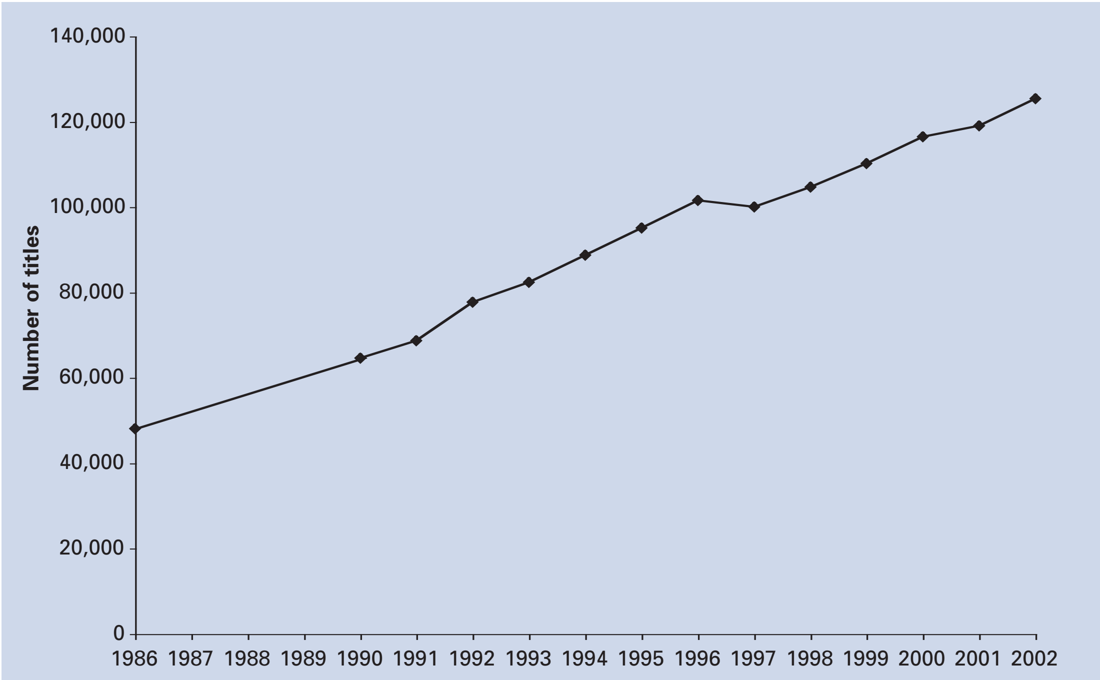
The relative loss of independent stores, and the relative gain of the chain bookstores and supermarkets will undoubtedly anger many people in and out of the book industry. This is clearly a possible downside of abolishing the NBA, but this effect was minimal and much smaller than some commentators argued. More importantly one has to remember that the NBA was artificially providing for the smaller, less profitable stores, and that this may have been contrary to society's interests

THE PRODUCTION OR AUTHORSHIP OF BOOKS

Finally effect iii) concerned the production of books, and the level of education and culture within the country. These concerns seem unwarranted. The figures are far easier to measure than prices, and show a healthy book market. Figure 4.3 shows that the number of published titles has increased at the same rate, as before the end of the agreement, with only a slight hesitation in 1995-7.

However there is naturally some unrest in the industry at the falling returns for writers due to retailer discounting (see The Bookseller 2003a), and there have been some rumours that publishers are set to cut the number of books they publish, blaming the fierce high street competition for promotion slots[73].

Figure 4.3 Number of UK Published Titles 1986-2002



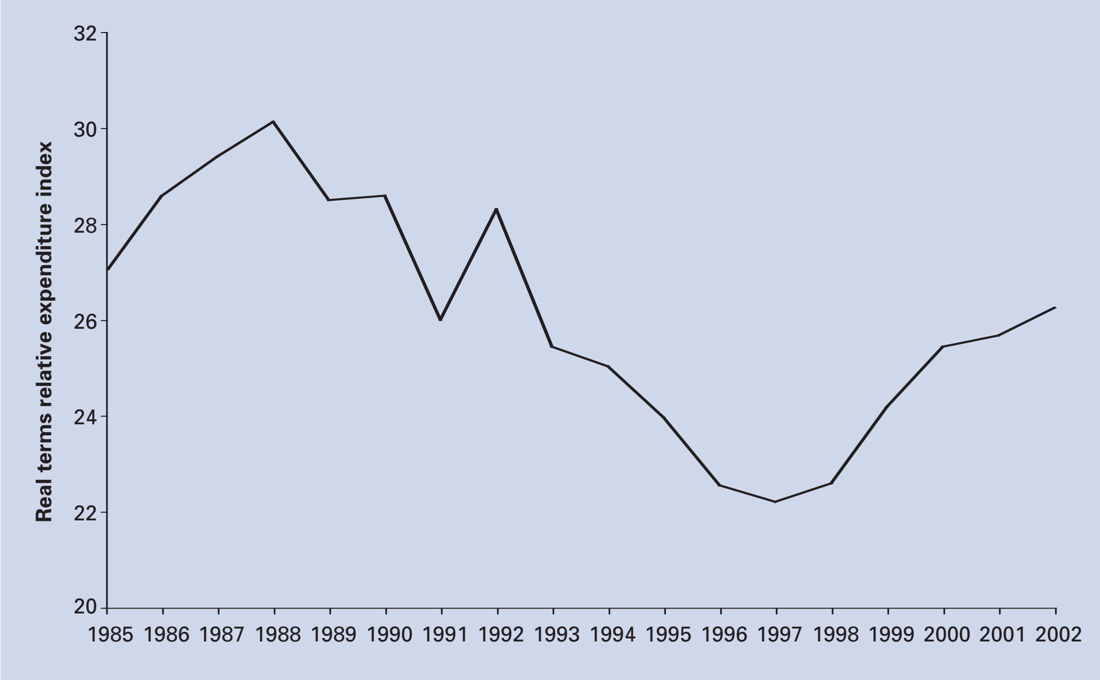
Note: A break occurs in the data series between the years 1987-1989
Source: www.booksellers.org.uk, www.bookmarketing.co.uk

One final piece of evidence would seem to underline the benefits accruing from outlawing the NBA. Figure 4.4 shows how book expenditure relative to total consumer expenditure has changed since 1985 (in real terms). Of course, price is only one determinant of demand, and, if demand is also income-elastic, one might expect consumers to devote an increasing share of their total expenditure to books. Nevertheless, for many, many years the share of books in total consumer expenditure was trending downwards. However, since 1995, after a short lag, relative expenditure has started to increase. From this pattern, we can further deduce that as prices have probably fallen since 1995, so the quantity of books being bought must have increased.

73 Matt Born and Sally Pook, Daily Telegraph, January 5, 2004.

It appears that more books are being bought since the ending of the NBA. One may think that the access of cheap books in supermarkets, and the growth of attractive chain book stores including coffee shops and new retailing methods, perhaps spurred on by increased competition, may have actually expanded the market.

Figure 4.4 – Relative Consumer Expenditure on Books 1985-2002 in Real Terms



Source: Office for National Statistics, Consumer Trends

4.6 Conclusions

The effect of abolition on book prices appears to have been downwards, as hoped, but problems of measurement and aggregation mean that we should admit some uncertainty on this count. Certainly, there is evidence that popular book prices have dramatically fallen. We can conclude that many of the feared side effects on independent bookstores, and title production have been either ill founded or have been smaller in magnitude than expected. Unexpectedly, the entry and growth of the chain store and supermarkets has brought with it large stockholdings and attractive retailing that has rapidly expanded the size of the book trade. Consumers are spending more and more on books, which is comforting from a cultural and education perspective.

5. Passenger Flights in Europe

5.1 Introduction

Until the early 1990s, the aviation market in Europe (and most other parts of the world) was heavily regulated in terms of access of airlines to routes, and prices were fixed, to a greater or lesser extent, by international agreement. This chapter examines the impact of the liberalisation which took place through the 1990s. It was anticipated that this would produce new entry, and this is exactly what happened with the emergence and rapid growth of low-cost airlines. However, these firms, notably Ryanair and EasyJet in the UK, were not just entrants, they were entrants with a quite different business model from that of the traditional airlines, and so this is a story of liberalisation coupled with innovation.

In order to confine our analysis to manageable proportions, we focus on just a sample of routes – from the London airports to various European and domestic destinations – comparing fares and frequency levels prior and post liberalisation. Because we are interested in how liberalisation and entry has changed the nature of competition, we focus attention on the strategic response of the traditional carriers – in the British case, this means, of course, British Airways (BA). We find evidence of quite dramatic price reductions.

5.2 Change in the competitive environment

Although this is a study of the impact of liberalising a market by opening it up to entry, it is as much about the impact of the new business practices introduced by the entrants. While the former was a necessary condition for the latter, it was no sufficient. Thus it is a story of the effects of a combination of (i) removal of a market imperfection and (ii) entrepreneurial initiative. We shall not attempt to disentangle their relative contributions, since the two are inextricably linked. We now introduce both in turn.

THE LIBERALISATION OF EUROPEAN AVIATION MARKETS

Prior to liberalisation and the establishment of a single European market in 1993, the air transport market in the EU was really a collection of separate national markets. Within each member state domestic air transport was governed by national rules, which varied in their competitive nature. Although the UK domestic market was more liberal than most other European domestic markets, the regulatory system helped to protect the interests of national carriers rather than promote competition. International air transport between member states was governed by bilateral air service agreements between each pair of member states. These restricted access to markets and often allowed only one airline to operate a service on a limited number of specified routes. The airlines met and coordinated fares through the International Airline Tariff Association (IATA), which was formed by a group of scheduled airlines in 1945. At IATA conferences airlines broke off into separate meetings to discuss fares by country pair.

The First and Second Packages of liberalisation were introduced in 1987 and 1990; these removed restraints on designation and capacity, but it was only with the introduction of the Third Package in 1993 that air transport became fully liberalised and the bilateral framework dismantled. This Third Package introduced the concept of European rather than national carriers, and allowed any airline, which had been granted an Operating License by any member state, the right to operate any route within the EU. However, some member states felt that their national markets still needed more time to adjust and it was not until 1997 that all domestic markets were opened up. From 1 April 1997 all domestic markets were free to competition from all EU-licensed carriers, and it is since then that the low-cost airlines have rapidly expanded their European networks. The Third Package also changed the nature of fare discussions at IATA conferences. Whereas previously these took place on a bilateral basis, since 1993 they have only been able to take place multilaterally, so that all airlines can take part in the discussions concerning a particular fare type and must allow any other airline access to their service on an interline basis for passengers travelling at that fare (CAA (1998, p. 13)).

THE DEVELOPMENT OF THE LOW-COST AIRLINE SECTOR

The emergence of low-cost airlines has been undoubtedly the most striking development post liberalisation. These airlines have adopted the business model pioneered by the US domestic airline Southwest. For UK consumers, whose travel originates in the UK, there are currently two main low-cost carriers: Ryanair and EasyJet. Since liberalisation a number of other low-cost carriers have entered and exited the market, including BA's Go and KLM's Buzz (acquired respectively by EasyJet and Ryanair).

Low-cost carriers offer a differentiated product when compared with traditional schedule and charter carriers. The key to their success has been their low-cost strategy, which has allowed them to charge very low fares. Their product is clearly defined as a point-to-point service provided at the lowest possible cost. Immediately post liberalisation it was estimated that low-cost carriers could achieve unit costs as low as half those of major traditional carriers (CAA (1998, p.ix)). More recently traditional carriers have been able to reduce their costs, but low-cost carriers still have a cost advantage. Low-cost carriers successfully minimise their costs by:

- The use of a homogenous fleet; this reduces pilot training costs and means it is easier to obtain spares and maintenance services on favourable terms. It is also simplifies the scheduling of crews and equipment;
- Outsourcing various functions, especially maintenance and handling, which they obtain at competitive prices without the need to maintain a specialised labour force;
- The pressure that they exert on suppliers to obtain contracts on the most favourable terms;
- The introduction of smaller/narrower seats;
- Not providing free drinks or meals on flights; not only does this cut catering costs but also allows the airlines to operate with fewer staff;
- Choosing airports which need the use of the airline and therefore offer them concessions on airport charges;
- Reducing turnover times and therefore increasing aircraft utilisation. This is achieved by free seating;

- Staff working longer hours; and
- Lower distribution costs; most tickets are now brought online and customers simply receive an email confirmation, so there is no need to use travel agents.

Whilst all low-cost airlines obviously seek to minimise costs and provide a simple point-to-point service, different low-fare strategies have emerged. For example, Ryanair's approach is focused on increasing the number of destinations that it flies to and the need to access low-cost secondary airports. Not only does this strategy allow the airline to achieve favourable airport charges but it also avoids head-on competition with the traditional carriers. In many cases Ryanair has therefore stimulated new traffic volume in and out of secondary airports. EasyJet's model is quite different; whilst it has been able to stimulate new traffic it has focused on existing markets and the use of primary airports and therefore competes more directly with traditional carriers. Flying out of primary airports results in a higher cost base but also better yields when compared with Ryanair.

RYANAIR

Ryanair was established in 1985 but became the first European low-cost airline when its operations were restructured in 1991, including a low-cost service between Dublin and London Stansted. They also provided the first European domestic service, between Stansted and Prestwick (Glasgow). Initially, Ryanair's customers booked through travel agents, but in 1997 it opened a large call centre in Dublin and in 2000 it launched its website and online booking. This is now the largest internet travel site in the world, over which the majority of bookings are made. In 2001 Ryanair recorded the best profit margin of any major airline in the world and briefly became Europe's number one airline in terms of market capitalisation. In 2003 it acquired Buzz, the low-cost subsidiary of KLM after three consecutive years of heavy losses. Its UK base is at Stansted and it currently operates 127 routes that cover 84 destinations. Ryanair's financial success over recent years has been consistent and greater than any other European low-cost airlines (www.ryanair.com).

