Dear Mr Gadhia

Audit Market Investigation
KPMG Response to “Price Concentration Analysis Working Paper”

Thank you for affording us the opportunity to comment on the Competition Commission’s (CC’s) Price Concentration Analysis Working Paper (the “Working Paper”) published on 28 September 2012. We believe that the CC identified the main problems associated with the application of Price Concentration Analysis (PCA) to the market for statutory audit services. Below we briefly set out our high level comments on the theoretical arguments presented by the CC.

We agree with the CC that the lack of variation of the concentration measure in the data is one of the main reasons why a PCA is not suitable. Performing the analysis disaggregated at industry level would induce more variation in the data. However, as outlined in several other submissions¹ and recognised by the CC², markets should not be defined at industry level and we agree with the CC that this would not be the right approach in the context of this analysis.

We agree that endogeneity (that unobserved cost changes may influence both prices and market structure) is a problem³ and that the usual techniques identified by the CC to overcome this issue (ie dummy variables and fixed effects regressions) are not suitable in this case. We also share the view that it is not straightforward to find adequate instruments to proxy for concentration.

In addition to the arguments set out by the CC, as set out in our Main Submission in response to the CC’s Issue Statement⁴, we noted that in industries characterised by a relatively small number of customers, like the one for statutory audit services, the level of concentration on the buyer-side provides a lower bound for the level of supply side concentration. We therefore

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¹ KPMG’s response to CC’s Working Paper on “Market definition”, paragraph 3.1.1.
³ KPMG Main Submission, Annex 3.
⁴ KPMG Main Submission, paragraph 9.1.
believe that any analysis that relies on concentration as an explanatory variable should take into account the bias induced by buyers’ side concentration.\textsuperscript{5}

We will reserve our comments regarding any other technical consideration on the CC’s econometric analyses for later responses.

We trust that these comments and observations are useful in informing your consideration of the Working Paper. Do not hesitate to contact me if you have any queries or wish to pursue any of these points further.

Yours sincerely

David L Gardner
Director of Public Policy

\textsuperscript{5} KPMG Main Submission, Annex 3.