

Legally privileged and confidential

Memo

To: **Herbert Smith**
Date: 4 February 2011
From: NERA
Subject: **Commercial Services**

NERA has been asked to consider the responses to the consultation on the NLC's provisional decision. On the basis of that material, we were asked whether we stand by the answers given in our report of 2 July 2010, and whether there is anything that we wish to alter in the light of the consultation responses. In particular, we have been asked to consider the following questions:

1. To what extent have the consultation responses provided more clarity on the existence and/or scale of the cost and/or non-cost advantage(s) that Camelot may enjoy as a result of entering the commercial services markets on the back of the National Lottery infrastructure compared to entry on the same scale on a stand-alone basis?
2. What further work could be undertaken in order to provide a firmer view on the extent of any such advantage(s) (both cost and non-cost)?
3. Does NERA have any particular comments on any of the criticisms by Camelot/KPMG of the July report?
4. Based on the consultation responses, can NERA comment on Camelot's analysis of the competitive impact of its entry into commercial services. What work would need to be carried out to reach a firmer conclusion on this?
5. Can NERA comment on the potential effectiveness and/or practicality of the remedies proposed by Camelot?

Insofar as we do not comment on any points made in the consultation responses, this should not be taken as indicating that NERA agrees with those points.

1. The Nature and Scale of Camelot's Advantage

In this section we discuss the nature of the advantages that Camelot's commercial services business may derive from the fact that Camelot also operates the National Lottery.¹ We consider

¹ This may be relevant to the question of whether Camelot's role as the National Lottery operator gives it an "unmatchable advantage" in the provision of commercial services. However, as previously stated (NERA 2 July Memo, page 4), it is

the potential impact of such advantages in Section 2, noting that they may affect either or both of (a) Camelot's decision whether or not to enter the market for commercial services, and (b) Camelot's decisions about pricing and services to provide once it has entered the market. Even if the impact were confined to the former of these, this would still lead the entry of one additional competitor in the market, which could in itself have a significant impact on competition. We do not examine the question of whether Camelot would have an overall cost advantage compared to rival suppliers.²

NERA's previous analysis concluded that there were still "realistic possibilities" that either:

- Camelot would have a "very large" advantage over competing providers of commercial services. This could be, for example, because it has avoided start-up costs that other firms have had to incur, because it also enjoys ongoing cost savings as it can share ongoing terminal and network costs with its Lottery business, and because it enjoys some non-cost advantages; or
- any advantage is "quite small". This might be because Camelot will have incurred start-up costs, for example with the roll-out of its Ingenico terminals, because it could incur extra costs because of the great importance of ensuring that there is no risk of disruption to National Lottery ticket sales, and because any remaining cost advantage is small in relation to the size of the business.

We have not altered our view that there are realistic possibilities that Camelot's overall advantage could be either very large or quite small. However, the consultation responses have shed additional light on the likely importance or otherwise of particular advantages, and suggest that the distinction between "cost" and "non-cost" advantages is not clear-cut.

unclear to us what precisely is the legal definition of an "unmatchable advantage", or what are the criteria for determining whether such an advantage exists.

² It is possible that Camelot may derive an "unmatchable" cost advantage (depending on the appropriate legal definition of the term) from its role as National Lottery operator, but that other suppliers have cost advantages of their own (e.g. because of economies of scope with other activities), with the overall effect being that Camelot may overall have higher, lower or similar costs as rivals. We are not aware of any specific advantages enjoyed by other suppliers, as a result of a grant of state rights, that are comparable in scale to the cost and non-cost advantages that some consultation respondents argue that Camelot enjoys as a result of its National Lottery activities. While we cannot reach a firm conclusion on the likely size of Camelot's advantage, the scale of the National Lottery (draw-based game tickets sold by retailers account for turnover of more than £3.5 billion per year) plus the evidence discussed in Sections 1.1 and 1.3 open up the possibility that Camelot's cost and non-cost advantages *could* be very large (or they could be quite small). While some existing commercial services suppliers have medium-term exclusive contracts with public sector organisations, in particular for payments at retailers for TV licences and the London congestion charge, Camelot does not advance evidence to show that these contracts - which have in any event been awarded following competitive tenders - are particularly important for commercial services suppliers (we note that there are many other contracts for commercial services - Camelot Figure 3.4(a)(2) lists numerous examples).

1.1. Summary of relevant new information provided

Reinforcing its previous submissions, Payzone refers to its estimate of “minimum aggregate entry costs” of £15 million, and states that Camelot will also avoid “normal operating costs to establish, develop and maintain a successful bill payments business” which it estimates to be in the order of £2 million a year.³

In contrast, Camelot argues that the cost of rolling out its Ingenico terminal, barcode scanner and key readers is £687 per store, and that this is comparable to Payzone’s estimated entry costs which are equivalent to £750 per store.⁴ KPMG argues that the difference between these figures is “within a reasonable margin of error, particularly when it is considered that the estimates have not been independently verified and Payzone has not provided any details underpinning its cost estimates”.⁵ On top of these costs, moreover, Camelot will also price its commercial services so as to cover an allocation of the common costs of its existing Altura terminals.

Camelot argues that the costs shared with the Lottery business are only 3 per cent of the total costs of the commercial services.⁶ Furthermore, it states that the Ingenico terminal, barcode scanner and Talexus key reader are similar in size to the equipment used by other providers, so there would not be a significant space saving for retailers from providing Camelot commercial services rather than those offered by PayPoint, Payzone or ePay.⁷

However, Payzone draws attention to Camelot’s statement (in footnote 1 of its submission on proposed remedies) that it will offer a user interface on National Lottery terminals and that “retailers may find such a user interface convenient”. Payzone describes this statement as “wholly misleading” and “a gross understatement”, and argues that the user interface is “of critical importance”.⁸ It states that it would need to incur a cost of £700 per terminal in order to provide an upgrade that offered the same functionality (“large touch screen, end of day reconciliation, etc”) as that offered by the interface with Camelot’s existing terminals.

Payzone states that the National Lottery terminal will therefore “offer overwhelming advantages to retailers which will displace rival terminals”.⁹ It also argues that, even though there is no

³ Payzone observations on the NLC Provisional Decision, paragraph 8.

⁴ Camelot response to the NLC Provisional Decision, Section 3.4(a).

⁵ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Section 4.2.1.

⁶ Camelot response to the NLC Provisional Decision, Section 2.4.

⁷ Camelot response to the NLC Provisional Decision, Section 2.3.

⁸ Payzone observations on Camelot Group Limited’s Proposed Remedies, paragraphs 9.3 and 9.7.

⁹ Payzone observations on the NLC Provisional Decision, paragraph 26.

Legally privileged and confidential

space saving for retailers simply from choosing Camelot services, a retailer with a National Lottery terminal is “likely” to take up the option of installing Camelot’s Ingenico terminal, scanner and key reader, and that installing this equipment “can only have the effect of displacing one or more terminals of rival operators”.¹⁰

A possible counterargument is set out by Camelot, which states that “the main incumbent operators offer retailers the option of integrating the commercial services offering into their electronic tills [...] such that retailers are able to use a single EPOS system for all retail sales, including commercial services.”¹¹ However it does not provide any further details (eg how the service would compare with the interface through Altura terminals, or what the cost of this option would be). KPMG argues, in addition, that PayPoint also uses a touch-screen interface.¹² Nevertheless, a table in KPMG’s report also lists “Camelot terminals are IP enabled, touchscreen and easy to use reducing staff training requirements” as one of the benefits of Camelot’s proposition.¹³

A further advantage of Camelot’s infrastructure is that it will allow faster transaction processing speeds than the current commercial services providers.¹⁴ This is not a feature that either Camelot or KPMG draw particular attention to.

PayPoint draws attention to the risk of “*de facto* tying”. It cites recent reports of retailers being threatened with the removal of their National Lottery terminal if they do not achieve increased sales, and identifies several ways in which such “economic muscle” could be used effectively to tie commercial services sales to National Lottery sales.¹⁵ In addition, PayPoint argues that the use of the National Lottery brand will provide Camelot with “a unique, unquantifiable benefit from the National Lottery’s position as an established public institution in the UK.”¹⁶ Payzone also argues that it is “highly likely” that Camelot would engage in exclusivity practices in both upstream and downstream markets, and leave open the option to “bundle” its National Lottery and commercial services offerings.¹⁷

¹⁰ Payzone observations on Camelot Group Limited’s Proposed Remedies, paragraph 9.4.

¹¹ Camelot response to the NLC Provisional Decision, Section 3.4(b).

¹² KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Section 4.2.2.

¹³ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Table K.3.

¹⁴ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Tables 5.2 and KI.1, and footnote 79.

¹⁵ Response of PayPoint plc to NLC provisional decision of 16 July 2010, paragraphs 22-25.

¹⁶ Response of PayPoint plc to NLC provisional decision of 16 July 2010, paragraph 21.

¹⁷ Payzone observations on the NLC Provisional Decision, paragraph 8.

In contrast to this, Camelot draws attention to rivals' "substantial advantages", including an installed base of EPOS links at retailers, a broader range of services (eg ATMs and ticketing services), and widespread outlet and operator exclusivity.¹⁸ And KPMG asserts that Camelot will not enjoy any branding advantage, as "customers will just be aware that a retailer offers a specific commercial service as opposed to being influenced in any way by the service provider who ultimately provides the service to the retailer".¹⁹

1.2. Camelot's proposed remedies

1.2.1. Transparency and Fair Trading conditions

Camelot has proposed a set of remedies including an undertaking or condition on financial transparency, and a fair trading condition. The existing providers of commercial services have commented extensively on these proposals.

