

ORR's approach to reviewing markets

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1. Introduction

Purpose of this document

The Office of Rail Regulation (ORR) has a range of functions and responsibilities to keep rail markets under review and to take appropriate measures where markets are not working to the benefit of users or funders. These arise both in exercising our powers as concurrent competition authority for services related to railways and as economic regulator. This document sets out the statutory framework within which we exercise these functions and responsibilities, identifies the powers we have to seek information and to take enforcement action including the power to make references to the Competition Commission (CC) and explains the procedures we will follow when reviewing markets under the Enterprise Act 2002 (EA02).

This document does not deal directly with our powers to investigate complaints under the Competition Act 1998 (CA98). It should, therefore, be read in conjunction with the CA98 guidelines (OFT430) *Application to services relating to railways*¹.

ORR's objectives

The ORR Board has set the following organisational aim for ORR:

“ORR applies independent, fair and effective regulation to enable the railway to be safe, well maintained and efficient and to ensure that it provides value for money for users and for its funders.”

ORR's consultation, in December 2005, on *Updating our Corporate Strategy*² affirms the ORR Board's conviction that alignment of industry incentives, devolved decision-making and effective market mechanisms are key to future development of the railway. At paragraph 5.12 of the draft corporate strategy we state that a well-developed and competitive supply market is vital to improving industry performance and efficiency and, in this context, state at paragraph 5.13 that we will use our powers to carry out market studies where this is most likely to be effective. It is our intention, in the light of the

¹ Also published on the ORR website and entitled ORR Competition Act Guideline, *Application to services relating to railways*, Office of Rail Regulation, August 2005 (<http://www.rail-reg.gov.uk/upload/pdf/247.pdf>).

² ORR Corporate Strategy 2006-09 and Business Plan 2006-07 (<http://www.rail-reg.gov.uk/upload/pdf/280.pdf>).

updated corporate strategy, to develop a 5-8 year rolling programme of market studies and to set out, at high level, in ORR's future Business Plans the business areas we will focus on during that year. We do not intend, however, to publicise the occurrence of individual desk studies

We recognise that within the UK context there is already a significant measure of regulation of the railways. As a consequence, there is already a wide range of information available to ORR as to how markets are functioning, and an equally comprehensive set of powers to ensure that markets work effectively. There is, therefore, a balance to be struck between how we utilise our resources in reviewing and monitoring rail markets and in conducting our other regulatory and competition activities during the course of a business year and decisions to be made as to the means by which value to the railways is best achieved.

ORR's approach set out in this document does not deviate to any material extent from that adopted by the OFT. This document should, therefore, be read in conjunction with guidance documents produced by the OFT, such as *Market Studies – Guidance on the OFT approach*, *Enterprise Act 2002* and *Market investigation references, Guidance about the making of references under Part 4 of the Enterprise Act*.

Structure of this document

This document is structured as follows:

- Chapter 2 sets out the statutory framework for keeping rail markets under review; and
- Chapter 3 describes the approach we will take to market reviews under the EA02.

A general guide to the economic framework within which competition is assessed, and the key factors that are taken into account when coming to a view on competition in a market or markets, is contained in Annex A.

2. The statutory framework

Introduction

- 2.1 The statutory framework for keeping UK rail markets under review is governed by two key legislative Acts: the Railways Act 1993 (as amended) (RA93) and the Enterprise Act 2002 (EA02). The statutory framework has now been supplemented by a new market monitoring function under the Railways Infrastructure (Access and Management) Regulations 2005³ which transposes and implements the requirements of the First Package of EU Rail Directives⁴ and parts of the Second Package⁵.

Railways Act 1993

- 2.2 Section 69 of the RA93, provides that ORR must, so far as it appears practicable from time to time, keep under review the provision of “railway services”⁶ in Great Britain and elsewhere. ORR must also (again so far as it appears practicable from time to time) collect information, with respect to the provision of those services, in order to facilitate the exercise of its functions under Part 1 of the RA93.
- 2.3 ORR's functions include approving agreements for access by operators to track, stations and light maintenance depots and the issuing of licences to operators of railway assets. ORR also has a number of public interest duties to balance in the performance of its functions. These are primarily set out at section 4 of the RA93 and include:
- to promote efficiency and economy on the part of persons providing railway services;
 - to protect the interests of users of railway services; and

³ SI 2005 No. 3049.

