

KPMG response to the Competition Commission Working Paper “Economies of scale in operating costs”

1 Introduction

1.1 This paper sets out our response to the Competition Commission’s (“CC”’s) Working Paper “Economies of scale in operating costs” (the “Working Paper”). We present our comments in two sections:

- costs considered by the CC in the Working Paper; and
- analysis conducted by the CC in the Working Paper.

2 Costs considered by the CC in the Working Paper

2.1 In the Working Paper the CC has considered economies of scale associated with three categories of expenditure:

- IT costs;
- accommodation costs; and
- marketing costs.

2.2 The CC finds that there are no ‘readily observable’ economies of scale associated with the IT expenditures, the marketing costs and partners’ activity that it examined in this paper¹. The CC states that it is not possible to draw a firm conclusion on whether the ‘efficiency of office space usage is an indicator of economies of scale’². We agree that there are unlikely to be significant economies of scale associated with these categories of expenditure.

2.3 However, we note that in our Main Submission we referred to the economies of scale arising from two categories of investment: i) relationship-specific investments that we make in auditing each individual client’s business³; ii) investments that are not client

¹ Paragraphs 4, 7 and 7 of the Working Paper.

² Paragraph 23 of the Working Paper.

³ Paragraph 213 and 261 of our Main Submission.

specific that instead improve the quality of the services offered across the whole of the client base⁴.

- 2.4 The failure to recognise that these investments (which are important elements of the competitive process) can also generate some economies of scale suggests that the CC may come to the erroneous conclusion that the level of concentration in this market is driven by barriers to entry, rather than the competitive process, a key feature of which is client demand.

3 Analysis conducted by the CC in the Working Paper

- 3.1 The KPMG data underlying this Working Paper has been explained and qualified in our letter to the CC on 14 September 2012 in response to the Operating Cost Data Request and our response to the putback document for this Working Paper (submitted on 16 October 2012). Please see these responses for more detail. Within this section, we note certain additional concerns regarding the CC’s analysis in this Working Paper.
- 3.2 We note that the definitions of the costs the CC uses are not entirely clear. In particular, non-staff costs are defined in footnote 1 as ‘costs of employing staff directly delivering professional services’. We request that the CC clarifies whether this definition is correct. In addition, in footnote 2, ‘staff’ is defined as employees of the firm. Therefore it is not clear whether ‘non-staff’ costs also relate to partner costs. We request that the CC clarifies the definitions of costs that it considers in the Working Paper.
- 3.3 Further, the CC’s analysis of economies of scale appears to involve comparing spend on the categories of costs identified in paragraph 2.1 above across audit firms of different sizes. In our view this simplistic analysis is unlikely to identify economies of scale as it will fail to control for other factors that are relevant to these costs and that additional issues of inconsistency in respect of certain costs may distort any analysis⁵. For example, as the CC recognises, the analysis of accommodation costs is complicated by different firms’ uses of space⁶.
- 3.4 It is difficult to comment further on the CC’s analysis, given the heavy redactions – for example, the redactions of the audit firm names mean it is impossible to tell whether larger or smaller audit firms are being referred to. To the extent that the CC relies on this work we would request that the CC discusses or considers ways to share more of its analysis and assumptions in this Working Paper.

⁴ Section 8 of our Main Submission.

⁵ Paragraph 11 of the Working Paper.

⁶ Paragraph 23 of the Working Paper.