Neither of these remedies would appear suitable for addressing all of the potential problems that may arise if the legal view is that economies of scope (including both cost and non-cost factors) from the National Lottery business give Camelot an unfair advantage that needs to be addressed. The financial transparency conditions will provide information about Camelot's actual costs, including an allocation of common costs, but they will not provide information about what these costs would have been if there were no economies of scope with Camelot's Lottery business. Neither will they provide any information about Camelot's non-cost advantages. In addition, even if they were able clearly to identify Camelot's cost advantage, they would not address it.

Similarly, while a fair trading condition might help to prevent further competition problems (for example, resulting from tying arrangements or below-cost pricing), it is unlikely that such a condition could be designed so as to neutralise the impact of the cost and non-cost advantages that Camelot enjoys because of its Lottery business (if the legal view is that these need to be addressed).²⁰

¹⁸ Camelot response to the NLC Provisional Decision, Section 3.5(b).

¹⁹ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section 4.5.

²⁰ In theory, it might be open to the NLC to issue guidance to Camelot (which it would have to comply with under the terms of the fair trading condition) that effectively neutralised the impact of any economies of scope – for example a requirement to maintain a specified minimum "headroom" (possibly large) between its effective charges (eg commission rates) and its costs. But we believe that this would extend the impact of the fair trading condition far beyond that contemplated in Camelot's proposals, and indeed it might threaten the financial viability of Camelot's proposed commercial services. Even if Camelot were amenable to this idea, which effectively amounts to the imposition of a price floor, that would still leave the difficult matters of determining what the price floor should be and considering how it should be enforced.

We have been asked to comment on the likely effectiveness of the transparency remedy if it does not apply to Camelot's sister company, Wholesale Commercial Services Ltd (WCSL). In addition to the problems noted above, a transparency remedy that applied to Camelot Group plc (the National Lottery licensee) but not to WCSL would not necessarily allow other competition problems, such as below-cost pricing, to be identified. This is because the separate accounts for Camelot Group plc's commercial services activities would not show all of the costs and revenues associated with commercial services. For example, they would show a commission received from WCSL rather than the revenues generated from commercial services, and they would not show the costs that WCSL incurs, for example in managing the software platform.

1.2.2. Remedies to address specific concerns

Camelot has also stated that it is prepared to offer additional remedies to address specific concerns and has given the following examples of possible additional remedies:

- a pilot period to allow empirical evidence to be gathered;
- a limitation on Camelot's market penetration to a low percentage of the market; or
- an obligation to set prices above an appropriate measure of costs, including infrastructure costs benchmarked to market rates.

We comment on each of these below.

1.2.2.1. A pilot period

This does not appear to be a "remedy" as such, but rather a possible means of obtaining more evidence on the impact of Camelot's entry. Even interpreted in this way, the proposal seems unlikely to succeed. Both Camelot's behaviour and that of its rivals would be conditioned by the knowledge that the pilot period may only be temporary and that their actions would be taken as evidence by the NLC in a subsequent evaluation of whether to allow Camelot's market entry to become permanent.

1.2.2.2. A limitation on market penetration

The potential effectiveness of a cap on Camelot's market penetration as a remedy to address competition concerns depends on the nature of the legal test underlying those concerns. If, for example, the concerns relate to the possibility that one or more existing suppliers will be forced out of the market, leading to greater concentration than at present, then it might be possible that such a cap could help to alleviate such concerns. However, even if this is the relevant legal test, we note below that there could be significant practical problems implementing such a remedy,

Legally privileged and confidential

and if the cap is set “too low” it would be likely to reduce the benefits to both consumers and good causes that might result from Camelot’s market entry.

However, if the legal test is whether Camelot is able to compete more aggressively because of advantages associated with the National Lottery (including the case where it would not enter the market at all if it did not have these advantages), then the remedy will only be effective if the cap constrains Camelot’s commercial services business to the size it would have been if Camelot were a standalone competitor without a lottery business.²¹ If Camelot would not have entered the market at all in the absence of the benefits derived from its National Lottery activities, then the cap would need to be set at a sufficiently low level that Camelot will decide not to provide commercial services, and a more direct remedy would simply be to refuse Camelot’s application to launch its commercial services business.

In addition, we note that there would be a number of significant practical difficulties associated with such a remedy. A cap that applied to Camelot’s market share would be difficult both to monitor (for example because it would require data from other market participants) and to enforce (because it could only be assessed on an *ex post* basis). In contrast, a limit that is easier to enforce, for example a cap on the number of retail outlets offering Camelot commercial services, may have a less predictable impact on competition between Camelot and other providers. There would also be difficult and contentious issues to address, for example concerning terminology and definitions, whether separate caps were set for different products and/or regions, and of course the precise level(s) at which the cap(s) should be set.

1.2.2.3. An obligation to set prices above an appropriate measure of costs

In principle, it might be possible to design remedies so that Camelot is required to set prices to reflect the costs of entry that a new entrant without Camelot’s cost and non-cost advantages from the National Lottery would face. However, we note that:

- there is no readily available objective measure of the scale of Camelot’s cost and non-cost advantages (see Section 1.4), and so it would be a difficult and contentious task to draw up a remedy (or set of remedies) that might neutralise the impact of any such advantages. Different parties might present evidence to the NLC that purports to show that these advantages are either very small or very large, and the likely impact of the non-cost advantages in particular would be extremely difficult to assess;
- setting a rule that Camelot’s prices must be above some appropriate measure of costs is likely to raise a number of further issues, even where the relevant measure of costs is agreed. For

²¹ Even this remedy would be ineffective if the legal test also requires that Camelot does not gain an advantage that has not been “paid for”.

example, a requirement that Camelot covers the fixed costs of assets that may be used over an extended time period may raise questions regarding the time period over which the fixed costs must be recovered, or decisions on what happens if market circumstances or the notional costs of supply turn out to differ from Camelot's expectations, and decisions on whether the price-cost requirement should cover individual services or the overall commercial services business. This is likely to add to the complexity of designing the remedy up front, and may result in subsequent quasi-regulatory deliberations being required on the part of the NLC;

- as discussed in Section 2.3.1, one of the main potential impacts arising from its economies of scope with the National Lottery is that Camelot might enter commercial services provision as a result of those advantages in circumstances where it would not otherwise have done. If this is the case, then the appropriate measure of costs will need to be set at a sufficiently high level that Camelot will decide not to enter the market at all, and a more direct remedy would simply be to refuse Camelot's application to launch its commercial services business;
- in addition, such a remedy could still allow Camelot to earn a higher level of profits from commercial services as a result of its cost and non-cost advantages from the National Lottery, which may be a concern if the relevant legal test requires that Camelot does not gain an advantage that it has not "paid for".

In theory, the last of these problems could be addressed by a remedy that, rather than merely requiring Camelot to set prices above a certain cost level, imposed an additional charge on it and therefore brought its actual costs in line with the benchmark.²² The charge would need to be based on an estimate of the value of Camelot's cost and non-cost advantages from the National Lottery, and would mean that Camelot would have "paid for" these advantages as well as ensuring that it could not compete more aggressively as a result of them. However, this remedy would still face the significant practical difficulties noted above.

1.3. NERA's analysis and conclusion

The scale of Camelot's cost advantage, and indeed the precise nature of that advantage, is still not clear. While Camelot and KPMG have drawn attention to the expenditure that Camelot will incur in rolling out its Ingenico terminals, barcode scanners and key readers, arguing that this is of similar scale to the costs existing providers will have incurred, other respondents have focused

²² For example, if Camelot's stand-alone costs of entry would be 100, but the actual costs (with the economies of scope provided by the National Lottery) are expected to be 80, then the remedy might be that Camelot had to pay an additional entry fee of 20. In this example, Camelot would then be faced with the decision of whether there was a profitable entry opportunity if the cost of entry was 100 (i.e. without the advantage deriving from the National Lottery) and, in the event that Camelot decided that it was worth entering notwithstanding the need to pay the 20 entry fee, Camelot would not in practice earn more than would be expected from a new entrant that did not have the advantage from the National Lottery.

on the additional functionality that Camelot's commercial services offering will provide, which they argue will be attractive to retailers and would be costly for them to replicate. We also note that, while KPMG draws a comparison between Payzone's estimate of start-up costs, equivalent to £750 per store, and Camelot's estimate of its own costs of £687 per store (or £629 if barcode scanner costs are shared with the National Lottery),²³ these estimates have not been validated. Moreover, it is not clear whether these are like-for-like comparisons, and in any case they do not reflect possible savings in ongoing costs, for example because Camelot can share network costs with its National Lottery business.

There is some lack of clarity, moreover, over the precise role of the different pieces of equipment that Camelot will use to provide its commercial services. In earlier documents,²⁴ Camelot stated that its Ingenico terminals were included so that Camelot could offer EFT and Tap & Wave services. It noted that these terminals "could" be used to provide the other commercial services, but with the implication that this was optional and that these other services could equally be provided using the existing Altura terminals. This was supported by the fact that Camelot allocated the entire cost of the Ingenico terminals to EFT and Tap & Wave services. Similarly, Camelot stated that its key readers were specific to prepay utility services, and the costs of its barcode scanners were allocated entirely to international calling card and bill payment services (though Camelot noted that these readers could also be used to provide other services, including National Lottery services).

We are not aware that Camelot has changed the basis on which it allocates the costs of this equipment to individual services. While it is true, therefore, that the projected revenues from Camelot's commercial services as a whole cover these additional costs (which Camelot and KPMG argue are comparable to the costs incurred by existing providers), we note that this does not necessarily apply to each of the specific services included within Camelot's commercial services offering. For some commercial services, therefore, the terminal costs that Camelot states will be covered by projected revenues are the common costs of the Altura terminals (which are shared with Camelot's main National Lottery business), rather than the additional costs of the Ingenico terminals which have been allocated only to a certain subset of Camelot's commercial services.

We also note that the mere fact that Camelot has chosen to integrate its commercial services with its existing terminals and network suggests that there are benefits from doing so. It is not clear where the balance of these benefits lies between cost savings and improved functionality, and we still cannot establish the likely size of this advantage with any certainty. Nevertheless, one might

²³ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section 4.2.1 and Appendix F.

