

CRA Competition Memo



Lessons from the Accountancy Mergers

In professional service firms, the most important assets are people. The merger between Price Waterhouse and Coopers & Lybrand was the first major service industry merger to be considered by the European Commission.¹ Two interesting questions raised during the case were as follows. First, how should markets be defined in service industries? Second, how should competition authorities differentiate between rival mergers in oligopolistic industries?

Market Definition in Service Industries

In common with other 'Big Six' audit and accounting firms, both Coopers & Lybrand (C&L) and Price Waterhouse (PW) offered a wide range of other professional services – including tax compliance, management consulting and corporate financial advice – in many countries around the world. The two firms were a neat fit geographically. PW was relatively weak in, for example, Germany and Japan, where C&L was well established. Similarly, C&L had a relatively small presence in Latin America and Russia, where PW was a leading player. Many multinational companies (MNCs) need advice in a number of countries. By plugging gaps in their respective networks, the merged firm would be able to offer enhanced geographic coverage.

The Commission accepted the product market demarcation suggested by the parties. Audit and accounting, management consultancy and the other service lines could be considered as separate relevant markets. The main focus of the inquiry related to the merged firm's strength in audit and accounting. Some MNCs can only really use the services of the Big Six firms, as only they have the resources, reputation and global coverage required. Did the importance of global coverage therefore imply that the relevant geographic market was pan-European, or even worldwide?

On closer inspection, the Commission was correct to decide that the relevant market was national: its decision reflects a logical application of the 'SSNIP test'. Audit regulations vary markedly across countries and auditing is labour intensive. As a result, a 'hypothetical monopolist' of audits in, say, Germany would be able to raise prices and increase profits because it would not face a binding constraint from auditors in other countries. Also, although there has been some centralisation of audit purchasing, many MNCs still allow their local subsidiaries to decide

which Big Six firm to employ. Not surprisingly, national subsidiaries will make this decision on the basis of national reputation.

As such, a 'global network' in auditing can be thought of as a combination of effective national firms. This market definition was consistent with the rationale for the merger. PW's relative weakness in Germany, for example, would have been a cause for concern for the firm only if the relevant market was national.² Note that this result cannot be generalised across different industries. It is perfectly feasible that the relevant geographic market for serving MNCs in other industries could be European or global (as has been found in a number of telecommunication cases). The key characteristics of auditing that underpinned national markets were its labour intensity, the difference in audit requirements across countries and the fact that customers were not compelled to use the same Big Six firm in every country in which it was present.

Differentiating Rival Mergers

Market definition was made all the more pertinent by the arrival of another merger. Shortly after the announcement of the proposed C&L/PW merger, two other Big Six firms – Ernst & Young (E&Y) and KPMG – signalled their intention to merge. This raised the question of whether the Commission would contemplate blocking one merger and not the other, or whether it was 'both or neither'. This posed a strategic dilemma for PW and C&L. They could not rule out the Commission deciding that four firms was 'too few', but any implied criticism of the other merger risked undermining their own merger plans.

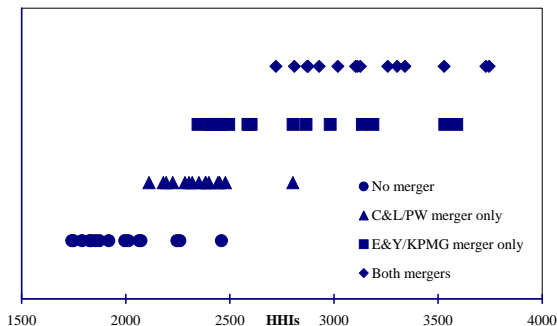
Differentiating the two mergers involved going back to one of the motives for the PW/C&L merger: geographic complementarity across national markets. It was rare for C&L to have a strong presence in countries in which PW was strong and vice versa. In no EU country would the combined firm have a share over 40%. In contrast, the merger between KPMG and E&Y would have involved a combination of the market leader and either the second or the third largest firm in six countries, and its combined share would have exceeded 40% in seven countries. Complementarity is best illustrated using the Herfindahl-Hirschman Index (HHI) (which is the sum of the square of the market shares for all firms in the market). One of the advantages of using the HHI

¹ Lexecon acted as economic advisers to Price Waterhouse and Coopers & Lybrand.