EASYJET

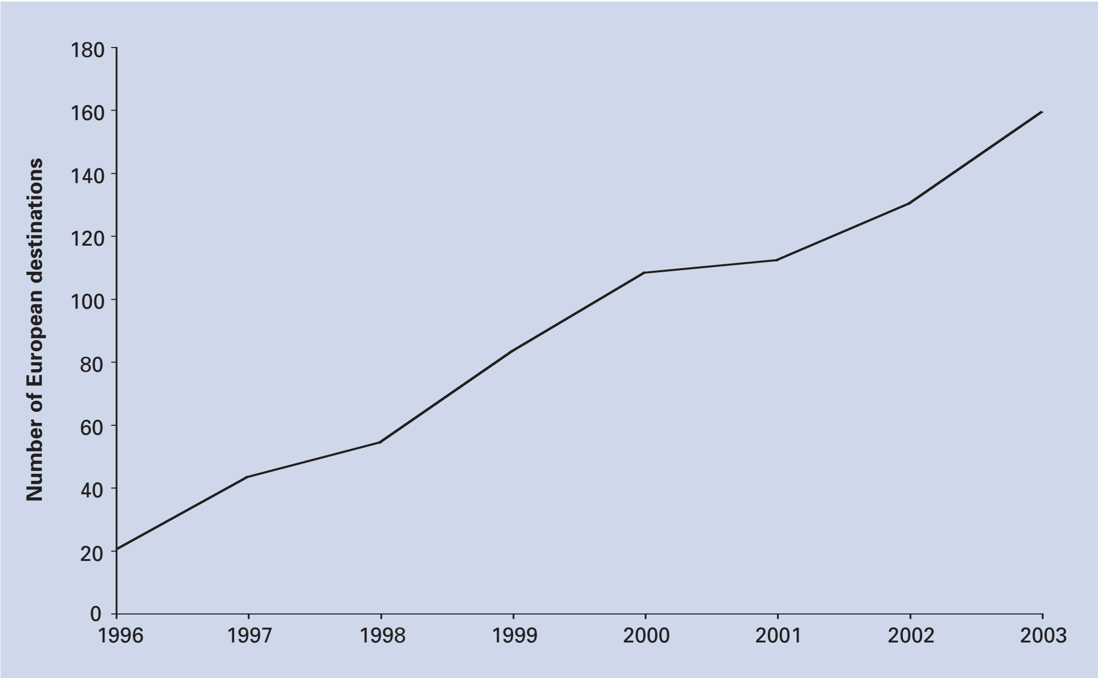
EasyJet's services began from its base in Luton in 1995 with three flights per day to both Glasgow and Edinburgh; in 1996 it opened its first international route Luton/Amsterdam. Initially all bookings were taken directly over the telephone; in 1997 the EasyJet website was launched, but online bookings were not taken until 1998. In 2002 EasyJet merged with Go, initially the low cost subsidiary of British Airways (BA). It currently operates 127 routes between 39 destinations. Although its profits fell in 2003 it is still making respectable profit margins (www.easyjet.com).

More recently, another successful entrant has been BmiBaby, the low cost subsidiary of British Midland. It was launched in 2002 and is based at the East Midlands Airport. It now also operates from Manchester, Cardiff and Teeside. BmiBaby has grown rapidly and currently operates 46 routes to 20 destinations (www.bmibaby.com).

The low-cost model has proved very successful in Europe. In 2003, 24% of the total capacity of flights in and out of the UK and 32% of the UK domestic capacity was accounted for by low-cost airlines (OAG Schedules data). It was in 1997 when the low-cost sector started to experience really rapid rates of growth; in that year alone EasyJet saw its passenger numbers jump from 420 to 1,140 thousand (www.easyjet.com). Figures 5.1 and 5.2 below illustrate this growth of the low-cost airline sector over the last 7 years.

Figure 5.1 shows the growth in the number of European destinations served: starting with 20 in 1996 this more than doubled in 1997 to 43, following the full liberalisation of European aviation markets. There is slight slowdown in 2001, probably an impact of September 11th and the general slowdown in the economy, but by 2002 growth levels were restored.

Figure 5.1 Number of European Destinations served by Low-Cost Airlines 1996-2003

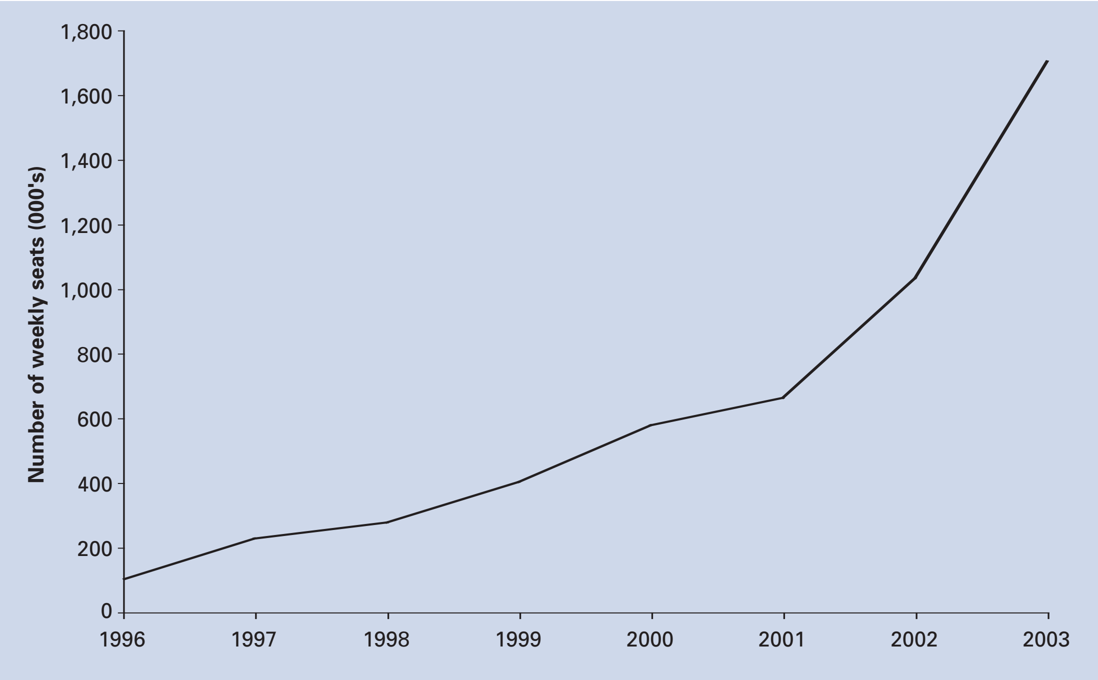


Source: OAG schedules data and low-cost airlines' websites

Figure 5.2 tracks a measure of the capacity of low-cost carriers – weekly seats in Europe. Again, the largest percentage increase occured between 1996 and 1997, when the number of weekly seats jumped from 100 thousand to 225 thousand. The annual increase in capacity also slowed in 2001, but was followed by a period of rapid growth in 2002 and 2003.

In contrast, over this period, a number of the European full service carriers faced financial difficulties and withdrew or decreased their services. The low-cost sector probably benefited from this, and made up for the gap in the market. This is a likely symptom of the economic slowdown and increased price sensitivity of consumers, including business travellers, who changed their purchasing behaviour and switched to the cheaper low-cost alternative. What is undeniable from this evidence is that low-cost airlines have successfully entered the market for air travel with a simple product that consumers demand.

Figure 5.2 Number of Weekly Seats (000's) on European Low-Cost Airlines 1996-2003



Source: OAG Schedules Data

5.3 For and against liberalisation

The aim of a fully liberalised air transport market was to deliver a more efficient airline industry – to encourage both product innovation and increase price competition.

However, given that national carriers dominated distinct national markets there was a real fear of them engaging in anti-competitive behaviour to protect their markets. It was possible that they would be able to abuse their dominant position to deter entry or foreclose the market. For example, in 1996 EasyJet filled a predatory pricing case against KLM with the European Competition Commission (the Commission). EasyJet alleged that in response to its entry into the London/Amsterdam market KLM had engaged in predatory behaviour. EasyJet entered the market with fares significantly lower than KLM's, who responded by reducing its lowest fare to below that of EasyJet. During the investigation the Commission found an internal KLM report which discussed the need to curtail the growth of EasyJet. In November 1997 KLM stopped its alleged predatory behaviour and EasyJet withdrew its complaint. It is unclear why EasyJet did not continue with the case, but this could be symptomatic of the difficulty in proving predatory conduct. However, given the financial success of EasyJet and Ryanair coupled with their aggressive growth, the evidence would suggest that predatory pricing strategies by traditional carriers against low-cost airlines are unlikely to have been successful. Moreover, given the cost advantage of low-cost airlines it is very unlikely that predatory behaviour by such airlines is in fact credible.

A possible feared negative side effect of the rapid growth in air traffic, post liberalisation and the expansion of the low-cost airline sector, was that safety might be compromised. We return to this below.

5.4 Outcomes

This section presents the evidence on domestic and European airfares, flight frequency, and choice. The analysis of airfares concentrates on the fares charged by traditional carriers rather than the low-cost airlines. This is for two reasons:

(i.) We wish to compare pre- and post-liberalisation fares on a like-for-like basis. But prior to liberalisation there were no (very few) low-cost carriers, therefore the only comparison we could make with low-cost carriers would be traditional carriers pre-liberalisation. However, this would fail to acknowledge the product differentiation involved: by their own admission, the low-cost carriers offer a no-frills, basic product, while the traditional carriers are associated, rightly or wrongly, with a higher quality product. Since the essence of the low-cost carrier's strategy has always been to provide a simple low-price service, evidence on their comparatively low fares would be therefore almost trivial.

(ii.) A secondary, and more pragmatic reason is that data are extremely difficult to collate on representative prices charged by the low-cost carriers. It is the nature of their selling strategy that prices on any given flight will change repeatedly over the weeks prior to the journey. As far as we know, no publicly available indices are available, and time constraints on the present project prevented us from undertaking any large scale data collection of our own.

Thus, our comparisons are not between, say, the cheapest available price, pre- and post-liberalisation. Rather, we focus more on how the entry by 'maverick' new firms has changed the intensity of competition in a market previously often associated with anticompetitive behaviour[74].

The low-cost carriers shook up the industry. They introduced a new successful business model, which the traditional carriers failed to pre-empt, and which forced the traditional carriers to compete more aggressively. Many of the traditional carriers have now adopted a number of their practices, such as online booking and pricing simplicity[75], in an attempt to compete profitably alongside low-cost carriers[76]. British Airways, in particular, has been very aggressive in its competitive response. In 2002, it launched its new website and online booking – over which the majority of reservations are now made, and it changed its European and domestic fare structure to give consumers lower fares, greater flexibility and more choice. New simple and lower all year round fares were introduced, advance purchase and Saturday night stay over restrictions were removed, and consumers were able to mix and match peak and off peak tickets to get the best possible deal (www.ba.com). BA has now become the cheapest traditional carrier on a number of routes with its fares often comparable to those provided by low-cost airlines. At the same time, BA continues to provide its traditional (superior) service, with flights to primary airports, pre-booked seats, free food and bar service and frequent flyer programmes.

74 The price transparency and multimarket contact in the airline industry has made collusion particularly easy in the airline industry, see Borenstein (1999) and Evans and Kissides (1994) for evidence.

75 There has also been removal of restrictions (designed to segment the market) such as the 'Saturday night rule' (whereby cheaper fares were only available to customers if their visit included a Saturday night).

76 It should also be acknowledged that the competitive impact has not been confined to just the full service scheduled carriers. For example, independent and city break holidays have become more feasible and flexible, while fixed period European package holidays have lost some of their attractiveness. To meet this challenge, Thomsons have recently started their own low cost airline from Coventry airport.

AIRFARES

This section examines the change in European and UK domestic airfares since 1992: the data cover the years 1992, 1997 and 2003, and was provided by the Civil Aviation Authority (CAA) and collected from the Galileo Central Reservations System, which travel agents use to book flights on traditional carriers. The fares of low-cost carriers do not usually appear in the system. Data was collected for nine international routes – London[77] to Amsterdam, Brussels, Copenhagen, Frankfurt, Madrid, Milan, Munich, Nice and Paris and on three domestic routes – London to Belfast, Glasgow and Manchester. These routes are all between capital cities or principal hubs with at least a double daily non-stop service[78]. Fares were only collected for carriers operating at least a daily weekday service. They are all return fares and arranged in three categories:

- lowest fully flexible business class fare;
- lowest overall fully flexible fare;, and
- lowest non-sale fare[79].

These will be compared with:

- The IATA fare: this is the fare that the airlines agree at IATA conferences, and the maximum that can be charged on a given route.

On each route, and for each types of ticket, we have collated the fare for both BA and the lowest priced carrier on that route in the market (sometimes this will be BA itself). These are then (simple) averaged across the sample routes. Figures 5.3 and 5.4 show the results, respectively, for European and domestic routes. In order to interpret these diagrams, note that all prices are expressed relative to the 1992 averages, and we also show the general RPI and IATA averages for comparative purposes.

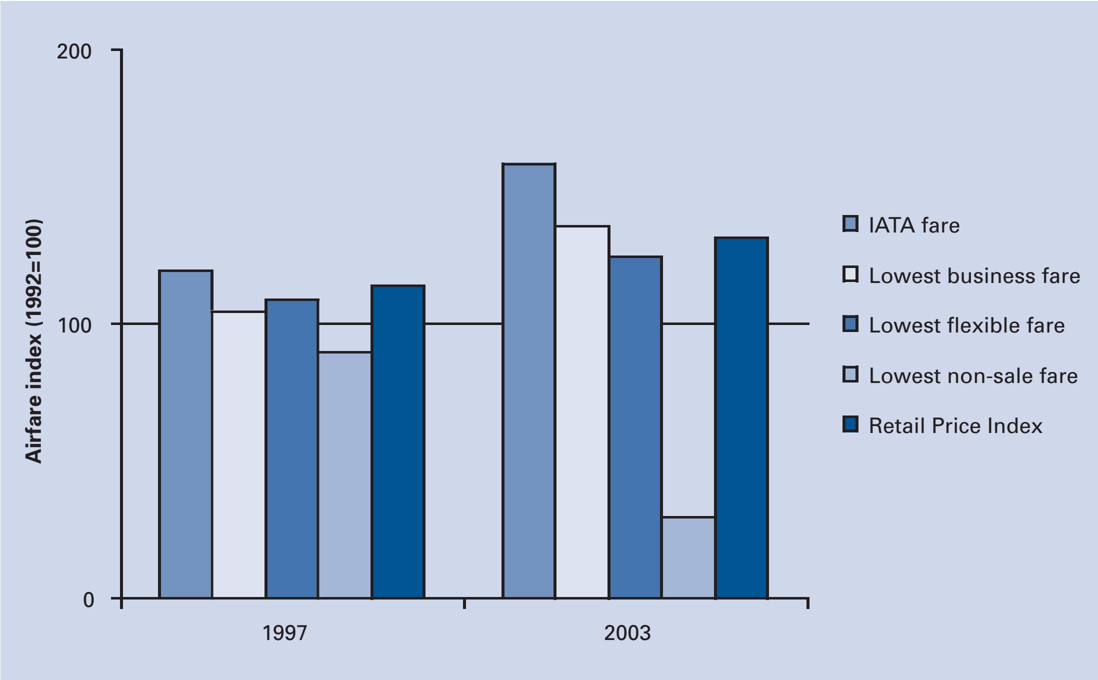
On the European routes for BA (Figure 5.3(a)), the most striking feature is the movement in the average lowest non-sale fare. The 1997 part of the histogram shows that this fare fell, compared to the 1992 base year, albeit fairly moderately, by about 10%. But, looking at the 2002 bars, a very dramatic fall (66%) occurs. This pattern is even more pronounced in Figure 5.3(b): the price of the lowest priced carrier (sometimes, but not always, BA itself) has fallen 36% by 1997, and 66% by 2002. In absolute terms, BA's average non-sale price was slightly higher in 2003 – £49 compared with £44 for the lowest of all carriers. In real terms (reflected in the difference between the columns for 'lowest non-sale fare' and the 'retail price index'), the fall is even more staggering.

