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The Use of Profitability Analysis in Market Investigations

Profitability analysis has figured prominently in some recent high profile market investigations by competition authorities, for example in the private healthcare (September 2016) and energy (June 2016) market investigations. This brings into focus the appropriate approach for measuring profitability of firms in different industries and how much weight should be placed upon this analysis. **Caitlin Wilkinson** (Director) and **Stella Deakin** (Associate Director) from KPMG's Economics team explain the significant considerations required when measuring profitability and discuss the importance of following correct principles when interpreting profitability levels, in order to avoid deterring firms from making efficient operational decisions and future investments.

The Competition and Market Authority's (CMA) remit in a market investigation is to determine whether there are any features of the market that give rise to an adverse effect on competition ("AEC"). If such features are identified, the CMA then seeks to put in place effective and proportionate measures to remedy these features or their effects.

In recent market investigations – in particular into private healthcare and into energy – profitability analysis has been used as evidence in both stages of the CMA's assessment. The CMA has found evidence of excess profitability informative of the existence of an AEC. Furthermore, the CMA has assumed its estimates of excess profit to be indicative of the detriment arising as a result of the AEC it identified. Estimates of detriment are a key plank of the CMA's proportionality assessment for proposed remedies.

By contrast, in the CMA's other most recent market investigation – retail banking – profitability analysis was not undertaken, and did not form part of the CMA's evidence to support either its AEC finding or its analysis of the proportionality of the proposed remedies.

Here, we compare and contrast the CMA's use (or non-use) of profitability analysis across recent market investigations. In doing so, we set out our views on best practice in the analysis of and reliance upon measures of profitability as evidence, and some areas where we are concerned that the CMA may have fallen short of these standards in recent cases.

What is 'economic' or 'excess' profit

Competition authorities generally estimate economic profit by considering how much profit has been earned in excess of that required to meet the cost of capital, which is usually measured by comparing the estimated return on capital employed ("ROCE") with the estimated weighted average cost of capital ("WACC"). The idea is that any profits earned over and above the amount required to compensate providers of capital is true economic profit i.e. after all costs of the business have been covered.

The term "economic profits" is often used interchangeably with "excess profits" in the context of competition analysis - the rationale being that a firm operating in a competitive market would earn enough profits to compensate its providers of debt and equity funding but no more.

Whilst profitability analysis can provide insight into how well competition is working in a market in the context of market investigations, there are limits to its usefulness.

First, while economic profit can be an indicator of a lack of effective competition, this is not always the case. Economic profit – particularly if earned by only a sub-set of firms in a particular market – can also be perfectly consistent with well-functioning competitive processes.

Second, there are inherent difficulties in measuring profitability accurately and consistently. Estimates of a number of different parameters are required, including estimating the cost of replacing the assets of the business at today's prices (when often there is no active market for the assets in question) and estimating the allocation of shared assets and shared costs to the area of the business being investigated.

The degree of judgement required, and also the reliability of estimates of economic profit, varies by industry and firm, depending on the characteristics of the business. Estimating economic profit for firms with a low tangible asset base (often call 'asset-light' businesses,) or for firms which are globally integrated with shared assets across several business segments (e.g., IT systems), is particularly susceptible to the uncertainties inherent in any analysis of profitability. In fact, in some cases there can be such a large number of assumptions made as part of the analysis that any estimate of economic profitability may be unreliable, or at least require careful interpretation.

When considering the weight to place on the results from a profitability analysis in the context of a market investigation, it is important that these limitations are taken into account.

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Using profitability analysis as evidence for the existence of an AEC

Interpreting economic profit as evidence of the existence of an AEC clearly requires a reasonable degree of confidence that meaningful economic profit exists. In certain industries, attaining such confidence is not straightforward.

Indeed, the difficulty in performing a robust profitability analysis in certain industries has in the past led the CMA not to rely upon such an analysis in the context of market investigations, as was the case in market investigations into retail banking and statutory audit. In retail banking, the CMA stated:

"The particularly large number of allocation adjustments and assumptions necessary would have had a cumulative effect making any objective judgement difficult. We have therefore decided not to undertake the market-wide profitability analysis."

Against this backdrop, it is striking that the CMA placed significant weight on its estimates of economic profit to support its AEC finding in the recent energy market investigation. Retail energy supply is an asset-light industry, where a high proportion of firms' asset bases are accounted for by intangible assets (such as suppliers' customer lists). Such assets are hard to value robustly, and there are several different potential valuation methodologies that could be deployed. In the case of retail energy supply, applying different valuation methods often caused large swings in the estimates of economic profit, moving from a position of little or no economic profit to one of high economic profit. Despite this, the CMA used estimates of economic profit, derived from one particular valuation methodology for the key intangible assets, as evidence for an AEC. The CMA's lack of sensitivity analysis in its profitability analysis for the energy inquiry meant that a large amount of reliance was placed on evidence that was not robust to a reasonable range of assumptions.

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Other industries, with a lower proportion of intangible assets (for example, energy generation), may be better suited to reliable analysis of economic profit. However, even in these cases, it is crucial that evidence of economic profit is appropriately assessed alongside the other evidence available. More specifically, if economic profit is to be used as evidence to support an AEC finding, an examination of why that economic profit has arisen must be undertaken – and ultimately, a clear link between economic profit and a lack of competition should be demonstrated.

High profit – particularly if earned by only one or a small number of firms in a market – can be the result of (and a reward for) superior efficiency. The possibility of enjoying high profit is also necessary if firms are to undertake risky investment (for example in research and development). Efficiency, investment and innovation are central to well-functioning competitive markets, and care must be taken to distinguish profit arising from these pro-competitive sources, from that arising from market power.