⁴ Directives 2001/12/EC, 2001/13/EC and 2001/14/EC - 'First Rail Package'.

⁵ In particular we refer here to Directive 2004/51/EC, which opens up the domestic freight market to competition in each Member State.

⁶ Section 82 of the Railways Act defines railway services as: services for carriage of passengers, carriage of goods by railway, light maintenance services, station services and network services.

- to promote competition in the provision of railway services for the benefit of users of railway services.

2.4 The statutory framework implicitly recognises that knowledge of markets will assist ORR in exercising its functions and will enable ORR to develop proportionate and evidence based regulatory policy.

The Enterprise Act 2002

2.5 ORR has a concurrent power with the OFT to make a reference to the Competition Commission (CC), under Part 4 of the EA02, if it has:

“reasonable grounds for suspecting that any feature, or combination of features, of a market in the United Kingdom for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom”.

2.6 The EA02 defines a “feature” of a market as:

- the structure of the market concerned or any aspect of that structure;
- any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services; or
- any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services. Conduct is described in the EA02 as including “any failure to act (whether or not intentional) and any other unintentional conduct”.

2.7 The market investigation provisions in the EA02 replaced the Fair Trading Act 1973 complex monopoly provisions. Market investigation references focus on the functioning of a market as a whole, whereas the Competition Act 1998 (CA98) deals with abuses arising from the conduct of a one or more firms within a market. However, if the anti-competitive conduct of a single firm or a number of firms is associated with structural features, it may still be appropriate to make a reference to the CC.

2.8 Concurrent jurisdiction under the EA02 goes wider than the definition of railway services in section 82 of the RA93 and includes services such as the leasing or maintenance of rolling stock as provided by the rolling stock

companies (ROSCOs), the supply of goods and services to Network Rail, and the provision and purchase of goods and services to, or by, London Underground Limited (LUL).

- 2.9 Chapter 3 of this document sets out how ORR would approach the market review process under the EA02.

European legislation

- 2.10 The First Package of EU Rail Directives (referred to in the *Introduction* to this section above) opens up access to the international rail freight market and provides a transparent regulatory regime for the allocation of capacity and charges for access to the rail infrastructure across the EU. The Second Rail Package, and in particular Directive 2004/51/EC, opens up the domestic freight market to competition in each Member State.
- 2.11 Article 10(7) of Directive 2001/12 on the development of the Community's railways, requires the regulatory body established under Directive 2001/14⁷ to monitor competition in rail markets and further on the basis of a complaint or, where appropriate, on its own initiative, to take appropriate measures to correct undesirable developments in these markets.
- 2.12 The Railways Infrastructure (Access and Management) Regulations 2005 (the "Access and Management Regulations" or "the Regulations") which transpose and implement a number of the requirements of the First Package of EU Rail Directives and parts of the Second Package⁸ came into force on 28 November 2005⁹.
- 2.13 Regulation 30 of the Regulations states:

"(1) The Office of Rail Regulation shall be responsible for

(a) monitoring; and

⁷ Article 30 (2001/14/EC) requires Member States to appoint a regulatory body, independent of the Infrastructure Manager, as a charging body, an allocation body and to whom applicants may lodge an appeal if they feel unfairly treated, discriminated against or in any other way aggrieved.

⁸ In particular we refer here to Directive 2004/51/EC, which opens up the domestic freight market to competition in each Member State.

⁹ The Railway (Licensing of Railway Undertakings) Regulations 2005 (SI 2005/3050), transposes Directive 95/18/EC as amended by 2001/13/EC and 2004/49/EC.

(b) determining complaints lodged under paragraph (2) relating to, competition in the rail services markets, including the rail freight transport market.

(2) Any applicant or interested party may submit a complaint to the Office Rail Regulation, in such form and manner as that Office may from time to time prescribe, if it believes that it has been treated unjustly, been the subject of discrimination or has been injured in any other way.