77 This includes all London airports – Heathrow, Gatwick, Stansted, Luton and City airport.

78 London/Dublin was removed from the sample since there was no business class service in 1992 and therefore one observation missing. BA did not operate this route over the sample period. The behaviour of fares in this market is, however, no different.

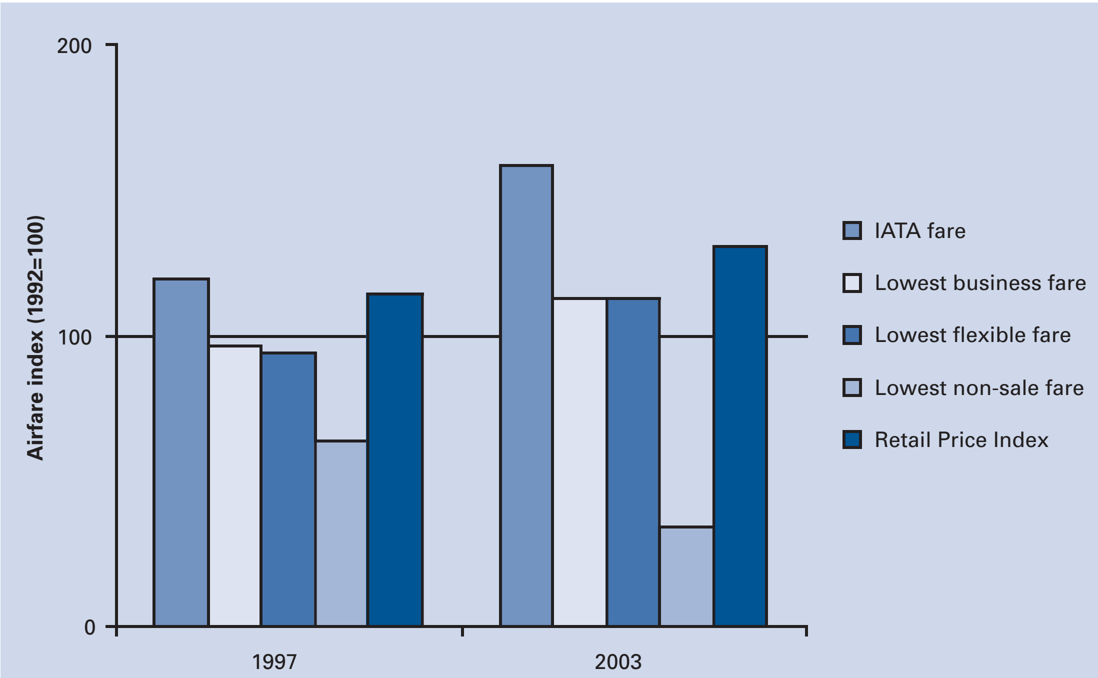
79 None of these fares include taxes or airport charges. Post September 11, airlines have also started to add new insurance or security taxes: none of our fares include these charges/taxes.

Figure 5.3(a) BA's Average European Airfares (1992=100)



Source: CAA

Figure 5.3(b) Lowest Priced Carrier's Average European Airfares (1992=100)



Source: CAA

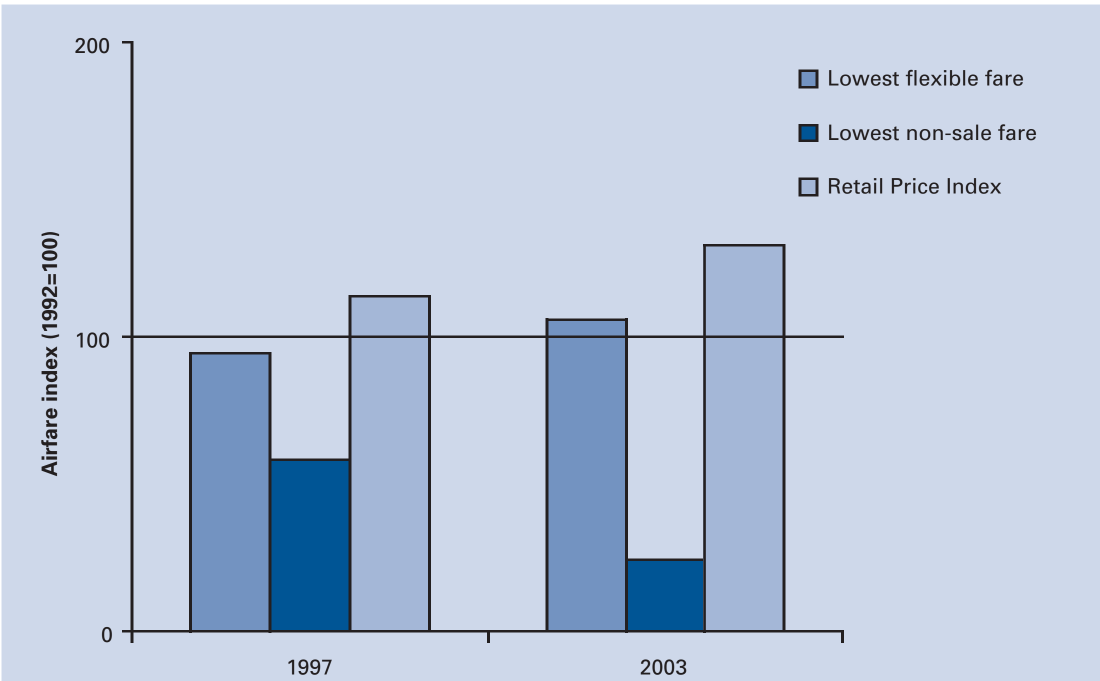
Turning to the other two types of fare, lowest business and flexible, BA's prices increased over both periods. However, once inflation is allowed for, the average business fare has increased very little and the average fully flexible fare has fallen in real terms. The lowest priced carrier's average business and flexible fares have followed a slightly different pattern. They both decreased slightly initially, but this was followed by an increase between 1997 and 2003. Again in real terms they have decreased over the entire period.

Between 1992 and 2003 it is clear from the figure that the IATA fares have risen faster than the rate of inflation, and faster than any of the three fare types. At the start of the sample in 1992 it was obvious that the IATA fares had a direct influence on business fares – they were the same on all routes for BA and the lowest priced carrier on all international routes. Since then, as price competition has increased, this link has broken and business fares have fallen in real terms. The influence of IATA fares on general fare structures is beyond the scope of this chapter but is certainly a topic worthy for more detailed investigation.

The fact that lowest non-sale fares have fallen far more than fully flexible and business fares is not surprising. The simple product provided by low-cost airlines can compete with the cheaper and lower quality standard service provided by traditional carriers. On the other hand, the traditional carrier's business and low-cost services are differentiated, with very little direct competition between the two. Our *a priori* expectation was, therefore, that the injection of competition was concentrated in the lower end of the market, and that standard (non-sale) fares should decrease the most. The evidence supports this – whilst business fares have remained relatively stable over the period, standard lowest non-sale fares, at the bottom end of the market, have fallen dramatically.

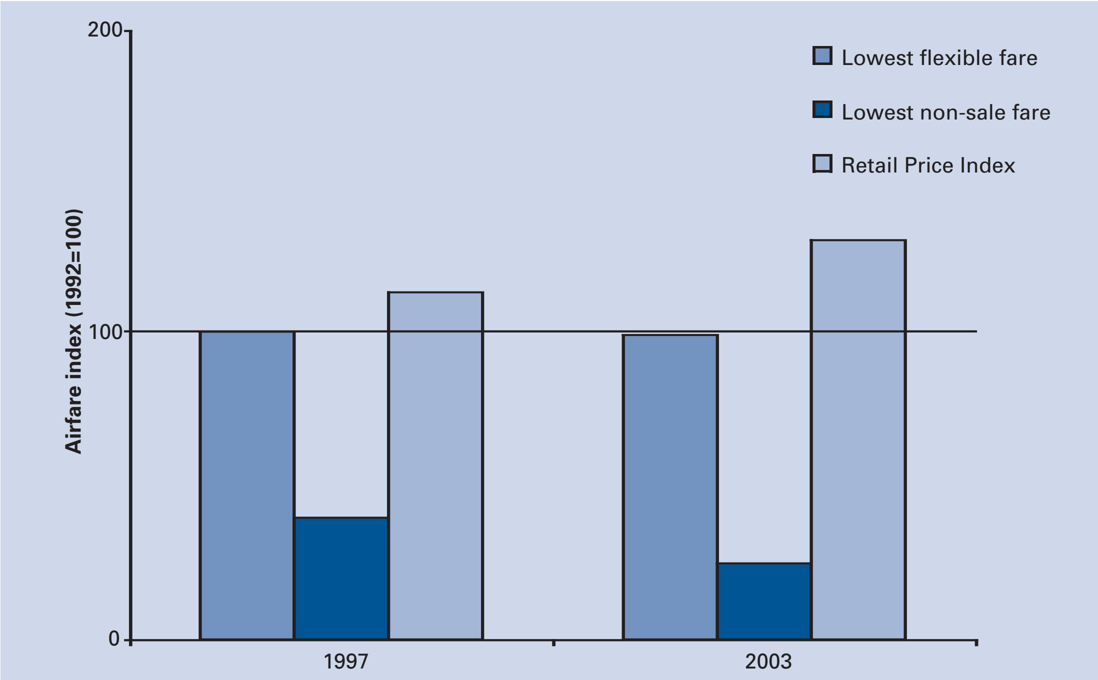
As explained earlier, it was only after 1997 that the low-cost airlines really 'took-off' and stimulated competition in the majority of European aviation markets. Accordingly, one would expect the fall in fares to be more pronounced in the second period, post 1997. The above evidence supports this. Figure 5.4a identifies the change in average domestic airfares for BA and the lowest priced carrier. The picture is similar to that of the European market, however there are only two types of fares considered – fully flexible and non-sale, since the majority of routes do not have a business class service. Again, the most striking feature is the dramatic fall in both carriers' average lowest non-sale fares. At first, the fall in BA's average non-sale fare was smaller, 42% compared to 60%, but post 1997 it fell faster. Overall, by 2003, both carriers' average lowest non-sale fares had fallen by 75% in nominal terms.

Figure 5.4(a) BA's Average Domestic Airfares (1992=100)



Source: CAA

Figure 5.4(b) Lowest Priced Carrier's Average Domestic Airfares (1992=100)



Source: CAA

Over the entire period, average fully flexible fares fell in real terms for both carriers. BA's average lowest fully flexible fare initially fell by 5% between 1992 and 1997 and then increased by 11% between 1997 and 2003, but the overall increase of 6% is far lower than the rate of inflation. Conversely, the lowest priced carrier's average flexible fare first rose by 1% but then fell back to its 1992 level, falling significantly in real terms.

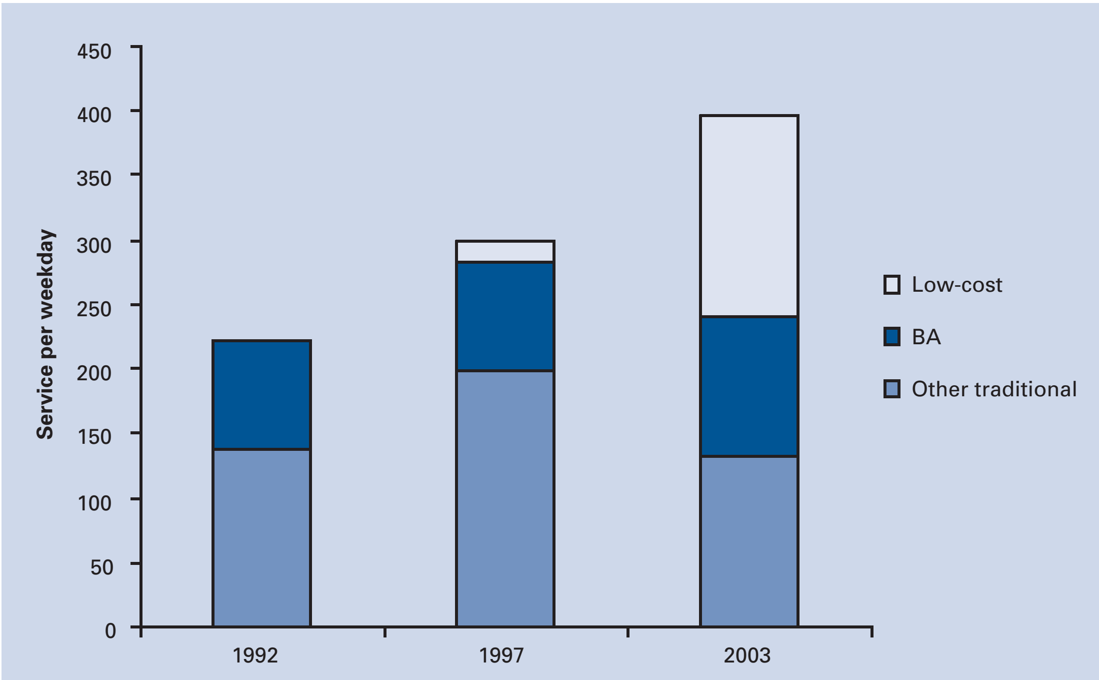
Thus, the evidence on domestic routes also supports the argument that entry by low-cost airlines increased competition and reduced fares. The overall reduction in average lowest non-sale airfares is greater in the UK domestic than the European market. This corresponds to the observation that low-cost airlines were initially concentrated in the UK, and that they have had a disproportionate effect on domestic routes. The first domestic route, which both Ryanair and EasyJet entered, was London/Glasgow in 1995, sometime before low-cost carriers entered European markets. Accordingly between 1992 and 1997 UK domestic average lowest non-sale fares fell more dramatically than European ones. Later (post 1997), as the low-cost airlines operated more international routes, these fares adjusted to mimic the behaviour of domestic fares.

The evidence in this section shows just how dramatically both European airfares and UK domestic lowest non-sale airfares have fallen post liberalisation and the expansion of the low-cost airline sector. The European routes that have seen the largest reduction in fares are London to Milan, Nice and Paris. The London/Nice lowest non-sale fare fell the most, by 83% in nominal terms from £188 in 1992 to £36 in 2003, whilst the lowest non-sale fare in the London/Milan and London/Paris markets fell by 25% and 27% (in nominal terms). In 2003 these flights cost just £62 and £28 respectively, compared with £248 and £102 in 1992. In the domestic market London/Glasgow and London/Manchester saw the biggest reductions. Again, in nominal terms the lowest non-sale fare fell 70% in the London/Glasgow market, from £102 in 1992 to £30 in 2003, and 65% in the London/Manchester market, from £88 to £30.

FLIGHT FREQUENCY

More frequent flights on a given route improve the quality of service for consumers as they have a greater choice of travel times and are more likely to find a flight with a convenient time. Figures 5.5(a) and 5.5(b) show the frequency of flights on the sample routes over the same years – 1992, 1997 and 2003[80]. Data was provided by the CAA and extracted from low-cost airlines' websites. Prior to liberalisation, bilateral agreements restricted the number of flights that airlines could operate on any given route, and national rules did the same in domestic markets. It was hoped that one of the benefits of liberalisation would be not only the entry of new airlines, which would increase flight frequency, but also that existing airlines would operate additional flights. The figures illustrate the change in the number of non-stop flights per weekday.

