Completed acquisition by Sector Treasury Services Limited of ICAP plc's treasury consultancy services business known as Butlers

The OFT's decision on reference under section 22(1) given on 31 March 2011. Full text of decision published 15 April 2011.

Please note that the square brackets indicate figures or text which have been deleted or replaced in ranges at the request of the parties or third parties for reasons of commercial confidentiality.

PARTIES

1. **Sector Treasury Services Limited** is a subsidiary of Capita Group plc and is active in the provision of capital financing, treasury advisory, and strategic advisory consulting services to local authorities, housing, education, and NHS customers. As part of its treasury consultancy service provision, Sector also provides treasury training. Sector's total turnover to year ended December 2009 was £[ ]m.

2. **Butlers** was a division within ICAP Securities Limited, ultimately owned by ICAP plc which provided treasury consultancy services to local authorities, housing, education, and NHS customers. The UK turnover associated with Butlers for the year ended 31 March 2010 was £[ ] million, however, £[ ] million of this turnover related to brokerage income, which was not transferred to Sector.

TRANSACTION

3. The transaction involved the transfer of seven staff under the TUPE regulations[1] from ICAP plc to Sector together with contracts worth approximately £[ ]million for a consideration of £[ ]. Of these contracts £[ ] million were assigned while the contracts making up the remaining £[ ] million were novated.

[1] Transfer of Undertakings (Protection of Employment) Regulations

4. Sector is currently in the process of novating, or attempting to novate all contracts that were assigned as part of the transaction, but which have an expiry date of later than 31 December 2011. This equates to approximately [ ] per cent of all the contracts assigned. This action is necessary because ICAP retains the regulatory responsibility for the performance of those contracts assigned to Sector. Therefore the intention is that all the Butler contracts transferred to Sector will either be novated, or terminated by 31 December 2011.

5. The transaction was completed on 25 October 2010 and the statutory deadline, as extended under sections 25(1) and (2) of the Enterprise Act 2002 (the Act), is 4 April 2011. The OFT investigated this merger following a complaint.

JURISDICTION

6. A relevant merger situation arises when two or more enterprises cease to be distinct and either the UK turnover test or share of supply test set out in section 23 of the Act is met. The requisite jurisdictional test for the OFT is that it has to reach a belief that it is or may be the case that a relevant merger situation has been created (section 22(1) of the Act).

Enterprises ceasing to be distinct

7. The term 'enterprise' is defined in section 129 of the Act as 'the activities, or part of the activities, of a business'. The OFT's guidance provides information on the factors that it considers relevant in determining whether an 'enterprise' has been transferred.[2] The OFT believes that the transfer of assets, customer contracts and staff constituted an 'enterprise' for these purposes. The OFT believes that the transaction led to the transfer of Butlers treasury consultancy services business and allowed Sector to take over the supply of these services to customers of Butlers.

8. Therefore, the OFT believes that two or more enterprises have ceased to be distinct since, as a result of this transaction, Sector has ceased to be distinct from Butler's treasury consultancy services business.

Share of supply

[2] OFT Mergers – jurisdictional and procedural guidance (OFT527), paragraph 3.10.

9. The parties have a combined share of supply of treasury consultancy services to local authorities in the UK of over 25 per cent. Therefore the share of supply test in section 23(2) of the Act is satisfied. The OFT therefore believes that it is or may be the case that the transaction has resulted in the creation of a relevant merger situation.

BACKGROUND

10. Treasury consultancy services involves the provision of information on:

- cash and investment management
- funding and debt management
- risk management
- compliance with legal and regulatory framework and
- accounting for debt and investment instruments.

Commons Select Committee Report on Local Authority investments[3]

11. The collapse of Icelandic financial institutions in the autumn of 2008 brought to light that local authorities had invested nearly £1 billion in Iceland, and that these funds were at risk. This prompted the Commons Select Committee on Community and Local Government (the 'Committee') to launch an inquiry into local authority investments. The purpose of the inquiry was to understand the then current practice, to study the roles and responsibilities of various groups and individuals involved, and to make recommendations intended to limit the exposure of local authority funds to such risk in future.

12. The Committee canvassed views from industry participants. These representations are published on the Committee's website and are referred to where appropriate in the market definition section that follows.

MARKET DEFINITION

[3] www.publications.parliament.uk/pa/cm200809/cmselect/cmcomloc/164/164i.pdf

13. Sector and Butlers overlap in the provision of treasury consultancy services to local authorities.

Product scope

14. The Commons Select Committee referred to above reported that most local authorities do not carry out their treasury management duties in-house, but employ private sector external service providers to supply expert assistance. These include the following broad types of suppliers:

    a. **treasury management consultants** - to aid them, to a lesser or greater degree, in their treasury management activities

    b. **fund managers** - may also be retained to manage local authorities' investments directly, observing the limits set out in the local authority's Annual Investment Strategy

    c. **brokers** - while some local authorities will deal directly with counterparties in setting up investments, others employ treasury management brokers to carry out the transactions on behalf of the local authority. Brokers cannot and do not offer treasury management or investment advice, but simply act as an intermediary.[4]

15. The parties' proposed that the relevant market should be taken as the provision of treasury and financial management information by way of retainer contracts and one-off assignments. Sector further submitted that these services would cover some or all of the following three categories:

    (i) **Strategic assistance** consisting of:

    a) Regular strategy meetings to review the client's financial position recognising both capital and revenue influences. This will normally include an on-going analysis of the client's balance sheet position, the reconciliation of the Capital Financing Requirement to the balance sheet, and the identification of key themes and trends to support the treasury management decision-making process.