(3) Subject to paragraph (4) where, following receipt of

(a) a complaint lodged under paragraph (2); or

(b) information gathered on its own initiative,

the Office of Rail Regulation identifies undesirable developments in relation to competition in the rail services markets it must, at the earliest possible opportunity, determine measures and take appropriate action to correct those developments.

(4) Paragraph (3) is without prejudice to the rights of any person to make an application to the court under Part 54 of the Civil Procedure Rules 1998."

2.14 The regulation, therefore, provides three interlinking roles of:

- monitoring competition;
- dealing with complaints from aggrieved parties; and
- whether on ORR's own initiative or as a result of a complaint taking appropriate measures to correct undesirable developments.

2.15 The intended scope of the EU Directives is wider than the railway currently regulated within the UK. To reflect this, the Regulations ensure that the appeal role of the ORR (including its responsibility under regulation 30) extends to facilities otherwise exempt from RA93 by way of *The Railways (Class and Miscellaneous Exemptions) Order 1994*. ORR is also, for the purpose of the Regulations, the regulatory body for the Channel Tunnel Rail Link (CTRL) and the Channel Tunnel Rail Link Act 1996, has now been amended, so that ORR is provided with concurrent competition powers over

the CTRL under the CA98 and the EA02. ORR's new jurisdiction will not extend to the Channel Tunnel or to shuttle services.

- 2.16 The Directives, which are aimed at liberalising rail markets specifically, recognise that there may be barriers to access and/or entry that have a significant impact on railway undertakings and potentially the number of competitors able to thrive or enter into rail markets, but which may have little or no economic effect on downstream markets, particularly where the passenger or good is able to travel by another mode. For example, a railway undertaking may require access to a specific rail terminal in order to make his rail service economically viable, but the rail terminal may not be considered an essential facility in competition law terms where the end customer can actually choose a number of other substitute services including a number of road-based alternatives. ORR therefore considers there is a key difference between the duty on ORR to monitor competition under regulation 30 (Article 10.7) and ORR's concurrent competition powers.
- 2.17 The range of powers available to ORR under the RA93, the Access and Management Regulations and as a concurrent competition authority, are sufficiently wide to enable ORR to fulfil the specific responsibilities given to it by way of regulation 30. However, if a novel situation arose that did not fall within the scope of ORR's powers, we would consider at that time, whether there would be benefit to publishing or submitting a report to Government and/or the European Commission.

New information gathering powers

- 2.18 Regulation 31 of the Regulations provides new information gathering powers to ORR, to assist ORR in its new responsibilities. ORR recognises, however, that within the UK context there is already a significant measure of ex-ante regulation of the railways, and as a consequence there is a broad range of information already available to it. Currently ORR expects to exercise its new information gathering powers only in the light of an appeal or a complaint.

3. The market review process

3.1 ORR proposes to adopt a three-stage approach for its conduct of a market review (similar to that set out by the OFT in its guidance document *Market Studies – Guidance on the OFT approach*). The process consists of:

- an initial in-house desk study (which will usually take no longer than one or two months), in which ORR will set out its initial view of the relevant economic market and an assessment of whether there are sufficient grounds to suspect that the market may not be working well;
- a more detailed market study (lasting no longer than three months), in which ORR will seek information from key market players to take a firmer view on market definition and to make a fuller assessment of any concerns identified during the first stage; and
- a full market review including public consultations with external stakeholders lasting between six and twelve months.

3.2 Potential outcomes during the second and third stages may be a clean bill of health or an indication of whether:

- to make a market investigation reference to the CC or accept commitments in lieu;
- there has been a breach of competition law, in which case, ORR may launch an investigation under the CA98; or
- the issues identified could be more effectively dealt with elsewhere, for example by ORR under sectoral legislation (licence enforcement) or by the DfT under franchise arrangements.