Figure 5.5(a) Typical Number of Services per weekday on European Sample Routes

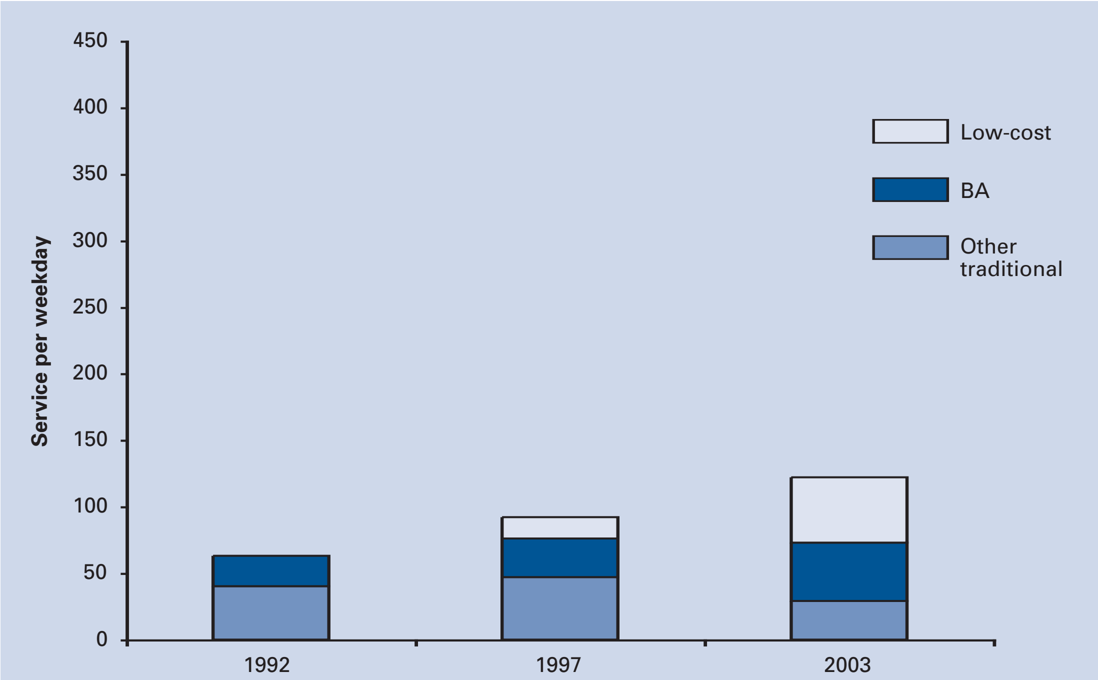


Source: CAA and low-cost airline websites

Figure 5.5(a) shows that over the entire period European flight frequency increased by 78%. The totals are also broken into the shares of the traditional and low-cost airlines. For example, in 1992 there were 223 daily flights, none of which were operated by low cost-carriers. BA alone accounted for 86 of these flights. By 1997 low-cost airlines had entered the market from London to Amsterdam, Madrid, Milan, Munich, Nice and Paris and operated 17 daily flights. The number of flights operated by traditional carriers also rose, to 283 a day; however BA operated slightly fewer of these – 84 a day. Between 1997 and 2003, low-cost airlines entered all of the sample European routes, and the number of flights they operated increased rapidly to 152. By 2003 they accounted for 38% of all flights. Over this second period the frequency of the traditional carriers, excluding BA, fell; conversely BA increased its flight frequency and in 2003 operated 24 more daily flights on these given routes than it did in 1992.

80 London/Dublin was included in this sample in this figure, therefore there are 10 European and 3 domestic routes in the sample.

Figure 5.5(b) Typical Number of Services per weekday on Domestic Sample Routes



Source: CAA and low-cost airline's websites

As illustrated in Figure 5.5(b), in the domestic markets, the frequency of the traditional and the low-cost carrier's flights increased over both periods. As in the European markets, no low-cost airlines operated in 1992. By 1997 low-cost airlines were present in the London/Belfast and the London/Glasgow market and by 2003 they had entered all of the markets and accounted for 40% of the daily flights. The figure shows that the share of the traditional carriers, excluding BA, fell over the period, whilst BA almost doubled its daily flights. The picture is therefore very similar to that of the European markets. In both markets consumers now benefit from more frequent flights than in 1992.

CHOICE

Table 5.1 records the number of airlines operating on each of the sample routes over the same three years. Again data was provided by the CAA and extracted from low-cost airlines' websites. An increase in the number of carriers operating on a given route should benefit consumers as competition increases. The reduction in airfares illustrated in Figures 5.4 captures the increase in competition following deregulation and new entry. But this is not the only benefit to arise from having more competitors; it also enhances consumer choice, especially in markets with differentiated products. In the markets where low-cost airlines operate, passengers can benefit from the choice of a traditional full service flight or a simple low-cost flight.

Table 5.1 Number of Airlines Operating on Sample Routes

	1992			1997			2003		
	Total	Low-cost	Total, all Traditional	**Total**	Low-cost	Traditional	**Total**	Low-cost	Traditional
Amsterdam	**5**	0	5	**6**	1	5	**5**	2	3
Brussels	**4**	0	4	**4**	0	4	**5**	2	3
Copenhagen	**3**	0	3	**5**	0	5	**4**	1	3
Dublin	**3**	0	3	**5**	0	5	**5**	1	4
Frankfurt	**3**	0	3	**4**	0	4	**3**	1	2
Madrid	**2**	0	2	**4**	1	3	**5**	2	3
Milan	**2**	0	2	**5**	1	4	**5**	2	3
Munich	**2**	0	2	**3**	1	2	**3**	1	2
Nice	**4**	0	4	**3**	1	2	**3**	1	2
Paris	**5**	0	5	**5**	0	5	**5**	2	3
Belfast	**4**	0	4	**3**	1	2	**4**	2	2
Glasgow	**3**	0	3	**5**	2	3	**4**	2	2
Manchester	**2**	0	2	**2**	0	2	**4**	2	2
Average	**3**	0	3	**4**	1	3	**4**	2	2

Source: CAA and low-cost airlines' websites

Table 5.1 shows how by 2003 low-cost airlines had entered all of the sample routes. It also shows how the average number of competitors has increased over the period, from an average of 3 in 1992 to 4 in 1997 and 2003. However, it would seem that some of the success of the low-cost sector could have been at the expense of the traditional carriers. The average number of traditional carriers has fallen over the period from 3 to 2. This is not surprising, given that prior to liberalisation inefficient carriers were protected from aggressive competition. After deregulation, some of these airlines could no longer survive as price competition increased; subsequently there was a wave of mergers across the airline industry as larger, more efficient, carriers took them over. The structure of the European airline industry has therefore changed significantly post liberalisation. Whilst primary national carriers, such as BA who operate in large markets and benefit from strong networks, have been able to survive, secondary carriers in smaller markets without a large network have found it difficult to reduce their costs and compete with both the low-cost carriers' and the larger national carriers. This is manifested in the reduction in traditional carriers frequency, excluding BA, discussed above[81]. Irrespective of the expansion of the low-cost sector it is likely that this consolidation would have taken place.

EXPANSION OF REGIONAL AIRPORTS

So far, the analysis has focused on London markets and therefore the cited benefits have been realised by consumers who live in the South East of England. This section briefly considers the expansion of regional airports around the UK. The evidence suggests that consumers all over the UK have been able to realise the above benefits from competition in the European airline industry.

Since the mid 1990s, airline liberalisation and the development of the low-cost sector have led to a substantial growth of regional air travel services. In particular, a number of the more recent entrants to the low-cost market, such as BmiBaby, have set up bases

81 As secondary carriers leave the market or merge with national carriers their frequency declines. Whereas the frequency of BA increases as it merges with smaller carriers and takes over operations on their routes.

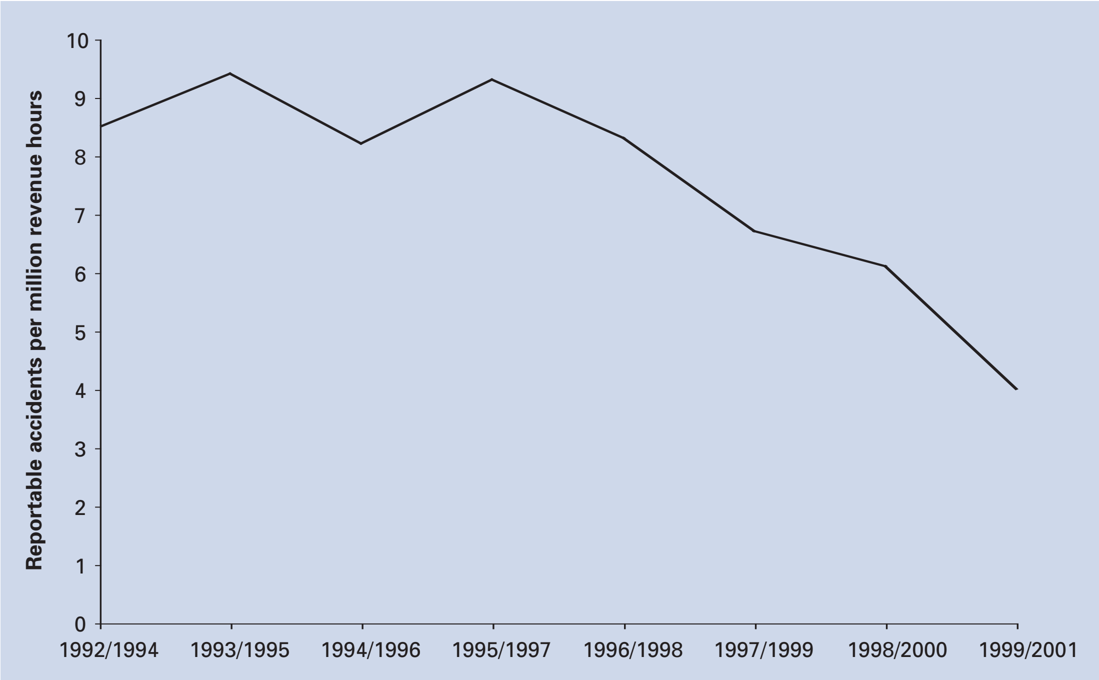
at regional airports. According to a recent report by the CAA on regional airports, Liverpool provides one of the best examples of rapid regional development. International scheduled traffic grew from 189,000 passengers in 1997 to 1.7 million in 2002, with an average annual growth in passenger traffic of 29% since 1997. Bristol, Edinburgh, East Midlands and Humberside also all recorded double digit annual growth rates over the last 10 years. The majority of the growth has been generated by the introduction of new scheduled services, by low-cost airlines in particular. This in turn has been made up by an increase in the number of destinations served, as opposed to an increase in frequency or capacity on existing routes. In 1990 there were only scheduled flights from the East Midlands airport to 3 international destinations; in 1996 there were 4 but by 2003 there were 18 (CAA (2003, p. 31)).

A before and after comparison of regional airfares is hard to make, since there were so few airlines flying from regional airports prior to liberalisation. However, low-cost carriers have generated the majority of the new traffic, therefore the passengers travelling from regional airlines are likely to be paying a low fare for a simple low-cost flight. Moreover, given the competitive constraint imposed by the low-cost carriers on the few traditional carriers that do operate from regional airports, their lowest non-sale fares are likely to have fallen post liberalisation. Therefore, the consumer benefits highlighted earlier for routes from London are likely to have been realised in markets from regional airports too. In fact, given the congestion at London airports and the low-cost preference for regional and secondary airports, the increase in frequency and choice may well be more pronounced in these regional markets.

SAFETY

Fortunately, safety fears have not been realised. Despite the increase in traffic and congestion at UK airports and the faster turnarounds, the safety of UK aviation has improved. At present the UK aviation safety record is almost four times better than the world average and UK airline operations are judged to be among the safest in the world (CAA (2002)). Between 1992 and 2001 there were no fatal accidents on UK registered or operated aeroplanes and the number of reported accidents has shown a significant downturn. This is illustrated in Figure 5.6, which shows the reportable accident rate per million revenue hours flown. Over the period there was an increase of around 71% in revenue hours flown over the period.

Figure 5.6 Reportable Accidents per million revenue hours 1992-2001



Source: CAA (2002).

The above evidence only relates to UK registered or operated airlines, up until late 2003 European member states were separately responsible for regulating their own civil aviation safety and therefore it is hard to get safety statistics on Europe as a whole. In 2003 the European Aviation Safety Agency (EASA) was set up to reduce fragmentation and increase communication between national regulators to improve safety across Europe. New European laws are also soon to be introduced which will require all EU member states to carry out safety checks on any suspicious non-European carriers.

5.5 Conclusions

This chapter has investigated the benefits to UK consumers following the liberalisation of European aviation markets and the entry and growth of the low-cost sector. We see the two as inextricably linked: without liberalisation, low cost airlines would not have been able to grow to their current size; but, equally, it is central that the entrants brought with them a new business model. In the main, we have focused on how liberalisation and entry has intensified competition, as characterised by the response, notably pricing, of the traditional carriers, notably British Airways. We find that the gains for consumers have been very pronounced, especially in the economy sector of the market. Traditional carriers have begun to adopt a number of the business practices associated with low-cost airlines in an attempt to cut their costs and make their lower fares profitable. The comparison of pre and post liberalisation airfares, frequency and choice clearly shows that consumers now benefit from lower airfares, more convenient travel times and a greater choice of airlines and quality of service. There has been no discernible negative impact on airline safety.

6. New Cars

6.1 Introduction

This case concerns the sale of new cars in the UK, in particular the effects of vertical restraints imposed by manufacturers on the retail sale of their product. Unlike the other cases in this report, the injection of competition cannot easily be attributed to any single, clear cut event, or legislation. Although we shall identify a report from the UK Competition Commission (2000) as a sort of focal point, in fact a number of other pressures were brought to bear upon car manufacturers concerning their UK prices. The Competition Commission's report mainly played the role of 'shining a light' on the problem, against a backcloth of (i) ongoing public concern about price differentials between the UK and continental Europe, and (ii) warnings from the European Commission.

While the policy intervention, which involves both the UK and European Competition authorities, is not complete at the time of writing, we already find evidence of quite large reductions, over a short period of time, in the retail prices paid by private consumers. Of course, price is not the only competitive weapon at the disposal of the sellers of a differentiated product such as cars, and vertical restraints can sometimes be justified in terms of quality of service, protection of brand name, etc. Whether or not the revisions to the European block exemption might ultimately have any harmful non-price effects remains to be seen.

6.2 The Market and vertical linkages

The product market in question is that of new cars sold within the UK, thus it excludes used cars. Within the European car market as a whole, there is clear segmentation of the market into national sub-markets. Each tends to be characterised by a leading national brand, and significant transportation costs exist between these sub-markets, not to mention the additional cost of meeting the need for right hand drive specification in the UK.