[4] source HC164-I, See also Chapter 7 of report

b) Interest rate forecasts and assistance to the client on the formulation of suitable borrowing and investment strategies in the light of the client's financial objectives.

c) Regular updates on economic and political change which may impact on and require modification to the client's borrowing and investment strategies.

d) Forecasts of movement in Public Works Loan Book[5] ('PWLB') rate which affect the timing of funding with fixed rate borrowing, conversion of variable rate debt to fixed and the conversion of fixed rate debt to variable.

e) Intelligence in respect of and assistance on the availability of and viability of market loan and stock issue structures.

f) Debt rescheduling opportunities, funding policy, volatility and maturity profile analysis.

g) Information and prudent parameters in respect of investment counterparty creditworthiness based on information from one or more of the UK's leading credit rating agencies and various other analysts as appropriate.

(ii) **Tactical assistance** consisting of:

a) Assistance with the timing of investments and borrowing decisions, based on current and future forecast interest rates.

b) Assistance with choosing duration periods and fixed/variable structures.

(iii) **Technical assistance** consisting of:

a) Support to finance teams within local authorities on the best practice accounting treatment to be adopted on all matters

[5] PWLB's lends money from the National Loans Fund to local authorities and other prescribed bodies, and collects repayments.

relating to the financing of capital expenditure and treasury management activities and compliance with the relevant accounting standards (eg Statement of Recommended Practice/International Financial Reporting Standards).

b) Access for clients to the technical bulletins and template documents as well as the provision of weekly or monthly updates. Workshops are also provided on updates to legislation and the implications of changes to the Chartered Institute for Public Finance and Accountancy ('CIPFA') Code of Practice/accounting regulations.

c) Only relatively straightforward technical assistance would be included in the retainer fee. Requests for assistance that involve typically more than half a day of chargeable work would normally be billed under a separate mandate to the retainer work.

Treasury consultancy on retainer, 'one off' treasury consultancy and other 'one off' consultancy

16. The OFT started its market definition exercise with the narrowest plausible market in which the parties overlap, that of treasury management consultancy services supplied on a retainer basis. The OFT then considered whether there was sufficient demand- or supply-side substitution to allow the market to be widened to encompass treasury management consultancy services on a one-off basis (on the demand side) and financial management and other consultancy services on a one-off basis (on the supply side) as Sector submitted.

Demand side

17. A number of pieces of evidence available to the OFT indicated that it may not be appropriate to widen the market on the demand side beyond treasury consultancy services supplied on a retainer basis:

- investments undertaken by local authorities must conform to the Prudential Framework (a system for ensuring a local authority's expenditure is prudent, affordable and sustainable). Third parties told the OFT that the Framework is complex and requires suppliers to have

experience of local authorities. That said, the parties suggested that one-off suppliers are not required to provide advice on how a particular project fits with the Prudential Framework, even though the parties believed that all of the competitors supplying one-off services could provide this advice

- the parties' internal documents indicate that they face significantly different competitors in tenders for financial management and other consultancy services than in tenders for treasury consultancy service retainers

- sector offers a reduced-service treasury consultancy retainer (which can be topped up with one-off projects) but only [ ] local authorities (out of 450 nationwide, some [ ] of which are Sector customers) have adopted it

- few customers who responded to the OFT said that they would switch to one-off treasury management consultancy (or other consultancy) in response to an across-the-board five per cent price rise in treasury management retainer services, and

- the variable profit margins earned by Sector and Butlers were high enough (at a little under [ ] per cent, see paragraph 47 below) to suggest that the hypothetical monopolist test is likely to be satisfied because the value of sales recaptured by the hypothetical monopolist when it raises the price of any of the products under its control will be greater, making the price rise less costly.[6]

18. Set against this, Sector provided 18 examples of 'one off' treasury consultancy projects that it said management consultancy firms and other non-specialist providers had supplied to local authorities (and that the parties had also bid for). However, the characteristics of six of the example projects provided did not appear to the OFT to be at all similar to treasury consultancy.[7] In particular:

- a customer service strategy project for [ ] local authority

[6] See *Merger Assessment Guidelines*, paragraph 5.2.15(b).
[7] Extracted from the e-mail correspondence provided in Sector's response dated 21 February 2011.

- a strategy project for [ ] local authority
- HR and finance projects for [ ]
- a project developing an investment appraisal model for housing for [ ] local authority
- consulting on a response to a negative corporate governance report for [ ] local authority and
- giving 'transformation advice' to [ ] local authority.

19. Sector also said that retainer contracts are typically of the same value as comparable one-off projects. Sector suggested that the average value of retainer contracts was £[ ] and that the value of one-off projects typically varied between £[ ] and £[ ] (implying that some combination of one-off projects may be comparably priced to a retainer contract). In and of itself, however, this is insufficient to demonstrate that the two belong in the same market.

20. Sector further submitted an example of one local authority [ ] which, it said, had substituted one-off projects for treasury management consultancy services on retainer. The OFT's market testing confirmed that this customer had reduced its retainer contract requirements and relied on ad hoc one-off specific pieces of treasury consultancy as and when required.

21. However, such a low level of switching—when considered alongside the other evidence discussed above—did not indicate to the OFT that demand-side substitution from retainer to (a combination of) one-off treasury consultancy services would be sufficient to defeat a five per cent price rise by a hypothetical monopolist of the former.