Selecting markets for study

3.3 The ORR will use a variety of sources from which to select possible markets for study. The *Introduction*, at Part I of this guideline, notes the ORR's Board's conviction, set out in ORR's *Corporate Strategy*¹⁰ that that alignment of

¹⁰ ORR's Corporate Strategy 2006-09 (<http://www.rail-reg.gov.uk/upload/pdf/280.pdf>).

industry incentives, devolved decision-making and effective market mechanisms are key to future development of the railway. In the *Introduction* we also refer to the Corporate Strategy where we state that a well-developed and competitive supply market is vital to improving industry performance and efficiency and, in this context, state at paragraph 5.13 that we will use our powers to carry out market studies where this is most likely to be effective. ORR will undertake own initiative market studies on that basis. Additionally ORR may be prompted to enter phase one of the review process as a of result factors such as:

- a “super-complaint” (within the terms of that under EA02)¹¹;
- information acquired in the course of performing its CA98, or wider regulatory functions; and/or
- evidence from general enquiries and complaints to ORR.

Phase 1: In-house desk study

3.4 The first step is a short desk-based study, which will usually take no longer than one or two months. Although ORR will aim to set out in its business plan the business areas it will focus on during the period, it would not expect to publicise the occurrence of individual desk studies. In conducting a desk study ORR will make use of information that is already in the public domain or held by other government departments or official sources. At this stage, ORR will not seek information from market participants.

3.5 The desk study will set out ORR's initial view of the relevant economic market and an assessment of whether there are grounds to suspect that the market may not be working well. The outcome of the desk study will be:

- a decision made to close the study and take no action on the basis that there are no identifiable competition concerns;
- a decision made to take a more detailed look at this market by progressing to the next stage;

¹¹ In section 205 of the EA02 provision is made for designated consumer bodies to make “super-complaints” to sectoral regulators, where there are market features that may be harming consumers to a significant extent. A super-complaint may be made to ORR in relation to the rail industry. ORR will have 91 days to respond to a super-complaint stating whether it will take action and what that action will be.

- ORR could find grounds to suspect that there has been a breach of the prohibitions within CA98 and choose to investigate using its powers under that legislation; or
- similarly, there may be matters capable of resolution under sector specific powers.

ORR does not expect that there will be sufficient information available at this stage to enable it to progress directly to a reference to the CC.

Phase 2: Market Study

- 3.6 During this phase (which will usually take no longer than three months) ORR will want to take a firmer view on market definition and to make a fuller assessment of any concerns identified during Phase 1. It will generally do this by asking for information (informally) from key market players. This phase is, therefore, likely to be more public than Phase 1. ORR will decide, at the outset, whether to make the fact that it is entering this phase of the study more generally known. Factors in making that decision will include the existence of commercial sensitivities, which may weigh against making the study public at this early stage. On the other hand there may be clear countervailing benefits of providing opportunities for others to demonstrate a relevant interest in the market concerned. If the decision is taken to announce a study it will be done by the issuing of a press notice. In cases where such an announcement could be market sensitive it will initially be made to the Stock Market via the Regulatory News Service (RNS).
- 3.7 There are a number of potential outcomes from this phase of the review including:
- a clean bill of health may be given, i.e. in ORR's opinion there are no substantive competition concerns, in which case ORR will terminate the review process;
 - ORR has grounds to suspect that any feature, or combination of features, of the market under scrutiny prevents, restricts or distorts competition. In order to assist in deciding whether to make a reference to the CC under section 131 of the EA02 or to accept undertakings in lieu under section 154, ORR may then progress to Phase 3 (which can include the exercise of formal powers of investigation, set out at section 174). Alternatively ORR

may decide it has sufficient information available to progress directly to a reference to the CC or to accept undertakings in lieu. If considered appropriate, it can make a referral at any time during Phase 2 and will not necessarily therefore, in those circumstances, consider it necessary to progress to a full conclusion or report;

- ORR finds grounds to suspect that there has been a breach of the prohibitions within the CA98 and choose to investigate using its powers under that legislation, similarly there may be matters capable of resolution under sector specific powers;
- ORR has identified issues which could be more effectively dealt with elsewhere, for example, under franchise arrangements. ORR could, in this circumstance, write a report to the DfT including recommendations as to how competition concerns could be met within the franchise or alternatively recommend that the DfT take certain matters into account when re-letting the franchise; or
- a detailed report may be made to the Government in circumstances where a significant issue or a pattern of behaviour has been identified for which a remedy is not available under ORR's powers or within the franchise and the matter is one which would not qualify for a referral to the CC either at this juncture or following a Phase 3 review. This report may, for example, include recommendations for changes to laws or regulations, which may, in their current form, be creating abnormal conditions of competition.