² If the relevant market was, say, European, having a significant market share in Germany would not matter because non-German firms could still be effective competitors in Germany.

measure of concentration is that it is sensitive to the relative sizes of firms in the market. The following diagram illustrates HHI levels in individual countries under the four possible scenarios.³

HHIs Under Different Merger Scenarios



This illustrates that allowing both mergers would have resulted in highly concentrated markets with just four players, raising significant doubts that the Commission would wave both through. Allowing only the E&Y/KPMG merger would still lead to a marked increase in concentration in most European markets. In contrast, allowing only the PW/C&L merger would not lead to a big jump in the range of concentration.

Other Competition Issues

In the end, the Commission did not have to decide whether to block one merger and not the other, as the E&Y/KPMG merger was abandoned shortly after the Stage II investigation started. The remaining issue the Commission had to address was whether a reduction in the number of competitors from six to five would have a detrimental impact on competition. To address this question, it explored the following issues.

- **Was five firms sufficient for competition?**

Analysis of audit tenders revealed that most clients asked either three or four of the Big Six firms to submit bids. As a result, the Commission accepted that a reduction in the number of feasible bidders from six to five would not adversely affect client choice. Bid analysis also revealed that each of the remaining four accountancy firms was able to win business from both PW and C&L.

- **Were there any niche markets?**

The Commission also investigated whether the skills required to audit the banking and insurance sectors were so specialised that they should be treated as relevant markets. However, analysis showed that all of the Big Six were in possession of the relevant skills and case studies showed that Big Six firms could win business in sectors in which they were previously relatively minor players, by a variety of means (such as by recruiting specialist staff from other firms). The

Commission therefore ruled out the possibility that high sectoral market shares represented a significant competition concern.

- **Was joint dominance an issue?**

Finally, the Commission examined the likely impact of the merger on the possibility of joint dominance. This related to the possibility that the merger would make tacit or explicit co-ordination more likely, allowing firms to sustain higher audit fees. Auditors operate in a service industry in which the product is tailored to each client's specific needs. It is arguable that joint dominance in such an industry is unlikely. However, rather than rule out the possibility of joint dominance, the Commission stated that it had found no conclusive evidence that joint dominance existed or would be likely to develop post-merger. The Commission clearly remains keen to investigate the feasibility of joint dominance whenever possible.

Conclusion

The Commission cleared the PW/C&L merger, which led to the formation of PricewaterhouseCoopers. Perhaps the most interesting issue raised by the case relates to the basis on which rival mergers should be differentiated. A common question about merger analysis in the corporate boardroom is: under what circumstances can a merger be considered a 'one-shot chance'? This occurs where competition authorities are likely to allow only one merger because any further consolidation would leave too few competitors. If later mergers appear certain to be blocked, the temptation is to be first at all costs, even if the proposed deal is not the merging parties' first choice.

Some commentators have stated that the reduction in the number of large accountancy firms from six to five signals the end of consolidation in this sector, as a reduction from five to four would not be tolerated. The PW/C&L merger, therefore, does have some features of the 'one-shot chance' model. This does not mean, however, that any combination of the Big Six would have been acceptable. The C&L/PW merger was allowed through because the parties were able to convince the Commission both that five firms left customers with an adequate choice of auditor and that the geographic complementarity meant that there was no risk of the merged firm being dominant. Arguably, the E&Y/KPMG case might have fallen down on the latter requirement. Its withdrawal means that we will never know whether the Commission would have been willing to block one merger and not the other.

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³ The identity of each country is not shown for reasons of space. Markets shares are based on data provided by the parties (more details can be found in the *Financial Times* of 14 February 1998).