Terms of reference and conduct of the inquiry

Terms of reference

1. On 31 March 2011 the OFT sent the following reference to the CC:

   1. In exercise of its duty under section 22(1) of the Enterprise Act 2002 ('the Act') to make a reference to the Competition Commission ('the CC') in relation to a completed merger the Office of Fair Trading ('the OFT') believes that it is or may be the case that—

      (a) a relevant merger situation has been created that:

         (i) enterprises carried on by or under the control of Sector Treasury Services Ltd have ceased to be distinct from enterprises carried on by or under the control of ICAP plc, that is the treasury consultancy services business known as Butlers; and

         (ii) as a result, the conditions specified in section 23(4) of the Act will prevail, or will prevail to a greater extent, with respect to the supply of treasury management consultancy by retainer contracts to local authorities; and

      (b) the creation of that situation has resulted or may be expected to result in a substantial lessening of competition within any market or markets in the UK for goods or services, including the supply of treasury management consultancy by retainer contracts to local authorities.

   2. Therefore, in exercise of its duty under section 22(1) of the Act, the OFT hereby refers to the CC, for investigation and report within a period ending on 14 September 2011, on the following questions in accordance with section 35(1) of the Act—

      (a) whether a relevant merger situation has been created; and

      (b) if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition within any market or markets in the UK for goods or services.

   3. In relation to the question whether a relevant merger situation will be created, the CC shall exclude from consideration one of the subsections (1) and (2) of section 23 of the Act if they find that the other is satisfied.

   (*signed)* ALI NIKPAY
   Office of Fair Trading
   31 March 2011

Conduct of the inquiry

2. On 1 April 2011, we published on our website an invitation to comment on the merger and a letter inviting views was posted to each local authority in the UK on 7 April 2011. The administrative timetable for our inquiry was published on 18 April 2011

and the website also linked to biographies of the members of the Group conducting the inquiry.

3. We invited a range of interested parties to comment on the proposed merger, including competitors, local authority customers who issue tenders for TMA contracts, trade bodies and new or potential entrants to the market including those whom the parties had identified as operating in a similar market. We held ten hearings with local authorities, competitors, trade bodies and potential competitors. Evidence was also obtained through further written requests.

4. Non-confidential submissions from third parties and summaries of third party hearings can be found on our website.

5. On 13 April 2011, members of the Inquiry Group, accompanied by staff, visited STS's office in Duke's Place, London, and were given a presentation on the operation of its business and the nature of treasury management advice.

6. On 3 May 2011, we published an issues statement on our website, setting out the areas of concern on which the inquiry would focus.

7. In May 2011, we invited every local authority in the UK to complete a focused questionnaire to understand:

   (a) how they chose and made use of treasury management advice; and

   (b) other issues relating to them as customers and as potential providers of TMA services to others.

8. We received written evidence from STS and ICAP and non-confidential versions of their respective submissions are on our website. We also held separate hearings with both STS and ICAP on 8 June 2011.

9. In the course of the inquiry we sent to STS, ICAP and other parties some working papers and extracts from those papers for comment.

10. We published our provisional findings on 15 July 2011. A non-confidential version of the provisional findings report was placed on the CC website on 20 July 2011. Non-confidential versions of responses to the provisional findings report were also placed on the CC website.

11. Our final report was published on 31 August 2011 and placed on our website.

12. We would like to thank all those who have assisted in our inquiry.

Interim undertakings

13. At the time of the reference, STS had not given any initial undertakings to the OFT. We accepted interim undertakings from STS on 27 April 2011. By means of these undertakings we took steps to ensure that, although the Butlers business had already been fully integrated into STS, no further action was taken by STS which might prejudice the outcome of our investigation or impede our taking any necessary remedial action as a result. STS provided a compliance statement in relation to these undertakings each month. On 3 May 2011, a copy of the interim undertakings was published on our website.

Further organizational structure and financial information

1. This appendix sets out:

   (a) STS's organizational structure and historical financial performance; and

   (b) Butlers' historical financial performance.

STS's organizational structure

2. STS is primarily managed through two business divisions, Advisory and Consultancy, each headed by an Executive Director [✂] of the wider STS business. Both Executive Directors report to STS's Managing Director. TMA services are provided out of STS's Advisory business.

3. Table 1 shows a breakdown of STS's FY2010 revenues by business division; each division's business activities; client type; and revenue stream. Further details of each business activity and revenue stream are set out later in this appendix.

TABLE 1 **STS FY2010 revenue breakdown, year ended December**

	£'000	*%*
Advisory division		
TMA services:		
Local authority retainer contracts*	[✂]	[20–40]
Local authority one-off contracts†	[✂]	[5–15]
Local authority transactional income‡	[✂]	[5–15]
Local authority treasury outsourcing retainer*	[✂]	[0–5]
	[✂]§	[50–75]
Housing association retainer contracts*	[✂]	[5–15]
Housing association one-off contracts†	[✂]	[0–10]
Corporate retainer*	[✂]	[0–10]
	[✂]	[5–35]
Asset Finance services:		
Local authority retainer contracts*	[✂]	[0–10]
Local authority transactional‡	[✂]	[5–15]
NHS & local authority contract-hire (transactional)‡	[✂]	[5–15]
	[✂]	[10–40]
Advisory division revenues	[✂]	[70–90]
Consultancy division (one-off)†	[✂]	[15–25]
Capita inter-company revenues	[✂]	[0–10]
	[✂]	100

Source: STS.

*Retainer contracts are annual contracts with set deliverables determined by the customer in its tender specification.
†One-off contracts relate to project-management-type work which is charged on a daily charge-out or fixed-fee basis.
‡STS receives transactional income from certain third parties whenever STS's clients request certain transactions from these third parties.
§STS's definition of local authorities includes local government authorities and all other public authorities, eg Fire and Police Authorities, but excludes housing associations.

4. In FY2010, STS generated total revenues of £[✂] million of which its Advisory division accounted for [70–80] per cent (£[✂] million), and its Consultancy division

accounted for [10–20] per cent [✂]. We first look at STS's revenue streams before turning to each of STS's business activities in turn below.[1]

STS's revenue streams

5. As shown in Table 1 above, STS generates its revenues primarily through three revenue streams: retainer fees, one-off fees and transactional income. We describe each revenue stream below.

Retainer fees

6. STS told us that retainer contracts included set deliverables determined by the customer in its tender specification, with a fixed retainer fee.

7. Based on our review of a sample of STS's TMA retainer contracts, we found that:

   (a) retainer fees covered the costs, expenses and disbursements incurred by STS employees in connection with the engagement; and

   (b) TMA retainer fees are usually quoted for TMA services only, but in some contracts a separate quote may also be given for STS to provide bundled services, eg TMA and Asset Finance advisory services.

One-off fees

8. One-off fees arise from stand-alone projects. In some cases, a separate facility for one-off project management fees may also be quoted in STS's retainer contracts, [✂].

Transactional income

9. STS receives transactional income from certain third-party institutions which execute transactions on behalf of STS's Advisory (ie its [✂]) clients. Further details of the various components of STS's transactional income are presented under our description of TMA and Asset Finance advisory services below.

STS's Advisory division

10. STS's Advisory division currently employs [✂] staff and provides TMA and Asset Finance advisory services predominantly to local authorities and housing associations.

11. There are currently [✂] employees who are engaged on TMA services on a full-time basis (including the [✂] Butlers' employees who transferred to STS as part of the merger). However, STS told us that this figure was higher in terms of 'full-time equivalent' employees [✂].

[1] The description and details of STS's business in this report are based on information submitted by STS as part of this investigation. We have not taken into account STS's recent acquisition in April 2011 of the Government and Health divisions of Tribal Consulting Limited, which we understand has been integrated into STS's Consultancy division.

TMA services

12. STS's TMA services generated £[✂] million of revenues in FY2010 ([70–80] per cent of STS's FY2010 revenues), of which local authority clients accounted for £[✂] million, whilst housing associations and corporate clients accounted for £[✂] million. Given the different TMA needs of local authorities, housing associations and corporate clients, the scope of TMA services provided to each client type will inevitably vary.

13. Revenues from TMA retainer and one-off contracts accounted for £[✂] million and £[✂] million respectively in FY2010. The balance of £[✂] million was accounted for by transactional income in relation to STS's TMA clients. In FY2010, [✂].

14. Details of STS's transactional income arising from its TMA services are set out below:

    (a) *'Call-and-notice' accounts*. STS receives transactional income (in the form of 'introductory fees') from Santander, Alliance & Leicester, Clydesdale and Svenska, if STS's client elects to open a 'call-and notice' account with one of these institutions. In FY2010, transactional income from these four banks was around £[✂].

    (b) *LOBO loans.* In respect of LOBO transactions, should STS's TMA local authority client elect to use Tullet Prebon as its broker for such loans, then STS receives a share of Tullet Prebon's brokerage income. In FY2010, transactional income from Tullet Prebon was around £[✂]. STS told us that the LOBO market is currently closed and that it was not in a position to speculate as to whether the LOBO market would remain closed for the remainder of FY2011, or, if it were to reopen, when this might take place.

    (c) *SunGard money market portal.* STS also receives transactional income whenever its TMA client elects to use a third-party money market portal operated by SunGard. In FY2010, transactional income from SunGard was around £[✂].

15. In relation to transactional income from STS's TMA clients, we note that minimal costs are associated with this revenue stream, as STS's 2011 business plan notes: [✂].