²⁴ See, in particular, Annex 1 of Camelot's Commercial Services Overview.

assume that, if these benefits were not material, then Camelot might have chosen instead to offer its commercial services on a standalone basis. This might have reduced the risk that its proposals would be rejected by the NLC or challenged by other parties, and might have also offered Camelot a better prospect of sustaining its commercial services business even if it ceases to be the operator of the National Lottery after January 2019.

Furthermore, we note the argument reported by KPMG that Camelot is uniquely well-placed as an entrant into commercial services (see Section 2.4.3).

Neither is Camelot's statement that common costs are only 3 per cent of total commercial services costs informative or important. This simply indicates that those common costs allocated to commercial services are small compared with other commercial services costs. But this could be simply the result of commercial services being allocated a small share of a very large cost,²⁵ and so does not convey useful information about the size of common costs in total, or the size of the advantage that Camelot's commercial services enjoy because they do not bear the full "standalone" cost.

Indeed, we note that such statements are also sensitive to the definition of costs adopted. Camelot's statement that common costs account for only 3 per cent of commercial services costs appears to be based on a definition of total commercial services costs that includes to
.²⁶ Indeed, these costs alone account for around 10 per cent of the total. If we were to exclude these payments from the definition of Camelot's costs, then even Camelot's 3% attribution of the common costs to commercial services would account for around 30% of Camelot's commercial services costs.²⁷

Overall, however, neither Camelot's statement about the proportion of commercial services costs that are common costs, nor NERA's subsequent analysis of information supplied by KPMG, provides any reliable evidence about the likely size of Camelot's cost advantage. The difference between attributing 0% and 100% of the common costs to the commercial services business could be regarded as providing a possible upper bound on the cost advantage, based on

²⁵ Information supplied to NERA by KPMG suggests that, for some common costs at least, the share allocated to commercial services is around 10%. If all of those common costs had been attributed to the commercial services business, they would account for around 30% of the commercial services business' costs. We do not suggest, however, that attributing all of the common costs to commercial services would provide a reliable indicator of Camelot's stand alone costs.

²⁶ Based on NERA inspection of information provided by KPMG.

²⁷ On the basis of excluding 10% and 30% of the common costs, if all of the common costs had been attributed to the commercial services business, they would account for around 30% of the cost base. We do not suggest, however, that attributing all of the common costs to commercial services would provide a reliable indicator of Camelot's stand alone costs.

Legally privileged and confidential

information already provided.²⁸ But it does not provide any indication of where, in practice, Camelot's cost advantage is likely to lie in the range between zero and this upper bound.

Moreover, the additional material included in consultation responses has provided further information about the possible nature of Camelot's non-cost advantages. There are various features of the interface with Altura terminals that might find favour with retailers, including the touch screen interface, the co-location with the National Lottery terminal, and facility for end of day reconciliation. Some of these may be available from certain other providers at present. In addition, however, it appears that Camelot's commercial services will offer faster transaction processing times than existing services, which could also be attractive to retailers.²⁹ Some consultation respondents have also argued that Camelot's commercial services business would benefit from association with the National Lottery brand.³⁰

Despite qualitative statements that these advantages are important, it is very difficult to say with any certainty whether they are likely to have a substantial impact on retailers' behaviour in practice. To the extent that retailers do find the advantages persuasive, moreover, it is not clear whether they would take Camelot commercial services in addition to those of an existing provider, or whether Camelot's services would displace those currently offered by the retailer. This will depend on factors such as the commercial terms offered by each party, and also the extent to which other providers have contracts that Camelot does not have (eg London congestion charge payments) that may also generate sizeable revenues or additional footfall for the retailer.

PayPoint's consultation response also draws attention to the risk of *de facto* tying. It is difficult to assess the seriousness of this risk. However, it is certainly plausible that retailers will be very concerned if they perceive a risk of losing their National Lottery terminal. An implicit signal from Camelot that this risk will be lower for retailers taking Camelot commercial services might be difficult for the NLC (or any formal competition regulator) to detect. And some retailers might reach this conclusion on their own, without any suggestion from Camelot staff at all.

Overall, therefore, our conclusion remains as before. There are still realistic possibilities that Camelot's advantage over existing commercial services providers could either be:

- very large, for example because it realises significant cost savings from the use of existing terminals and network, plus other shared services, because the Altura terminal interface and

²⁸ NERA has not itself verified the cost assumptions in the KPMG data.

²⁹ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Tables 5.2 and K1.1, and footnote 79.

³⁰ See, for example, Response of PayPoint plc to NLC provisional decision of 16 July 2010, paragraphs 18-21

faster transaction processing times mean that retailers have a strong preference for Camelot commercial services, and because some retailers believe that they will reduce the risk of losing their National Lottery terminal if they also take Camelot commercial services; or

- quite small, for example because Camelot will still incur substantial start-up costs (including the roll-out of its Ingenico terminals, key readers and barcode scanners) and possibly face additional costs that its competitors do not, and also because retailers choose to keep other providers' terminals as these offer services that Camelot's terminals do not.

1.4. Possible further analysis

As noted in our memorandum of 2 July, we have not examined in detail the likely size of Camelot's cost advantage.

In principle, one way to obtain additional useful information would be to ask Camelot to provide an additional set of cost estimates based on the assumption that commercial services are to be provided independently of its National Lottery activities. As well as any cost savings from using the Altura terminals, this could also shed light on other potential cost savings to Camelot, including the shared use of Camelot's existing network, the shared use of printers, the shared distribution network for consumables, shared maintenance services,³¹ and shared corporate overheads.

Comparing this "standalone" cost with Camelot's previous cost estimates for an integrated business could provide one indication of the likely scale of Camelot's cost advantage compared to other providers of commercial services. However, we note also that:

- this might be a difficult and time consuming exercise for Camelot, as it implies a fundamental change to its existing business plan;
- the NLC might feel that it should carry out some form of verification of Camelot's calculations
 - this could involve a detailed review by an independent expert, who would have to be located and engaged specifically for this task. The expert would need to be familiar with

³¹ In addition, there may be economies from shared field maintenance staff. Camelot states that it has not taken account of these potential synergies when estimating the long run average incremental cost of its commercial services. Nevertheless, this is a further cost advantage which could lead to lower costs being allocated in practice to Camelot's commercial services, as compared with a fully standalone operation. Camelot has identified the additional (or "incremental") staff required in functions such as sales, finance, IT, regulatory, content support, call centre and PR. But it is not clear from the description in Camelot's *Commercial Services Overview* document whether these staff are integrated with National Lottery staff (in which case there might be some economies of scope) or dedicated to commercial services.

Legally privileged and confidential

the different types of technology that could be used to provide commercial services, and be sufficiently knowledgeable that they could validate both Camelot's cost estimates and whether or not the proposed equipment would deliver the service quality/functionality as stated by Camelot. Because Camelot's standalone cost estimates will be compared with those of its existing business plan (where it is able to use National Lottery infrastructure), it would be sensible for the independent expert to review these cost estimates as well,

- a possible alternative approach would be to allow other consultation respondents to comment on these calculations. Any such review would be unlikely to be useful unless market participants (or their advisers) were given access to Camelot's cost projections. We would expect that information about Camelot's projected costs under its entry plans would be considered commercially sensitive, and this may also apply - though possibly to a lesser extent – to the additional (and hypothetical) costs included in Camelot's standalone cost estimate. Given market participants' strong commercial interest in blocking Camelot's proposal, moreover, it is likely that input from an independent expert would still be required to assess the conflicting arguments put forward by Camelot and by existing suppliers.

It is difficult to predict how long it would take Camelot to generate a revised "standalone" cost estimate, or for the NLC to locate and engage an appropriate independent expert, and for that expert to carry out the required analysis. In very broad terms, we would expect that this additional analysis and verification might take at least one month, and even this would only be possible if Camelot could respond quickly and if an expert could be identified who was already familiar with the different types of technology used to provide commercial services (either because the expert is already familiar with commercial services, or because the technology used is the same as that used more widely, for example for other forms of remote electronic payment). It is difficult to say how much longer the analysis could take if either Camelot cannot provide its standalone cost estimates quickly or if the independent expert needs to undertake significant new primary research, but a period of three months or longer cannot be ruled out.

Significant additional time, perhaps another 1-2 months, would be required if existing suppliers were involved in the review process as well. This does not allow for any up-front time required, for example to agree and implement any necessary confidentiality arrangements (though it might be possible that this could be progressed while Camelot and/or the independent expert are still carrying out their analysis). Additional time, beyond this, might also be required to analyse the responses and consider their implications.

Provided a suitable independent expert can be recruited, then we believe this analysis would provide a reasonable prospect of providing a reasonable estimate of the likely size of Camelot's cost advantage. But this cannot be guaranteed and this additional analysis would not provide information about the likely importance of any non-cost advantages.

Despite these difficulties, we believe that requesting such "standalone" cost projections from Camelot is probably the most promising approach to establish a clearer view of the broad scale of Camelot's cost advantage. Possible alternatives (or additional sources of evidence) might include:

- requesting detailed financial information from existing suppliers about the costs they incurred when setting up their networks, and the ongoing costs associated with maintaining terminals and operating communications networks. This information could then be compared with Camelot's own cost projections. However, there is no guarantee that the suppliers would be willing to provide the information as requested, and in any case comparisons might be affected by other factors – these include any cost advantages or disadvantages that are not related to Camelot's role as National Lottery operator, or the likelihood that some costs may have changed significantly since the time when the existing suppliers installed their networks;
- appointing an expert to derive an independent estimate of the likely cost of establishing a standalone network to deliver the services proposed by Camelot. Clearly, this is dependent on being able to appoint a suitably knowledgeable expert, and also on the quality and reliability of that expert's work. This exercise could also take a long time, as the independent expert would need to become fully familiar with all aspects of Camelot's proposed service, and consider how best such a service could be delivered without access to Camelot's existing network.