Phase 3: Market Review

- 3.8 Once ORR has decided to progress to a Phase 3 Market Review it will set out and publish the terms of reference for the market review including its scope and projected timescales. In cases where such an announcement could be market sensitive it will initially be made to the Stock Market via the Regulatory News Service (RNS). At this stage stakeholders will be given the opportunity to comment on matters such as the criteria being used to assess competition in the particular market(s) under review and on ORR's proposed methodology. This phase of review will be entirely public and may take between six and twelve months to complete.
- 3.9 During the course of the market review, ORR will gather information from market participants and other key parties, for example other public bodies and

consumer groups, either on an informal (questionnaires or market research telephone surveys) or formal basis (using its powers of investigation under Section 174 of the EA02, which includes the power to give notice to any person requiring him to give evidence to the ORR). Where appropriate, ORR may also hold industry-wide seminars, meetings and/or interviews. ORR may also commission research from consultants; for example, we may require specific railway technical expertise and advice.

- 3.10 The final market review report will set out ORR's conclusions including, where appropriate, a discussion of options, the final recommendations and a timetable for implementation of recommendations.
- 3.11 Market reviews should not be confused with the market investigations carried out by the CC. On reference, the CC will conduct a detailed public investigation and reach its own conclusions about the market. The CC has the power to impose remedies that go beyond those available to ORR, for example structural remedies. Further details of the UK market investigation regime and remedies available to the CC are available on the CC's website¹².
- 3.12 If ORR considers that a decision to make a reference to the CC or accept undertakings in lieu is likely to have a substantial impact on the interests of any person it must, so far as is practical, consult that person about what is proposed before making that decision.
- 3.13 There are a number of alternative outcomes to this phase of the review process other than a decision to make a reference or accept undertakings in lieu; these will include all of those options described above in the discussion of the Phase 2 process.

Decision to make a reference

- 3.14 In considering whether to make a reference to the CC, ORR will take into account a number of factors including:
- the nature and significance of the competition problems that ORR believes to exist in the market concerned;

¹² This can be found at: www.competition-commission.org.uk.

- whether a market investigation reference would be a proportionate response to the scale of the competition problems identified;
- whether it would be possible to accept commitments/undertakings in lieu of a market investigation reference (see below);
- whether ORR, as an alternative, has available to it regulatory powers to fully address the concerns identified; and
- whether appropriate remedies are likely to be available to the CC or in the absence of appropriate remedies whether a CC report might provide a useful alternative contribution.

Undertakings in lieu of a reference

3.15 Section 154 of EA02 gives ORR the power to accept undertakings in lieu of a reference to the CC. In exercising this power, ORR must have regard to the need to achieve as comprehensive a solution, as is reasonable and practicable, to any adverse effects on competition identified (and any detrimental effects on consumers so far as they result or may be expected to result from such adverse effects). ORR may also have regard, as appropriate, to the effect of the undertakings on any relevant customer benefits¹³ arising from a feature or features of the markets concerned.

3.16 Before accepting any undertakings in lieu of a reference, ORR must consult and consider any representations arising from the publication of that notice.

Disclosure of information and Freedom of Information Act 2000

3.17 From 1 January 2005, the Freedom of Information Act 2000 (FOIA) gives any person the right to request non-published information from ORR. This is known as “the right to know”. ORR, as an organisation, is committed to openness and transparency. However, it recognises that it will obtain information in the context of market studies and competition investigations that should not be widely disclosed. There are certain exemptions from the FOIA that could be relevant to information held by ORR through the exercise of its functions.