Yearly registration of new cars in the UK has increased by almost a million over the last decade, reaching a record sales figure of 2.565m last year (2003). The leading manufacturers, as at November 2003, were Ford (14.7% market share), Vauxhall/Opel (12.6%), Renault (7.4%), Peugeot (7.3%) and Volkswagen (6.9%). Manufacturers supply in bulk to both fleet customers and franchised dealers who in turn sell to the public. The franchised dealer sector is highly fragmented, with no significantly large players.

The major barrier to competition in 1998 was the European Commission regulation no.1475/95, which declared that distribution agreements within the industry may be exempted from the prohibition on anticompetitive agreements (subject to certain restrictions). In effect, the exemption allowed the suppliers the freedom to impose vertical restraints on the behaviour of their franchised dealers, most importantly through the network of selective and exclusive dealerships – the SED system.

The ‘exclusivity’ refers to the exclusive territory a dealer is allocated, and the ‘selection’ is the setting of criteria upon which the granting of a franchise must be judged. The combination of these twin vertical restraints allows suppliers to control: the quantity and geographical spread of their dealerships; the size and quality of the showrooms; the provision of specific services, such as demonstration cars and specialist sales personnel; as well as ensuring the dealers stock the full range of the brand and sell only to end users. Furthermore, suppliers also have the ability to terminate dealer agreements at short notice (2 years) without providing adequate compensation for the investments made by dealers. Due to these restraints on their behaviour and the prospect of punishment for non-adherence, dealers are clearly vulnerable to pressure from suppliers. As a result this distribution system gives suppliers significant control over the price of their models on the forecourt and therefore allows them to avoid unnecessary price competition. The usual defence of such restrictions is that they allow manufacturers to protect brand image, and to compete via product quality and marketing.

Given the strict controls over sales territory, dealers are prevented from establishing outlets in foreign markets in which the price level is higher than that of their domestic market. Instead, the onus is on the consumers to search (at cost) for cheaper deals abroad. Effectively this largely eliminates arbitrage possibilities. In preventing intra-EU competition, the SED system successfully prevented the erosion of the high UK prices by dealers and hence perpetuated the suppliers’ ability to price discriminate on an international level[82]. This price discrimination was in evidence in the sometimes very large price gaps between the UK and the mainland European (especially Benelux) car markets. There has been public concern over this for many years in the UK. This culminated in the UK Competition Commission judging that UK prices were approximately 10% ‘too high’[83].

6.3 The policy intervention

As suggested in the introduction to this chapter, it is difficult to argue that any one change in policy gave rise to a change in the competitive environment; nevertheless, it is possible to highlight some significant events.

TIMELINE OF EVENTS

In 1998, Volkswagen received a fine of €120 million for imposing supply quotas on Italian dealers to restrict their export to other EU markets. Volvo, Opel and Daimler Chrysler were each fined in separate cases as the policing of the exemption became increasingly rigorous. Subsequently, in early 1999, the UK Competition Commission began an investigation into the industry (its second in 7 years). On 7th February 2000 the EU competition commissioner Mario Monti stated that he would “take into full account the companies’ behaviour when proposing the (EU) commission’s decision regarding the future legal framework of car distribution.”[84] When the (UK) Competition Commission reported in April 2000, it recommended the abolition of the SED system. In order to achieve this goal, it was considered that there were three possible courses of action:

82 Verboven (1996) and (2001).

83 Competition Commission (2000).

84 European Commission press release 7/2/00http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/00/121|0|RAPID&lg=EN

- revoking the block exemption in the case of individual agreements in the UK;
- prohibit acts expressly permitted by the present exemption; or
- allowing the exemption to expire in September 2002 without replacement.

In addition to these three alternative threats to the block exemption, the Commission confirmed KPMG's[85] estimate that UK prices were approximately 10% too high in comparison to certain continental nations (Benelux).

Following this report, the British Government attempted to exert pressure on suppliers, whilst European Commissioner Monti continued to remind firms that: i) the exemption would shortly expire; ii) the Commission was in the process of formulating their proposal for its future; and iii) it was not happy with the price variations observed within the Union.

In September 2000 the Supply of New Cars Order was introduced. Since the desired changes to the block exemption could only be implemented by EU law, these Orders were the only immediate tangible result of the UK Competition Commission report. The Orders addressed issues outside the scope of the block exemption, most importantly prohibiting the suppliers' price discrimination between fleet customers and dealers. This reform gave dealers buying in bulk the same discounts that fleet customers received on equivalent size orders. They also outlawed agreements which caused dealers to pre-register cars in order to meet sales targets since this discouraged the setting of a market clearing price. However, while important, the Commission did "not see these remedies as a substitute for the abolition of the SED system."

In the summer of 2002 the European Commission unveiled its own plans for significant reform of the block exemption. The changes will not be completed until September 2005, but, in the meantime, the intervention of the UK Competition Commission already appears to have delivered the 10% price reduction demanded in April 2000.

In its report there is no judgement against the suppliers; it simply made a recommendation that was then used over the next year to extract substantial price cuts. By the summer of 2001 the dramatic reductions were complete and prices settled on a gently declining trajectory of 1-2% year-on-year nominal price reductions. It remains to be seen what effect the drawn out reforms to the exemption will actually have. It may be 2006 before we can assess their success in engendering further progress on price competition.

If we accept the UK Commission's judgement as an indirect intervention, then it is one that might be characterised as the effective removal of legally sanctioned anti-competitive practices. In particular the selective and exclusive distribution system, which operated against the public interest through its adverse effect on prices, was threatened with termination unless these price maintenance practices were ended.

85 Quoted in 2002 by the World Market Research Centre, http://www.worldmarketsanalysis.com/InFocus2002/articles/automotive_blockexempt.html

The threat to break up this system was not carried out in the end. Instead after substantial price cuts, the EU proposal in summer 2002 opted to forcibly separate the exclusive and selective systems. Manufacturers would be allowed to choose either an exclusive distribution system or a selective system for a particular market, but not both. An exclusive distribution system would allocate an exclusive territory to each dealership but with the proviso that they can sell their cars to anybody – including independent resellers such as grey dealers, internet sellers and supermarkets. Given this prospect of supermarket style multi-brand mega retailers (such as those in the US), it is anticipated that suppliers will instead choose a selective distribution system.

The criteria upon which they select may involve the qualitative standards mentioned earlier as well as direct limits on the total number of dealers. Clearly an important demand will be that dealers sell only to end users (consumers) and therefore supermarket discounting can be avoided. However, dealers will not receive a sales territory and in October 2005 the location clause will be banned. This clause allows suppliers to prevent dealers establishing sales and delivery outlets in other locations; effectively this preserves the existing exclusive territories. Once this clause disappears, dealers who satisfy the selective criteria will be able to open outlets all over the EU, creating the possibility of significant cross-border competition, as well as the counter balancing power of a less fragmented dealer market.

Due to the European Parliament's decision, under pressure from manufacturers to postpone the full effect of the reform until 2005, it appears that the price cuts of 2000 have gained the manufacturers five additional years of coverage for the outdated block exemption.

6.4 Arguments for and against

Obviously, a main criterion by which any policy intervention should be judged is its effect on price, and, in this case, on price differentials between the UK and Europe. Looking beyond the UK Competition Commission report to the reformed block exemption one might hope to see increased consumer choice, in the form of multiple brands being sold from the same dealerships. If so, there is the possibility of a fall in the seller concentration of the car manufacturing industry.

Whether or not there are any feared detrimental side effects depends on one's view of the purpose of the vertical restraints. In this respect, we should note that the Commission's recommendations were challenged by the motor industry on a number of grounds. Firstly that, in giving control of the pricing of their models to the manufacturers, the exemption prevented cut-throat competition, involving unsustainable price reductions. Secondly, the SMMT (the Society of Motor Manufacturers and Traders) warned that an undesirable side effect would be the creation of mega retailers with near monopolies on pricing. However the evidence from the US suggests no reason to believe that multi-franchise mega retailers increase prices; in fact they appear to simply increase the choice of car models available to the consumer. Finally suppliers argued that the exemption allowed them to ensure that franchised dealers provide a higher level of quality in regard to the safety and servicing of vehicles. However, in November 2000, the EC reviewed the effectiveness of the block exemption and concluded that this 'natural link' between sales and after sales service had ceased to exist and noted that independent servicing firms were being denied technical information on the suppliers' products. There appears to be a convincing argument that any lack of quality at independent servicing firms was actively enforced by the suppliers. In any case the evidence, such as it is, on the quality of servicing suggests little difference between franchised dealers and independents, only that the franchised dealers charged approximately 45% more for the service[86].

Since, in the event, the block exemption was not abolished, the validity of these questionable side effects was not tested. However the Commission judged their actual value to be heavily outweighed by the adverse effects on prices that the exemption created, and was therefore quite prepared to risk their occurrence and abandon the exemption. It remains to be seen precisely what level of control suppliers will retain after the reforms are completed. However, the decision to partially preserve the exemption shows, according to Professor Garel Rhys of the Cardiff Business School, that "the Commission has taken on board the argument that, if there were no restrictions, there could be less competition. A free-for-all could see big retailers forcing dealers out of business".

While the (UK) Commission disagreed with this conclusion, the relatively modest reforms presently taking place seem certain to avoid the creation of such negative effects, though whether they prove quite as effective at reducing prices (and differentials) as tearing up the exemption would have done, will hopefully be more apparent in 2005.

One empirical trend that appears to be related to the general upheaval in the car market is the significant decline in the number of main new car dealers in Western Europe and the UK in particular, down 14% between 1997 and 2000[87]. There is little reason to believe that this is due to the Commission's investigation since it was a strong trend before that intervention. Nevertheless the anticipated reform of the EU distribution system must be a significant contributor to this trend. It is possible that suppliers are attempting to deal with the loss of exclusive territory by cutting the total number of franchised dealers. However it is far from clear that this is a serious negative effect since it must be weighed against the move towards greater choice at each dealer that does exist – the "supermarketisation" of the new car industry.

6.5 Outcomes

In the aftermath of the investigation by the Competition Commission, we have seen sharp falls in prices across every segment of the new car market. To show this, we have collected evidence from a variety of sources: official UK statistics (the Office of National Statistics), the European commission (Eurostat), and private research (A&L).

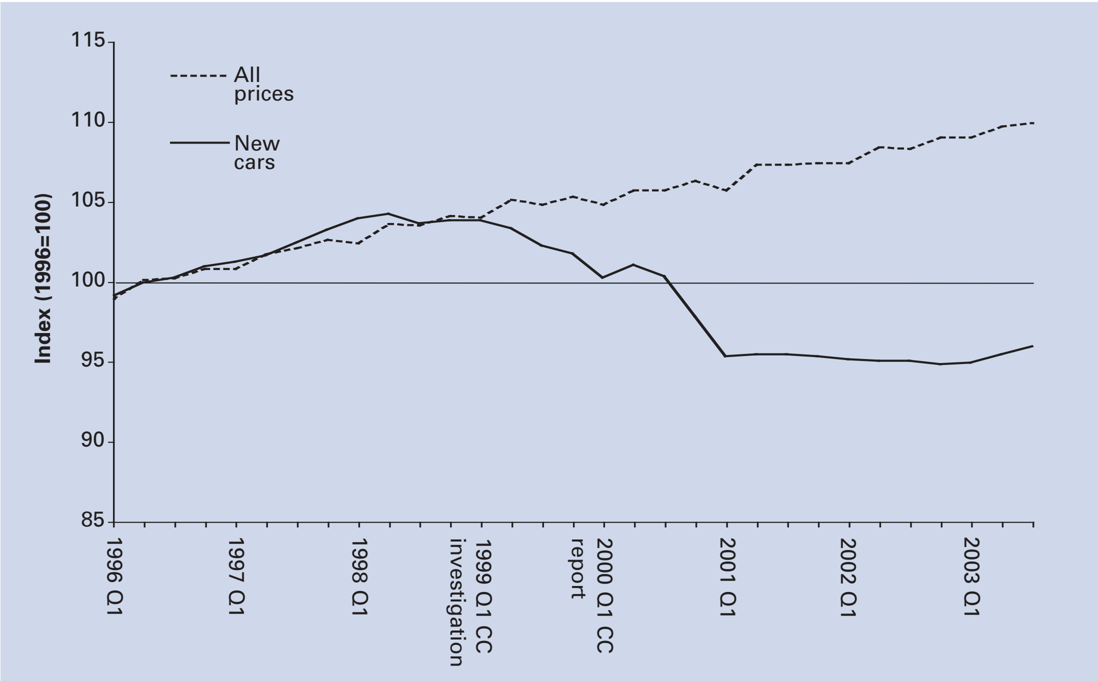
Data from the HICP[88] new cars price index (Figure 6.1) shows prices beginning to fall in the spring of 1999, when the case was referred to the UK Competition Commission, then rapidly declining over the course of 2000 as the full effects of the indirect intervention were felt by consumers. By summer 2001 the correction was almost complete and the changes begin to stabilise at this lower level.

86 The Consumers Association – Which (1999) (disputed by dealers).

87 The European car distribution handbook 2000 available at http://www.automotivedesktop.com/ reports/ECDH%20Press%20Release.doc however "the total number of franchised sales points (including sub-dealers) has fallen by only 1.7% over the last 4 years"

88 Harmonised Index of Consumer Prices (now the CPI: consumer price index) collected by the ONS via contracted market research firms.

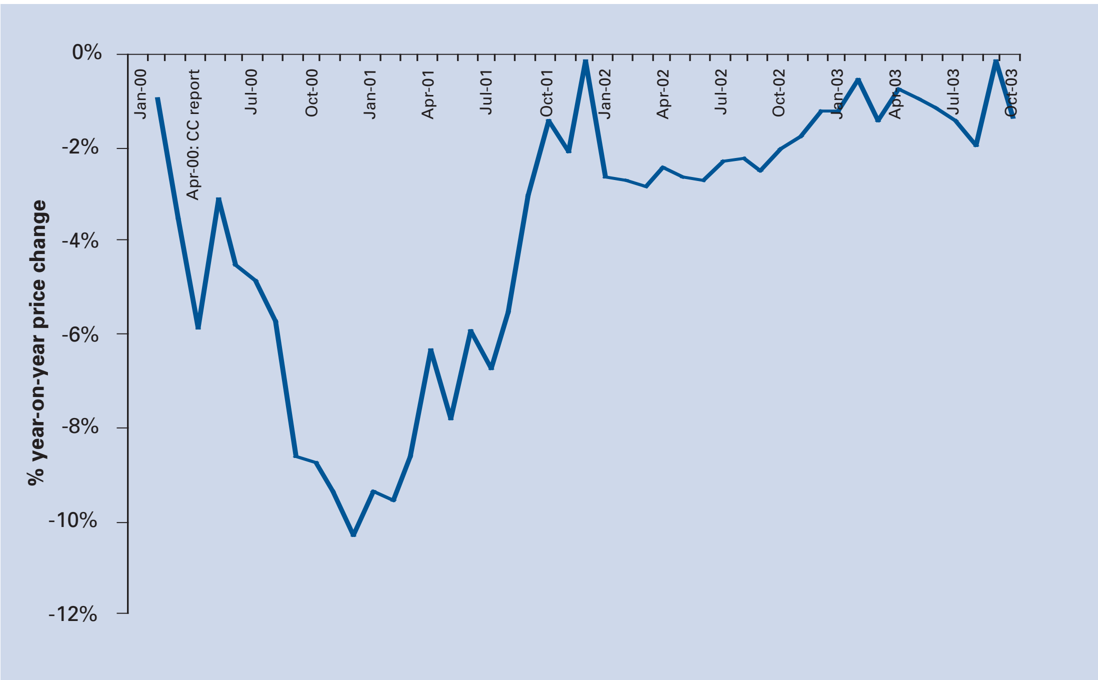
Figure 6.1 HICP New Cars Price Index (1996=100)



Source: Office for National Statistics

Corroborating this evidence is the Alliance and Leicester car price index[89] (Figure 6.2), which gives year-on-year price changes between February 2000 and November 2003. Between February 1999 and February 2000, nominal prices fell by 1%; however, following the publication of the Commission report in April 2000, we see a dramatic reduction in this year-on-year value to -5.9%. The figure for December 2000 shows that prices fell by 10.4% over the course of the year 2000. The index concludes that nominal prices fell by 10.02% in the three and a half years between publication and October 2003.

