COMPETITION AUTHORITY OF KENYA

GUIDELINES ON RELEVANT MARKET DEFINITION

I. INTRODUCTION

1. The purpose of these guidelines is to provide guidance as to how the Authority applies the concept of relevant market in its enforcement of the Competition Act, 2009, Chapter 504, Laws of Kenya (the Law).

2. By rendering public the procedures which the Authority follows when considering market definition, the Authority expects to increase the transparency in its decision-making under the Law.

3. Market definition is the first step in a full competition analysis. It helps the Authority to identify actual competitors of the undertakings involved and their capability of constraining those undertakings' behavior and of preventing them from behaving independently of their competitors, customers and suppliers.

4. Market definition is important because: a) market shares can be calculated only after the boundaries of a market have been defined; b) it sets the stage on which competition takes place, for example, when considering the strength of existing competition and the potential for a new entry, it is necessary to identify the relevant market; and c)it establishes whether or not particular undertakings fall within the scope of the prohibitions.

5. The Authority does not follow a rigid hierarchy of different sources of information or types of evidence in defining markets. Rather, the guideline is a conceptual framework within which information/evidence can be organized.

6. The Authority's interpretation of relevant market is without prejudice to the interpretation which may be given by a court of competent jurisdiction.

II. DEFINITION OF RELEVANT MARKET

7. A market is commonly understood to consist of both buyers and sellers of a product in a certain geographical area. However, the term *market* has a specific meaning for competition law purposes. The relevant market within which to assess a competition issue has two dimensions; product market and geographic market.

8. The first and essential task of the Authority in market definition is to delineate the product market by identifying all the products that buyers

regard as reasonable substitutes for the product under investigation. Therefore a relevant product market comprises all those products[1] which are regarded as reasonably interchangeable or substitutable by the consumers, by reason of the products' characteristics, their prices and their intended use.

9. The identification of product market is followed by defining the geographical market, which may extend beyond the area under investigation and in which the product is sold. The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas.

The process of market definition

10. Demand substitutability and supply substitutability constitute the main factors to be considered in market definition. Demand substitution constitutes the most immediate and effective disciplinary force on the suppliers of a given product, in particular in relation to their pricing decisions. Demand substitutability is therefore the main factor considered in market definition.

A. Product market definition

Demand-side substitution approach

11. Demand-side substitution occurs because an increase in price makes a product less affordable to customers who therefore decide to purchase less of it and more of substitute products. The question to answer is whether customers would switch to readily available substitutes or suppliers located elsewhere in response to a hypothetical small (in the range of 5% to 10%), but permanent relative increase in price of the products- SSNIP Test. (*For details regarding SSNIP Test refer to the Appendix*). If substitution would be enough to make the price increase unprofitable because of the resulting loss of sales, additional substitutes are included in the relevant market. This would be done until the set of products is such that small but permanent increases in relative prices would be profitable.

12. A practical example of this test can be provided from the fortified alcoholic beverages (wines) sector where the issue to examine would be to decide whether different flavours of wines belong to the same market. In practice, the question to address would be if consumers of flavour A would switch to other flavours when confronted with a permanent price increase of 5-10% for flavour A. If a sufficient number of consumers would switch to, say,

[1] Product means goods and or services

flavour B to such an extent that the price increase for flavour A would not be profitable due to the resulting loss of sales, then the market would comprise at least flavours A and B. The process would have to be extended in addition to other available flavours until a set of products is identified for which a price rise would not induce a sufficient substitution in demand.

The type of evidence relevant to reach a conclusion as to the product market

Product characteristics and intended use

13. An analysis of the product characteristics and its intended use allows the Authority, as a first step, to limit the field of investigation of possible substitutes. However, product characteristics and intended use are insufficient to show whether two products are demand substitutes. Functional interchangeability or similarity in characteristics may not, in themselves, provide sufficient criteria, because the responsiveness of customers to relative price changes may be determined by other considerations as well. Conversely, differences in product characteristics are not in themselves sufficient to exclude demand substitutability, since this will depend to a large extent on how customers value different characteristics.

Evidence of substitution in the recent past

14. In certain cases, it is possible to analyze evidence relating to recent past events or shocks in the market that offer actual examples of substitution between two products. When available, this sort of information is fundamental for market definition. If there have been changes in relative prices in the past (all else being equal), the reactions in terms of quantities demanded will be determinant in establishing substitutability. Launches of new products in the past can also offer useful information, when it is possible to precisely analyze which products have lost sales to the new product.