22. On balance, therefore, the evidence available to the OFT on demand-side substitution was not sufficient for it to conclude that the market should be widened beyond treasury consultancy services on a retainer basis to include one-off treasury consultancy projects.

Supply side

23. Notwithstanding the apparent demand-side differences between one-off treasury consultancy projects supplied by third parties and the parties' retainer business, and the lack of actual or potential switching between them as a result, Sector argued that—on the supply-side—there were numerous other consultancy firms providing advice to local authorities with the necessary skills to provide treasury consultancy and financial assistance.

24. The OFT considers that the boundaries of the market are generally determined by reference to demand-side substitution alone. However, there are circumstances where the OFT may aggregate several narrow markets into one broader one on the basis of considerations about the response of suppliers to changes in price. The OFT may do so when:

    - production assets can be used by firms to supply a range of different services that are not substitutes and the firms have the ability and incentive quickly to shift capacity between these services depending on demand for each, and

    - the same firms compete to supply these different services and the conditions of competition between the firms are the same for each service so that aggregating these services and analysing them as one market does not affect the OFT's findings on the competitive effect of the merger.[8]

25. In respect of the first bullet point above, Sector highlighted auditors, who it considered provided advice that competed with the technical advice provided under retainer contracts. In support, Sector provided two examples of Deloitte bidding for contracts to supply treasury consultancy services on retainer: one to [ ] Borough Council and one to [ ] District Councils jointly. [ ] the OFT has not been able to verify that Deloitte bid in this second tender.

26. However, customers generally only identified Sector, Butlers, Arlingclose and Sterling as providers for treasury consultancy services on retainer. According to the parties, customers requiring advice requiring more than

[8] See *Merger Assessment Guidelines*, paragraph 5.2.17.

half a day's billable work are billed under a separate mandate to the retainer work. There was very little evidence of other providers of retained services, although the OFT notes that JC Rathbone has one retainer contract in Scotland. Moreover:

- in respect of [ ] Council, the evidence indicated that Deloitte's bid [ ] and that both the Council and Sector were 'quite taken aback' that Deloitte bid, and

- in respect of [ ] District Councils, the evidence appeared to indicate that Deloitte's bid was third out of three (Arlingclose and Sector being the others), and Sector was initially uncertain as to the identity of the third bidder (having first assumed that it was Sterling).

27. Sector further pointed to the supply-side constraint from providers of member training in relation to the treasury functions, for example Griffiths Morley and CIPFA. Sector told the OFT that it believed that Griffiths Morley was already supplying treasury consultancy services on a one-off basis.

28. However, Griffiths Morley told the OFT that it has not entered and had no intention of entering into the supply of treasury consultancy services, albeit that it is active in the provision of one-off management consulting and financial advisory projects. Griffiths Morley's website confirms this.[9]

29. Sector also argued that it would be possible and economically feasible for customers to use a combination of self supply supplemented by ad hoc advice to obtain the same or similar services to those obtained under a retainer contract. Here, Sector told the OFT that the majority of the staff that it had recently recruited were ex-local authority treasury managers and the move to supplying treasury consultancy services in house would therefore be simple for local authorities. Sector also provided an example of Avon and Somerset Police which, Sector said, awarded its treasury consultancy services contract to Somerset County Council.

30. Set against this, none of the local authorities that responded to the OFT said that self-supply was an option for them. Further, evidence submitted by Sector suggests that at least some councils do not have the skills

[9] www.griffithsmorley.com/consultancy

necessary to self-supply. For example, a PWC assessment of Kent County Council's treasury risk procedures found that:

'Like most other councils, Kent County Council does not directly employ specialist treasury staff. This expertise is provided through a specialist treasury advice organisation called Butlers.'

In its submission to House of Commons' Communities and Local Government Select Committee, Sterling said:

'Although many finance staff in local authorities are qualified accountants, investment management is not a core part of accountancy training, and few accountants will be fully conversant with the details of treasury risk management.'[10]

That self-supply would not be a feasible option is clear from The Society of Local Authority Chief Executives and Senior Managers' submission to House of Commons' Communities and Local Government Select Committee:

'In order to form views on different institutions, authorities have generally employed Treasury advisors and used international ratings agencies (Standard & Poors, Fitch and Moodies) who are experienced in evaluating the relative strengths of different institutions. Most Local Authorities would not have the resources, access or in-house expertise to do this work efficiently themselves.'

31. While the above responses do not directly indicate whether a local authority would find it profitable to self-supply following five per cent increase in the price of retainer services, it does suggest that it is unlikely. Only one of the local authorities responding to the OFT's market testing said that it would have the skills necessary to self-supply treasury consultancy whereas another stated that treasury advice needs to be independent and therefore, by definition, cannot be done in-house.

[10] www.publications.parliament.uk/pa/cm200809/cmselect/cmcomloc/memo/locauinv/uc4202.htm

32. The OFT further understands that the Avon and Somerset Police's tender was for a treasury manager, not an advisor, and that, Somerset County Council [ ] receives advice from Arlingclose, a competitor to the parties.[11]

33. Therefore, there appears to be virtually no scope for local authorities to self-supply because of the reputational risk associated with loss-making investments.

34. In respect of the second bullet point in paragraph 24, there is a wider competitor set for the one off management and financial consultancy projects and Sector in competing for the financial element will face competition from accountants, and other financial consultants. However, as discussed above these same competitors do not compete for treasury consultancy services on retainer to local authorities, and the conditions of competition are not the same.