16. The impact on STS's profitability of TMA transactional income generated from its TMA clients is illustrated in Table 2. The figures for FY2010 are based on out-turn figures.

TABLE 2 **Financial impact of TMA transactional income on STS's profitability**

			£'000
	FY2008 Actual	*FY2009 Actual*	*FY2010 Out-turn*
Profit before tax	[✂]	[✂]	[✂]*
Adjust for [✂] loss/(profit)†	[✂]	[✂]	[✂]
Adjust for office move costs	[✂]	[✂]	[✂]
Profit before tax from core activities	[✂]	[✂]	[✂]
Memo: TMA transactional income‡	[✂]	[✂]§	[✂]
As % of profit from core activities	[75–100]	[50–75]	[25–50]
Underlying profit excl transactional income	[✂]	[✂]	[✂]

Source: STS.

*FY2010 profit includes the part-year effect of the Butlers contracts [✂].
†[✂]
‡Transactional income margin assumed to be 100 per cent, ie transactional income = profit.
§STS generated transactional income from LOBOs of £[✂] in FY[✂].

17. As Table 2 above shows, STS's TMA transactional income in FY2008 represented up to [75–100] per cent of its profit from core activities. Whilst this was expected to fall to [25–50] per cent in FY2010, it still represented a significant driver of STS's overall profitability. This is confirmed by STS in its 2011 Business Plan, which stated that [✂].

Asset Finance services

18. Asset Finance advice is provided to local authorities, [✂], and can range from generic advice on leasing options for capital financing and the provision of client training on asset finance, to advice on raising third-party finance on certain assets.

19. Asset Finance advisory services accounted for £[✂] million ([10–20] per cent) of STS's FY2010 revenues. Revenues from Asset Finance advisory services are [✂].

STS's Consultancy business

20. STS's Consultancy division has [✂] employees and provides management consultancy services to local authorities. In FY2010, it generated revenues of £[✂] million ([15–25] per cent of STS's FY2010 revenues) from [✂].

21. STS's Consultancy division focuses on providing local authorities with advice in relation to the cost or financing aspects of managing their housing stock, eg the costs of housing stock repairs and maintenance, and advice in relation to large-scale voluntary transfers of housing stock.[2]

Inter-company Capita revenues

22. In FY2010, STS generated inter-company revenues of £[✂] million ([0–10] per cent of STS's FY2010 revenues) from [✂].

[2] The voluntary transfer of a local authority's housing stock to housing associations and registered social landlords.

STS's back-office and central functions

23. Back-office support is provided partly by [✄] STS employees engaged in [✄].[3] A number of Capita employees also provide STS with the following central functions: [✄]. STS also has one non-executive Chairman from Capita on its board.

STS's business strategy

24. In its 2011 Business Plan, STS stated that TMA services were a core part of its business. [✄]

25. In its 2011 Business Plan, STS also stated that [✄].

26. [✄] in its 2011 Business Plan [✄].

STS's historical financial performance

27. STS's board meeting packs show that [✄]. STS's historical financial performance at company level is set out in Table 3 below.

28. STS told us that it did not measure the individual profitability of [✄].

TABLE 3 **STS's historical financial performance (FY2006–2010)**

£'000

	2006	*2007*	*2008*	*2009*	*2010*
Gross revenues	[✄]	[✄]	[✄]	[✄]	[✄]
Cost of third-party consultancies*	[✄]	[✄]	[✄]	[✄]	[✄]
Net revenues	[✄]	[✄]	[✄]	[✄]	[✄]
Growth (%)	[✄]	[15–25]	0–10]	[10–20]	[-10– -20]
Operating costs	[✄]	[✄]	[✄]	[✄]	[✄]
Operating profit before central costs	[✄]	[✄]	[✄]	[✄]	[✄]
Margin (%)	[25–50]	[25–50]	[0–25]	[25–50]	[0–25]
Capita central costs	[✄]	[✄]	[✄]	[✄]	[✄]
Profit before tax†	[✄]	[✄]	[✄]	[✄]	[✄]
Margin (%)	[25–50]	[25–50]	[0–25]	[0–25]	[0–25]
Full time equivalents (staff)	[✄]	[✄]	[✄]	[✄]	[✄]

Source: STS.

*Since FY2007, STS's Advisory division expanded and began using third-party consultancies [✄]. STS told us that these third-party consultancies were used for its provision of one-off services.
†[✄]

29. Based on Table 3 above, STS's net revenues steadily increased year-on-year from £[✄] million in FY2006 to £[✄] million in FY2009, before declining [5–15] per cent in FY2010. Operating profit before Capita central cost recharges showed that margins have steadily declined over the period from [30–40] per cent in FY2006 to [15–25] per cent in FY2010. STS mentioned that [✄].

30. STS stated that its TMA services business in FY2010 continued 'to perform well and maintains market leader position in local government. [✄]

[3] [✄]

31. Table 3 above shows that Capita central costs increased from £[✂] in FY2006 to £[✂] in FY2010. STS explained that these increases were largely due to: [✂].

32. In relation to its margin decline in FY2010, STS stated that [✂].[4]

33. STS has forecast FY2011 turnover and profit to be £[✂] million and £[✂] million respectively (excluding Butlers). The full-year effect of the acquisition of Butlers would increase FY2011 revenues by £[✂] million to £[✂] million and increase operating profit (before Capita central cost recharges—see Table 3 above) by £[✂] million to £[✂] million. STS stated that [✂].

Butlers' historical financial performance

34. Butlers' historical financial performance is set out in Table 4.

TABLE 4 **Butlers' historical financial performance (FY2007—2010)**

				£'000
	2007	*2008*	*2009*	*2010*
Revenues:				
TMA services	[✂]	[✂]	[✂]	[✂]
Transactional income	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]
Revenue growth (%)	[✂]	[-5–15%]	[-10–20]	[0–10]
Direct costs:*				
Employment costs	[✂]	[✂]	[✂]	[✂]
Other direct costs	[✂]	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]	[✂]
Profit before bonuses	[✂]	[✂]	[✂]	[✂]
Margins (%)	[50–75]	[50–75]	[50–75]	[50–75]
Bonuses/commissions	[✂]	[✂]	[✂]	[✂]
% of TMA revenues	[25–35]	[25–35]	[20–30]	[20–30]
Profit after bonuses	[✂]	[✂]	[✂]	[✂]
Margins (%)	[25–50]	[25–50]	[25–50]	[25–50]
Overheads:				
Allocation of ICAP overheads†	[✂]	[✂]	[✂]	[✂]
Operating profit‡	[✂]	[✂]	[✂]	[✂]
Margin (%)	[25–50]	[25–50]	[25–50]	[25–50]
% of total revenues:				
TMA services (%)	[75–85]	[85–95]	[85–95]	[75–85]
Transactional income (%)	[15–25]	[10–20]	[5–15]	[15–25]
	100	100	100	100

Source: ICAP.

*Any costs directly incurred by the Butlers division.
†ISL (of which Butlers is a trading division) receives services for central functions from ICAP Management Services (IMS) and is recharged for these services by IMS. ICAP told us that Butlers received an allocation of these charges based on agreed allocation metrics ([✂]).
‡ICAP told us that over the period considered in the table above, there were no material exceptional items or any significant non-recurring items or reorganization costs.

[4] [✂]

35. Based on Table 4 above, Butlers' revenues from TMA services[5] (excluding transactional income) declined year-on-year from £[✂] million in FY2007 to £[✂] million in FY2010. When transactional income is included, revenues increase to £[✂] million and £[✂] million respectively. As shown in Table 4, transactional income by its very nature (ie non-contractual and one-off) is volatile. Over the period considered, transactional income ranged from £[✂] to £[✂] million.

36. Butlers' draft 2010 Business Plan, which was prepared by Butlers' second-tier management,[6] highlighted its difficult market environment, [✂].

37. Against the backdrop of the decline in Butlers' revenues from TMA services year-on-year since FY2007, its draft 2010 Business Plan contained plans to [✂].

38. In addition to its revenues from retainer and one-off contracts, Butlers generated transactional income [from ICAP]. [✂]

39. Minimal costs were associated with this transactional income revenue stream. The impact of transactional income on Butlers' profitability is illustrated in Table 5.

TABLE 5 **Impact of transactional income on Butlers' operating profit (FY2007–2010)**

				£'000
	2007	*2008*	*2009*	*2010*
Operating profit:*				
Including transactional income†	[✂]	[✂]	[✂]	[✂]
Excluding transactional income‡	[✂]	[✂]	[✂]	[✂]
Memo: Transactional income	[✂]	[✂]	[✂]	[✂]

Source: ICAP.

*Operating profit is calculated after the deduction of all direct costs, bonuses and allocation of corporate overheads.
†Transactional income relates to [✂].
‡When deducting transactional income from operating profit, we have assumed that transactional income generates 100 per cent margins and therefore the full amount of transactional income represents profit. [✂]

40. Butlers' transactional income of £[✂] million in FY2009 and £[✂] million in FY2010 respectively accounted for [0–10] per cent and [10–20] per cent of ICAP's Non-Banking desk's total revenues (including Butlers' transactional income). Since Butlers' transactional income represented only its share, the total contribution of Butlers' clients would account for a higher percentage of the Non-Banking desk's revenues. We therefore considered that, whilst Butlers' TMA services were not key to ICAP's strategic focus on its core brokerage business, the ability of Butlers to generate additional revenues for ICAP's core brokerage business represented additional strategic value to ICAP.