¹³ Including greater innovation or greater choice, for more detail on such factors please refer to *Market Investigation References: Competition Commission Guidelines*, paragraphs 4.26 to 4.38.

- 3.18 Part 9 of the EA02 restricts the ability of ORR to disclose information it receives in the course of its work. In particular, the EA02 contains a general prohibition against the disclosure of information that relates to the affairs of a business or individual, unless disclosure is otherwise permitted (for example where the parties have given their consent). It is a criminal offence to disclose information in breach of those provisions.
- 3.19 Where information obtained by ORR in the course of investigations made under the EA02 falls within the prohibition of disclosure contained in Part 9 of the EA02, it would be exempt from disclosure under section 44 of the FOIA. There are also exemptions, for example, for information that would prejudice any civil proceedings (including competition proceedings) if disclosed.
- 3.20 Section 145(1) of the RA93 restricts the disclosure by ORR of information it has obtained under or by virtue of the Railways Act. However, section 145(2) of the Railways Act allows disclosure for the purpose of facilitating the carrying out by ORR of any of its functions under the Railways Act, the Transport Act 2000 and the Railways Act 2005, including ORR's concurrent competition powers. Therefore, ORR can use or disclose information gathered under the RA93 to facilitate its EA02 functions.

Annex A: Assessment of competition within markets

1. This annex sets out the main factors that ORR will consider in order to come to a view on whether there is effective competition in the market(s) under review and whether there are any features, or combination of features, within the market(s) which may have the potential to prevent, restrict or distort competition.

Competition policy and the benefits of competition

2. Competition involves rivalry between suppliers and should serve to bring prices closer in line with costs, while incentivising firms to develop new products and services and reduce costs. In competitive markets, successful firms are those that meet customer needs in the most cost-efficient way. However, certain market structures; conduct within the market; and indeed laws, regulations and government policy can impair the competitive process and harm efficiency and ultimately affect end-customers (i.e. consumers).
3. ORR's studies and reviews can cover a range of rail-related activities and could involve assessing effects at various levels of the rail supply-chain in both passenger or freight markets.
4. The majority of franchise services have been let under competitive tender, where bidders compete for the minimum subsidy (or, as the case may be, the maximum premium to Government). Therefore, even though competition in certain passenger rail markets may be limited (e.g. no other competing rail operator and/or limited competition from other modes of transport), there will have been competition to provide the services in question. Effective competition at the franchise tendering stage should ensure that expected monopoly profits are competed away and franchise subsidies minimised (or premiums maximised). Passenger franchises are typically prescriptive in terms of setting service levels and provide consumer protection, most notably through price caps on certain fares or fare baskets.
5. Given the way that the rail industry has been structured and funded by Government, a lack of effective competition in input markets, for example

maintenance services, may not necessarily feed through immediately or directly to passengers or users of freight services. Therefore, ORR will also consider whether lack of competition in the provision of specific rail inputs has the potential to affect whole industry costs.

Market definition

6. Market definition provides the framework for analysing competition within a relevant economic market and is usually the first step in the assessment of market power. There are normally two dimensions to the definition of a market: a product dimension and a geographical dimension. The key to market definition is substitutability; the ease with which customers switch between alternative products (and across different geographical areas) and the extent to which suppliers can switch their facilities between supply of alternative products (and across different geographical areas).
7. The conceptual approach to market definition, used in many jurisdictions, is known as the hypothetical monopolist test. The OFT guidelines on market definition¹⁴ set out a detailed explanation of how this test is to be employed. In summary, the test is designed to identify the smallest product group (and geographical area) such that a hypothetical monopolist controlling that product group (in that area) could profitably sustain a small but significant non-transitory increase in price (usually 5 to 10%) above the competitive level.
8. Once the product and geographic dimensions of a market have been defined, it is then possible to assess competition within that market.