Views of customers and competitors

15. The Authority will contact the main customers and competitors of the companies involved in its enquiries, to gather their views on the boundaries of the product market as well as most of the factual information it requires to reach a conclusion on the scope of the market. Reasoned answers of customers and competitors as to what would happen if relative prices for the candidate products were to increase in the candidate geographic area by a small amount (for instance of 5 % to 10 %) are taken into account if they are sufficiently backed by factual evidence.

Consumer preferences

16. In the case of consumer goods, it may be difficult for the Authority to gather the direct views of end consumers on substitute products. Marketing studies that companies have commissioned in the past and are used by companies in their own decision-making as to pricing of their products and/or marketing actions may provide useful information for the Authority's delineation of the relevant market. Consumer surveys on usage patterns and attitudes, data on consumer's purchasing patterns, the views expressed by retailers and more generally, market research studies submitted by the parties and their competitors are taken into account to establish whether an economically significant proportion of consumers consider two products as substitutable, also taking into account the importance of brands for the products in question. The methodology followed in consumer surveys carried out ad hoc by the undertakings involved or their competitors for the purposes of a merger procedure will usually be scrutinized with utmost care. Unlike pre-existing studies, they have not been prepared in the normal course of business for the adoption of business decisions.

Barriers and costs associated with switching demand to potential substitutes

17. There are a number of barriers and costs that might prevent the Authority from considering two demand substitutes as belonging to one single product market. It is not possible to provide an exhaustive list of all the possible barriers to substitution and of switching costs. These barriers or obstacles might have a wide range of origins, and include the need to incur specific capital investment or loss in current output in order to switch to alternative inputs, the location of customers, specific investment in production process, learning and human capital investment, retooling costs or other investments, uncertainty about quality and reputation of unknown suppliers, and others.

Chains of substitution

18. Sometimes a product under investigation will be part of a long and unbroken chain of substitutes. For example, five products namely A-E differentiated by their perceived quality are considered. The closer the two products are in the alphabet, the more substitutable they are from the point of view of customers. Thus consumers whose favourite product is C consider B and D to be very good substitutes for C but consider A and E to be poorer substitutes for C. Even though all products in the chain are substitutes, this does not mean that the whole chain is the relevant market.

Patterns in price changes

19. This can provide good evidence when combined with other data. For example, two products showing the same pattern of price changes, for reasons not connected to costs could be strong evidence that they are close substitutes. Equally, price divergence over time, without significant levels of substitution, provides evidence that the two products may be in separate markets. However, if the absence of substitution could be explained by a divergence in both price and quality, the products could still be in the same market.

Supply-side substitution approach

20. Supply side substitution may also be taken into account when defining markets in those situations in which its consequences are effective and immediate. The Authority considers whether it is feasible to incorporate supply-side substitution in definition of the market or whether it will define the market based on the demand side only.

21. Analyzing supply-side substitution raises similar issues to the analysis of potential new entry. In both cases, the question is to whether undertakings would start supplying a particular product if there is a price rise. The difference is typically one of timing and/or investment; supply-side substitution occurs in the short-run with little or no investment required, whereas new entry is likely to occur over a longer period and may require more significant investment. Therefore, any significant investment or set-up costs, especially those which firms consider as unlikely to be recoverable, reduces the likelihood of supply-side substitution. Therefore, the response should, normally, be likely to occur within a year of the price rise although the exact time period depends on the nature of the market considered.

22. An example of supply side substitutability can be found in the case of paper. Paper is usually supplied in a range of different qualities, from standard writing paper to high quality paper to be used for instance to publish books. From demand point of view, different qualities of paper cannot be used for a specific use i.e. an art book or a high quality publication cannot be based on lower quality papers. However paper plants are prepared to manufacture the different qualities of paper and production can be adjusted with negligible costs and in a short time frame. In the absence of particular difficulties in distribution, paper manufacturers are able therefore to compete for orders of the various qualities, in particular if orders are passed with a sufficient lead time to allow modifying production plans. Under such circumstances, the Authority cannot define a separate market for each quality of paper and their respective usage. The various qualities of paper

are included in the relevant markets, and their sales added up to estimate total value and volume.