41. In relation to Butlers' costs, ICAP told us that the:

> principal costs … were the salaries of its staff, the payment of consultants, seminar and conference costs, the costs of visiting clients (a key part of the service) and the 'on costs' that were charged by ICAP for the provision of certain services to Butlers (e.g. IT costs, general management and office rent).

[5] As part of Butlers' TMA service offering, Butlers provided clients with generic advice on investments in different asset classes, eg money market funds and gilts. However, since advice in relation to these products was generic and focused on the asset class in general, this was not regulated investment advice under FSMA RAO. Whilst Butlers did not provide regulated investment advice, its employees were still registered with the FSA CF30 (controlled function 30) status which enabled them to give regulated investment advice to clients.
[6] The draft 2010 Business Plan for Butlers was not finalized or approved by Butlers' senior management.

42. Between FY2007 and FY2010, Butlers' margins (based on profit before bonuses) decreased from [50–75] per cent to [50–75] per cent. After the deduction of bonuses, its margins were [25–50] per cent and [25–50] per cent respectively.

The sale process, the terms of the transaction and post-merger integration

Butlers sale process

1. ICAP first approached STS on 5 July 2010 about a possible sale of Butlers to STS. On the following day, STS submitted an initial information request to ICAP to commence its due diligence on Butlers. ICAP did not approach any other potential purchasers.

2. During a meeting on 16 July 2010, ICAP told STS that if it did not sell Butlers to STS, it would close down the Butlers business and that 'ICAP's Board had decided to exit the advisory business [ie Butlers] as a result of various issues, including [✂]'.

3. In September 2010, ICAP conducted a 'reverse due diligence' exercise on STS to determine whether it was a suitable purchaser from a compliance point of view. ICAP concluded that STS was an appropriate purchaser which 'benefits from having a compliance officer who dedicates 50% of his time to this relatively small company while also able to benefit from the ample resources of the large Capita compliance and training arrangements'.

4. On 1 October 2010, ICAP and STS signed the business transfer agreement to transfer the assets of the Butlers business to STS, involving the transfer of up to [✂] clients and [✂] employees to STS, with an effective date of 25 October 2010.

5. On 4 October 2010, ICAP publicly announced its decision to transfer the Butlers business to STS, stating in its press release that 'After a thorough review we have decided to withdraw from providing treasury consultancy services and will concentrate on our interdealer broking businesses'.

Key terms of the transaction

6. The final terms of the transaction were, in summary:

   (a) STS paid ICAP a consideration [✂] for the Butlers assets. STS told us that the consideration amount was based on [✂].

   (b) Butlers' assets which comprised around [✂] contracts and [✂] staff were transferred to STS on 25 October 2010. Of the [✂] Butlers staff who transferred to STS, [✂] were engaged in the provision of TMA services at Butlers, including [✂] Directors, [✂] Associate Directors, [✂] Assistant Director, and [✂] Treasury Manager. [✂] Personal Assistant.

   (c) [✂]

   (d) ICAP entered into a non-compete clause with STS in the areas covered by Butlers' business activities for a period [✂].

   (e) STS told us that there was a 'netting-off' arrangement in respect of fees received from Butlers' customers before and after the completion date. [✂] As a result of this 'netting-off' arrangement, ICAP paid around £[✂] to STS and STS paid ICAP around £[✂], resulting in a net payment from ICAP to STS of around £[✂].

(f) Butlers’ contracts which could not be assigned or novated to STS [✂] would be terminated. STS told us that the Butlers contracts were worth around £[✂] a year, of which £[✂] were assigned to STS ([between 80 and 90] per cent). STS added that the remaining £[✂] of contracts were not capable of assignment and therefore the customer’s consent had to be sought for novation.

(g) Between [✂] and [✂] STS and ICAP would aim to novate all of Butlers’ contracts assigned to STS, with any contracts which had not been novated to STS by [✂] being terminated. [✂]

Integration of Butlers into STS following the merger

7. Following the completion of the merger, Butlers was fully integrated into the STS business with STS and Capita providing the same central administrative services in relation to the transferred Butlers’ assets as for the STS business.

8. STS stated in its October 2010 board meeting pack that [✂].

9. STS told us that it offered a [✂].

10. STS told us that it was currently in the process of novating all contracts that were assigned to it, which had an expiry date of later than [✂] (around 75 per cent of the contracts assigned to STS). STS told us that any remaining contracts that could not be novated before [✂] would be terminated.

Background to the transaction

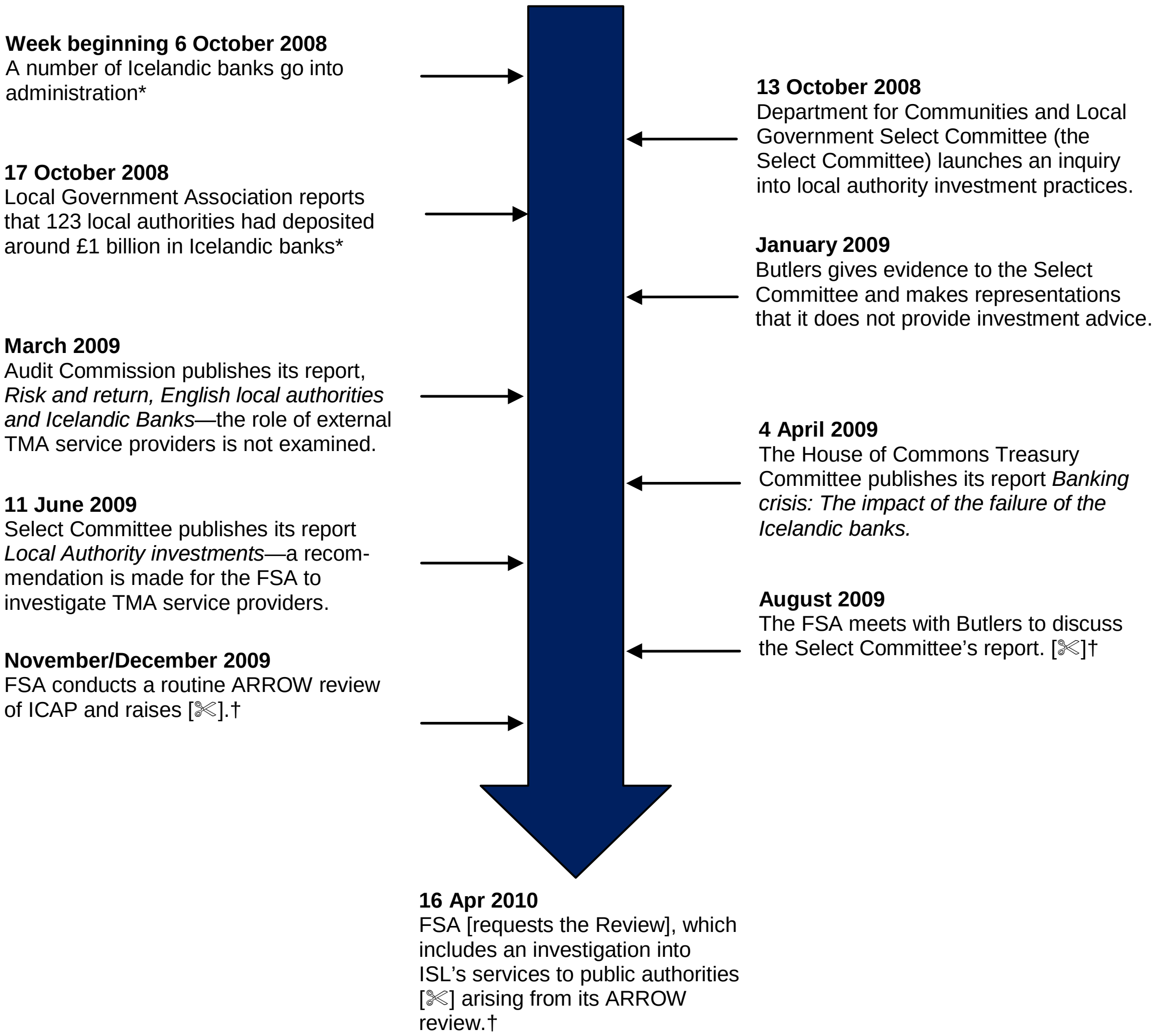
Why did the FSA [seek the Review]?

1. In April 2010 the FSA [requested ISL to undertake a general review of certain aspects of] [✂] [(including Butlers) ('the Review')] because the FSA had [✂] concerns regarding the operation of the firm's TMA services to local authorities, in particular that it was giving advice on regulated instruments.

2. A timeline showing the key events leading up to the [Review] is shown in Figure 1.

FIGURE 1

Timeline of events leading up to the [Review]



Source: See footnotes for various sources.
*House of Commons Treasury Committee report, *Banking Crisis: The impact of the failure of the Icelandic banks*, 4 April 2009.
†[Review].

3. In the wake of the Icelandic banking crisis, the Department for Communities and Local Government Select Committee (the Select Committee) launched an inquiry into local authorities' investment practices on 13 October 2008. On 26 January 2009, Butlers gave evidence to the Select Committee stating that it

> offer[s] advice in a number of areas, for example in accountancy, capital finance issues, economic analysis, interest rate forecasting, and in addition… training courses, but it is quite clear on the counterparty issue that [Butlers] act[s] as a pass through of information. [Butlers does] not provide advice on [investment] counterparties.[1]

[1] The Select Committee's report, *Local authority investments*, 11 June 2009.