35. On this basis, the conditions under which the OFT may aggregate several narrow markets into one broader one on the basis of supply-side substitution do not appear to be met. The OFT has therefore taken a cautious approach and considered the relevant product scope to be retained treasury consultancy services to local authorities.

Geographic Frame

36. Local authorities are based in the UK. Sector commented that all the established providers of treasury consultancy services compete for contracts on a national basis, and that it was not aware of local or regional variations in competitive conditions. None of the local authorities that the OFT contacted indicated that it was important for their supplier to have a local presence. The relevant geographic market is therefore considered to be national in scope.

UNILATERAL EFFECTS

37. The parties overlap in the supply of treasury consultancy services by retainer contract.

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[11] See: www1.somerset.gov.uk/council/board3c%5C2010%20July%2012%20Item%209%20Annual%20Treasury%20Management%20Outturn%20Report%202009-10.pdf

Market shares

38. Sector estimates that the parties combined market shares in the supply of treasury consultancy services by retainer, by value, to be [70-80] per cent in 2010. The merger has resulted in an increase in concentration of four to three; this was noted by most customers.

Table 1: Market shares in the supply of retained treasury consultancy services

	Parties' estimate	
	Revenue	**Per cent market share**
Sector	[ ]	[40-50]%
Annual value of contracts transferred from Butlers to Sector	[ ]	[20-30]%
Combined	**[ ]**	**[70-80]%**
Arlingclose	1,090,336[12]	[20-30]%
Sterling	[ ]	[0-10]%
Total	[5-10] million	100%

Source: the parties

39. The parties' next largest competitor is Arlingclose with an estimated market share of [20-30] per cent. Arlingclose's accounts show that its revenue for 2010 declined slightly from £1,107,080 in 2009. Sector has submitted that Arlingclose has traditionally competed on quality rather than price but that Arlingclose has recently adopted a more aggressive pricing strategy. Sector submit that Arlingclose's new strategy is consistent with local authorities becoming more sensitive to price.

40. Sterling has an estimated market share of approximately [0-10] per cent. Sector submitted that Sterling's bidding strategy is mainly focused on price and is therefore a strong competitor.

41. On the basis of number of local authorities served, the overlap between the parties is around 84 per cent. This figure is derived from the Common's Select Committee Report (2008/09). At this time, Sector claimed to advise

[12] Obtained by the parties from Arlingclose's statutory accounts and is the turnover to year ended 31 March 2010.

250 UK councils: 53 per cent of the total, Butlers claimed to advise 144 UK councils: 31 per cent of total, and Arlingclose claimed to advise 40 (50 after Icelandic collapse) UK councils: nine per cent of the total number of UK local authorities. It was reported that there were at least 16 UK councils without advisers.[13]

Remaining constraints from direct competitors — Arlingclose and Sterling

42. Sector acknowledges that the major competitive constraint that the merged entity faces comes directly from Arlingclose and Sterling. Sector's view is that Arlingclose has traditionally competed on the quality of its service whilst Sterling has traditionally competed on price. It argues, however, that Arlingclose has recently begun competing more aggressively on price because, it says, local authorities have become increasingly price sensitive.

43. In support of its argument that Arlingclose had begun to compete aggressively Sector provided data on retainer contracts won and lost for 2009 and 2010. [ ].

44. Sterling also won contracts [ ].

45. The OFT considered the parties gross margins since if firms are able to mark-up prices to a substantial degree over the cost of sales, this suggests that the collective competitive pressure from rivals is relatively low, thus making unilateral effects more likely because the value of sales recaptured by the merged firm will be greater, making a post-merger price rise less costly. Otherwise price-sensitive marginal customers of the firm would switch to these rivals and oblige the firm to lower its margins (through lower prices or increased spend on its non-price offer).

46. Sector submitted the audited financial accounts for Sector and the March 2010 management accounts for Butlers. However, Butler's management accounts included brokerage income which was not included in the transaction. Sector submitted that by using the forecast profit and loss account provided to Sector at the time of the transaction, the indicated profit of approximately £[ ] suggested, for Butlers, a profit margin of some

[13] These figures appeared first in *The Independent* on 19 January 2009, and were reported at page 39 of the Select Committee Report.
www.publications.parliament.uk/pa/cm200809/cmselect/cmcomloc/164/164i.pdf

[ ] per cent. It has not been possible to verify this figure as the costs contained in the profit and loss accounts are not disaggregated.

47. Using Sector's audited 2009 accounts the OFT calculated its gross margins to be [ ] per cent, or, if staff costs are subtracted, around [ ] per cent. Sector submitted that it was more appropriate to use net profit, which would give a net margin of [ ] per cent. Sector provided unaudited accounts to 31 December 2010, where the net profit provided a net margin of only [ ] per cent. Calculating Sector's gross margin using these 2010 accounts the OFT arrived at a direct margin of [ ] per cent.[14]

48. The OFT also considered switching data. The following table shows switching for tenders where Sector was the incumbent and, separately, where Butler was the incumbent for 2009, 2010, and combined 2009, 2010. Data was taken prior to October 2010, when the transaction took place.

[14] The direct margin was estimated as turnover less payroll costs, temporary staff and consultants, office consumables, travel and subsistence. The OFT considers that some of these costs may not necessarily be variable costs, and so this estimate of direct margins may be an underestimate.