The type of evidence relevant to reach a conclusion as to the product market

23. The following are examples of the types of information that can be useful, when available, in the analysis of supply-side substitution:

- Information on past supply-side substitution (for example, information on the extent to which supply-side substitution has resulted from variations in price differentials);
- Information on the willingness of customers to switch to new supplies following a SSNIP;
- Information on the size of adjustment costs for potential supplies;
- Information on the production processes involved;
- The extent of spare capacity within the industry;
- The business plans of potential suppliers and the assessment of their competitive threat by firms in the market;
- Assessment by independent technical consultants and interested third parties of the likelihood and feasibility of supply-side substitution; and
- Information on supply-side substitution in similar markets in other countries.

24. If necessary, a further check on supply factors is carried out to ensure that those companies located in differing areas do not face impediments in developing their sales on competitive terms throughout the whole geographic market. This analysis includes an examination of requirements for a local presence in order to sell in that area the conditions of access to distribution channels, costs associated with setting up a distribution network, and the presence or absence of regulatory barriers arising from public procurement, price regulations, quotas and tariffs limiting trade or production, technical standards, monopolies, freedom of establishment, requirements for administrative authorizations, packaging regulations, etc. In short, the Authority identifies possible obstacles and barriers isolating companies located in a given area from the competitive pressure of companies located outside that area, so as to determine the precise degree of market interpenetration.

B. The Geographic Market definition

25. The geographic market refers to the area over which substitution takes place. If buyers will travel further afield to buy products when their local prices are increased, then the geographical spread of the market is wide and

vice versa. If sellers from afar supply to local markets because the local price has risen, then the geographic market is also wider than the situation where only local sellers are willing to supply.

26. The geographic scope of the market can be defined using the same framework used to analyze the product market, while putting emphasis on three particular categories of issues:

• Demand-side issues (usually for defining retail markets);
•Supply-side issues (usually for defining wholesaling and manufacturing markets); and
• Imports.

Demand-Side

27. The process for defining the geographic market begins by looking at a relatively narrow geographic area, which normally refers to the area supplied by the parties to an agreement or the subject of a complaint, by asking if a 5%- 10% increase in the price of a product in one area would lead to buyers switching to sellers in neighbouring areas. If a significant number of buyers are likely to switch to other sellers, this would restrain the ability of a hypothetical monopolist to charge higher prices in its area. These neighbouring areas would be included in the market definition. This process will continue until a group of locations is identified over which a hypothetical monopolist could profitably impose a SSNIP.

28. Chains of substitution can also be an important factor in geographic markets, particularly retail markets. Consumers in any one location might not be willing to travel more than a certain distance to purchase a particular product, but there may be a chain of substitution creating a much larger geographic market. Not all of the neighbouring areas may be included in the geographic market (depending on the case). There could be areas where the chain of substitution is broken.

29. The evidence used by the Authority to define geographic markets on the demand side is usually similar to that used to define the product market. An additional consideration is the value of the product. Generally, the higher the value of a product, the greater the willingness of customers to travel further in search of cheaper supplies. The mobility of buyers (whether buyers have the ability to travel to buy cheaper supplies) is also considered.

Supply-Side

30. Apart from the willingness of buyers to switch to sellers from neighbouring areas in response to a price increase, the Authority considers

the potential for undertakings in neighbouring areas to supply to buyers. As in the product market definition, these sellers are considered if they can respond in the short run, (for example, within one year). Supply-side substitution may not be possible within one year if undertakings need to spend significant costs in terms of advertising or marketing, or if distribution channels are foreclosed.

31. The Authority considers the costs of transportation. If buyers and sellers face high transportation costs, then the geographic market is smaller than when transport costs are low. The higher the costs of transportation, the smaller the geographic market is likely to be.

Imports

32. Significant imports of a particular product may indicate that the market is wider than Kenya. If imports come solely from the international operations of domestic sellers, they may not act as an independent constraint on domestic undertakings. Also, in order to import on a larger scale, international sellers may require substantial investments in establishing distribution networks or branding their products in the destination country. These factors may mean that sellers of the relevant product located outside Kenya would not provide a sufficient constraint on domestic sellers to be included in the relevant geographic market.

33. On the other hand, a lack of imports does not necessarily imply that the market could not be a regional or a wider international market. The potential for imports may still be an important source of supply-side substitution should prices rise. This possibility could constrain the exercise of market power by existing sellers.

The type of evidence relevant to reach a conclusion as to the geographic market

Basic demand characteristics.

34. The nature of demand for the relevant product may in itself determine the scope of the geographical market. Factors such as national preferences or preferences for national brands, language, culture and life style, and the need for a local presence have a strong potential to limit the geographic scope of competition.