4. Between March and June 2009, various government bodies published their respective reports into the Icelandic banking crisis, namely the Audit Commission,[2] the House of Commons Treasury Committee,[3] and the Select Committee.[4] In particular, the Select Committee's report examined the role of external TMA service providers to local authorities in the Icelandic banking crisis. Its report recommended that the FSA take a more active role in their regulation and also stated that the evidence examined raised concerns about potential conflicts of interest in relation to whether there were any 'financial transactions between treasury management advisers and brokers that might compromise the independence of advice being given to local authorities'. The Select Committee added that there was a 'strong case for a full investigation by the FSA of the services provided by local authority treasury management advisers. [The Select Committee] recommend[s] that such an investigation be carried out as soon as possible'.[5]

5. In August 2009, the FSA held a meeting with Butlers to discuss the issues raised by the Select Committee. [✂]

6. In November and December 2009, during the FSA's routine ARROW review of ICAP's subsidiary ISL, the FSA raised the following [✂].

7. Prior to the [Review], ICAP was experiencing regulatory difficulties in both the UK and the USA with its wider business, including issues in relation to failings in its corporate governance and regulatory compliance. In the 18 months prior to the [Review], ICAP had been required to respond to a number of regulatory interventions which included interventions by the FSA and two separate US regulatory inquiries—from the Securities and Exchange Commission and the Commodities and Futures Trading Commission. [✂][6]

8. Against this backdrop, the FSA [requested] ICAP to provide it with [the Review] on 16 April 2010. [✂]

9. ICAP's strategic review of Butlers commenced in early June 2010 during the [Review]'s investigation phase. ICAP told us that during [the] investigation phase, which commenced on 29 April 2010, [✂].

10. The [Review]'s findings and recommendations suggested that [✂].[7]

The [Review]'s findings and recommendations in relation to Butlers

11. Overall, the [Review] concluded that [✂] as a high priority it recommended that the ICAP Board decide if it would allow Butlers to offer regulated investment advice.

12. [✂] The [Review] identified three options in relation to Butlers [✂]. These options were:

    (a) option 1: ICAP allowing Butlers to give regulated investment advice;

[2] Audit Commission report, *Risk and return, English local authorities and Icelandic Banks*, March 2009.
[3] House of Commons Treasury Committee report, *Banking Crisis: The impact of the failure of the Icelandic banks*, 4 April 2009).
[4] The Select Committee's report, *Local authority investments*, 11 June 2009.
[5] *Local authority investments*, op cit.
[6] [✂]
[7] [✂]

(b) option 2: ICAP retaining Butlers and its current business model with controls to ensure that it does not provide regulated investment advice (including the possibility of housing Butlers in a separate legal entity); or

(c) option 3: withdrawing from the Butlers business altogether.

13. If ICAP wished to retain the Butlers business, ie either Option 1 or 2, the [Review] recommended [✄].

14. If ICAP had chosen option 1, the [Review] recommended [✄].[8]

15. Under Option 2, the [Review] recommended greater controls to demonstrate that Butlers was not providing regulated investment advice; [✄].

16. In addition, if ICAP were to retain Butlers, the [Review] [✄].

ICAP's strategic review of Butlers

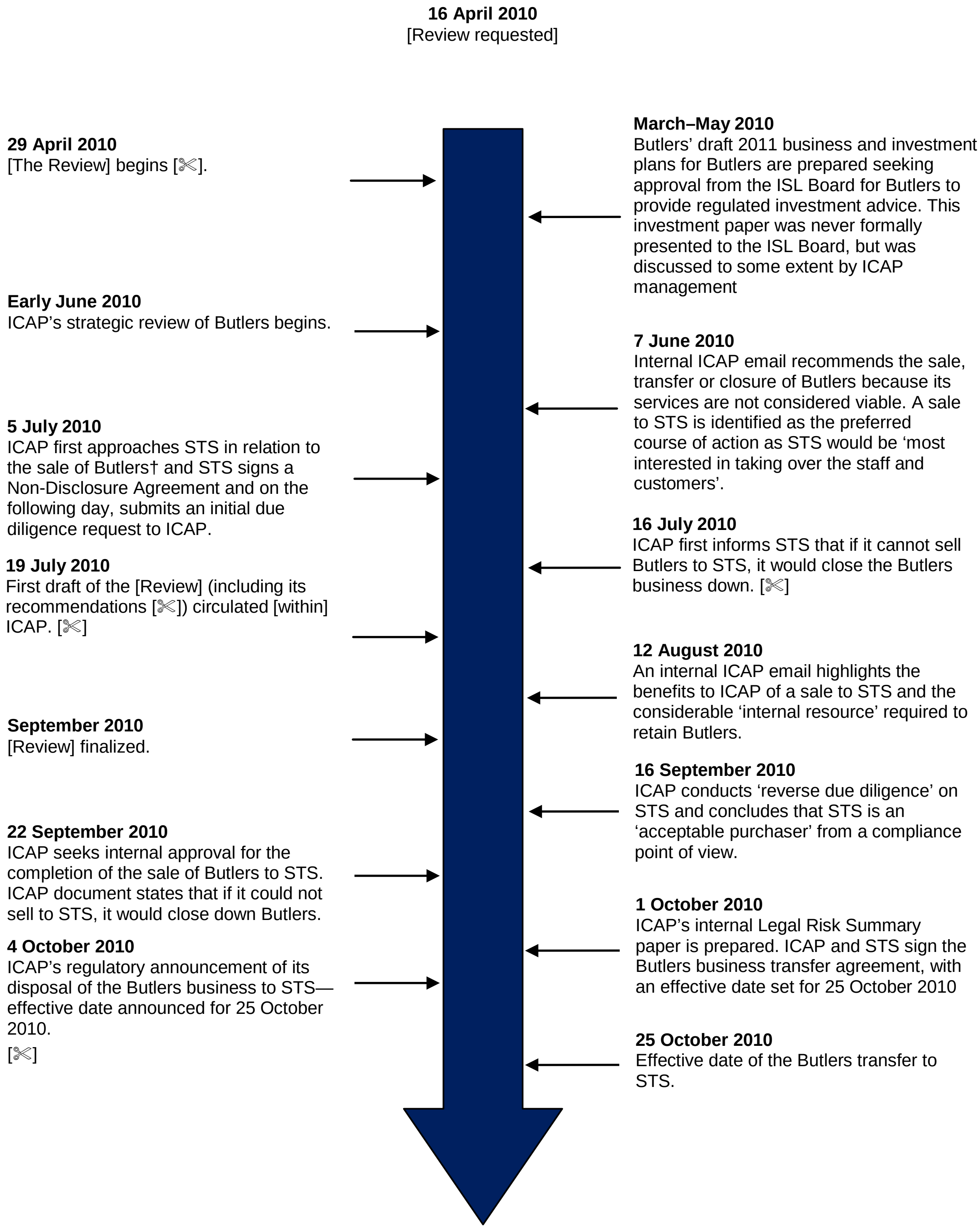
17. ICAP told us that in light of [the Review], it undertook a [separate] strategic review of the Butlers business in early June 2010 'to determine whether it was appropriate for [ICAP] to continue to operate all or any part of [Butlers]'.

18. A timeline showing the key evidence received in relation to ICAP's strategic review is shown in Figure 2.

[8] [✄]

FIGURE 2

Timeline of ICAP's strategic review of Butlers



Source: ICAP and STS.

19. ICAP told us that between March and May 2010, Butlers' management had explored the prospect of expanding Butlers' scope of services and prepared an investment proposal to allow Butlers to provide regulated investment advice. This investment proposal was never formally presented to the ISL Board. ICAP told us that in May 2010, ICAP's CEO of Europe, Middle East and Asia (EMEA) for Money Markets and Foreign Exchange, had discussed the proposed expansion of Butlers' business with

ICAP's London and EMEA CEO, who was against the proposal because of the additional monitoring resources this would have required; the adverse publicity Butlers had already attracted; and the fact that Butlers was non-core to ICAP.

20. Thereafter, ICAP told us that Butlers' senior management began investigating the prospect of a sale of Butlers. An internal ICAP email sent on 7 June 2010 (during the [Review]'s investigation phase) which discussed Project Indus (ICAP's strategic review of Butlers), set out its recommendations in relation to Butlers 'that will maintain profitability, meet the needs of its customers and comply with ICAP's most recent Corporate Governance standards'. It was at this stage, before the recommendations of the [Review] were confirmed that a recommendation was made to sell Butlers to STS. We noted the email's following points:

(a) The Chairman of Butlers said that Butlers' services [✂].

(b) Butlers' three service areas (ie Investment, Debt and Technical Services) did not seem viable on their own, and therefore ICAP should consider 'selling, transferring or closing down' the business. Whilst we have received other evidence about the context for the decision, this appears to be the main reason for this email's recommendation to exit from the Butlers business.

(c) STS is identified as a potential purchaser and a recommendation is made that Butlers begin negotiations with its staff, customers and STS 'to explore the following initiatives: (a) Transfer all Butlers' services to Sector [STS] by mutual agreement for either a fee or share of future revenues... [and] (b) Transfer of Butlers' staff to Sector [STS] by mutual agreement'.