> *"Drawing conclusions from profitability analysis in the absence of a connection between profits and a lack of competition risks punishing successful firms for their superior efficiency and/or quality."*

For the existence of excess profit to provide evidence in support of an AEC, therefore, evidence must also be provided that it is a lack of competition that is causing the alleged high level of profits. Specifically, profitability must be measured across the majority of firms in a particular market (to avoid focussing only on the most successful, efficient providers), over a suitably long time period (to capture a full business cycle) and the existence of excess profit must be clearly linked to other features of the market driving a lack of competition. By way of example, in the Movies on Pay TV case, the Competition Commission found Sky to be earning excessive profits, but concluded that it could not link this profit to a specific feature that gave rise to an AEC.

By contrast, in the CMA's recent private healthcare market investigation, the CMA carried out a profitability analysis for three providers, HCA, BMI and Spire, and came to the view that they earned returns substantially and persistently above the cost of capital. However, the CMA attempted to use its profitability analysis to support an AEC finding only in relation to one provider, HCA. There was no evidence put forward by the CMA to show that this provider was inefficient, and substantial evidence was submitted by the provider on its investment record and high quality of care. The CMA's reliance on its estimate of economic profit to support its AEC finding in the private healthcare investigation, therefore, appears to fall short of best practice. No clear link between profit and a lack of competition was demonstrated. This oversight is particularly problematic given the lack of evidence on any excessive prices or sub-standard levels of quality. Drawing conclusions from profitability analysis in the absence of such a connection between profits and a lack of competition risks punishing successful firms for their superior efficiency and/or quality.

Using profitability to measure consumer detriment

As set out above, using estimates of economic profit to support an AEC finding requires sufficient confidence in the estimates in order to be able to conclude that material economic profits exist.

Even greater confidence in the precise level of economic profit is, however, required if such estimates are to be used to quantify consumer detriment as part of a proportionality assessment for potential remedies.

For example, a proportionality assessment based on estimates of economic profit needs to be robust to a range of sensitivities surrounding these estimates, reflecting the degree of judgement that was involved in arriving at them.

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In private healthcare, (setting aside concerns about whether profitability was linked to a lack of competition) the CMA recognised the uncertainty surrounding its estimates of economic profit. It conducted several sensitivities on key judgement areas in its profitability analysis, such as the valuation of the hospitals. Ranges to reflect these sensitivities were then applied in the proportionality assessment. The CMA stated:

"We recognise that there is some uncertainty regarding both the precise extent to which HCA's prices (to UK self-pay and insured patients) exceed the level at which HCA would make returns in line with its cost of capital…We have, therefore, considered a range of estimates in our analysis."

This range of estimates for the level of excess profits, alongside other evidence, meant that ultimately the CMA could not conclude with any degree of certainty that a divestment remedy would generate sufficient expectation of customer benefits (in the form of reduced prices) to outweigh the serious intrusiveness of a divestment remedy.

In contrast, in the energy market investigation, the CMA did not appear to recognise that its estimate of economic profit was characterised by any degree of uncertainty. The CMA performed limited sensitivity analysis in reaching its estimate of economic profit. In a proportionality assessment for its remedies, the CMA relied on a single point estimate of a "fair return", derived from its own profitability analysis, to measure consumer detriment. Failing to recognise the uncertainty surrounding its profitability analysis means that the CMA did not properly consider the very real possibility that its estimate of consumer detriment was significantly overstated.

Even more concerning, the CMA also used this point estimate to set the level at which to apply a price cap to a significant part of the energy supply industry.

By not considering the uncertainty surrounding its profitability analysis, and in particular the material possibility that the appropriate price cap should be set at a significantly higher level, the CMA risks setting a price cap that does not allow suppliers to make a reasonable return.

What can we conclude?

The CMA has taken different approaches in recent market investigations to analysing economic profit. While some industries that the CMA has investigated appear better suited in principle to such analysis, the CMA has not confined its profitability analysis to only those cases. The use of profitability analysis by the CMA in the energy supply market shows that the CMA is in some cases willing to conduct profitability analysis even in industries which typically would not be judged as good candidates for yielding reliable results (in this case, due to the importance of intangible assets). It is therefore important that even in industries where ROCE analysis would not ordinarily be undertaken, as part of "business as usual", firms are ready to engage in this sort of analysis from an early stage in a market investigation.

Where profitability analysis is conducted, the CMA has been very willing to put significant weight on the results - both to support AEC findings and to quantify the benefits of potential remedies. However, in our view the CMA appears to have failed to hold itself to the highest standards in the weight it has placed on its estimates of economic profit in some recent cases.

In the energy market investigation, the CMA did not recognise the high level of inherent uncertainty surrounding its profitability analysis due to the asset light nature of the industry, potentially overstating consumer detriment and setting a price cap at too low a level.

In the private healthcare inquiry on the other hand – while the CMA was more willing to recognise the uncertainty surrounding its results – it was too quick to ascribe high profit to a lack of competition. No link between HCA's economic profit and a lack of competition or a high market share was shown. Such an approach risks punishing firms that have achieved healthy economic profit as a result of superior efficiency or undertaking risky investment or more generally providing a more attractive product to consumers than do their rivals. In short, it risks creating at least a perception of an efficiency offence.

Failure by competition authorities to address these issues in future could stifle investment and the proper functioning of competitive markets, not just in private healthcare and energy but across the economy more broadly, if a perception of an efficiency offence was created. This, ultimately, risks creating significant harm to consumers.

KPMG Economics advised main parties to the CC's / CMA's market investigations into private healthcare, energy, retail banking and statutory audit.

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