Especially if a more reliable estimate of the size of Camelot's cost advantage could be obtained, then the different potential indicators of the size of this advantage could be compared both with Camelot/KPMG's projections of the costs and revenues of Camelot's commercial services, and also with publicly available data (for example, from company annual reports that are either published or obtainable from Companies House). This would provide a stronger basis for us to assess the likely scale of Camelot's advantage, both in absolute terms and also relative to the other costs and revenues that both Camelot and other commercial services providers will incur. However, unless the analysis reveals that the cost advantage is either very small (with a low likelihood of material competitive impact)³² or very large (eg it makes the difference between Camelot entering and not entering the market), there may remain considerable uncertainty as to how the cost advantage is likely to affect Camelot's behaviour and the market for commercial services. Section 2.8 considers the analysis that could be carried out to undertake a better founded analysis of the likely competitive impact of Camelot's market entry.

³² At face value, this outcome would appear difficult to reconcile with UBS' view, as reported by KPMG (see Section 2.4.3 below), that Camelot is in an "almost unique position".

A further important caveat, moreover, is that such an exercise would not shed light on the importance of the potential non-cost advantages highlighted by market participants. These would be very difficult to evaluate, as we are not aware of any recent comparable situation that could shed light on retailers' likely decisions, in practice, when confronted with the specific advantages (and disadvantages) that Camelot's commercial services would offer. Some additional information could be obtained by consulting directly with retailers, or with experts that can offer insights into retailer behaviour. But even in this case, the results would be based on hypothetical questioning, which may not be a good indication of how retailers would react in practice when faced with specific commercial propositions (covering both the commissions on offer to the retailer and also the specific range of services offered through each terminal, some of which may be exclusive).

It is important to stress, moreover, that such analysis would simply provide somewhat more reliable information about the nature and scale of Camelot's cost and non-cost advantages. There would still remain the legal question of whether this represents an unfair advantage that distorts competition, or an economy of scope that can deliver benefits to consumers (as well as increased returns to good causes). The implications for competition are discussed in the following section.

2. Evidence on the Impact of Camelot's Entry into Commercial Services

2.1. NERA's 2 July 2010 opinion on competitive effects

NERA's 2 July memo did not present a detailed appraisal of the likely competitive effects of Camelot's entry into commercial services. NERA's high level observations on the matter, which were based on *a priori* reasoning rather than empirical analysis, were that:³³

- there were potentially differing perspectives on what is meant by "competition";
- in the short run Camelot's entry would be likely to intensify competition (all else equal), in the sense of putting downward pressure on prices;
- in the long run Camelot's entry might increase or reduce competition, or have no net effect;
- accordingly, on the basis of *a priori* reasoning it was not possible to conclude whether Camelot's entry would or would not result in an appreciable distortion of competition;

³³ NERA 2 July Memo, Section 8.

- substantial further work would be necessary in order to reach a more conclusive view on the impact of Camelot's entry, with no guarantee that the answer would prove to be conclusive.

As discussed in the following sections, the material submitted by Camelot and KPMG does not lead us to revise the above views.³⁴

2.2. Camelot/KPMG arguments on competitive effects

Camelot and/or KPMG advance the following key arguments:

- the market for commercial services is currently not competitive. Camelot relies on KPMG's analysis, which argues that:
 - there is a relevant market for wholesale provision of commercial services, subdivided into mobile top-ups, bill payments, ICC and EFT,
 - the market is "less than fully competitive", as evidenced by market concentration and the examination of margins and profitability, and
 - barriers to entry are high;
- Camelot's entry into the market for commercial services will appreciably increase competition:
 - Camelot is uniquely well placed as a potential entrant,
 - KPMG appears to suggest that Camelot's presence in the market place will drive prices to perfectly competitive levels,³⁵ and
 - the result will be a total gain in consumer welfare of up to £1.27bn and a total gain in social welfare of up to £92m.³⁶

³⁴ We do note KPMG's argument that Camelot's entry is not expected to be on a sufficiently large scale to drive existing competitors from the market; we agree that if the expectations are borne out it would appear unlikely that Camelot will "swamp" the market, but we are not well placed at this stage to assess whether KPMG's expectations are reliable, and we note that even if some or all of the competitors remain in the market, Camelot's entry may still increase the intensity of competition for a long period (relative to a counterfactual where Camelot would not enter). See Sections 2.6 and 2.7.

³⁵ It is not entirely clear whether KPMG regards Camelot's entry as prompting the perfectly competitive outcome. On page 29 of its report (KPMG An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal), KPMG states that "[e]ntry by Camelot would generate gains for society since entry would – via more intense competition – increase the number of transactions and push down prices as illustrated in Figure 5.1"; Figure 5.1 illustrates a move to a perfectly competitive outcome. Later, KPMG's analysis of the welfare impact of Camelot's entry is conducted by reference to Figure 1.3 which is said to "illustrate diagrammatically the potential benefits from Camelot's entry, assuming that Camelot's entry instantaneously makes the market perfectly competitive". However, KPMG's welfare calculations simply assume that Camelot's entry will result in a price reduction of 7.5%, and do not give the basis for this assumption.

- it is not possible to forecast the long run competitive impact of Camelot's entry (which may be positive or negative), so little weight should be placed on this for the purposes of the current policy debate.³⁷ In addition KPMG offer some observations to the effect that Camelot's entry would not be likely to result in exit by rivals.³⁸

Our observations on this material are structured as follows:

- first, we consider the implications for the broader debate in this case if KPMG's conclusions are assumed (hypothetically) to be well founded;
- second, we examine KPMG's analysis of current intensity of competition in commercial services;
- third, we examine KPMG's analysis of the impact of Camelot's entry into commercial services; and
- fourth, we outline the nature of the appraisal that would need to be undertaken in order to arrive at a better founded conclusion as to the likely impact of Camelot's entry into commercial services.

2.3. What is the test for a "distortion of competition"?

It is not for NERA to opine³⁹ on the legal issues in this case or on the policy merits of the relevant legal precedents, but our understanding is that the essential concern arising from one firm being given any "unmatchable advantage" is that the beneficiary would, by virtue of that advantage, be able to compete more aggressively with its rivals, and this would be viewed as a distortion of competition rather than a potential benefit to consumers.

³⁶ KPMG describes these estimates as "*illustrative analysis*" and states that the welfare benefits might be "*as much as*" the figures cited (KPMG An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 28).

³⁷ Camelot response to the NLC Provisional Decision, page 36.

³⁸ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section 5.1.1.

³⁹ In our 2 July memo we explained that there were differing perspectives on what was meant by "competition", stating that: "*At the outset, we also note that one could assume different meanings for "competition". From an economic perspective, a restriction of competition is often measured on the basis of whether consumers are worse off. A slightly different interpretation of "competition" may place greater emphasis on market structure. To crystallise the difference: under the latter interpretation, entry of a very efficient supplier that led to the exit of the pre-existing suppliers but at the same time resulted in a permanent reduction in prices, without quality degradations etc, would amount to a "distortion" of competition, whereas under the former view it would be considered an example of effective competition at work and therefore pro-competitive. Yet another meaning of "competition" might be given by the concept of "equality of opportunity".*" NERA 2 July Memo, page 11. NERA also noted that there are likely to be many instances where firms have different competitive advantages by virtue of their ability to diversify into different activities, see NERA 2 July Memo, page 5.

Viewed from that perspective (and assuming that Camelot's ability to enter results from an "unmatchable advantage" that is derived from its role as the National Lottery operator) KPMG's argument that Camelot's entry will have a major impact on the commercial services market is suggestive that the impact of that unmatchable advantage on rivals will be appreciable.⁴⁰

Accordingly, we observe that the implications of KPMG's analysis and conclusions regarding the competitive effects of Camelot's entry (even if they are assumed to be well founded) appear to be conditional upon the appropriate legal test for a distortion of competition. If the essential test is "will the unmatchable advantage give Camelot an ability to compete more aggressively with its rivals" then KPMG's analysis (if well founded) would indicate that the test is met. If, in the alternative, the test is "will the net effect of Camelot's entry be to reduce consumer or social welfare" then KPMG's analysis (if well founded) would indicate that the test is not met.

2.3.1. The nature of the impact of a cost advantage on competition

In principle, an "unmatchable advantage" might influence a firm's ability and incentives to compete in a variety of ways. For example, a subsidy that reduces a firm's marginal costs might lead it to price more aggressively than it otherwise would; a subsidy to build a new manufacturing facility might result in greater capacity in a market and downward pressure on prices; or a subsidy to keep a firm solvent may result in one more competitor remaining in the market place than would otherwise have happened.

In the case of Camelot, our analysis in this section takes as its working assumption⁴¹ that one of the primary effects of any "unmatchable advantage" is that it would result in Camelot entering the market for commercial services in circumstances where Camelot would not otherwise have entered the market. If, following a fuller review, this assumption proves to be incorrect, and

⁴⁰ This perspective may have some parallels with policy on state aid. One of the concerns in state aid cases is that a subset of firms obtains a source of competitive advantage that is denied to their rivals. The short term effect of this will usually be to increase competition in the sense of putting downward pressure on prices (either because the state aided firm is able to compete more aggressively or because the state aid allows the firm to continue trading when otherwise it would have exited the market or reduced the scale of its operations). However, state aid is viewed as having downsides in other respects, such as misallocation of resources (more production is undertaken by less efficient firms or firms located in less efficient areas) or blunting dynamic incentives (firms may be reluctant to invest in new facilities or new products to obtain competitive advantages if they fear that rivals may obtain state support to help them catch up or overtake). However, we do not suggest that this type of state aid concern should be assumed to apply to Camelot's entry into commercial services. Indeed, to the extent that Camelot's unmatchable advantage derives from economies of scale and scope and synergies with the National Lottery business, from an economic perspective Camelot's entry would often be viewed as merely the realisation of potential efficiency advantages. Whether realising these efficiencies is to be regarded as exploiting an inequality of opportunity is a legal issue on which we do not comment.