(d) This recommendation is presented as the

> preferred course of action because it is the view of senior Butlers' staff that Sector [STS] will be the most interested in taking over the staff and customers... it is believed the majority [of customers] will see the offer as a suitable way for Butlers to try and exit the business. This strategy should therefore have the least impact on Butlers/ICAP's reputation...

(e) ICAP also mentions that a sale to STS would also be 'the best alternative for the majority of staff who wish to stay in the business. As such, Butlers/ICAP's reputation for looking after its employees will be best protected'.

21. During ICAP's discussions with STS to sell Butlers (see Appendix C), it appeared that as at mid-August 2010, ICAP had not fully committed to the sale. An internal ICAP email dated 12 August 2010, set out to 'determine whether it [was] appropriate for ICAP to continue all or any part of the Butlers' business in light of the recently received [the Review] recommendations and proposed deal with Sector [STS]…'.

22. The email stated that the [Review]'s recommendations in relation to the retention of Butlers 'would require considerable internal resource to implement' and listed a number of the [Review]'s recommendations under option 2.

23. At this point in ICAP's strategic review, ICAP considered whether Butlers' debt portfolio management business should be retained by ICAP, but noted that the purchase of Butlers without its debt business would not be considered commercially attractive by STS. This option was subsequently abandoned. It was also noted in this email that any option to retain Butlers would need to take into consideration the [Review]'s recommendations.

24. The email also stated that

> if a sale of Butlers to a third party is not possible and the decision is taken to close down the business, ICAP will incur significant costs and resource…
>
> *(a)* Redundancy costs of up to £[✂];
>
> *(b)* Contract termination costs…; and
>
> *(c)* Resource required to wind down the business which may include [✂].
>
> *(d)* In addition, closing down Butlers with no contingency plan for the local authorities may lose ICAP considerable goodwill [✂].

25. In this email, ICAP highlighted a number of advantages of transferring the Butlers business to STS rather than closing down the business: [✂].

26. ICAP subsequently [✂].

27. In September 2010, an internal ICAP Board briefing document sought approval to conclude the merger with STS. The document stated that the strategic review of Butlers had involved evaluating the three options set out [in the Review] and that '[a]fter due consideration it was agreed to pursue the option to sell the business and in the event that this was not possible that ISL should proceed to close the business'.

28. On 1 October 2010, ICAP and STS signed the Butlers Business Transfer Agreement with an effective date of 25 October 2010.

Further details of the counterfactual assessment

1. In this appendix, we set out further details of ICAP's arguments as to why it did not consider Arlingclose to be a suitable alternative purchaser of Butlers, and Arlingclose's response to these arguments.

ICAP's arguments as to why it did not consider Arlingclose as an alternative purchaser of Butlers

2. In its initial submission, ICAP stated that Arlingclose was rejected as a potential purchaser of Butlers for the following reasons:

   (a) *Lack of staffing resources.* ICAP told us that it was clear that Arlingclose was not adequately staffed to handle the Butlers business being transferred.

   (b) *Narrow focus on investment advice*. ICAP stated that it believed Arlingclose had a narrow focus on providing investment advice and did not have sufficient depth of expertise to service Butlers' clients.

   (c) *Credit counterparty service.* ICAP told us that unlike Arlingclose, STS subscribed to receive credit rating information directly from the three main credit rating agencies, which was an expensive service to run. ICAP was unconvinced that Arlingclose would offer an equivalent service within an acceptable time frame.

   (d) *Economic analysis and interest rate forecasting service.* ICAP stated that whilst STS could draw on the economic analysis and interest rate forecasting services of its external consultant, internal economist and three external companies, Arlingclose did not appear to offer such a comprehensive service.

   (e) *Partnership arrangements.* ICAP told us that STS had a number of external partnerships to provide coverage in areas where it did not have in-house expertise, but which might be required by clients. ICAP told us that Arlingclose did not have any of these arrangements.

Assessment of Arlingclose as an alternative purchaser of Butlers

3. We asked Arlingclose how it would respond to ICAP's concerns listed above. Arlingclose submitted a detailed response which addressed each issue.

Lack of staffing resources

4. Arlingclose told us that central to achieving its commitment of providing a high-quality and independent service was a sensible client to executive ratio. Arlingclose told us that during its launch phase in 2004, local authorities told Arlingclose that this was an important area and mentioned that STS, and to a lesser extent Butlers, were offering 'increasingly impersonal services'.

5. Arlingclose told us that it currently employed 14 full-time executives, of whom ten were client-facing with 85 local authority clients, equating to a nine-to-one client to executive ratio. Arlingclose believed that it had a superior client to executive ratio to that of both Butlers and STS and therefore rejected ICAP's claims that Arlingclose's

staffing levels were a primary consideration when deciding to dismiss Arlingclose as a suitable purchaser.

6. Arlingclose told us that it believed six client-facing staff transferred from Butlers to STS, and that it would have needed the majority of these staff to transfer over to Arlingclose for it to take on all of Butlers' contracts. However, Arlingclose also believed that STS was in no different a position.

7. During its hearing, ICAP told us that [✄] Butlers employees ([✄]) had informed Butlers' senior management prior to the sale that, for personal reasons, they would not transfer to Arlingclose if Butlers was sold to Arlingclose and that these issues were known at the time to ICAP. ICAP argued that, absent these [✄] employees, there were serious doubts that Arlingclose would be able effectively to service Butlers' clients. However, whilst ICAP's evidence may suggest that fewer Butlers staff may have transferred to Arlingclose than to STS, it is not possible to predict precisely how many staff would have transferred to Arlingclose, if Butlers had been to sold Arlingclose instead of STS. In any event, Arlingclose told us that it required only a majority of the six Butlers staff to transfer to it in order for it to take on all of Butlers' contracts. Further, we noted that ICAP had not approached Arlingclose to ascertain whether Arlingclose would have had any staffing issues if it had wanted to take on all of Butlers' clients.

Narrow focus on investment advice

8. ICAP told us that the majority of local authorities were looking for a 'one-stop-shop' provider of TMA services and that STS offered the broad range of services which would appeal to local authorities. ICAP was concerned that Arlingclose did not have sufficient depth of experience to service Butlers' clients. ICAP also told us that STS (like Butlers) offered a balanced portfolio of services across debt advice, investment services and technical/accounting advice, whilst there was a 'widely held perception' that Arlingclose had a narrow focus on providing investment advice.

9. Arlingclose told us that ICAP's statement did not accurately reflect Arlingclose's services, and that this had been used by Butlers as a 'marketing line' over the past few years in an attempt to counter Arlingclose's success. Arlingclose told us that it provided debt management as well as investment advice to all its clients and that the overall scale of its clients' debt portfolios was significantly in excess of the scale of its clients' investment portfolios. Arlingclose told us that it provided a full range of advisory services to local authorities and therefore considered ICAP's claims to be without foundation.

Credit counterparty service

10. In relation to ICAP's concern that Arlingclose would not have offered a credit counter-party service that would have matched STS's offering, Arlingclose told us that it had chosen to provide counterparty services to its clients using a different model from STS and Butlers, since the ratings approach was proven to be wholly inadequate, and that this no longer met the professional obligations of local authority finance departments. However, Arlingclose added that, had it been approached by ICAP to acquire Butlers, then Arlingclose would have considered, and would have been capable of, adopting the approach that Butlers' clients had experienced to date if this was what those clients wanted.

11. Arlingclose added that if contractual arrangements with the rating agencies had been an issue, then this could have easily been made a condition of sale. Arlingclose also

told us that, based on its research and experience, this was not an expensive service to run.

12. We did not find the reason given by ICAP for rejecting Arlingclose relating to direct credit rating feeds to be compelling, mainly on the basis that such areas represent a point for negotiation between any vendor and purchaser. We therefore consider that, had ICAP sold to Arlingclose, such practical issues could have been dealt with between the two parties. [✂]

Economic analysis and interest rate forecasting

13. ICAP told us that Butlers had access to the services of an external consultant and an internal economist to provide clients with economic analysis and interest rate forecasts, which were essential for the formulation of debt management and investment strategies. ICAP also added that STS had arrangements with [✂], [✂] and [✂] to provide the same analysis. ICAP added that Arlingclose did not appear to offer such a comprehensive service.

14. Arlingclose told us that whilst it did not employ any academic economists, it had established relationships with a number of investment banks that enabled access to its written economic research and its economists in a similar manner to STS's arrangements with [✂], [✂] and [✂]. Arlingclose told us that it had arrangements with the Royal Bank of Canada Capital Markets, National Australia Bank, and other financial institutions, eg Investec and JP Morgan Cazenove, alongside publicly available analysis readily available from the Bank of England, HM Treasury and the Office for Budget Responsibility.

15. Arlingclose stated that all TMA retainer contract mandates included interest rate and economic forecasting as a required element of the overall scope of services, and therefore the fact that Arlingclose had over 85 local authority clients would suggest that it was able to provide a very credible offering in this area.

16. Arlingclose also argued that Butlers' in-house economist (to whom ICAP referred in its arguments for rejecting Arlingclose) did not move to STS, and therefore Butlers' clients had experienced a change in service with their transfer to STS, which would have been no different to what Butlers' clients would have experienced in a move to Arlingclose.