Views of customers and competitors.

35. Where appropriate, the Authority contacts the main customers and competitors of the parties in its enquiries, to gather their views on the

boundaries of the geographic market as well as most of the factual information it requires to reach a conclusion on the scope of the market when they are sufficiently backed by factual evidence.

Current geographic pattern of purchases.

36. An examination of the customers' current geographic pattern of purchases provides useful evidence as to the possible scope of the geographic market. When customers purchase from companies located anywhere in the country on similar terms, or they procure their supplies through effective tendering procedures in which companies from anywhere in the country submit bids, usually the geographic market will be considered to be nation wide.

Barriers and switching costs associated to divert orders to companies located in other areas.

37. The absence of trans-border purchases or trade flows, for instance, does not necessarily mean that the market is at most national in scope. Still, barriers isolating the national market are identified before it is concluded that the relevant geographic market in such a case is national. Perhaps the clearest obstacle for a customer to divert its orders to other areas is the impact of transport costs and transport restrictions arising from legislation or from the nature of the relevant products. The impact of transport costs will usually limit the scope of the geographic market for bulky, low-value products, bearing in mind that a transport disadvantage might also be compensated by a comparative advantage in other costs (labour costs or raw materials). Access to distribution in a given area, regulatory barriers still existing in certain sectors, quotas and custom tariffs might also constitute barriers isolating a geographic area from the competitive pressure of companies located outside that area. Significant switching costs in procuring supplies from companies located in other countries constitute additional sources of such barriers.

38. The paragraphs below describe the factors which might also be relevant to define markets. This does not imply that in each individual case it will be necessary to obtain evidence and assess each of these factors. Often in practice the evidence provided by a subset of these factors will be sufficient to reach a conclusion.

Other issues

Temporal dimension

39. Another dimension that may be relevant in some markets is time. Examples of how timing in the production and purchasing of products can affect markets include:

• Peak and off-peak services (for example, bus fares during peak hours and off-peak hours)

• Seasonal variations (for example, umbrellas which have a significantly higher demand during rainy seasons

• Innovation/Inter-generational products (for example, hand phones and computers): Consumers may choose to defer expenditure on present products because they believe innovation will soon produce better substitutes or they may own an earlier version of the product, which they consider to be a close substitute for the current generation.

40. Temporal dimensions may be appropriate when:

• it is not possible for customers to substitute between time periods. For example, peak customers might not view peak and off peak bus fares as substitutes, and
• Suppliers' capacity varies between time periods. For example, capacity to supply umbrellas varies according to the season.

To some extent, the time dimension is simply an extension of the product dimension: i.e. the product can be defined as the supply of bus services at a certain time of day.

Functional dimension

41. The production, distribution and sale of a product typically occur through a series of functional levels e.g. manufacturing, wholesale and retail levels. It is often useful to identify the relevant functional level in describing a market as the conduct or merger being considered may affect one level but not others. Generally, the Authority will identify separate relevant markets at each functional level affected by the conduct or merger being considered and assess the impact on each.

Appendix

The SSNIP Test - (Small but Significant Non-transitory Increase in Price)

In competition law, before deciding whether companies have significant market power which would justify government intervention, the test of Small but Significant and Non-transitory Increase in Price is used to define the relevant market in a consistent way.

The SSNIP-test is designed to avoid ad hoc debates about what products compete with each other, based for example on product characteristics. Regulation and litigation can thus proceed on firmer ground.

The SSNIP test defines a relevant market as "something worth monopolizing." The relevant market consists of a 'catalogue' of goods and/or services which are considered substitutes by the consumer. Such a catalogue is worth monopolizing because if only one single supplier provided it, that supplier could profitably increase its price without its customers turning away and choosing other goods and services from other suppliers.

The SSNIP test seeks to identify the smallest relevant market within which a hypothetical monopolist or cartel could impose a profitable significant increase in price. The application by the Authority of the test involves talking to people who make buying decisions. It asks whether such a monopolist or cartel could profit from a price increase of 5% - 10% for at least one year (assuming that "the terms of sale of all other products are held constant"). If sufficient numbers of buyers are likely to switch to alternative products and the lost sales would make such price increase unprofitable, then the hypothetical market should not be considered a relevant market for the basis of litigation or regulation. Another larger basket of products is proposed for a hypothetical monopolist to control and the SSNIP test is performed on that relevant market.