⁴¹ We stress that this is merely the working assumption for the competitive analysis; as described in Section 1 and previously, NERA has not undertaken a full appraisal of the scale of any cost advantage or of whether it is sufficient to make the difference between entering or not entering the market.

Camelot would be likely to enter the commercial services market even if any unmatched advantages were withdrawn, then a different analysis of the nature of the effects of the unmatched advantage would be required.^{42,43}

2.4. KPMG's analysis of the current intensity of competition in commercial services

KPMG concludes that:⁴⁴

"the wholesale commercial services markets are largely dominated by three major players (PayPoint, Payzone and epay) which have market power and are protected from competition by significant barriers to entry. The wholesale commercial services markets, which Camelot proposes to enter, are therefore currently not fully competitive".

We note at the outset that KPMG appears to view "perfect competition" as the benchmark for whether or not a market is "fully competitive".⁴⁵ If that is KPMG's benchmark then NERA has little difficulty in agreeing that KPMG's conclusion is probably correct: very few markets are "perfectly competitive" in the textbook sense of economic theory. However, such a benchmark is rarely utilized in competition policy, in part because the conditions for perfect competition are hardly ever observed in practice.

KPMG's conclusion rests on three strands of analysis:

- market definition;
- intensity of competition in the market; and
- barriers to entry.

⁴² For example, if Camelot would enter commercial services even if the unmatched advantage was withdrawn, an unmatched advantage might in theory still have some impact on the scale and nature of Camelot's entry, on Camelot's pricing or marketing strategies, or other aspects of competition. However, the scale of effects of these types will clearly be smaller than the effect that KPMG and we have focussed on, namely the effect on competition if Camelot does or does not enter at all.

⁴³ This observation would also apply to KPMG's analysis, since KPMG focus on appraising the competitive effects of Camelot's entry into commercial services.

⁴⁴ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 11.

⁴⁵ In KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, KPMG relies on the evidence at Appendix E.3, which includes empirical benchmarks for a perfectly competitive outcome, to conclude that the markets are not "fully competitive". And on page 87, KPMG states that "[u]nder perfect competition, a firm's marginal cost (MC) and marginal revenue (MR) will equal its average cost (AC) and average revenue (AR) or price (P). If $MR=MC=AR=AC=P$ does not hold then this could be interpreted as evidence that the market is not perfectly competitive and that some or all of the firms in the market has market power."

We discuss each in turn. We note at the outset that an appraisal of the nature and intensity of competition in a market, and of the impact of the entry of an additional competitor, is a complex exercise that demands a more in-depth examination than KPMG has provided. If the legal analysis requires a quantification of these matters, the NLC would need to conduct a broader and more in-depth appraisal than that provided by KPMG – see Section 2.8 for the sorts of work necessary.

2.4.1. Market definition

2.4.1.1. Wholesale level

In relation to the “wholesale markets” - the provision of services to enable the electronic delivery of commercial services by retailers⁴⁶ - KPMG concludes that the relevant markets are the:⁴⁷

“wholesale markets for the provision of services as intermediary and cash handling agent for operators to enable the delivery, via electronic terminal at independent retailers, of:

- *mobile phone ETU;*
- *bill payment;*
- *ICCs; and*
- *EFT”*

We do not dispute that there may be a distinct market for delivery of commercial services in this way, and that it may be appropriate to delineate it further by different service categories. However, we note that KPMG’s analysis appears to be based primarily on qualitative observations concerning product characteristics and supplier considerations, which are often viewed as insufficient evidence to conclude that a particular market definition is the most appropriate and would, in any event, require market testing before it could be relied upon.

2.4.1.2. Retail level

KPMG concludes that retailers that provide each of the commercial service categories to customers are highly competitive with other means of providing these services.⁴⁸ This conclusion

⁴⁶ Although we do not wish to understate the complexities that may arise from the multi-sided nature of commercial services provision, we agree that analysis of competition between the core platforms that do or could deliver these services is a natural point to focus on in any preliminary analysis.

⁴⁷ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal pp75-76.

⁴⁸ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 11. Good substitutes for one or more of the commercial services provided by electronic platforms are said to include the Post

is used to support KPMG's view that the reductions in the costs of electronic service provision (that Camelot's entry is said to result in) would be passed on to consumers.

KPMG's analysis of the degree to which consumers are likely to view bank tills, post office etc as a good substitute for electronic payments is based largely on qualitative observations by KPMG to the effect that some categories of consumers have alternatives available to them together with some observations as to how likely it is that the consumers view these alternatives as good substitutes. We cannot comment on these observations without a more detailed market analysis.

KPMG goes on to assert that limiting the retail market to electronic payments using in-store terminals would fail a SSNIP test. For example KPMG states:⁴⁹

“if a hypothetical monopolist increased the price to end users of making a payment or topping up their mobile phones via multi-functional terminals at retail outlets by a SSNIP, it is likely that a share of customers would use alternative methods of payment (e.g. paying bills or topping up mobile phone credit at a Post Office), making such a price increase unprofitable” (emphasis added).

We cannot see how the evidence advanced by KPMG can be viewed as sufficient to support (or reject) this conclusion. While KPMG puts forward some observations to the effect that some consumers have alternatives available to them, those observations are not sufficient to conclude that sufficiently many would switch to make a SSNIP unprofitable.⁵⁰ Accordingly, we are not persuaded that KPMG's conclusions on this point are well founded.

2.4.2. Competition in the wholesale commercial services markets

KMPG's view that the commercial services markets are “less than fully competitive” is based on three strands of evidence:

- an argument that incumbents' “costs, revenues and margins” are above competitive levels and consistent with the providers having market power;

Office, multi-lane supermarkets and other retail outlets without terminals where one can buy vouchers for international calling cards, and bank tills. Supporting analysis is provided at KPMG Appendix D.3.1.

⁴⁹ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal page 77.

⁵⁰ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal (page 77) motivates its analysis with the statement “*if a hypothetical monopolist increased the price to end users of making a payment [...]*” (emphasis added). However, we understand that in most cases retail customers are not charged directly for the use of electronic payment services. This suggests that the ways in which an increase in commissions charged on electronic payments are passed on to consumers are likely to be complex and indirect.

- an argument that incumbents' profitability is consistent with super-normal profits and that their margins are high, which corroborates the other evidence; and
- the market is concentrated.

2.4.2.1. Analysis of existing operators' costs, revenues and margins

KPMG (Appendix E.2) provides an analysis of PayPoint's revenue, costs and margins, and uses this to estimate PayPoint's average net revenue and cost per transaction, and its average margin per transaction, for each of the commercial services.⁵¹ KPMG then offers the following interpretation of its estimates:

- the average cost per transaction is a good proxy for the marginal cost per transaction;⁵²
- under "perfect competition" price will equal marginal cost;⁵³
- KPMG estimates that PayPoint's average revenue is greater than marginal cost for all four commercial services, which is consistent with PayPoint being a "profit maximising oligopolist" and "suggests that PayPoint enjoys some market power", which reinforces KPMG's conclusion that the market "is not perfectly competitive due to the barriers to entry".⁵⁴

We do not disagree with KPMG that PayPoint (and other providers) are likely to set prices in excess of marginal costs. Given that commercial services provision exhibits fixed costs it would be surprising to find otherwise.⁵⁵

Pricing above average total cost is also not proof of market power. Indeed KPMG itself notes that:

⁵¹ Bill payments and general, Mobile ETUs, Retail services, Internet. KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 86.

⁵² KPMG recognise that there may be some difference between average costs and marginal costs per transaction, but state that they regard their approach as a reasonable first approximation – KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, footnote 123.

⁵³ See footnote 45.

⁵⁴ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 87.

⁵⁵ However, demonstrating that the commercial services do not conform to a textbook model of perfect competition does not show that provision of commercial services is currently subject to "market power" in the sense that this term would usually be understood by competition economists.

Legally privileged and confidential

“accounting revenues should exceed accounting costs – and positive margins made – even in perfectly competitive markets because accounting costs do not incorporate any measure of economic profit.”⁵⁶

We have no disagreement with this statement. However, its implication is that KPMG’s finding that PayPoint is earning a positive accounting margin does not justify KPMG’s conclusions that PayPoint enjoys market power or that the provision of commercial services is not perfectly competitive. To the extent that analysis of margins or profits can cast light on whether there is currently market power in commercial services, it would be necessary at a minimum to appraise them against appropriate benchmarks for what constitutes “excessive” profits.⁵⁷

Accordingly, we do not believe that KPMG’s analysis of PayPoint costs, revenues and margins demonstrates that the provision of commercial services displays market power or is “less than fully competitive”, even if “perfect competition” was taken as a relevant benchmark in this case.

2.4.2.2. Analysis of PayPoint’s profits

KPMG estimates PayPoint’s return on capital employed (ROCE) to be around 60% or more,⁵⁸ and states that all of the estimates are much higher than any plausible estimate of the weighted average cost of capital (WACC). KPMG reports broker estimates of WACC of around 11%.⁵⁹

NERA has not undertaken its own appraisal of PayPoint’s ROCE or its WACC, or of other possible sources of evidence that might cast light on whether profitability in this sector is consistent with market power or barriers to entry. However, we do not regard the analysis and evidence presented by KPMG as adequate to draw confident conclusions that PayPoint’s profits indicate market power, for at least the following reasons.

⁵⁶ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 87. KPMG goes on to assert that PayPoint’s margins for all four services appear to be “very high”, but KPMG does not provide any benchmark for appraising whether a particular margin is “very high” or not (save for the analysis of PayPoint’s Return on Capital Employed – see Section 2.4.2.2). Accordingly, in itself this does not provide a sufficient guide for appraising the intensity of competition in commercial services provision.