Partnership arrangements

17. In relation to ICAP's concerns that Arlingclose did not have any partnership arrangements in place, Arlingclose told us that, if it had acquired Butlers, then many of the companies which provided these partnerships might have been interested in forming partnerships with Arlingclose, and that Arlingclose could have taken on such extensive partnership arrangements if it had so wished. Again, we considered that this represented a point for negotiation between any vendor and purchaser.

Further evidence on competitive effects

Dimensions of competition

1. Sterling told us that the marketplace was differentiated. Local authorities often perceived Sterling as an average-quality, low-price provider during the bidding process. According to Sterling, Arlingclose was perceived to be a high-price, high-quality operator, Butlers was perceived to be an average-to-high quality, average-price operator and STS was perceived to be a low-price, low-quality operator.

2. Arlingclose told us that it competed mainly on quality. Arlingclose also told us that the current financial environment made local authorities a little more sensitive to price.

3. We found that Sterling's account of the local authorities' perception of the providers' position in the product space was accurate at least as far as price was concerned (see Table 1). It would also appear likely that Sterling was servicing fewer complex contracts. [✂] This cannot be explained by a different pricing or business structure as Sterling has no transactional income to supplement this revenue. This also cannot be explained by Sterling's willingness to accept lower gross variable margins as its margins are similar to those of the remaining competitors.[1]

TABLE 1 **Comparison of the value of contracts of the four existing providers**

£

	Average value of retainer contract (per year in the past five years)	*Average value of one-off contract (in the past five years)*
Arlingclose	[✂]	[✂]
Butlers	[✂]	[✂]
STS	[✂]	[✂]
Sterling	[✂]	[✂]

Source: Arlingclose, ICAP, STS and Sterling.

Nature of competition in the provision of TMA services to local authorities

Closeness of competition

Diversion ratios

4. Diversion ratios are a good indicator of closeness of competition between various competitors in the markets.[2] The higher the diversion ratios between the merging parties, the greater the scope for the merged entity to recapture sales that follow a price increase (or a worsening in other aspects of its retail offer) by one of the merging parties.

[1] Sterling's published accounts.
[2] The Guidelines explain (paragraph 5.2.15(b), footnote 52) that '[a] diversion ratio between Product A and Product B represents the proportion of sales that would divert to Product B (as opposed to Products C, D, E etc) as customers' second choice in the event of a price increase for Product A'.

5. STS submitted diversion ratios calculated on the basis of its 'win/loss' data (see Table 2). STS argued that this data showed that *(a)* both STS and Butlers were more constrained by Arlingclose than by each other and STS more considerably so, and that *(b)* it was more relevant to assess the constraint that Butlers exerted on STS rather than STS on Butlers.

TABLE 2 **Diversion from STS and Butlers based on STS's win-loss data**

per cent

Diversion ratio from Butlers (STS win/loss data)		*Diversion ratio from STS (STS win/loss data)*	
Arlingclose	[35–45]	Arlingclose	[55–65]
STS	[35–45]	Butlers	[15–25]
Sterling	[15–25]	Sterling	[15–25]

Source: STS.

6. We requested comprehensive bidding data from the merging parties for the past five years. We requested similar information from Arlingclose, Sterling and the large four accountancy firms. STS's data was only fully comprehensive from 2009 onwards with less comprehensive information for the period 2007 to 2008. Butlers' data covered the entire period we requested but often proved to have gaps. Arlingclose's and Sterling's data was generally comprehensive.

7. We used the data from the competitors to carry out our own diversion ratio analysis. This analysis relied on cross-checking the four competitors' bidding data and customer lists with each other. We focused on the period between the beginning of 2007 and the acquisition of Butlers by STS in October 2010.

8. STS told us that we should have carried out an assessment of the losses of contracts that occurred following the merger (ie from October 2010 to date) [✂]. We did not do this analysis for the following reasons: *(a)* we did not have a sufficient number of data points to establish sound diversion ratios post-merger; *(b)* price is only one aspect of the retail offer that STS could have worsened and the information provided by local authorities suggests that it is not the most important variable; and *(c)* during the period in question STS has been subject to scrutiny from competition authorities which would have reduced its incentive to worsen its retail offer substantially.

9. Our analysis found very similar results to those found by STS, indicating that Arlingclose captures most of the switching from both Butlers and STS with STS being the second closest competitor to Butlers and Butlers the second closest competitor to STS. However, we note that this may be at least partly driven by the impact of the Icelandic banking crisis which provided a boost to Arlingclose's business as Arlingclose was the only TMA services provider not to advise local authorities to invest in Icelandic banks.

10. STS told us that it considered Arlingclose to be its closest competitor, with Sterling and Butlers being equally close competitors. We accept that the diversion ratio analysis suggests that Arlingclose is STS's closest competitor. However, the diversion from STS to Butlers is large enough to raise concerns irrespective of the size of diversion from STS to Arlingclose or Sterling.

11. We further carried out an analysis of the diversion from Arlingclose and for completeness Sterling for the purposes of understanding whether a sale of Butlers to Arlingclose or Sterling might itself have raised competition concerns (although we considered a sale to Sterling to be unlikely). The results of this analysis are based on very few observations ([✂] for Arlingclose and [✂] for Sterling) and are therefore

unlikely to be reliable. The reason for this is that Sterling has only limited presence in the market and therefore lost only [✂] contracts, and Arlingclose maintained an aggressive expansion strategy throughout the analysed period and therefore lost only [✂] contracts.[3] The results of the diversion ratio analysis are in Annex 1.

Bid ranking

12. We used the data from the local authorities' questionnaire to see how often STS ranked as the second preferred bidder in instances when Butlers won a tender and vice versa. We found that Butlers ranked most often as the second bidder when STS won and, similarly, STS ranked most often as the second bidder when Butlers won. We note that this result is not out of proportion with the parties' market shares, with STS being the largest provider and Butlers the second largest. Further details are in Annex 2.

13. STS told us that because this result was based only on 82 responses from local authorities, we should put more weight on the diversion ratio analysis. We note that we took both pieces of evidence into account. Given that the 82 responses we received in response to our question regarding bid ranking represented around 20 per cent of all local authorities in the UK and that we have no reason to believe that the responses received were not representative of the total local authority population (see Appendix G), we consider that the second preferred bidder analysis is sound and valuable.

Evolution of market share

14. We also found it useful to consider market share information to assess the strength of competition between the existing providers. For instance, historic market share data shows us that the importance of Arlingclose as a competitive constraint on the merging parties has increased over time as Arlingclose increased its market presence (see Table 3).[4] We understand that Arlingclose has further plans to expand in the TMA services market which means that its competitive constraint on the merging parties is likely to grow.

TABLE 3 **Evolution of market share in the provision of TMA services to local authorities**

	2008		*2009*		*2010*	
	Number of contracts	*%*	*Number of contracts*	*%*	*Number of contracts*	*%*
Arlingclose	[✂]	[5–15]	[✂]	[5–15]	[✂]	[15–25]
Butlers	[✂]	[25–35]	[✂]	[25–35]	[✂]	[25–35]
STS	[✂]	[45–55]	[✂]	[45–55]	[✂]	[45–55]
Sterling	[✂]	[0–10]	[✂]	[0–10]	[✂]	[5–15]
Total	[✂]	100	[✂]	100	[✂]	100

Source: Arlingclose, ICAP, STS and Sterling.

15. STS disputed the data presented in Table 3. It argued that it excluded those contracts where STS provided advice on capital finance options. It argued that it had [✂] contracts before the merger. It also argued that it had [✂] housing association

[3] This effect may have been further exacerbated by the fact that, as a new entrant growing rapidly, a lower proportion of Arlingclose's contracts have yet to come up for renewal.
[4] We note that we used the numbers of retainer contracts to establish market shares over the past five years. We preferred this approach over the approach of relying on the value of contracts as we found the data underlying the numbers of contracts easier to verify. This data also contained fewer inconsistencies across the various data sources. If we had used value-based market shares, it would not have altered the outcome of our analysis.

clients. We did not accept STS's revised figures. First, we concluded that housing associations do not form part of the relevant market (which consists of TMA services provided under retainer contracts to UK local authorities). Second, we did not consider capital finance to be an integral part of TMA services provided to local authorities. Third, STS's capital finance revenue is generated from retainer contracts and asset finance transactions. STS's capital finance retainer contracts account for a very small proportion of STS's overall revenues ([0–10] per cent). Their omission is therefore unlikely materially to influence our decision. The transactional income is generated on a one-off basis and cannot easily be attributed to any given contract. Finally, the data we rely on is taken from the data provided by STS in response to our data request.

16. STS also told us that Sterling posed as strong a constraint on STS as Butlers did. We note that on the basis of the diversion ratios that we obtained (see below), Sterling would appear to pose a smaller constraint on STS than Butlers did, although we accept that this constraint is higher than Sterling's market share would suggest. The second preferred bidder analysis (also presented later in this appendix) shows a considerably weaker constraint from Sterling on STS than from Butlers on STS. Finally, the considerably lower average value of Sterling contracts would suggest to us that Sterling was servicing fewer complex contracts.

Evidence on margins

17. In this case, gross variable margins depended crucially on whether we considered payroll costs as fixed or variable. There are arguments for both approaches and we therefore propose a range of margins.