Table 2: Butler's and Sector's win/loss tendering data

			Incumbent/From	
			Butlers	Sector
Tender winner/To	2009	Arlingclose	[ ]	[ ]
		Butlers		[ ]
		Sector	[ ]	
		Sterling	[ ]	[ ]
	2010	Arlingclose	[ ]	[ ]
		Butlers		[ ]
		Sector	[ ]	
		Sterling	[ ]	[ ]
	Both years	Arlingclose	[ ]	[ ]
		Butlers		[ ]
		Sector	[ ]	
		Sterling	[ ]	[ ]

Source: the parties

49. [ ].

50. The results are mixed in that Sector and Arlingclose appear to be equally close competitors to Butlers. It also appears that Butlers does not place as strong a constraint on Sector as Sector places on Butlers. Sector argued that any apparent detriment to Butlers customers arising from the loss of the competitive constraint imposed by Sector would be offset by the customers continued ability to choose between Sector, Arlingclose and Sterling, as and when contracts came up for tender.

51. Arlingclose submitted that the increase in switching from Butlers which it has enjoyed was mainly a result of the Icelandic bank crisis.[15] As a result, Arlingclose was able to win some customers from the parties at tender. Arlingclose advised that this initial growth spurt has since slowed.

52. Customer views were mixed on Arlingclose's actual strength as a competitor. Some local authorities believed that Arlingclose was small and was considered a niche operator, whilst others considered Arlingclose to be of sufficient size and quality.

[15] Arlingclose was the only treasury management consultancy company that had no customers banking in Iceland at the time of the Icelandic banking crash.

53. Sector submitted that Sterling is 'strengthening its position in the market' following the placement of a job advertisement for a new local government treasury consultant. Sterling stated that: 'Our experience is that it is relatively difficult to recruit staff with the necessary experience from the public sector. We currently have the capacity to take on a small number of additional clients'.

54. Using this switching data the OFT calculated the diversion ratios between the merging parties. Where this ratio is significant, this suggests relatively close competition between the parties that the merger would remove, and suggests that the merged firm, having internalised this rivalry, would have an incentive from the merger to raise price or worsen its non-price retail offer.

55. The table below shows the customer diversion ratios for switching from Butlers to Sterling. [ ].

Table 3: Customer diversion ratio from Butlers to Sector

	2009	2010	Both years
Diversion ratio	[ ]%	[ ]%	[ ]%

56. [ ].

57. One local authority [ ] was concerned that the merger brought together the two biggest providers. [ ]. As far as this local authority was concerned, Arlingclose is a relatively small provider with a small proportion of local authority contracts, although, it had heard from other authorities using Arlingclose that its service is good. Sterling was similarly viewed as a small provider. This local authority was not aware of any firm in a neighbouring product market that would enter.

Constraints from potential competitors

58. Sector submitted that there were no particular skills associated with supplying treasury consultancy services to public sector organisations that were distinct from supplying these services to private sector firms. Therefore, any firm that provided similar services to the private sector are potential competitors. However, the job description referred to above tends

to indicate that the skills are specialist and are confined to individuals with significant experience in providing treasury consultancy services within a local authority. The description of typical tasks[16] produced by CIPFA is also consistent with the role being a specialist one.

59. Further, Sector was able to provide only two instances where a major accounting firm or other consultancy firm was active in the market for retainer contracts, [17] and ultimately accepted that these firms were more likely to be potential competitors rather than actual competitors. No third parties identified any firms that could be characterised as treasury consultants advising private sector organisations as potential competitors to the parties.

60. [ ] told the OFT that it was, by and large an audit firm. While in practice, it might be able to erect Chinese walls around employees that were to provide treasury consulting services to those local authorities that it is already providing audit services to, it did not think that the margins in this sector were sufficient to outweigh the reputational risk that is incurred when risky investments made by local authorities make losses. Its reasons for not entering into the supply of treasury consultancy services to local authorities included:

- the high reputational risk if the local authorities' investments made a substantial loss
- the risk noted above is not countervailed by sufficient margin, and
- there may be a conflict of interest if the authorities' auditor is also its treasury advisor (albeit there are ways of constructing Chinese walls).

61. Sterling told the OFT that firms supplying private sector companies would not switch to providing these services to local authorities because they would 'need to deal with':

- the unique legal and regulatory frameworks

[16] www.cipfa.org.uk/panels/treasury_management/publications.cfm
[17] The parties submitted that JC Rathbone has a retainer contract with Lanarkshire, and pointed to Deloitte's bid for Trafford's retainer contract. J.C. Rathbone's website indicates that is has several public sector customers, including customers on the housing and further education sector, yet it does not list any local authority customers - www.jcra.co.uk/our-clients.php

- a more bureaucratic corporate style and method of working
- less experienced staff, and
- public tender process driving fees down.

62. Arlingclose also noted the potential conflict in relation to being both a local authority's auditor and its treasury consultant. Other factors that Arlingclose, and Sterling, considered would prohibit entry and expansion are the availability of staff with the appropriate skills to enable them to expand capacity. Also, both companies held the view that it was important to have an established reputation gained through servicing several clients. Arlingclose advised that this was difficult to do because so few contracts come up for tender annually.

