



## **KPMG Response to CC's Working Paper "Market definition"**

### **1 Introduction**

- 1.1.1 This note sets out KPMG's response to the Competition Commission's (CC's) working paper "Market Definition" (the "Working Paper").
- 1.1.2 We recognise that the CC is required to define a relevant market for the purposes of its analysis in a market investigation. In this Working Paper, the CC defines the relevant product market as including companies that are currently or have recently been listed on the London FTSE100 and FTSE250 indices ("the FTSE350").
- 1.1.3 It is our view that market definition is very difficult in this case because there is no clear dividing line between the characteristics of different audit clients. Instead, there are a number of factors that affect the characteristics of a company's audit, which vary continuously. There is therefore no discontinuity in audit clients' characteristics (or in their needs or demands) at any particular point, which we recognise makes the application of the hypothetical monopolist test very difficult.
- 1.1.4 As a result, rather than focussing on a precise market definition, in our view it will be more important that in its broader analysis the CC recognises all of the competitive constraints acting on audit firms, including from 'outside' of whatever particular relevant market it defines.
- 1.1.5 We agree with the CC's finding that it is not possible to define narrower markets within the FTSE350.

### **2 The CC's analysis of FTSE350 and non-FTSE350 companies**

#### *2.1 Comments on the CC's approach and conclusions*

- 2.1.1 In this section we set out our views on the CC's approach and analysis that leads it to conclude that companies that are or have recently been listed on the FTSE350 constitute a relevant product market.
- 2.1.2 In particular, we note that the CC's conclusion appears to be based largely on the following pieces of analysis:
- **Evidence from the public dataset:** that FTSE350 companies were more likely than private and other listed companies to have had the same audit firm for more than ten years and have higher fees and fee per hour; and

- **Evidence from the survey that suggests that:** FTSE350 companies are more likely to require an international audit, considered different factors important in assessing audit quality and tender less frequently.

- 2.1.3 We discuss the CC's analysis in more detail in section 2.2, but in this section we note that in relying on this analysis, the CC appears not to have performed a hypothetical monopolist test to arrive at its conclusion on the relevant product market<sup>1</sup>. We recognise that this test will be difficult to apply precisely in this case, since there is no clear point of division between one group of companies and another at which a hypothetical monopolist test can be evaluated. Instead, there are a number of factors that affect the characteristics of a company's audit, including size and listing status, but also other factors (as set out in section 4 of our Main Submission), and across most of these dimensions, companies' characteristics change in a continuous fashion<sup>2</sup>. In addition, as the CC points out in paragraph 31 of the Working Paper, the FTSE350 is dynamic and changes every quarter.
- 2.1.4 As a result, we would suggest that any particular market definition is unlikely to be fully accurate, and precisely capture the set of relevant competitive constraints on audit firms. For example, the CC's definition of the FTSE350 applies only to past and current constituents of the FTSE350 index, rather than also including potential entrants to the FTSE350 and it may be that some of these companies should be included in the relevant product market.
- 2.1.5 Given these difficulties, in our view the CC should focus on ensuring that in its broader analysis it takes into account the competitive constraints imposed by audit firms providing statutory audit services that fall outside of whatever definition of the relevant market the CC arrives at.
- 2.1.6 Specifically, assuming the FTSE350 listed companies formed the relevant market, it is our view that if the audit firms currently providing services to those companies were to worsen their offer by some relatively small amount, they would lose business to other audit firms not providing statutory audit services to this group of companies. As a result, these other audit firms provide a very real competitive constraint, which in our view is important for the CC to acknowledge and take into account in its analysis, whether or not these firms' services form part of the relevant product market.
- 2.1.7 We would also reiterate our view that an audit firm's competitive offering includes its price, its technical quality and its quality of service. As we set out in our submission in response to the CC's Issues Statement ("Main Submission"), the ability to provide an audit of high technical quality is driven by the investments audit firms make to deliver the necessary capabilities to do so<sup>3</sup>, and as a

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<sup>1</sup> As set out in Part 2 of CC3, Market Investigation References: Competition Commission Guidelines, June 2003

<sup>2</sup> We note that the existence of a continuum of companies according to a range of different characteristics is consistent with the views of the largest four and the mid-tier audit firms, summarised in the CC's Working Paper.