18. We found that STS's gross variable margins are likely to be between [75–100] and [75–100] per cent, ie moderately high to very high margins, giving rise to at least moderate unilateral effects post-merger. We found that Butlers' gross variable margins are likely to be between [25–50] and [75–100] per cent. For comparison, we established that Arlingclose's gross variable margins are likely to be between [25–50] and [75–100] per cent. These margins are important for our assessment of the competitive effects under different counterfactual scenarios. Further details on how these margins have been derived and the assumptions used are in Annex 3.

19. STS told us that our own counterfactual analysis (see Appendix E) shows that payroll costs are variable. This is an incorrect interpretation of our analysis. We used both estimates of gross variable margins and found that even on the lower estimate (ie the estimate based on the assumption that staff costs were fully variable) the scope for post-merger unilateral effect was at least moderate.

20. We carried out a GUPPI analysis which combines the effect of diversion ratios and margins on the merging parties' incentives (see Annex 4 for more details).

21. STS told us that GUPPI analysis assumed that purchasers saw posted prices and made their purchasing decisions accordingly. Therefore STS argued that this analysis was less appropriate when prices and margins varied by customer as in this case. STS believed that analysis of tender data was more informative. In addition, STS argued that the GUPPI was only an indicator of pricing pressure and did not provide the likely price effect of the merger.

22. We considered STS's arguments. First, we agree (as set out in our initial analysis) that GUPPI is an indicator of pricing pressure. This means that GUPPI will be a useful indicator of the competitive constraint that has been lost post-merger, but will not on its own be a reliable indicator of by how much we would expect prices to rise

for each tendered contract. However, we also note that GUPPI can be used in bidding markets.[5] Second, a key component of the GUPPI is the diversion ratio. This ratio has been derived from the bidding data and approximates the probability with which STS will lose contracts to the remaining competitors and thus provides an indication of closeness of competition in this market. Finally, margins are a useful indicator of the value of the bids that can be internalized by the merged company following a price rise.

Incumbency advantages

Size of market share

23. We considered whether a particular distribution of market shares may have a considerably different impact on the degree of competition between the remaining three operators. We found in our assessment of the likelihood of entry into the relevant market (see Appendix H) that new entry into the provision of TMA services to local authorities might be difficult because of the need (among other things) to establish a track record with local authorities. However, we also found that once an operator is present in the market, it can grow irrespective of its existing market share. Arlingclose's fast growth and future growth plans are evidence of this. On the basis of this reasoning, it would not appear important for future competition how the existing Butlers' contracts are distributed between the remaining competitors, since Arlingclose, STS and Butlers have been able to compete strongly in the past despite differences in market shares.

Local authority inertia

24. We further considered whether TMA services contracts showed a degree of 'stickiness', by which we mean that the incumbent is more likely than it would otherwise be to retain its contract at retendering. Such an effect would relax the competitive pressure on the incumbent to offer a good deal.

25. The local authority questionnaire responses show that both STS and Arlingclose retain a large proportion of their contracts over time (see Table 4). Arlingclose retains [75–100] per cent of its contracts and STS retains [75–100] per cent of its contracts.

TABLE 4 **Retention of contracts over time**

Base: 139 local authorities	*Contracts lost as % of all contracts serviced over the past five years that came up for retendering*
Arlingclose	[15–25]
Butlers	[45–55]
STS	[15–25]
Sterling	[30–40]

Source: Local authorities, Sterling.

26. We are aware that this data may not be entirely accurate as it does not take into account the fact that some contracts may not have come up for retendering in the

[5] See, for instance, Serge Moresi: 'Bidding Competition and the UPP Test', HMG Review Project – Comment, Project No. P092900, 9 November 2009.

five-year period that we were observing. However, this effect will be mitigated by the fact that 89 per cent[6] of all contracts have durations of between three and five years.

27. Not all local authorities that were supposed to retender their contracts did so. We estimated that about 27 per cent[7] of authorities rolled over their contracts. Such practice further delays the time when contracts are subject to competition.

28. Our analysis suggests that, once a local authority has established a good relationship with a TMA services provider, it may look more favourably on that TMA services provider in any retendering process. Local authorities may also not want to run a tender procedure for contracts that they consider of low value (see Table 5).

TABLE 5 **Local authorities' reasons for rolling over their current TMA services contracts**

	Number of mentions	*% of local authorities answering this question that mentioned this reason*
Happy with/values existing provider	30	79
Contract amount too low for a retender to be worthwhile	13	34
Has got a good price already	13	34
Rollover is within Council's procurement rules	5	13
Busy on other work	2	5
Few alternatives to current provider	2	5
Considers aligning contract with another local authority for a joint tender	2	5
Waits to see what happens with Butlers after the merger	1	3
Was offered a price reduction by the existing provider	1	3
Total mentions	69	

Source: Local authorities.

Note: 38 local authorities provided detailed answers to this question. Some mentioned more than one reason for rolling over their TMA services contracts.

29. STS noted that the fact that local authorities might choose not to retender was not because of a lack of choice or opportunity to tender but because they were satisfied with their provider and the price. We accept that the degree to which contracts are rolled over could diminish if local authorities were less satisfied with their existing providers following, for instance, worsening of the retail offer. However, even in such circumstances, an element of uncertainty about alternative providers along with the costs of retendering, may contribute to some reluctance to retender.

30. We note that the 'stickiness' of contracts applies in equal measure to Arlingclose and STS. This suggests that, at least on this measure, there is no difference between the merger in which Butlers was acquired by STS and the scenario in which Butlers would be acquired by Arlingclose.

31. Finally, we note that the stickiness of contracts relaxes competition only temporarily and any such effect erodes over time.

Effect on one-off contracts

32. We considered the impact of the merger on the provision of TMA services to local authorities under one-off contracts. Both STS and Butlers provided such services before the merger.

[6] Based on the responses of 96 local authorities.
[7] Based on the responses of139 local authorities.

33. We found that only 22 per cent of local authorities that responded to our questionnaire had one-off TMA contracts. We further found that 79 per cent of those local authorities obtained their one-off TMA services from their existing provider of TMA services under a retainer contract and a further 3 per cent used the same provider at least for some of their one-off contracts. According to the responses to our questionnaire, it appeared that one-off contracts mostly covered ad hoc pieces of advice relating to special, unpredicted needs of the local authority not covered within the scope of any pre-existing retainer contract (see Table 6).

TABLE 6 **Evidence on one-off contracts from local authority questionnaire**

Prevalence of one-off contracts	*Number of local authorities*	*% of local authorities*
Base: 148 local authorities		
Number of local authorities with one-off contracts	32	22
Number of local authorities without one-off contracts	116	78
Total	148	100
Same provider as the one servicing a retainer?	*Number of local authorities*	*% of local authorities*
Base: 29 local authorities		
Yes	23	79
Yes (among others)	1	3
No (but other TMA services provider)	3	10
No (other provider)	2	7
Total	29	100
Reason for one-off contracts	*Number of mentions*	*% of mentions*
Base: 31 local authorities		
Ad hoc/additional/extraordinary items	17	55
Specialized piece of work	16	52
Independent/second view	4	13
Training	9	29
Total	46	

Source: Local authorities.

34. As shown in Table 6, in a minority of cases, local authorities used providers other than their existing providers of retained TMA services for their one-off TMA contracts. Based on the information provided by local authorities, PwC and BRC Consulting provided one-off TMA services. According to the information provided by the large accounting firms, KPMG and Deloitte also provided some one-off TMA services. There were indications that the type of advice provided under one-off TMA contracts was not always the same as that provided under TMA retainer contracts by the four existing providers of retainer services (ie Arlingclose, Butlers, STS and Sterling). For example, KPMG told us that its one-off TMA contracts were linked to dealing with the aftermath of the Icelandic banking crisis and took the form of treasury and investment reviews.

35. We also found that one-off revenues only accounted for a relatively small proportion of the overall local authority TMA revenues of STS, Butlers, Arlingclose and Sterling, ranging from a maximum of [15–25] per cent for STS to a minimum of [0–10] per cent for Butlers and Sterling (see Table 7).

TABLE 7 **Proportion of local authority TMA revenue from one-off contracts**

	One-off TMA contract revenues as a % of revenues from all local authority TMA contracts between 2007 and 2011
STS*	[15–25]
Butlers	[0–10]
Arlingclose	[0–10]
Sterling	[0–10]

Source: Arlingclose, ICAP, STS, Sterling.

*STS's data refers to an average of 2009 and 2010 data. STS did not provide data for 2007 and 2008. For 2010, we considered the one-off revenue for the entire period and rescaled the revenue for the period up to October 2010 (ie before STS purchased Butlers) for the remainder of the year rather than taking the closing balance as this already included Butlers' retainer contracts. [✂]

36. Overall, it would appear that one-off TMA contracts are mostly an aftermarket for retainer TMA contracts. Only a small proportion of TMA services are provided under one-off contracts and only a small proportion of one-off TMA contracts appear to be contestable by providers other than the provider(s) currently servicing the TMA retainer contract(s) with the local authority in question. The large accounting firms seem to be the main competitors for one-off TMA contracts alongside the existing TMA providers. We concluded that:

(a) the merger had no effect on competition for those one-off TMA contracts that are contestable by providers other than those currently supplying TMA services under retainer contracts to a given local authority when compared with the counterfactual. Both following the merger and in the counterfactual, the number of competitors for such one-off contracts has decreased by one; and

(b) the merger had no effect on competition for one-off TMA contracts that follow on from existing TMA retainer relationships when compared with the counterfactual. Both following the merger and in the counterfactual, the competitive constraint on STS has relaxed as a result of reduction in competition for retainer contracts.