⁵⁷ For example, in *Classified Directory Advertising Services (2006)* (e.g. Section 7) the Competition Commission’s analysis of the profitability of Yell and Thomson examined accounting ratios such as return on sales, but its analysis compared these ratios to those of “benchmark” companies, whereas KPMG’s appraisal merely asserts that the margins for PayPoint are “high” without comparing them to any appropriate benchmark.

⁵⁸ KPMG also presents broker reports that estimate PayPoint’s ROCE to be 43.3%-66.2%, and refers to ROCE estimates presented in PayPoint’s annual reports of 88%-115% - KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Tables E.6 and E.7. NERA has not reviewed these documents.

⁵⁹ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Section E.3.1.

- KPMG does not provide the underlying data or the calculations of ROCE on which its analysis is based. Indeed it does not even give full details of the period which its ROCE estimate covers.⁶⁰
- While an ROCE approach is one method that competition authorities may use to examine profitability it can have serious problems, in particular in respect of the valuation of assets (see below). Other methods may also be applied and may be preferred in some cases. For example, estimating the IRR of cashflows⁶¹ over an extended period or the life of the industry (where the aim is to take up front costs of establishing the business into account) might be considered. Another approach that might be considered with businesses with “small” asset bases recorded in their balance sheet is to look at other measures of profitability and benchmark them against comparator companies, or to look at stock market based measures of profitability. KPMG might have looked at whether other approaches yield results that are consistent with the ROCE analysis.
- Attempting to use ROCE based approaches to examine whether there are super-normal profits can be particularly problematic in industries where valuation of the assets is problematic. Balance sheet estimates of capital employed can in some circumstances give a very misleading indication of the “real” economic assets of the company. KPMG itself notes that *“balance sheet accounting data understates the value of some assets or does not include all assets e.g. internally developed intangibles like brand.”*^{62, 63}
- KPMG’s attempt to deal with this potential issue is to estimate PayPoint’s “economic profit”, which is defined as ROCE x Capital Employed minus WACC x Capital Employed and is held to be *“unaffected by any misstatement of capital employed”*.⁶⁴ But since KPMG estimate ROCE = EBIT/Capital Employed⁶⁵, the equation reduces to: economic profit = EBIT – WACC x Capital Employed, so this approach continues to raise the question of what the appropriate asset valuation should be.

⁶⁰ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 89, merely states that *“We have calculated ROCE for PayPoint and Payzone over most of the past decade based on publicly available data. The results indicate PayPoint’s ROCE has been in the order of 60 per cent or more for the past several years – somewhat above any plausible estimate of the WACC. Alphyra’s ROCE has been considerably lower, but still above 20 per cent for most of the period leading up to its financial difficulty.”*

⁶¹ For example, in *Classified Directory Advertising Services* (2006), the Competition Commission utilised the “truncated IRR” method for examining the return on assets for Yell and Thomson, in addition to the ROCE approach (which KPMG has utilised in this case).

⁶² KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 90.

⁶³ Similar issues can arise when looking at Tobin’s Q (KPMG E.3.2).

⁶⁴ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 90.

⁶⁵ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, page 88.

Legally privileged and confidential

- In the context of its discussion of Tobin's Q, KPMG returns to the question of whether book asset values might reflect "accounting biases" and argues that for PayPoint book asset values are likely to be a good proxy for replacement costs. The reasons given are that PayPoint is not a capital intensive business and has to replace its assets relatively frequently.⁶⁶ This is a matter that would need to be looked into in more depth before any conclusion could be drawn that KPMG's estimates of ROCE measures of PayPoint's profitability are well-founded. We also note that if KPMG is correct to conclude that PayPoint is "not a capital intensive business", that is one indicator that ROCE based measures of profitability need to be appraised with great care, and that other indicators might also be considered.
- KPMG compares the ROCE to estimates of the WACC, which is a standard approach. However, it does not provide the results of benchmarking the ROCE in other ways, such as comparing the ROCE (or other measures of profitability) to potentially similar companies.
- Other issues can arise where part of the investment in developing a business lies in accepting losses in early years which are not capitalized on the balance sheet.⁶⁷
- KPMG's analysis focuses on PayPoint and not on the other suppliers (see below for a discussion of Alphyra). This is a drawback because it leaves open the possibility that other suppliers are substantially less profitable than PayPoint and that market profitability may be lower than KPMG's assessment.⁶⁸
- KPMG claims that Alphyra (Payzone's UK subsidiary) earned a ROCE above 20% "for most of the period up to its financial difficulty".⁶⁹ Precisely what these financial difficulties were is not explained.
- Competition policy appraisal of the relationship between "super normal profits" and "market power" raises a number of wider issues that we would expect KPMG to have considered and

⁶⁶ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, footnote 132. KPMG states in relation to the "accounting biases" "(i) Book asset values may be recorded at historic cost; (ii) Book asset values may be understated as they often do not include important intangible assets; (iii) Book debt values may be understated as off-balance sheet finance may not be included. All of these factors would generally lead to book values lower than the 'true' replacement cost, though historic cost book values can sometimes overstate 'true' replacement cost due to technological progress inter alia. We do not consider it likely that [these] issues affect PayPoint's data as it is not a capital intensive business, has to replace its assets relatively frequently and has little or no market traded debt."

⁶⁷ Issues such as this have arisen, for example, in the context of the assessment of BSKyB's profitability – see *Director General's Review of the BSKyB's Position in the Wholesale Pay-TV Market*, 1996, Section 7.

⁶⁸ Of course, it is theoretically possible that PayPoint has market power, but that the other suppliers do not. In such a situation, it might be the case that Camelot's entry would displace one of the low-profit competitors, with limited effect on PayPoint (or have the effect of both displacing a low profit competitor and providing more effective competition to PayPoint). Quite how that should be interpreted under the legal tests that govern the NLC's decision is outside the scope of our expertise.

⁶⁹ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 89

to have provided reasons for why they could be disregarded in this case. A non-exhaustive list includes the *ex ante* risk and *ex post* returns⁷⁰ as well as survivorship bias⁷¹.

Accordingly, we do not regard KPMG's profits analysis as providing reliable evidence that there is currently market power in commercial services. Conversely, we cannot conclude that the provision of commercial services is fully competitive. In order to reach a more considered view we believe that a more detailed analysis would be required. A full analysis would need to grapple in much more depth with the matters raised above; with the issues of how best to measure profits and the appropriate valuation of PayPoint's asset base being important elements.

2.4.2.3. Concentration analysis and current competition

KPMG argues that the wholesale commercial services markets for "mobile top up" and "bill payment and mobile top up" are highly concentrated, with Hirschman-Herfindahl indices (HHI)⁷² estimated at over 2,900.⁷³ However, even if these share estimates are reliable⁷⁴ it is well established that market shares are only one indicator of the existence of market power and that it is not a conclusive indicator on its own.⁷⁵ Accordingly we cannot infer the existence of market power from concentration analysis alone.

KPMG's analysis of the welfare impact of Camelot's entry into commercial services advances some further arguments that there is only limited price/service competition in the market.⁷⁶ KPMG alleges that the provision of commercial services is best thought of as a Cournot

⁷⁰ For example, it may be the case that prior to commercial services evolving, there were significant risks as to scale of the potential business and the likelihood that future profits would cover the investments in entry. Looking at the profits earned by the business *once it has been established for several years* and comparing this to the WACC (also evaluated against the businesses risk in circumstances where it is already established) may fail to take important factors such as initial risks into account.

⁷¹ Survivorship bias refers to situations where there is competition to become established in the market, but only a subset of firms are successful, with others exiting the market or surviving only as fringe competitors. In these situations arguably the profits of the failures should be taken into account in the profits appraisal. See for example the Competition Commission's 2000 supermarkets inquiry, paragraph 8.85. http://www.competition-commission.org.uk/rep_pub/reports/2000/446super.htm#full.

⁷² The HHI is the sum of the squared market shares of each market participant.

⁷³ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section E.4.

⁷⁴ The basis for the market shares relied upon are said to be broker reports. A competition regulator would often look to market test share estimates, or to build up its own estimates based on submissions from the parties. However, if there are only three major suppliers, then an HHI of around this level is to be expected.

⁷⁵ For example in some oligopoly models (e.g. undifferentiated Bertrand), even those with barriers to entry, a duopoly can give rise to intense competition.

⁷⁶ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section I.2.

oligopoly, and notes that prices will be higher and output lower in a Cournot oligopoly than under perfect competition. However, KPMG's justification for concluding that competition in commercial services will conform to a standard Cournot model is not persuasive.⁷⁷

The only point of evidence for limited price/service competition that is advanced is a statement that:⁷⁸

"we understand that there is little variation between operators' commission levels and services. Given the presence of high service margins, this suggests limited price/service competition."

This is not persuasive for at least the following reasons: (i) the evidence advanced to support the proposition – that this is merely KPMG's understanding – is very weak and (ii) limited variation in commission levels/services can be consistent with a highly competitive market.

2.4.3. Barriers to entry

KPMG argues that there are significant barriers to entry into commercial services at present.⁷⁹ KPMG argues, relying on the opinion of UBS, that Camelot is in an "almost unique position" in being able to enter this market. We are not in a position to opine how large the barriers to entry are (that would require further market testing). But we do observe that if this argument is correct,

⁷⁷ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 102. Although it is not central to the rest of KPMG's analysis (since many other oligopoly models – such as differentiated Bertrand - will typically also predict some mark up of prices over marginal costs, which appears to be KPMG's benchmark for a competitive market), we observe that KPMG's explanation for the technical matter of why wholesale commercial services markets should be viewed as essentially Cournot in nature (KPMG, pp 101-102) is not persuasive. Some of KPMG's observations are not specific to Cournot oligopoly and could also apply to (differentiated) Bertrand oligopoly, namely the observations on market structure, the existence of significant barriers to entry, and the assertion that there is a lack of variation in commissions/service levels. One of KPMG's observations, which asserts the possible existence of a "punishment" strategy appears to have in mind an argument that wholesale commercial services are subject to tacit collusion, which is (i) not Cournot specific and (ii) not elaborated in sufficient depth to permit comment. We also note that KPMG's description of how a Cournot oligopoly operates (KPMG, page 102, final paragraph) is not recognisable as a normal Cournot model. In most Cournot models quantities are set by each firm taking into account other firms' output decisions and solving for the Nash equilibrium of output decisions, whereas KPMG's description entails firm A setting output independently of firm B, and firm B then "choos[ing] to satisfy residual market demand".