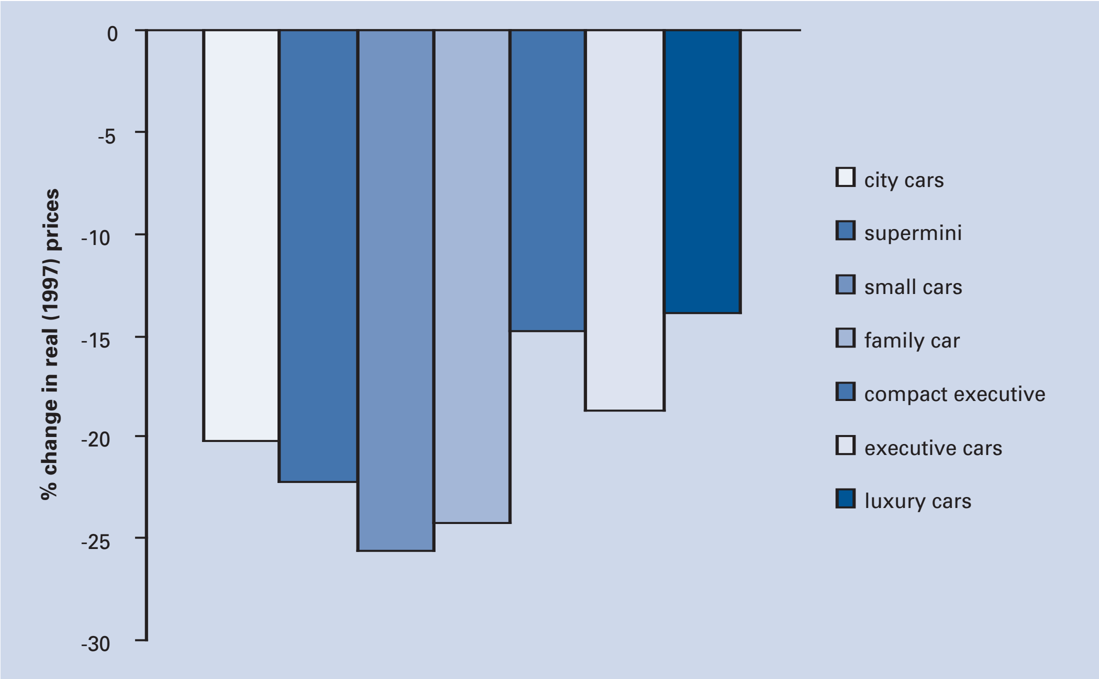
Figure 6.2 Alliance and Leicester car price index



Source: based on figures provided by http://www.allianceleicester.co.uk/ smartermotoring/ carpriceindex

Both indices reflect the state of the new car market as a whole, but within these figures there are some variations by category and manufacturer. The A&L data allows comparison of price changes in different segments of the market, Figure 6.3 showing that the executive/luxury car segments have seen less dramatic reductions than the small and family car segments.

Figure 6.3 Change in A&L Price Index by Market Segment, 1998-2003



Note: each bar in the histogram shows the change in price for the different categories of car.
Source: http://www.allianceleicester.co.uk/smartermotoring/carpriceindex/

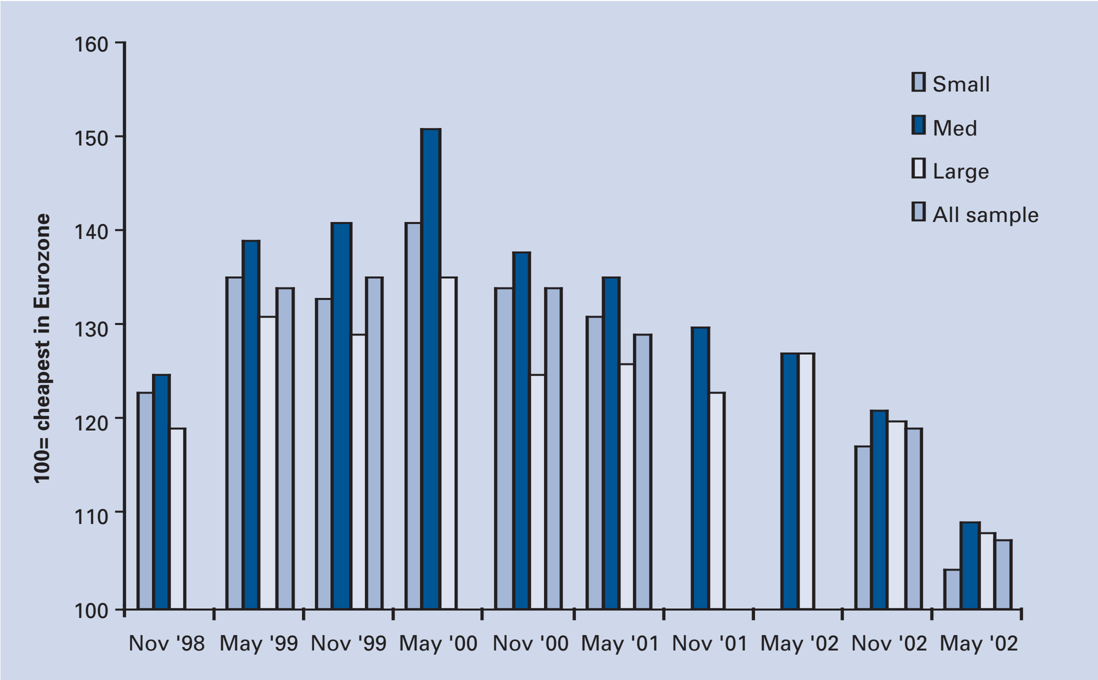
Similarly, information on recommended retail prices (RRPs) submitted to the European Commission reveals real price reductions of 7% for Audi and Fiat between May 1998 and May 2003 whilst Seat (32%), Volkswagen (27%) and Vauxhall/Opel (22%) show large cuts that illustrate the scope that existed for change. This sample data is based on the average RRP over the manufacturers' best selling models, and therefore should be taken as an indication of supplier decisions, rather than the actual forecourt price which is picked up by the A&L figures.

The European Commission collected supplier's RRP for each member state of the EU in order to investigate price disparities across the union. Taking the lowest price nation as the base price (=100), they illustrated these price differentials within the Union in an index. Figure 6.4 shows the changes in the UK's index value, both by segment and for the whole sample. From a peak of almost 135 (35% disparity) in 1999, the value is down to 107 (7%)[90] and for many individual models the UK is currently cheaper than the lowest Eurozone price (Volkswagen Polo=95.9).

89 This data is collected by mystery shoppers in order to include forecourt discounts that may exist. The data is verified by the CEBR (Centre for Economic and Business Research)

90 This is partly accounted for by the additional cost of specifications such as right hand drive.

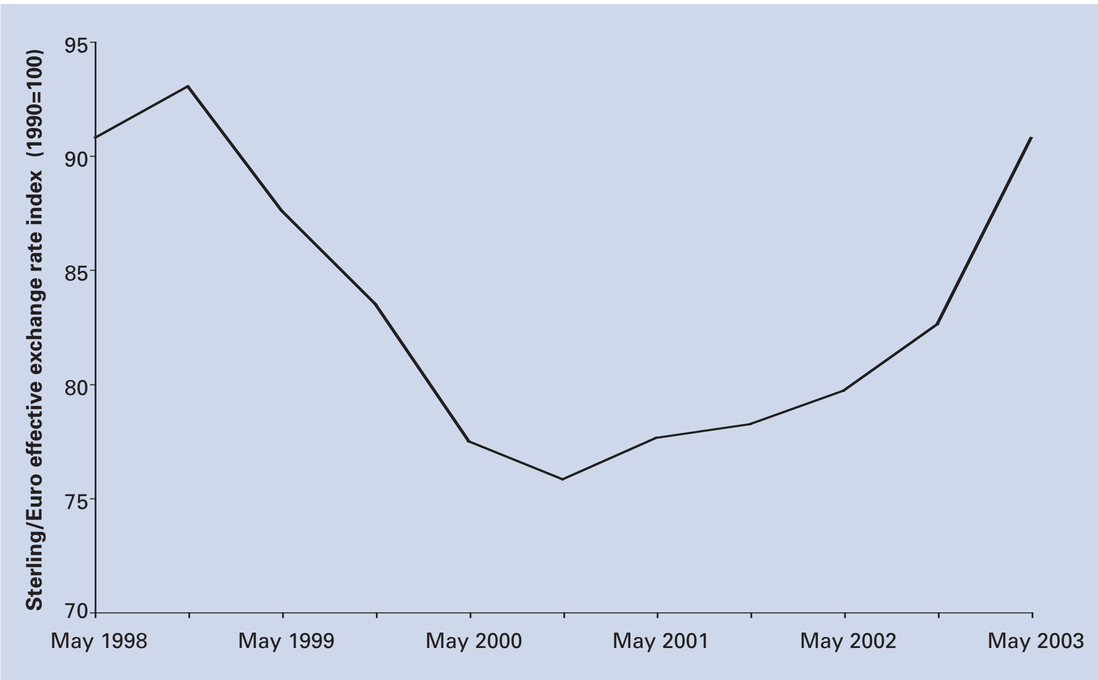
Figure 6.4 UK/EU Price Disparity Index



Source: EuroStat data from http://europa.eu.int/comm/competition/car_sector/price_diffs/

An obvious concern with these figures is that much of this effect might be attributed to fluctuations in the exchange rate across this period. However Figure 6.5 shows that the exchange rate between sterling and the Eurozone had, by May 2003, returned to almost exact parity with its value in May 1998. Therefore the general trend in price changes is not merely the result of a change in the exchange rate.

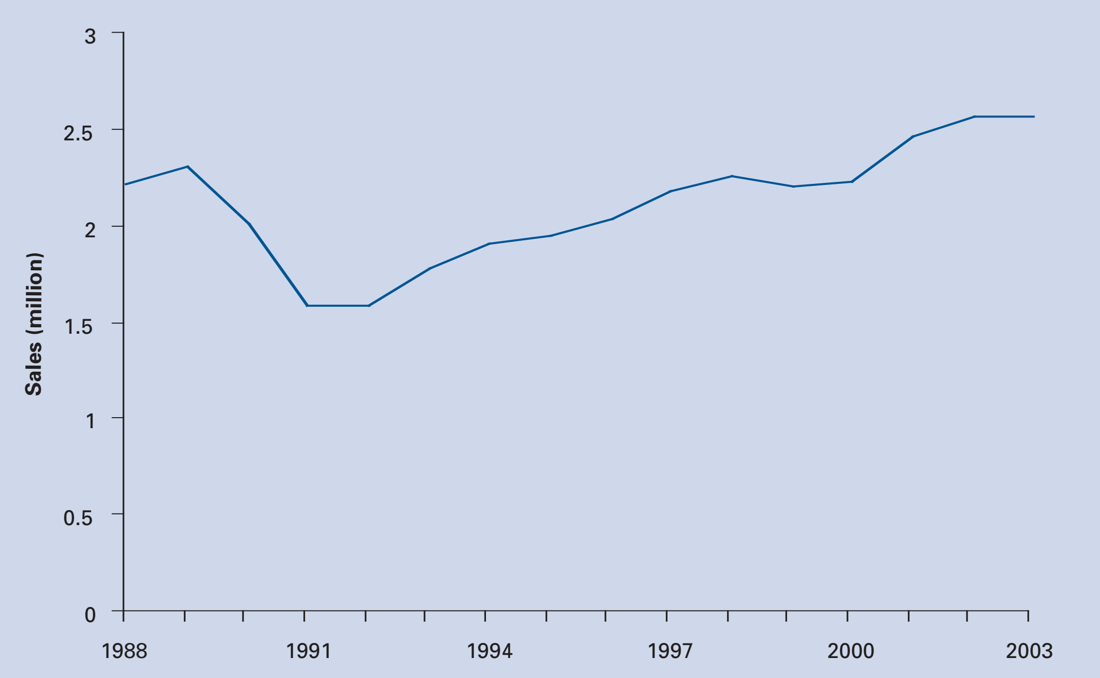
Figure 6.5 The Sterling/Euro Exchange Rate



Source: Bank of England dataset: XUMAERG

As prices fell, the sales figures rocketed by 370,000, from a stable 2.19m in 1999 to 2.565m in 2003 (Figure 6.6) as consumers took advantage of the firms' discounting. This rate of growth is more than double that in all consumer expenditures across the economy as a whole.

Figure 6.6 Volume of UK Car Sales



Source: SMMT

SIDE EFFECTS

It is probably too early to assess what side effects will result from this scale of price reduction. However, it is interesting to observe that the 5 firm concentration ratio fell from 53.1% of the market to 48.8% between 2000 and 2003 as the leaders saw their market share decline (Table 6.1). This offers little support to the argument that a powerful block exemption was required to prevent cut throat price competition at a supplier level by the market leaders. Perhaps the EC reforms, which encourage multi-franchise dealerships, will continue this trend of reducing market concentration by allowing smaller suppliers' access to customers of large dealerships.

Table 6.1 Changing Market Shares of the Leaders

	% Market Share (Year)	
Manufacturer	**2000**	**2003**
Ford	16.8	14.7
Vauxhall/Opel	13.3	12.6
Renault	7.3	7.4
Peugeot	8.6	7.3
Volkswagen	7	6.9
Share of top 5	53	48.9

Source: SMMT

Concerns over the quality of servicing in the absence of the block exemption were effectively dismissed by the UK Commission; evidence submitted to the investigation showed the absolute quality of the work was more likely to be 'very poor' at the dealers, whilst the most recent survey in 2003 shows that customers were more satisfied by the service at independent garages than that at franchised dealerships[91]. As the dealers point out, customers that use these firms may have differing expectations, perhaps based on the 45% price premium paid at the franchised dealers, and this may affect their satisfaction level; nevertheless service quality does not appear to have suffered since the intervention.