Assessment of competition and market structure

9. ORR's analysis of competition in any given market, will focus on two separate but linked aspects; namely the structure of the market and the conduct of parties within that market. ORR's analysis may include, but is not limited to, rivalry between firms in a relevant market, the threat of entry, historic patterns of entry and exit, the existence of any barriers to expansion or exit from the market and the presence of countervailing buyer power of customers. ORR will also consider less obvious structural aspects such as information asymmetries and the effect of economic regulation. Economic regulation is typically designed to limit the extent to which regulated firms can exploit their

¹⁴ *Market definition – understanding competition law* OFT publication 403.

market power in certain areas of their business, but such regulation is typically tailored to specific markets/lines of business and to specific potential problems (e.g. exploitative pricing) and so the existence of economic regulation does not necessarily preclude problems in other markets or other forms of problematic behaviour.

Market shares and concentration

10. Market shares both absolute and relative to each other can provide an indication of market power¹⁵. Market power is more likely to exist if an undertaking (or a group of undertakings) has a persistently high market share and when all other competitors have very low market shares.
11. The history of market shares over a period of time is typically more informative in terms of market power rather than market shares at any particular point in time. For example, volatile market shares over a period of time may be consistent with effective competition.
12. Market concentration can provide useful insight into the ability of the leading firms within the market to exercise market power collectively. Two commonly used measures are the Concentration Ratio and the Herfindahl-Hirschman Index (HHI). The Concentration Ratio measures the combined share of the largest firms in the market (for example the market share of the five largest firms). The HHI in contrast reflects both the number of firms in the industry and their relative size. It is defined as the sum of the squares of all the market shares in the market. An HHI in excess of 1800 is indicative of a highly concentrated market, and an HHI in excess of 1000 as concentrated.
13. However, market shares cannot be relied upon to conclude on the existence or extent of market power. The threat of entry, extent of buyer power and ex-ante regulation can all serve to mitigate what might otherwise appear to be market power based on a consideration of market shares alone.

Barriers to entry, expansion and exit

14. Where rivalry between existing firms in a market is not strong, ORR will consider other possible constraints such as barriers to entry, expansion and exit. Generally speaking, adverse market outcomes are less likely to

¹⁵ Market power refers to the ability of a firm to sustain increase in prices consistently and profitably above the competitive level regardless of the actions of its competitors.

materialise when barriers to entry and expansion are low and new entry is sustainable.

15. When assessing the impact of entry barriers, ORR will take into account a number of factors. These include but are not limited to:
 - the extent to which costs are sunk;
 - whether there is limited access to key inputs (including access to essential facilities or intellectual property rights);
 - the effects of regulation;
 - economies of scale;
 - network effects; and
 - the existence of anti-competitive behaviour.
16. To be an effective competitive constraint, a new entrant must be able to attain a large enough scale to have a competitive impact on the behaviour of market incumbents. For detailed discussion on different types of barriers to entry, expansion and exit see OFT guideline 415 – *Assessment of market power*.

Countervailing buyer power

17. The strength of buyers and the structure of the buyer's side of the market may constrain the market power of a seller. Buyers may have sufficient bargaining power to prevent suppliers from exerting market power. Factors that will influence the ability of buyers to constrain suppliers include:
 - a small number of large and informed buyers;
 - the buyer's ability to find credible alternative suppliers;
 - low switching costs (relative to product prices); and/or
 - if buyers can produce the goods or services themselves or sponsor new entry.
18. Clearly, buyer power can exert downward pressure on a supplier's prices, which may ultimately be passed onto consumers. Assessment of the

buyer/supplier transactional relationship would be required to assess whether the buyer is in a position to provide an effective constraint on the seller.

Conduct

19. In addition to the structural features of a market, ORR will also assess the conduct of firms and their effects on competition within markets, with specific regard to prices, costs and profits and longer-term dynamics such as innovation, differentiation and development of products.
20. ORR will assess how competition between firms actually takes place within the market and how effective it is. ORR will, where possible, consider (and this is not an exhaustive list):
 - current and historical pricing behaviour and corresponding profitability;
 - whether firms in the same market have different cost bases, which lead to different behaviour;
 - whether there is sufficient capacity in the market to enable firms to increase output;
 - the ability and capacity for firms to innovate;
 - the objectives and cultures of firms within the market and their strategies; and
 - how the incumbent firms perceive the market is developing.