⁷⁸ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, page 102.

⁷⁹ These are said to include the need for new entrants to rapidly achieve a sufficient scale of entry in order to offer an attractive product to all sides of the market (retailers and operators), the existence of economies of scale, and the existence of legal and contractual barriers to entry.

it is suggestive that Camelot does have a unique advantage in delivering these services that other potential entrants do not have.⁸⁰

2.5. KPMG's analysis of the impact of Camelot's entry into commercial services

KPMG offers an "illustrative calculation" of the magnitude of the welfare gain that would arise if Camelot's entry were to move the market to the "perfectly competitive equilibrium position". The illustrative calculation produces figures of a social welfare gain of £92m and a consumer welfare gain of £1.27bn.⁸¹

We do not regard these figures as a reliable estimate of the likely impact of Camelot's entry into wholesale commercial services, for at least the following reasons:

- the estimates assume that Camelot's entry results in a price reduction of 7.5% into perpetuity. The assumption that the gains last a very long period of time is an important driver of KPMG's estimate; if the period was restricted to eight years (the remaining period of Camelot's current licence), then KPMG's methodology would point to gains in welfare of around £6.8m (not the £92m advanced by KPMG) and consumer welfare gains of around £94.5m (not the £1.27bn estimated by KPMG);⁸²
- KPMG's calculations are based on a series of assumptions:
 - KPMG's assessment is said to assume that Camelot's entry will result in prices dropping to perfectly competitive levels.⁸³ If this genuinely is KPMG's assumption (which is unclear – see next point) then it appears to be remarkably ill-founded and inconsistent with KPMG's market analysis. KPMG states that it believes commercial services to be characterised as a Cournot oligopoly with three firms and KPMG further expects Camelot's entry to merely result in a fourth firm of comparable scale to the existing incumbents. But moving from a three-firm to a four-firm Cournot oligopoly will not produce an outcome equivalent to perfect competition,

⁸⁰ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section 3.3, sub-section "barriers to entry". KPMG states that the advantage lies in Camelot's pre-existing relationships with retailers which will help Camelot to achieve the sufficient scale of entry quickly, which is one of the advantages that Camelot's rivals have alleged will assist it unfairly (see, for example, paragraph 3.4 of Payzone's response to the first NLC consultation).

⁸¹ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal, Section I.3. KPMG also suggests that competition could result in non-price benefits and benefits "outside" the market.

⁸² See Appendix A.

⁸³ KPMG, An economic review of the NLC's provisional decision on Camelot's Commercial Services proposal page 104 explains that one of its assumptions is that "the market will move to the perfectly competitive equilibrium after Camelot's entry".

- the basis for the assumption that Camelot’s entry would result in a commission reduction of 7.5% is unclear. Camelot’s entry is said to be assumed to result in a perfectly competitive outcome, but it is not clear why this should be assumed to result in a commission reduction of 7.5%,⁸⁴
- The estimates for the market price elasticity of demand and the price elasticity of supply are simply asserted.⁸⁵
- the basis for the assumption that the annual benefits will grow at a rate of 2.5% per annum is unclear, yet the assumption is material to the welfare estimates (since the large majority of KPMG’s estimated welfare increases arise in the very long run – see above). If no allowance of an annual increase was made, KPMG’s estimates of the gain to social welfare – into perpetuity - would be around £26m (compared to the £92m estimated by KPMG) and the gain to consumer welfare around £361m (compared to the £1.27bn estimated by KPMG).⁸⁶

In summary, we agree with KPMG that entry by Camelot might well result in an increase in competition (in the sense of downward pressure on prices) in the short run, but we do not regard KPMG’s illustrative calculations as reliable.

2.6. Long run impact of Camelot's entry

Our distinction between “short run” and “long run” is conceptual, and refers to the difference between the two following situations:

- “short run” – the period after Camelot enters commercial services provision and competes with incumbent suppliers, with the incumbents’ investments and assets (including their networks) taken as a “given”. In this period the incumbents may well adjust their pricing or marketing strategies in response to entry, but not their basic networks and basic product offerings.
- “long run” – the period once incumbents are able to react to Camelot’s entry by altering their investments in the market, substantially altering their basic product offerings, or rethinking

⁸⁴ A reduction in commissions of 7.5% would not appear sufficient to eliminate the margins over marginal cost that KPMG presents on pp 86-87 and that KPMG relies upon to conclude that PayPoint has market power and that the commercial services market is not fully competitive.

⁸⁵ KPMG’s estimate for the price elasticity of -1 implies that a 1.3p increase in the cost per transaction of using electronic payment mechanisms would result in a decline in transactions of 10%. This is based on KPMG’s estimate that the current average commission is 13.1p, hence a 10% increase equates to a commission increase of 1.3p, which KPMG’s price elasticity of demand would result in a 10% reduction in volumes of transactions.

⁸⁶ See Appendix A.

their overall market positioning and scale, and even whether they should continue to participate in the market at all.

We do not have sufficient information to attribute a particular time period for the “short run” and the “long run” as defined above. It is possible that Camelot’s entry will not take a long time to impact on incumbent’s market positioning and investment strategies, and the “long run” could therefore emerge within a few years and potentially faster.⁸⁷ This might be the case, for example, if an existing supplier needed to carry out a major upgrade or refresh to its network in order to remain in the market, and therefore needed to decide whether or not to undertake this investment.

Camelot argues that there is consensus that its entry would increase competition in commercial services in the short run, and that the policy decision should be primarily placed on this observation, rather than on the speculative possibility that Camelot’s entry might result in a loss of competition in the long run.⁸⁸ If the question is what the net impact on competitive intensity arising from Camelot’s entry will be, then we have sympathy with this view. However, as noted in Section 2.3, it appears to be a matter for legal debate what the relevant test in this case actually is, and on that question we cannot offer an opinion.

KPMG also advances some arguments to the effect that Camelot’s entry will not be on a sufficiently large scale as to drive an existing service provider from the market:⁸⁹

- it is pointed out that Camelot’s current plan targets only 10,000 retailers, which compares to 55,000 retailers that already have a terminal of one of the three main incumbents.
- UBS is said to have indicated that it was optimistic to expect Camelot to achieve a market share of 20%.

We agree that these figures, if they are borne out in practice, are suggestive that Camelot’s entry would not be on a sufficient scale to “swamp” the market.

⁸⁷ Incumbents might begin to alter their investment strategies quickly in response to Camelot’s entry, though it may take some time for this to filter through into their actual service offerings. A potentially relevant matter is whether Camelot’s commercial services business is expected to survive Camelot’s current licence period (which expires in 2019). For example, if Camelot were expected not to retain the right to operate the National Lottery beyond 2019 and it were expected to wind up its commercial services business in 2019 (rather than being sold on to the new National Lottery operator), and the new National Lottery operator was assumed not to launch a new version of the commercial services businesses, incumbents’ may be less likely to retrench their businesses in the interim. We do not know at this stage what the likely outcome would be. However, we note that KPMG’s analysis of the welfare effects of Camelot’s launch of commercial services appears to assume that Camelot’s entry is into perpetuity (see Section 2.5).

⁸⁸ Camelot response to the NLC Provisional Decision, page 36.

⁸⁹ KPMG, An economic review of the NLC’s provisional decision on Camelot’s Commercial Services proposal, Section 5.1.1.

KPMG also argues that if exit did occur, Camelot would be constrained by the threat of re-entry since the other suppliers would continue to operate in other national markets and in other customer segments (e.g. multilane supermarkets). This line of argument appears to have a degree of tension with KPMG's argument that there are significant barriers to entry into commercial services.⁹⁰

2.7. Conclusion on KPMG's analysis

Our views on the likely impact of Camelot's entry into commercial services have not changed in the light of KPMG's analysis. Our original view was that Camelot's entry (all else equal) would result in an increase in short run competition (in the sense of downward pressure on prices) with the impact in the long run unclear.

In respect of long run competition, KPMG argues that Camelot's entry will not be on a sufficient scale to swamp the market, but will merely add another competitor of roughly comparable scale to the incumbents. If this was borne out in practice, it would seem unlikely that competition in the long run would be reduced by virtue of Camelot achieving future monopoly. However, we are not in a position to assess whether KPMG's expectations about the future are reliable and we note that even if some or all of the competitors remain in the market, Camelot's entry may still affect competition for a longer period (relative to a counterfactual where Camelot would not enter).

Finally, as noted in Section 2.3 it appears to be a matter for legal debate what the relevant test in this case actually is, and on that question we cannot offer an opinion.

2.8. Work necessary to undertake a better founded analysis of competitive impact

In addition to addressing our above comments on the analysis and argumentation put forward by KPMG (e.g. in relation to profitability analysis and inferences about the current degree of competition), we consider that a more detailed analysis of the competitive impact of Camelot's entry into the provision of commercial services would require investigation of issues such as:

- the implications from the multi-sidedness of commercial services provision, in relation to e.g. barriers to entry and switching costs;

⁹⁰ See Section 2.4.3. KPMG argues that the barriers to entry into wholesale commercial services relate to the need to enter the markets on a sufficient scale to make a viable offering to both retailers and operators, economies of scale, and the existence of exclusivity agreements. It may be that these barriers to entry may be lessened if Camelot is the incumbent and the existing incumbents are the potential entrants, but on the basis of inspection of KPMG's arguments alone it is difficult to reach a conclusion on this.