Providers of treasury consultancy services to other public bodies, for example Housing Associations

63. The parties submitted that providers of treasury consultancy services to other public bodies, for example, Housing Associations were either competitors or potential constraints on the merged entity's activities. In this regard, CIPFA submitted that the capital accounting and financial regime governing local authorities is distinct from that which governs Housing Associations. CIPFA stated that the Prudential Framework is complex and requires experience of the local authority sector. It indicated that a lack of understanding of the Prudential Framework may dissuade firms providing a treasury consultancy service to housing associations from entering the market for the supply of treasury consultancy services to local authorities following a SSNIP.

64. This was confirmed by third parties currently specialising in the provision of treasury consultancy services to the housing sector. Murja advised the OFT that they have not and do not intend to bid for retainer contracts for local authorities. While TradeRisks told the OFT that local authorities have historically been risk averse and inert, making this sector a 'closed shop'. Although, it speculated that authorities' inertia may change in the future given that the Public Works Lending Board (PWLB) is likely to be reduced and so Local Authorities will need to turn to the private capital markets for funding.

65. The parties also submitted [ ] that TradeRisks is offering bond placement services. The parties submit that this indicates that TradeRisks is at least a potential competitor to the parties. CIPFA confirmed to the OFT that bond placements are not typically included in retainer contracts and, as such, the OFT has not been provided with sufficient evidence to show that Trade Risks has entered or has plans to enter the supply of treasury consultancy services to local authorities by retainer contracts.

66. The OFT, based on the evidence available to it, does not consider that providers of treasury consultancy services to other public bodies, for example, would be likely to provide a sufficient constraint to the merged entity.

BUYER POWER

67. Sector has suggested that local authorities have buyer power because they must comply with public procurement rules either through holding tenders for contracts above a certain value and, for very large local authorities, may be compelled under EU public procurement legislation to advertise in the EU's Official Journal. It also believes that local authorities can increase their buyer power by joint tendering or using Buying Solutions (the national procurement partner for all UK public services).

68. In relation to the argument that by virtue of the very fact that a tender is held, then high competitive pressure is achieved, the following points taken from the Competition Commission's paper on bidding markets, are noted: [18]

    a) 'Tenders and auctions are likely to be more competitive when the income from the prize is large relative to total income'. This is not the case in treasury consultancy services. [ ].

    b) 'There is no advantage to being the incumbent.' This is clearly not the case in treasury consultancy: since between January 2009 and September 2010, [ ] of Sector's customers tendered and Sector retained around [ ] per cent of the contracts. Third parties told us there are advantages to having a relationship with Finance Directors and with understanding a client's needs. That it is important to develop

[18] See: www.competition-commission.org.uk/our_role/analysis/bidding_markets.pdf

relationships with Financial Directors is evidence in the e-mails submitted by Sector pertaining to switching.

c) 'Entry is easy'. Barriers to entry have been discussed above and the evidence appears to demonstrate that they are not sufficiently low so as to imply that holding a bidding contest is, by itself, a sufficient condition to achieve pre-merger levels of competition.

69. That authorities may advertise tenders is also not sufficient evidence to imply that there will be strong levels of competition. Moreover, the parties have supplied no evidence to suggest that advertising has enticed entry, or that local authorities have prolonged the period over which they advertise in order to put pressure on bidders.

70. In terms of joint tendering, the parties have provided no evidence which directly demonstrates that joint tendering will be an option in all or most cases. The parties have provided evidence of joint tendering, but it is not clear that it is the joint tendering rather than the pre-merger level of competition that leads to lower prices.

71. The Local Government Association (LGA), a body which lobbies on behalf of local government, thought that local authorities might form a buying group if they wished to constrain the merger parties. The LGA, however, was still concerned that the merger is a merger to duopoly since it did not count Sterling as a significant competitor against the merged parties.

BARRIERS TO ENTRY AND EXPANSION

72. Sector argued that, despite the degree of concentration, the OFT should not be concerned since Sector will face significant and **direct competitive constraints** from the remaining competitors, namely Arlingclose and Sterling. In addition. Sector believed it will be constrained by a new entrant, Griffith Morley.

73. The parties note in particular that the Big Four accounting firms understand local authorities' requirements because these accounting firms need to understand the rules governing local authorities' accounts in order to conduct an audit. The parties claim that they therefore face significant

constraints from **potential competitors**, and that barriers to entry are low. The parties also argue that these firms, although not currently directly competing for treasury consultancy services, do compete for some services that typically make up part of a treasury consultancy retainer. For example, technical accounting and compliance advice; and one-off assignments that are not covered by the standard retainer contract.

74. From third party responses it is clear that reputation; the right people, that is those with experience, or existing relationships with the tendering authority, for example; and a critical mass of local authority clients are the main barriers to entry or expansion.

75. A competitor told us that the financial barriers to entry were low because ultimately what is being supplied is information. In the competitor's view, the main barrier was reputational: winning local authority contracts requires having a portfolio of local authority customers or other such experience in supplying treasury consultancy services to local authorities. This is consistent with the job advertisement submitted by Sector which indicates significant narrow experience is required.

76. Arlingclose told us that expansion is likely to be difficult because of the lack of available staff with the appropriate skills and because only small number of contracts come up each year. This is confirmed by Sector's internal risk register report which lists losing client relationship management staff as a main risk facing Sector.

77. In terms of new entry put forward by Sector, the OFT has spoken with Griffith Morley who advised that they have just two consultants. They advised that they have not entered and have no intention of entering into the supply of treasury consultancy services, albeit they are active in the provision of one-off projects characterised above as management consulting and financial advisory services. Griffith Morley's website confirms it to be the case that it competes to provide one-off services.[19]

78. The evidence therefore suggests that barriers to entry and expansion may be high and the OFT has not been provided with compelling evidence indicating that entry will be timely, likely or sufficient to constrain the merged entity.