6.6 Conclusions

All of the evidence on prices, both list prices and prices actually paid, confirm that retail prices paid by private consumers have been drastically reduced over the last three years. As yet, there is no evidence of any harmful side effects. While there can be no denying the scale of these reductions, there is room for disagreement about the causes. We have highlighted the impact of the Competition Commission's report in 2000, but alternative/complementary explanations are that this was as much to do with public concern at what was widely perceived to be exploitation of UK consumers, and/or a preemptive move by manufacturers, in anticipation of policy changes at the European level. Further benefits might be hoped for when the actual reform of the European block exemption is completed in 2005.

91 Despite the guaranteed custom of drivers with cars under warranty.

7. Replica Football Kits

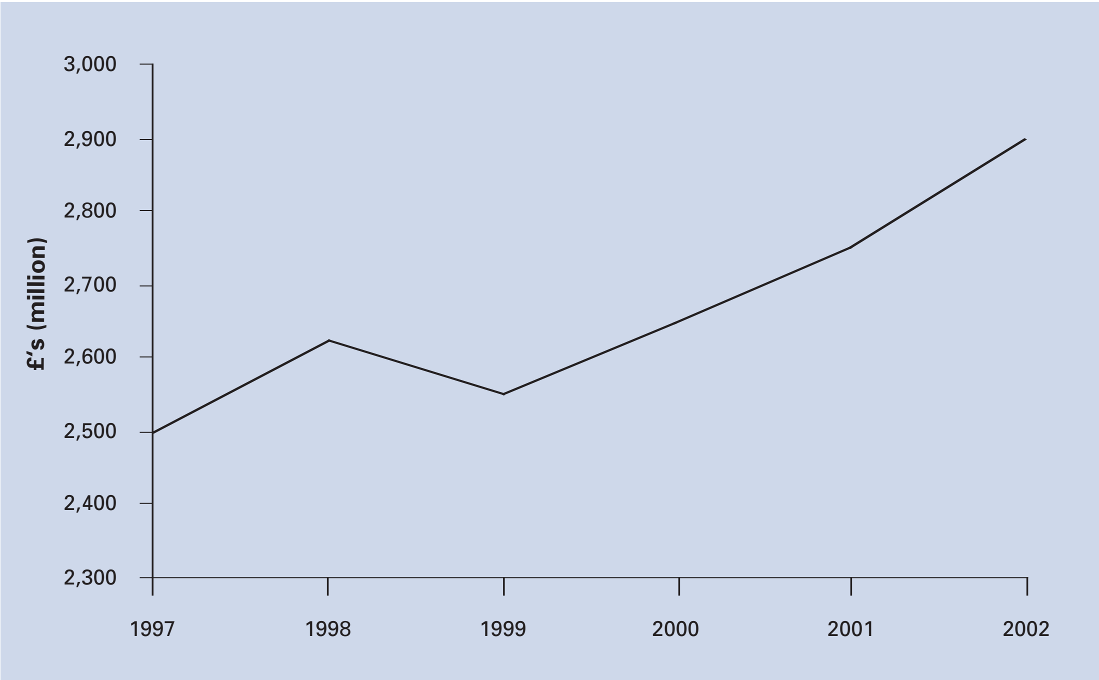
7.1 Introduction

Professional Football is now an extremely commercial business in the UK, and the football clubs are increasingly reliant on merchandising to raise additional revenue to fund playing success[92]. This case relates to one important part of that merchandising – the sale to supporters of replica football kits. Football merchandising has received considerable criticism from various quarters, with suggestions that clubs often exploit supporters[93]. This led to complaints to, and investigations by, the Office of Fair Trading (OFT), which concluded (2002/3) with the finding that there had been price fixing. Under new competition law, this led to financial penalties for the firms involved. Since then, there is emerging evidence of very large subsequent reductions which have already taken place in retail price

7.2 The market

The sports clothing industry as a whole has recently experienced relatively high growth (Figure 7.1); and a significant proportion (9.1%) is accounted for by replica football shirts – in 2001, turnover was estimated at £250m[94].

Figure 7.1 The UK Sports Clothing Market



Source: Keynote, Clothing and Footwear, Market Report 2003.

92 In 1998, on average, a club in the English top division made £5.24m from merchandising (Football Task Force, Commercial Issues, 1999, Review of 1998 Annual Accounts by Deliotte & Touche.) For example, Manchester United, one of the biggest clubs in the world in terms of turnover, has become a global brand, and its "commercial activities" account for £40m (27% of turnover) (Manchester United, 2003).

93 The 'Toongate' affair in 1998 highlights the growing perception of exploitation: tabloid newspapers exposed two Newcastle United directors boasting about large mark-ups on replica kits and suggesting supporters were gullible, (Football Task Force (1999)).

94 Keynote (2002).

PRODUCT DEFINITION

The replica football kit is authentic reproduction of the shirts, shorts and socks worn by club players for matches; and the same applies to the shirts worn by national teams. The most purchased part of the kit is the short-sleeved shirt[95]. Most clubs have at least two different kits, one for home matches and one for away matches; in addition a third kit plus the goalkeeper's kit can often also be purchased. An example of how lucrative replica shirt sales can be is shown by the transfer of David Beckham from Manchester United to a Spanish club, Real Madrid, in the summer of 2003. In the 6 months following this transfer, it is estimated that an additional million replica shirts were sold[96]. The clubs generally launch a new kit every year, with a shelf life of 2 years. The replica shirts of English clubs are increasingly sold throughout the world, especially now that the larger clubs have opened official stores overseas. However, we restrict our attention to the UK retail market as this was the market investigated by the OFT.

The market for replica shirts has a number of distinguishing features. Firstly, customers are extremely loyal to a particular club and therefore, will never consider the shirts of a rival club as a substitute. (The shirt of the national team is perhaps a weak substitute for a limited number of consumers). The demand for any particular club shirt and for a national team's shirt is, therefore, relatively price-inelastic. A replica shirt is not just a sportswear good, it is also typically purchased for leisurewear and as a fashion garment. Replica shirts are also typically worn to attend matches: for the 1997/98 and 1998/99 seasons one survey estimates that 74% of match attending supporters had purchased a replica shirt within the previous 2 years. Of this group, a large proportion suggested that the shirts were not reasonable value[97]. It is also significant that, as already mentioned, the shirt has a limited shelf life, it is typically replaced every two years and fashion normally dictates that the shirt becomes obsolete after this period. Consequently the value of the shirt to the consumer rapidly declines over time and the most significant period of demand immediately follows the kit's launch. Demand is also high following playing success by a particular club and around the time of important World and European tournaments, particularly for the national team's kits. One other important issue is that a large proportion of consumers are children, as this exacerbates claims of exploitation.

INDUSTRY STRUCTURE[98]

The club's official logo is an extremely important asset, and clubs make significant attempts to protect their monopoly use. A potential threat to their sales of replica kits and other merchandise comes from the sale of non-licensed merchandise. For example, in November 2002, Arsenal Football Club won a case in the European Court preventing a street trader from selling non-licensed merchandise[99].

A key feature of the market is that it generally involves combining a club's brand name with that of a leading sportswear 'name' firm. In general, the club/national team will negotiate an exclusive contract with the firm, e.g. Adidas, to manufacture its

95 For this reason the OFT investigation focused on replica shirts but also applied to all components of replica kit. For the remainder of the chapter replica shirt can be taken to mean short sleeved replica shirt.

96 The Guardian Newspaper, 08/12/2003.

97 Football Task Force (1999).

98 Unless otherwise shown, all facts reported in this subsection are taken from OFT, Price-Fixing of Replica Football Kit, August 2003.

99 The street trader had been selling merchandise outside the Arsenal ground for over 30 years and claimed to make clear his products were 'badges of allegiance' and not officially sanctioned by the club. Ananova, www.ananova.com/news/story/sm_707788.html?menu=, (24/11/2003).

merchandise including replica kits. In the past, contracts were often for 4 years, however, recently longer contracts have become more common. Every shirt contains a sponsor's name/logo in exactly the same way as the shirts worn by the players. Table 7.1 shows the current manufacturers of the kits for clubs in the Premiership (the top division).

Figure 7.2 The Vertical Structure of the Industry:

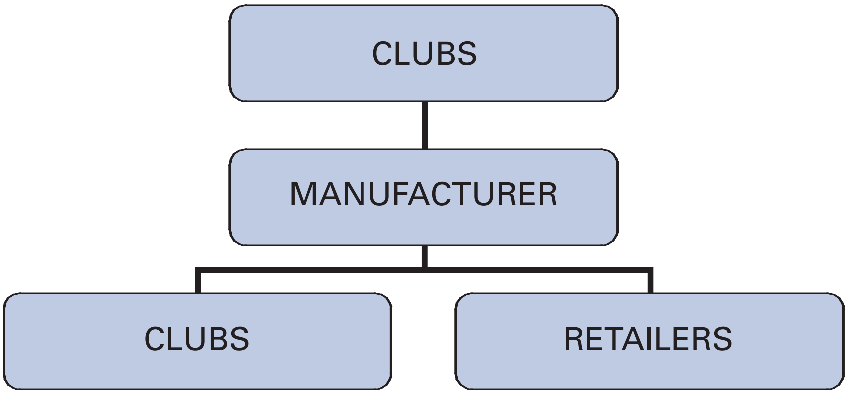


Table 7.1 The Manufacturers for the Premiership Clubs, 2003/04 Season

Manufacturer	Club
Adidas	Newcastle
Diadora	Aston Villa
Errea	Middlesbrough
Joma	Charlton Athletic
Kappa	Blackburn, Tottenham
Le Coq Sportif	Birmingham, Leicester
Nike	Arsenal, Leeds, Manchester Utd.
Puma	Everton, Fulham, Wolves
Reebok	Bolton, Liverpool, Manchester City
Umbro	Chelsea
Own production	Portsmouth, Southampton

No manufacturer produces the replica kit for more than three clubs, and in that sense, the market is relatively unconcentrated. However, the larger manufacturers generally produce the kits for the more successful clubs with the largest number of supporters. Interpreting advertising spend as an indicator of brand strength, Table 7.2 reveals Nike and Adidas as the leading brands.

Table 7.2 Advertising Spends by Manufacturers of Sports Clothing

Manufacturer	£000	%
Nike	3227	25
Adidas	2919	22
Reebok	1291	10
Umbro	**494**	**4**
Other	5115	39
Total	13046	

Source: The figures relate to Main Media Advertising Expenditure on Sports Clothing Brands in 2000-01, Keynote, Sports Clothing and Footwear, Market Report (2003).

The OFT investigation was concerned with Umbro's replica kits: although not as significant a brand name in the sports market as a whole as Nike or Adidas, Umbro is still a major player in football kits. Indeed, at the time of the investigation, it manufactured for Chelsea, Celtic, Manchester United, Morecambe, Nottingham Forest and the English national team. In financial year 2000, Umbro's UK turnover was just over £83m.

Throughout the period covered by the investigation, Umbro operated a selective distribution policy, only supplying retailers who traded solely in sportswear goods. Umbro argued that selling its products alongside non-sportswear products would detract from the image of the product. Thus, Umbro would not supply supermarkets, despite evidence of attempts by several supermarkets to obtain merchandise from Umbro. Retailers were also obliged to only sell the product from their own retail outlets and not to sell on to any other firm. Manchester United also opposed the supermarkets selling its shirts, claiming that they would be used as loss-leaders, thereby damaging brand image.

There are two main types of retail outlet: the clubs' own outlets and sportswear retailers. Both also now sell replica shirts via the internet. Typically, the clubs have a shop at their ground selling merchandising particularly on match days and it is now increasingly common for clubs to open official stores elsewhere. The sportswear retail chains are an important, and increasing, form of retailing, although independents remain significant.

There were five main retailers involved in the case (Table 7.3). JJB is by far the largest; during the period of the investigation, it was the England national team's official retailer. Allsports was the official retailer for Manchester United. Blacks at the time owned the retail chain First Sport and in 2002 sold just over 200 stores to JD.

Table 7.3 The Five Main Retailers Involved in the Case

Retailer	Turnover £m	Number of stores
Allsports	140	240
Blacks	208	209
JJB	659	430
JD	171	130
Sports Soccer	320	90

Source: OFT (2003). Turnover figures vary in period covered 1999- 2001.

In addition to these retailers and the manufacturer Umbro, there were also a number of other firms involved in the case, including a small retailer, Sports Connection, which had only 32 stores and which went into receivership by the time the investigation was completed. The Football Association (FA) was also involved. The FA is the main regulatory body of English football and is also the licensor for the English national team's merchandise. Umbro is licensed by the FA to manufacture the English national team's replica shirts. In February 2000 the FA awarded the English national team's retail operations, known as England Direct, to Sportsretail. The other firm involved was the football club Manchester United. At the time, Manchester United was one of Umbro's main customers, but since then, Nike has replaced Umbro.

7.3 The OFT intervention

PRIOR TO THE MAIN INVESTIGATION

Prior to the OFT case, brought in 2000, the OFT had already investigated the market, following complaints by retailers, including one from Coventry. This retailer had advertised a 10% discount for pre-orders on a particular team's new strip. The supplier had responded by threatening to delay orders and the retailer subsequently experienced supply problems. The investigation found evidence of clubs encouraging manufacturers to withhold supply from price cutting retailers. The Resale Prices Act makes it illegal for suppliers to set minimum resale prices, impose resale price maintenance or discriminate against retailers in any other way[100].

In August 1999, the Director General of Fair Trading received assurances from the Football Association and the Premiership clubs that they would not practice Retail Price Maintenance (RPM). Instead, they planned to introduce contracts which would not prevent retailers from discounting. The OFT responded by expressing its hope that this would lead to a reduction in prices, but it also pointed out that, as from 2000, the Competition Act would give it the power to impose significant financial penalties of up to 10% of turnover if price fixing was found still to exist[101].

100 OFT Press Release PN 19/98 (21 April 1998), Supplier of Football Shirt Gives Promises, www.oft.gov.uk/news/press+releases/1998/pn+19-98.htm.

101 OFT Press Release PN 30/99 (6 August 1999), Football kit price fixing ended, www.oft.gov.uk/news/press+releases/1998/pn+30-99.htm.

The findings of the Football Task Force, set up in the late 1990s, also highlight the growing concerns with football merchandising at that time. Their 1999 report advocated the following changes: (i) kits should have a life span of at least two seasons, (ii) supporters should be consulted on kit design, (iii) shirts should state on the collar when the kit will become obsolete, (iv) all clubs and the FA should adhere to the assurances, discussed above, given to the Director General of Fair Trading. It also recommended that a Football Audit Commission should be established with a role, inter alia, of working with clubs in order to encourage best practice on merchandising issues.

OFT INVESTIGATION, 2000

In August 2000 a complaint was made to the OFT by the retailer Sports Soccer, claiming that, in the last year, price fixing had become more frequent and now involved a large number of retailers and brands[102].