<sup>3</sup> Paragraph 178 of our Main Submission

result these investments are an important parameter of competition<sup>4</sup>. Therefore it will be important for the CC to analyse the constraints on all of these aspects of an audit firm's offer, in its analysis of competition.

## 2.2 *Detailed comments on the CC's analysis*

2.2.1 In presenting statistics to compare FTSE350 and non-FTSE350 companies over the period 2000 to 2011<sup>5</sup>, the CC defines FTSE350 companies as "any company that has been in the FTSE350 during the period 2006-2011"<sup>6</sup>. As a result it is our understanding that any company in the public dataset for that period should be included in the CC's definition of FTSE350 companies<sup>7</sup>. It is therefore unclear how the CC can use, as it appears to have done, the public dataset to analyse private and other listed companies separately from FTSE350 companies, since those private and other listed companies that the CC has captured in the public dataset are also included in the CC's definition of FTSE350 companies.

2.2.2 In addition, while we agree with the CC that it is impracticable to separate audit from audit-related fees within the public dataset, we nevertheless note that this might make it even more difficult to draw conclusions from an analysis of fees in the public dataset for the purposes of market definition even more difficult to apply.

2.2.3 We are not able to comment in more detail on the CC's analysis based on the information in the Working Paper, and look forward to an opportunity to comment further on this analysis. Consequently, we would particularly appreciate clarity from the CC on which companies are included in the FTSE350 and non-FTSE350 groupings respectively.

2.2.4 In paragraph 26 (c) of the Working Paper, the CC notes that UK fees per hour are higher for FTSE350 than other listed or private companies. It is our view that the CC should bear in mind that one of the drivers for higher hourly rates will be related to the international dimension of the audit. For those entities with high proportions of operations overseas, the group head office fees are likely to represent a higher proportion of the UK fees than they would do where all the operations are in the UK. Given that head office audit fees would have a (much) higher component of senior time, other things being equal inevitably hourly rates appear to be higher for companies with high proportions of international operations (ie the larger FTSE companies).

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<sup>4</sup> As we discussed in our Main Submission (section 8, for example) and in our responses to the CC's working papers on 'The framework for the CC's analysis and revised theories of harm' and 'Restrictions to entry and expansion.

<sup>5</sup> Paragraph 25-29 of the Working Paper.

<sup>6</sup> Paragraph 31 and footnote 27 of the Working Paper

<sup>7</sup> If FTSE350 companies include all companies that formed part of the index at any point in time during this period, inevitably, some companies that formed part of the FTSE350 index during this period have delisted, or dropped out of the FTSE350 listing, to become private or other listed companies. By definition these companies form part of the CC's FTSE350 classification even though private or other listed. It is unclear how these have then been separately analysed.

2.2.5 We also note that the reference to question 57 of our response to the CC's Market and Financial Questionnaire is incorrect – we believe the correct reference is to question 59.

### **3 The CC's analysis of sub-segments within the FTSE350**

3.1.1 For the reasons set out in the previous section, it is not possible to draw precise dividing lines between different companies operating, for example, in different sectors of the economy. Instead, companies (both within and without the FTSE350) vary continuously according to a number of different characteristics.

3.1.2 Audit firms supplying statutory audit services to companies that are currently or have recently been listed on the FTSE350 are able to compete for all companies in this group. For example, as recognised by the CC in this Working Paper and as discussed in more detail in our response to the CC's Market and Financial Questionnaire<sup>8</sup>, the all of the largest four firms compete for companies in almost all sectors.

3.1.3 As a result, we agree that there it is not possible for the CC to draw separate product markets within the FTSE350.

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<sup>8</sup> Questions 56 – 58.