[19] www.griffithsmorley.com/consultancy

THIRD PARTY VIEWS

79. Third party views are, where relevant, referred to in the preceding assessment. The OFT contacted customers, competitors and potential competitors of the merged parties.

80. In general customers were concerned at the merger, citing the high market shares, and the increased concentration - four to three, or possibly a merger to duopoly depending on the customer's view of Sterling's position in the market.

ASSESSMENT

81. The parties overlap in the supply of treasury consultancy services by way of a retainer contract. The merger creates a combined share, by value, of [70-80] per cent in 2010, increment [20-30] per cent.

82. The OFT's investigation indicated the following:

    i. There are only two other regularly active competitors in the market for the supply of retained treasury consultancy services; namely, Arlingclose and Sterling, with estimated market shares of [20-30] and [0-10] per cent respectively.

    ii. As noted by third parties, especially customers, the merger increased the concentration in supply in this market from a four to three, while some third parties considered the merger represented a three to two, given the fourth player, Sterling's small share of the market.

    iii. There was evidence of switching between the parties and diversion ratios based on switching data indicated that the parties were close competitors.

    iv. The parties gross margins were relatively high, based on OFT's assessment of Sector's audited accounts for 2009, once staff costs were subtracted came to some [ ] per cent. Using Sector's unaudited 2010 accounts the OFT arrived at a gross margin of [ ] per cent. This evidence suggested to the OFT that Sector, at least, was able to mark

up prices to a degree over the cost of sales and suggests that the collective competitive pressure from the other players in the market was comparatively low.

83. For these reasons, the OFT considered that there was a realistic prospect of a substantial lessening of competition and considered whether there were any countervailing factors which would outweigh these concerns.

84. Sector submitted that the merged entity would face direct competitive constraint from Arlingclose and Sterling, as well as from new entrants to the treasury consultancy service market. The OFT's investigation did not confirm that entry or expansion was expected to be timely, likely or sufficient to constrain the merged parties' ability to raise prices or worsen their competitive offer. In particular, the constraints suggested by Sector from potential competitors, including providers of treasury consultancy services to other public bodies, and accounting firms have not been borne out by the OFT's market testing.

85. Sector argued that entry was easy given that it was essentially a 'people' business with Sector's key risk being the loss of personnel. Third party responses suggested that a key barrier to entry or expansion was reputation. Winning local authority contracts appears to require having a portfolio of local authority customers. It was also clear from the evidence supplied by Sector that the working relationship between the Treasury Consultant and the local authority official was key.

86. Third parties were in general concerned at the merger, given the high market shares and the increased concentration in the market. Sector argued that local authorities were able to exercise buyer power due, in part, to public procurement rules compelling them to hold tenders. That local authorities may advertise tenders is not sufficient evidence to imply that there will be strong levels of competition or that they are able to exercise countervailing buyer power which would sufficiently reduce or lessen the substantial lessening of competition that may have resulted from the merger. Moreover, the parties have supplied no evidence to suggest that advertising has enticed entry, or that local authorities have prolonged the period over which they advertise in order to put pressure on bidders.

87. For the reasons outlined above, the OFT believes that it is or may be the case that the merger has resulted or may be expected to result in a

substantial lessening of competition within a market or markets in the United Kingdom.

EXCEPTIONS TO THE DUTY TO REFER

88. The OFT's duty to refer under section 22(1) of the Act is subject to the application of certain discretionary exceptions, including the markets of insufficient importance or 'de minimis' exception under section 33(2)(a)

89. The OFT has found a realistic prospect of a substantial lessening of competition in the market for treasury consultancy services to local authorities. The OFT believes that the annual value of this market is less than £10 million. It has therefore considered whether it should apply the 'de minimis' exception to the duty to refer.

Availability of undertakings in lieu

90. The OFT generally will not apply the 'de minimis' exception where clear-cut undertakings in lieu of reference could be offered by the parties to resolve the competition concerns identified. The OFT's judgment in this respect is an 'in principle' one that does not depend on any actual offer of undertakings in lieu.[20] In any event, the existence of any such offer is unknown to the decision maker at the time of his or her decision as to whether undertakings in lieu are in principle available.

91. The OFT considered whether there was a clear-cut undertaking in lieu available in this case. The OFT takes a conservative approach in assessing whether undertakings in lieu are in principle available. To the extent that there is any doubt as to whether undertakings in lieu would meet the 'clear-cut' standard, as is the case here, it will not be included in the 'in principle' assessment.[21] In this case, the only structural remedy open to the parties to address the competition concerns raised would be to unwind the transaction. The OFT does not include prohibition of the transaction when considering whether an 'in principle' undertaking in lieu is available.[22]

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[20] *Exceptions to the duty to refer and undertakings in lieu of reference guidance*, OFT1122 December 2010, paragraphs 2.18-2.27
[21] *Exceptions to the duty to refer and undertakings in lieu of reference guidance*, OFT1122, December 2010, paragraph 2.27.
[22] *Exceptions to the duty to refer and undertakings in lieu of reference guidance*, OFT1122, December 2010, paragraph 2.25.

92. On the basis that the OFT believes that there is no clear-cut undertaking in lieu available, it has proceeded to examine whether to exercise its 'de minimis' exception in this case.