In response, the OFT conducted a survey of prices for England, short-sleeved home shirts. This showed that most retailers were charging identical prices of £40 for adult sizes and £30 for junior sizes[103]. At the time the wholesale price was around £21[104]. Therefore, the retail price for an adult shirt represented a 60% mark-up on the wholesale price (after taking VAT into consideration). Given the serious accusations of Sports Soccer and previous general disquiet, this provided the OFT with sufficient reason for an in-depth investigation of the industry, to establish whether price fixing was occurring.

The investigation discovered that RRPs were issued by Umbro to all retailers, with the suggestion that maintaining these prices was essential to protect Umbro's brand image. The investigation came to the conclusion that these RRPs were used as focal points for the price fixing behaviour.

In particular, the investigation found evidence of three main sets of agreement:

(i) (from April 2000 to August 2001) concerned the fixing of prices for all of the major Umbro replica shirts. This involved all five retailers in Table 7.3, (Manchester United and Umbro);

(ii) (for a short period in spring 2001) concerned the fixing of the price of a major Scottish club shirt (Celtic) with a retailer primarily trading in Scotland (Sports Connection);

(iii) (spring 2000 to autumn 2001) involved attempts to ensure that Sportsretail (the FA's online retailer) did not undercut the prices of JJB.

All three agreements were attempts to fix price during crucial selling periods, and often withdrawal of supply was used to enforce the agreements. The OFT reports detailed tables of pricing patterns during the infringements[105]: price of the shirts at launch was generally the RRP, then the date at which discounting first takes place is shown. Typically pressure was then applied on discounting retailers to return to the RRP.

The agreements were enforced by a number of informal meetings and the frequent monitoring of retail prices. Evidence based on emails, letters, faxes, internal memos,

102 Slides from OFT Internal Seminar, Competition Enforcement Division 'Replica Kit'.

103 OFT Press Release PN 107/03 (1st August 2003), Large fines for replica football kit price fixers, www.oft.gov.uk/news/press+releases/2003/pn+107-03.htm.

104 OFT (2003a). However, the evidence in the OFT investigation suggests that retailers often obtained discounts on this wholesale price.

105 OFT (2003a), Annex 2, Tables 1-8.

meeting and telephone conversation notes and Umbro's monthly managements reports were used as evidence. The agreements uncovered were of both a vertical nature i.e. between Umbro and retailers, including Manchester United, and also horizontal i.e. between retailers. Pressure was exerted by retailers on other retailers, as well as by Umbro on retailers, and by retailers on Umbro, requesting Umbro discipline other firms.

Negotiations were also taking place at this time over the renewal of Umbro's contract as the manufacturer of Manchester United's merchandise; this gave Manchester United significant bargaining power, with the potential implicit threat (subsequently enacted) of a change to a competing sportswear manufacturer. Although the football club argued that a point in favour of high retail price was the protection of brand image, the OFT pointed out that Manchester United was supplied by Umbro at a wholesale price which was dependent on the RRP – lower retail prices would imply lower wholesale, and reduced club profits.

According to the other firms involved, the main reasons why Umbro was concerned to maintain price at the RRP were: (i) wholesale price was determined by the RRP, (ii) Umbro was under considerable financial pressure, and (iii) because a new contract with Manchester United might allow Umbro itself to retail the products. However, it was also in the other sportswear retailers' own interests to attempt to fix prices. The investigation suggests that Umbro played a crucial facilitating role by keeping firms informed of various retailers' prices; however, it also recognises the pressure placed on Umbro particularly by Manchester United and JJB as the largest retailer. Overall, the OFT found that all of the firms were involved in the intentional price fixing agreements.

SIGNIFICANCE OF THE 1998 COMPETITION ACT

En passant, it is important to stress the key role of The Competition Act, which came in to force in March 2000. This replaced various previous Acts including the Restrictive Trade Practices (1976), Resale Prices (1976) and Competition (1980). It 'outlaws agreements, business practices and conduct that damage competition in the UK'[106], and prohibits: anti-competitive agreements (Ch1 prohibition based on Art 81 of EC Treaty), and abuse of dominant positions (Ch2 prohibition, based on Art 82 of EC Treaty)[107].

Chapter 1 prohibits both formal and informal arrangements and this does not require the agreement to be in written form. The relevant infringement in the replica football shirt industry concerned Chapter 1. Important elements of the Act, as far as this case is concerned, are:

- significant fines for infringement could be levied. Companies found guilty of infringement could be fined up to 10% of their UK turnover for each year, up to a maximum of three years, in which the infringement took place. The directors of the companies involved could also face disqualification (See Table 7.4 for the main fines in this case);
- in order to gather the evidence required to prove infringement, OFT officials were allowed to enter the premises of firms to obtain relevant documentation. This allowed much of the evidence for this case to be obtained;

106 OFT website, Competition Act 1998, http://www.oft.gov.uk/Business/Legal+Powers/ca982.htm (12/02/04).

107 Department of Trade and Industry (DTI) website, Competition Act 1998, www.dti.gov.uk/ ccp/topics2/competition_act.htm (12/02/04).

- leniency can be granted to firms involved in the agreement who approach the competition authorities with evidence[108]. This can take the form of partial or total immunity from financial penalties. In this case, OFT granted a number of firms some degree of leniency, and this appears to be crucial to the success of the case.

Table 7.4 Fines Imposed Following the OFT Investigation

Company	Fine (£m)
JJB	8.37
Umbro	6.64
Manchester United	1.65
Allsports	1.35
Others (Blacks, FA, Sports Soccer, JD Sports, Sports Connection, Sportsretail)	0.61
Total	18.59
FA, Sports Connection and Sportsretail each enjoyed reduced fines due to leniency	

Source: OFT Press Release PN 107/03 (1st August 2003), Large fines for replica football kit price fixers, www.oft.gov.uk/news/press+releases/2003/pn+107-03.htm.

7.4 Arguments for and against[109]

The price fixing which occurred in this case is equivalent to resale price maintenance (RPM), which is generally illegal under most competition law. RPM is the term given to the imposition of a minimum or maximum price enforced on retailers by manufacturers, and it is an example of a vertical restraint, where some form of contract is used to restrict the behaviour of a vertically related firm.

The expected benefits from eradicating this practice are relatively straightforward: facilitating collusive pricing (in principle, both intra-brand and inter-brand), RPM will be detrimental to consumers particularly when consumer demand is relatively inelastic. However, there are circumstances under which RPM may be welfare enhancing. In many industries consumer demand depends on the amount of sales effort exerted by retailers. In this case RPM might be necessary to ensure that retailers engage in adequate sales effort, for example training staff and displaying products in a way which is attractive to consumers. Without RPM, retailers may have an incentive to free-ride on the sales efforts of other retailers: retailers engaging in high sales effort help promote the product, but the consumer may then purchase from rival retailers who can price low by avoiding the expenditure on sales effort. RPM removes this possibility and there remains an incentive for retail sales effort: this is in the interest of both retailers and manufacturer. If consumers benefit from this increased sales effort then RPM may be welfare enhancing.

However, due to the nature of the product in this case it is questionable whether this latter argument has much validity – perhaps one minor form of investment required for retailing replica shirts is the provision of a fitting-room.

108 OFT website, Competition Act 1998, www.oft.gov.uk/Business/Legal+Powers/Competition +Act +1998.htm

109 The arguments summarised in this section are discussed in more detail in most standard textbooks on Industrial Organisation, for example, Cabral (2000).

7.4 Price outcomes

OFT EVIDENCE

The OFT itself conducted a new random survey of England replica kit prices immediately following the launch in April 2003. Prices were noted on the first two days immediately following the launch, as well as the prices for pre launch orders placed on retail websites for the week before. The results showed considerable variation in prices. Adult prices varied from £24-40 and juniors from £18-30[110]. This suggests that significant discounting was now taking place, and these prices compare favourably with those gathered by the OFT at the start of the investigation.

WHICH MAGAZINE

Which magazine also recently conducted a survey of the prices of replica football shirts[111]. Their results broadly confirm the above OFT results: prices for an adult Manchester United home shirt varied from £30-40 and, for an England home shirt, from £25-40. In particular one retailer in both cases appears to be substantially undercutting its rivals.

OUR OWN (UEA) SURVEY

We also conducted our own small survey of prices for both club and the national team replica shirts, in a number of different locations, during November and December 2003. This corroborates the above post-investigation findings.

We recorded the prices[112] of Manchester United, Chelsea and England[113] adult and junior home shirts in four towns/cities: Boston, Cambridge, Coventry and Norwich. In addition we included prices from several online retailers and club websites. Prices were also recorded in the official Manchester United store located at its home ground. Chelsea and England were chosen as two of the most popular shirts currently manufactured by Umbro; Manchester United shirts were included (although they are no longer manufactured by Umbro) because they are the biggest seller, it was the shirt that was central to the case, and because it is now manufactured by an alternative retailer, giving a useful comparison. With the exception of Cambridge and the online outlets, we actually visited the stores, and only included shirts which were in stock. For Cambridge, the survey was conducted by telephone. Most of the retailers visited featured in the case.

Of course, the relatively small number of observations limits the confidence with which we can draw definitive conclusions, but they are perhaps illustrative of what might emerge from a larger scale, more random, survey of current pricing by retailers. Table 7.5 shows results by shirt type and Table 7.6 by geographical location.

110 OFT (2003b).

111 Which (2003).

112 If a range of prices were observed e.g. prices depending on size the midpoint price was selected.

113 For Manchester United, this was the replica shirt for seasons 2002/3 and 2003/04, manufactured by Umbro; for Chelsea and England . 2003/04 and 2004/05, manufactured by Umbro.

Table 7.5 Prices by Replica Shirt (UEA survey)

	Price (£)			
Replica Shirt	**Minimum**	**Average**	**Maximum**	**Observations**
MU Adult	30.00	35.50	40	15
MU Junior	17.50	26.50	30	13
Chelsea Adult	29.99	34.00	40	10
Chelsea Junior	17.50	24.94	30	9
England Adult	24.00	32.94	40	17
England Junior	17.50	25.15	30	13

Table 7.6 Prices by Location (UEA survey)

		Price (£)			
Location	**Shirt Type**	**Minimum**	**Average**	**Maximum**	**Observations[114]**
Online	Adult	29.00	35.37	39.99	8
	Junior	24.99	27.50	29.99	8
Boston	Adult	25.00	31.00	35.00	4
	Junior	19.00	23.50	25.00	4
Cambridge	Adult	24.00	34.26	40.00	15
	Junior	17.50	25.96	30.00	15
Coventry	Adult	29.00	34.14	40.00	7
	Junior	20.00	23.33	25.00	3
Norwich	Adult	25.00	33.28	40.00	7
	Junior	20.00	23.13	27.50	4
MU club store	Adult	40.00	40.00	40.00	1
	Junior	30.00	30.00	30.00	1

Prior to this case, as discussed above, the OFT evidence suggests that the standard prices for replica shirts were £40 for adults and just under £30 for juniors (the OFT found this to be the case for the England national team replica shirts and is likely to have also be very similar for club shirts). The above results suggest that this is no longer the case. Although some retailers still set these high prices, the average in all

114 Each geographic location does not necessarily contain an observation for each different shirt type.

cases is much lower and the price range is considerable. The prices were collected during key selling periods; for two of the three replica shirts chosen (Chelsea and England) the kits were close to the beginning of their shelf life and in all cases, it would seem reasonable to expect the two months prior to Christmas to be a crucial selling period. Somewhat surprisingly, the average prices for the Manchester United shirts are the highest despite this being the kit closest to the end of its shelf life. One plausible explanation is that supporters of this particular club have particularly inelastic demand due to (arguably) their more intense club loyalty[115].

In addition to this price information, a number of other casual, but arguably significant, observations were made in the process of carrying out the survey. Firstly, at least one retailer offered a free gift (a watch), as an incentive to purchase a particular replica shirt. In the OFT investigation it is reported that retailers were often discouraged from this type of promotion during the price fixing periods. There was also some evidence that manufacturers or retailers now attempt to inform consumers of the limited shelf life of the product (one online club shop warns that the replica shirt has a shelf-life of at least one year). Finally, one retailer informed us that it had decided to discontinue selling replica shirts as a consequence of the intervention by the OFT, which had reduced its profit margin.

OTHER POSSIBLE FUTURE OUTCOMES

In this case, of course, only a short period has elapsed since the change in competition, and it is too early to explore the implications beyond just the current retail price. However, we can offer some speculative remarks.

First, there are a number of reasons why more intense price competition is likely to continue into the future. The OFT investigation and fines are likely to have a significant deterrent effect – not just for the manufacturer and retailers involved in this case but for all manufacturers and retailers of replica football kits. There is also already evidence that the case will encourage new retailers to enter the replica kit market. For example several supermarkets have indicated that they are interested in selling replica shirts. In August 2003 the supermarket chain Asda purchased replica shirts on the ‘grey market’ and sold them at heavily discounted prices[116]. An important knock-on effect is that in the future these supermarkets should be able to obtain replica shirts directly from the manufacturers.

Second, as implied above, reduced mark-ups may deter some independent sports retailers from selling replica football shirts. This is especially likely if reduced prices are being met by reduced retail margins (on this, no evidence is yet available). Exit of some firms is often the inevitable consequence of a toughening in competition in any market, and, if it is the less efficient who exit, this is not necessarily welfare reducing. However, this might have a harmful effect on locational availability of the replica shirts of smaller clubs with fewer supporters (which are already generally sold in a smaller number of locations).

115 Manchester United has a reputation for drawing an unusually large proportion of its fan base from supporters outside of its home city. These are supporters who were first attracted to the club by its playing success in large parts of the second half of the 20th century. But they are also very infrequent visitors to home games. Thus the purchase of a kit is often their best, if not only, way of signalling allegiance.

116 BBC website, www.news.bbc.co.uk/1/hi/england/manchester/3115177.stm, (25/11/03).

Thirdly, there may be future strategic responses by the football clubs themselves. In order to maintain high prices, they may choose to concentrate on developing their own, on ground, retail outlets. Arguably, consumers buying kits from their club shop tend to be more 'captive', i.e. less price-sensitive, and it is interesting to note from our own small sample, that there has been no price reduction post-investigation, in the price charged in Manchester United's own club shop. This, and other possible developments in the retail market are necessarily just a matter of conjecture, at the time of writing. However, it is not unlikely that structural developments will occur in the retail market as a consequence of this case.

7.6 Conclusions

In terms of price, this is one of the most clear cut of our six case studies. The OFT's investigation under the new Competition Act, on the back of consumer unrest, has undoubtedly led to large price reductions: a ball-park figure is about 15% on average. This is a direct and immediate reflection of a tightening in the intensity of price competition in a particular market. At the time of writing, we have no evidence of any harmful side effects. However, longer-run structural changes might be expected, and, as usual, when competition becomes more intense, we might expect exit of some marginal, less efficient players. On the other hand, entry, with different business models (notably hypermarkets), also seems very likely. Initially, this might mean wider consumer choice in terms of alternative retail outlets, although a subsequent concentration of sellers might eventually obtain. But this remains to be seen.

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