Legally privileged and confidential

- the links between commercial services and the National Lottery (which may require a consumer survey to obtain an understanding of demand at the retail level);
- the drivers of competition at the wholesale level, e.g. commissions, brand, space limitations, and footfall generation (which may require several “market test” iterations with stakeholders such as the current incumbents and their customers, as well as potential input from industry experts and analysts);
- the relative importance to retailers and to Camelot of commercial services and the National Lottery;
- the scope (e.g. in terms of proportion and distribution of potentially affected outlets for the various incumbents) for head-to-head competition between Camelot and the current providers of commercial services;
- the minimum viable scale of the current providers of commercial services and whether entry by Camelot would push them below that scale (e.g. in terms of geographic density or ability to serve customers that have minimum coverage requirements from their regulators);
- the extent to which the current incumbents have sunk their fixed costs and the resulting implications for the likelihood of exit or substantial scaling back; and
- future trends in commercial services (e.g. movement to online services, or additional economies of scope becoming available to the current incumbents and/or potential entrants) to assess the weight that should be given to medium and longer-term considerations.

We anticipate that the process required to undertake such an exercise would involve significant research, requests for information from the industry and market testing of the information received. One possible process would be broadly along the following lines:

- Stage 1: issue an information request to Camelot, incumbent suppliers and customers (both retailers and customers wishing to offer electronic bill payments to their consumers). In the case of retailers – who are particularly fragmented - this may need to be in the form of a market survey.
- Stage 2: analyze and market test the responses, issue follow up requests and complete the market impact assessment.

Assuming prompt replies to the information requests, the time line for such a process would likely be comparable at minimum to the time taken by the Competition Commission to review a

Legally privileged and confidential

merger that has been referred to it for detailed investigation (around six months), and a longer time period may be necessary.⁹¹

While the above will provide a better basis for assessing the competitive impact of Camelot's entry into the provision of commercial services, the findings may not be conclusive, in particular because of the unavoidable and increasing uncertainties that accompany any attempt to predict developments further into the future.

We also note that the above issues cannot bypass the legal question of what should be the relevant test for assessing Camelot's proposal to provide commercial services.

⁹¹ The competition authorities have substantially longer time to conduct a market investigation case (than a merger case), and as NERA previously noted, competition authorities often take years to assess an exclusionary abuse case (see NERA 2 July Memo, page 14).

3. Camelot and KPMG Comments on NERA’s Memorandum

Camelot / KPMG comment	NERA observation
<p>“We note the NLC’s economic advisers indicate that the cost of entry is around £3.3m, or £244 per store. The NLC’s advisers’ estimate of costs is much lower than Camelot’s estimate and suggests Camelot has a significant cost advantage.”</p> <p>However, the NLC’s economic advisers state:</p> <p><i>“we cannot be sure, however, that these figures provide a like-for-like comparison with the start-up costs estimated by Payzone ... KPMG’s projections include depreciation ... for key readers and barcode scanners, though it is not clear whether or not similar costs are included within Payzone’s estimated entry cost.”</i></p> <p>The NLC’s advisers have taken into account the cost of additional Ingenico terminals and a contribution to common terminal costs. However, a significant number of other costs relevant to Camelot’s entry, such as Talexus key readers, bar code scanners and labour costs, have been excluded, as Figure 4.1 shows.”</p> <p><i>(KPMG report Section 4.2.1)</i></p>	<p>NERA’s memo did <u>not</u> indicate a cost of entry of around £3.3m. Instead, NERA’s memorandum included a factual description of some specific parts of KPMG’s projections.</p> <p>At different points in the memo, we referred to specific assumptions adopted by KPMG. We assume that the £3.3m wrongly cited by KPMG as NERA’s “estimate” is the result of adding the two most prominent of these assumptions (£2.5m and £0.8m) together – this despite the fact that the first of these figures is a one-off cost and the second is an annual recurring cost.</p> <p>In addition, as KPMG acknowledges, NERA drew clear attention to the uncertainty about whether these figures are comparable with the cost estimate provided by Payzone. However, KPMG fails to acknowledge that NERA also gave details, in a footnote on the same page, of other costs that KPMG describes as “excluded”. In particular, footnote 8 reports the depreciation cost (£ . . . per year) associated with the key readers and barcode scanners.</p> <p>All of these numbers are isolated figures, given in separate places in a memo, rather than contributing to a “NERA cost of entry estimate”. KPMG’s assertion that certain numbers have been “excluded” is therefore difficult to understand.</p>

“Upon review of NERA’s Report of 2 July 2010, KPMG’s immediate concern was that it appears to misstate significantly Camelot’s costs. NERA indicates Camelot’s costs of entry to be of the order of £3.3 million. It then compared this figure with Payzone’s cost of entry estimate of £15 million (in respect of an entrant wishing to install 20,000 terminals). This is the only factual evidence NERA presents as the basis for its reasoning on the alleged “advantages” on this apparent substantial cost advantage to Camelot. In fact, as KPMG analyses in some detail, the costs of Camelot entering the commercial services market on a per store basis (£687) are broadly in line with the estimates provided by Payzone in respect of a hypothetical new entrant (£750). In particular, NERA did not include in their calculations a number of Camelot’s start up costs, including Talexus key readers, bar code scanners and labour costs.”

.... “Accordingly, NERA presents no evidence that Camelot has a substantial costs advantage over other commercial services operators”

(Camelot response, pages 28-9)

NERA has not misstated Camelot’s costs. As described above, NERA provided a factual description of several specific assumptions used in KPMG’s projections, and we also highlighted our doubts about whether these were comparable with the cost estimate provided by Payzone.

NERA did not carry out any calculations with these numbers, so it is difficult to understand why Camelot states that we have excluded items from our “calculations”. Any “exclusion” in fact refers more appropriately to the (simple but mathematically incorrect) calculation that KPMG appears to have carried out using some (but not all) of the numbers included in NERA’s memo. Furthermore, as noted above, our memo does indeed report the cost of key readers and barcode scanners.

Moreover, rather than claiming that these estimates provide evidence of a substantial cost advantage, NERA actually concluded that “there are still realistic possibilities that either Camelot’s advantage is very large ... or Camelot’s advantage is quite small”.

Commercial Services

Legally privileged and confidential

<p>“Camelot was also concerned that the Commission’s economic advisers appear to have been misinformed factually. The analysis which forms the basis of the Commission’s provisional views contains incorrect statements as to key costs and technical matters, including the nature of the equipment Camelot will use to provide its services and the costs of providing the services.”</p> <p><i>(Camelot response, pages 4-5)</i></p> <p>“The Commission’s economic advisers appear to have been misinformed as to important aspects of Camelot’s commercial services proposal. Camelot has no material advantages over its rivals in this market, but has the potential to be an active force for substantially increased competition in the industry.”</p> <p><i>(Camelot response, page 6)</i></p> <p>“Camelot submits that the full analysis conducted by KPMG should enable the Commission to correct some of the misappraisals made by NERA in its economic analysis.”</p> <p><i>(Camelot response, page 33)</i></p>	<p>In the absence of any other explanation, we assume that these cases of “misinformed” and “misappraisals” refer to the instances listed above.</p> <p>Contrary to the impression given by KPMG, NERA did not attempt to estimate Camelot’s cost of entry, and indeed we concluded that its cost advantage could be very large <u>or quite small</u>.</p> <p>We do not agree, therefore, that there was any misappraisal.</p>
---	--

Appendix A. Sensitivity analysis of KPMG's Welfare Estimates

This Appendix sets out our attempt to replicate KPMG's estimate of the welfare impact of Camelot's entry, and also the estimates if KPMG's basic methodology is retained, but some of the assumptions are varied.

KPMG assumes that the market equilibrium prior to Camelot's entry is characterised by price elasticity of demand of -1. The average commission is 13.1p and the number of transactions is 1,334m. The price elasticity of supply at this quantity is assumed to be 1. KPMG assumes that the areas of triangles D and E in KPMG's Figure I.3 are equal.

To arrive at KPMG's new price of 12.2p per transaction the fall in commission "by around 7.5 per cent" needs to be interpreted as dividing the original commission by a factor of 1.075. The new price is then given by $13.1p/1.075=12.186p$ (a price fall of 0.914p).

The new number of transactions following the fall in commission price is given by $1.075*1,334m=1,434.05m$, and increase in volume of 100.05m.

KPMG assume that this change in price and quantity happens one year after the transaction.

The undiscounted consumer gain one year after the transaction is given by the sum of areas of rectangle B and triangle D. The undiscounted welfare gain is given by the sum of areas of triangles D and E.

$$B=0.914p*1,334m=12.192m$$

$$D=(0.914p*100m) / 2=0.457m$$

The undiscounted consumer gain from the transaction in the first year is given by

$$B+D=12.649m, \text{ and}$$

the undiscounted welfare gain in the first year is given by

$$2*D=0.914m.$$

The benefits of the transaction are assumed to grow at a rate of 2.5 per cent in the following years (starting from year 2). The benefits are, however, discounted at a rate of 3.5 per cent starting from year 1.

By summing the infinite stream of discounted benefits we arrive at a total welfare gain of £91.441m and a total consumer benefit of £1,264.934m which are nearly the same as the welfare effects calculated by KPMG. The KPMG figures are £92m and £1.27bn respectively.

Using the same method but only including the benefits from the first eight years following the transaction we arrive at a total welfare gain of £6.833m and a total consumer benefit of £94.530m.

As an alternative sensitivity, if we assume a zero growth rate of benefits from the transaction (i.e. we do not apply KPMG's assumption that the benefits grow at 2.5% per annum) the total welfare gain into perpetuity is £26.126m and the consumer benefit is £361.410m.