Application of the 'de minimis' exception

93. The market concerned is the market for the supply of treasury consultancy services by way of a retainer contract to local authorities. The size of this market, as estimated by the parties, was around £[5-10] million in 2010. Therefore, the annual value of the market exceeds the £3 million benchmark for which a reference to the Competition Commission would generally not be justified.[23]

94. When determining whether it should apply its 'de minimis' discretion, the OFT assesses the expected customer harm from the merger, in particular whether the expected merger impact is expected materially to outweigh the public costs of a reference to the Competition Commission. The main factors that the OFT considers in determining the expected customer harm are the following:[24]

- the size of the market
- the strength of the OFT's concern (that is, its view on the likelihood
- that the substantial lessening of competition will occur)the magnitude of competition lost by the merger
- the durability of the merger's impact, and
- any wider implications, including the merger's potential replicability and rationale.

The OFT has considered each of the above factors in determining whether to exercise its discretion to apply the 'de minimis' exception in this case.

[23] *Exceptions to the duty to refer and undertakings in lieu of reference guidance*, OFT1122, December 2010, paragraph 2.15.

[24] *Exceptions to the duty to refer and undertakings in lieu of reference guidance*, OFT1122, December 2010, section 2.

Market size

95. The starting point for the OFT's consideration is the size of the market concerned. For the purposes of applying the 'de minimis' exception the market concerned is the affected market, in this case the market for the provision of treasury consultancy services on a retainer basis to local authorities. The annual value of this market is around £[5-10] million.

Strength of the OFT's concerns

96. The strength of the OFT's belief that the merger may be expected to result in a substantial lessening of competition is towards the higher end of the 'realistic prospect' standard. As discussed above, the OFT was unable to conclude that buyer power or entry prospects were sufficiently likely to mitigate any competition concerns. As a result, the strength of the OFT's belief that harm will result from the merger tends to point away from the exercise of the 'de minimis' exception in this case.

Magnitude of competition lost

97. The OFT has regard to customer comments indicating that Sector and Butlers were each other's closest competitors. It also notes the very high combined shares of the supply of retained treasury consultancy services for local authorities created by the merger and the relatively large margins achieved by the parties. Such customer concerns, high shares and margins would normally be indicative of a large degree of competition lost by the merger. Given that the merger results in a reduction in choice from four to three (or in the view of some third parties, a three to two) the OFT considers that the magnitude of competition lost by the merger is a factor that points strongly against the application of the de minimis exception.

Durability

98. The evidence available to the OFT indicates that barriers to entry are high in this market, as set out above. The parties have referred to the ease of entry by suppliers of treasury consultancy services to housing associations and other public bodies and also from suppliers to the private sector, however, the OFT's market testing has not supported this view. There is no evidence that timely, likely or sufficient entry to counter the substantial lessening of competition arising from this transaction will occur, therefore

the OFT considers the duration of harm arising from the Transaction weighs against the exercise of the 'de minimis' discretion.

Replicability

99. The OFT considers that this factor is neutral as regards the exercise of its 'de minimis' discretion since there is limited scope for similar future cases in the same sector: retained treasury consultancy services to local authorities.

Conclusion on the 'de minimis' exception

100. The OFT considers that the balance of factors set out above is not in favour of the exercise of its 'de minimis' discretion. The OFT therefore considers it is not appropriate to exercise its 'de minimis' discretion in this case.

UNDERTAKINGS IN LIEU OF REFERENCE

101. Notwithstanding the conclusion above that there was no clear cut undertakings in lieu of reference that were available in this case, Sector nevertheless offered for consideration a package of undertakings that it would be prepared to give.

102. The proposed undertakings offered by Sector were made up of a package of behaviour measures; specifically that Sector will:

- not, for a period of three years, increase or attempt to increase its annual fee for any retainer contract for treasury consultancy above the rate of inflation

- not, for the same period, increase its net headcount of fee-earning staff employed predominantly in the provision of treasury consultancy services to local authorities on a retainer basis

- provide to the OFT:

    - a list of all its retainer contracts for treasury consultancy services with local authorities indicating the annual fees payable and the expiry dates of those contracts

- a list of all fee-earning staff employed predominantly in the provision of treasury consultancy services to local authorities on a retainer basis.

103. Section 73(2) of the Act provides the OFT with the ability to accept undertakings in lieu 'for the purposes of remedying, mitigating or preventing' competition concerns. The OFT's starting point is to seek an outcome that restores competition to the level that would have prevailed absent the merger. Therefore the OFT will, as a general rule not accept behavioural undertakings that simply aim to mitigate concerns rather than remedy or prevent competition concerns.[25]

104. Given that these retainer contracts are individually negotiated, both in terms of price and scope, it is not clear how the proposed undertakings could seek to replicate the competition between the parties that is lost by the merger. It is not clear how the contract price would change if the scope of the contract was altered. Nor is it clear why a 'rate of inflation' price rise should be allowed. [ ]. Limiting the net headcount of fee earning staff is an attempt to limit capacity but the OFT has no information on current levels of spare capacity whether within Sector or the market more widely. On balance, therefore, the OFT does not believe that the offer of undertakings would provide a 'clear-cut' remedy capable of ready implementation.

DECISION

105. This merger will therefore **be referred** to the Competition Commission under section 22(1) of the Act.

[25] Paragraph 5.12 Mergers — *Exceptions to the duty to refer and undertakings in lieu of reference guidance* OFT 1122 December 2010.