37. STS told us that because it sold one-off TMA services to its retainer clients, its one-off business would suffer if it were to worsen its retainer offering (by raising prices or reducing quality). We did not agree that STS's one-off TMA contracts constrained its TMA retainer contract pricing, because, as shown in Table 7, one-off contract revenue represents a relatively small proportion of STS's total TMA contract revenue from local authorities. Even if the proportion of STS's revenue derived from one-off contracts were larger, the evidence in Table 6 regarding local authority purchasing behaviour indicated that most of this revenue would be generated from contracts that were not contestable by any other provider. In this case, whether we consider the retainer market alone or in combination with the aftermarket of one-off contracts, the merger has not changed the competitive conditions with respect to the counterfactual (ie in both cases the number of competitors reduced from four to three).

Increase in contract numbers by existing competitors

Arlingclose

38. Arlingclose characterized its growth as 'organic' and suggested that difficulties acquiring new staff and the delay before new staff were hired and could be used were a barrier to expansion.

39. Despite this, in the past five years Arlingclose has almost tripled the number of local authorities it serves (from 31 in 2007 to 87 in 2011).[8] However, we note that Arlingclose's rate of growth is partly due to it having been a new entrant and the fact that it was growing from a low base—it still has [15–25] per cent market share (see Table 3 above).

40. Arlingclose told us that it was currently over-resourced which meant that it had capacity to grow and was planning growth of approximately one client per month, hoping to reach 100 clients by June 2012. It considered this growth ambitious for the relatively organic pattern of growth that was typical in this market but it considered its goal realistic.

41. Arlingclose also told us the Icelandic banking crisis had provided it with a boost, but the effects were slightly wearing off. Before the Icelandic banking crisis, Arlingclose grew by 10 to 12 contracts a year, during the crisis it attracted between 15 and 20 new contracts a year and it was currently attracting between 15 and 17 contracts a year. Arlingclose could not fully test the new situation because of the limited number of contracts that came up for tender. We analysed Arlingclose's growth rate and found that it accelerated significantly in 2009, but slowed slightly in 2010 and 2011 (see Table 8).

TABLE 8 **Arlingclose's growth rate**

Year	*Total number of retainer contracts*	*Growth in the number of retainers per month*
As at April 2011	87	1.5
As at the end of 2010	81	1.7
As at the end of 2009	61	1.8
As at the end of 2008	40	0.8
As at the end of 2007	31	

Source: Arlingclose.

Sterling

42. Sterling has not radically increased its presence in the market in the past five years [✄].

43. With respect to its growth plans, Sterling told us that it had three members of staff delivering TMA services to local authorities and had just hired a fourth one. Sterling could not estimate precisely how large it would grow: in an ideal world, it would serve about one-third of the market, but until it started to see the benefits of what the three or four consultants could bring to the company, it could not make any predictions about the future.

Competition in the regions of UK

44. We analysed the client lists of the four providers of TMA services to local authorities (see Table 9) and found that Butlers, like the other three TMA services providers, had contracts in England and Wales, but did not have contracts in Scotland and Northern

[8] Arlingclose.

Ireland. Only Arlingclose and STS have contracts in Scotland and no provider has contracts in Northern Ireland.

TABLE 9 **Regions in which the four TMA services providers have contracts**

	England	*Wales*	*Scotland*	*Northern Ireland*
Arlingclose	✓	✓	✓	X
Butlers	✓	✓	X	X
STS	✓	✓	✓	X
Sterling	✓	✓	X	X

Source: Arlingclose, ICAP, STS and Sterling.

45. Sterling told us that it had clusters of clients in the South-West and South-East of England. It believed that this was at least in part likely to be caused by the preference of local authorities to appoint a company with regional presence or with references from a neighbouring authority.

46. Arlingclose told us that it occasionally sought to gain a toehold in a new region by pricing keenly. Its further growth in that region would then be stimulated by the recommendations of those local authorities to others within that region. Arlingclose would also consider lowering prices if it felt that it was under-represented in a region, as it is, for instance, north of the Mersey. Arlingclose told us that a reference from a respected neighbour could be very powerful.

Competition for customer segments

47. Our analysis shows that Sterling tends to service lower-priced contracts. This may mean that it does not offer the same depth and breadth of services as STS and Butlers. Arlingclose, however, competes on quality (see paragraph 2), which would suggest that it is able to offer the same range of services.

48. Arlingclose told us that over the years there were instances where it was unable to bid for a contract as it did not have the required expertise, however, this concern has not been a serious one to date. Arlingclose further submitted that despite not serving every type of local public body, it had a good exposure to all major local public bodies that tendered for TMA services in line with its smaller market share. For instance, Arlingclose does not serve National Parks and Joint Waste Authorities, but noted that these authorities had not tendered for TMA services in the past five years.

Diversion ratio analysis

	Number of instances	Proportion
Diversion ratio from STS from the beginning of 2007 to October 2010		
Arlingclose	[✄]	[65–75]
Butlers	[✄]	[15–25]
Sterling	[✄]	[5–15]
Total diversion	[✄]	100
Diversion ratio from Butlers from the beginning of 2007 to October 2010		
Arlingclose	[✄]	[40–50]
STS	[✄]	[35–45]
Sterling	[✄]	[15–25]
Total diversion	[✄]	101*
Diversion ratio from Arlingclose from the beginning of 2007 to October 2010		
Butlers	[✄]	[45–55]
STS	[✄]	[45–55]
Sterling	[✄]	[0–10]
Total diversion	[✄]	100
Diversion ratio from Sterling from the beginning of 2007 to October 2010		
Arlingclose	[✄]	[35–45]
Butlers	[✄]	[35–45]
STS	[✄]	[15–25]
Total diversion	[✄]	100

Source: Arlingclose, ICAP, STS and Sterling.

*Sums to more than 100 per cent due to rounding.

The proportion of instances when the four providers ranked as the second preferred bidder

	Number	*%*		*Number*	*%*		*Number*	*%*		*Number*	*%*
Arlingclose won	[✂]		**Butlers won**	[✂]		**STS won**	[✂]		**Sterling won**	[✂]	
Butlers 2nd	[✂]	[40–50]	Arlingclose 2nd	[✂]	[25–35]	Arlingclose 2nd	[✂]	[35–45]	Arlingclose 2nd	[✂]	[25–35]
STS 2nd	[✂]	[45–55]	STS 2nd	[✂]	[65–75]	Butlers 2nd	[✂]	[35–45]	Butlers 2nd	[✂]	[0–10]
Sterling 2nd	[✂]	[0–10]	Sterling 2nd	[✂]	[0–10]	Sterling 2nd	[✂]	[15–25]	STS 2nd	[✂]	[65–75]

Source: Local authorities.

Note: There were 82 instances (out of a total of 139 responses by local authorities with retainer TMA services contracts) where a local authority with a retainer contract provided the ranking of the bidders at their last tender.

Margin analysis

1. We estimated gross variable margins for STS, Butlers and Arlingclose.

TABLE 1 **Margin analysis**

	£'000
STS's gross variable margins for FY2010	
Revenues	
TMA retainer services	[✂]
Transactional attributed to TMA clients (based on proportion of TMA retainer services of total revenues)	[✂]
Total	[✂]
Variable costs	
Payroll attributable to TMA retainer services (based on proportion of TMA retainer services of total revenues)	[✂]
STS direct costs attributable to TMA retainer services (based on proportion of TMA retainer services of total revenues)	[✂]
Total	[✂]
Gross variable margin (payroll not deducted) (%)	**[75–100]**
Gross variable margin (payroll deducted) (%)	**[25–50]**
Butlers' gross variable margins for FY2010	
Revenues	
TMA services	[✂]
Transactional income	[✂]
Total	[✂]
Variable costs	
Employment costs	[✂]
Bonuses/commissions	[✂]
Other direct costs	[✂]
Total	[✂]
Gross variable margin (payroll not deducted) (%)	**[75–100]**
Gross variable margin (payroll deducted) (%)	**[25–50]**
Arlingclose's gross variable margins for FY2010	
Revenues	
TMA services	[✂]
Total	[✂]
Variable costs	
Staff costs	[✂]
Costs of sales	[✂]
Total	[✂]
Gross variable margin (payroll not deducted) (%)	**[75–100]**
Gross variable margin (payroll deducted) (%)	**[25–50]**

Source: STS, ICAP, Arlingclose.

2. The key to establishing the gross variable margin was to understand whether we should consider staff costs as variable. We found that in the case of STS, staff numbers were not stable with a large number of both joiners and leavers. However, we could not easily associate this variability with the variability of STS's TMA services business as STS did not provide us with granular data as we requested. (See Table 2 below.)

TABLE 2 **STS's staff and retainer contract fluctuation**

Number

Year	*New joiners*	*Leavers*	*Total STS staff*	*TMA services contracts*
As at April 2011	[✂]	[✂]	[✂]	[✂]
As at the end of 2010	[✂]	[✂]	[✂]	[✂]
Before the merger in October 2010	[✂]	[✂]	[✂]	[✂]
As at the end of 2009	[✂]	[✂]	[✂]	[✂]
As at the end of 2008	[✂]	[✂]	[✂]	[✂]

Source: STS.

3. We further allocated STS's 'transactional' income to its TMA services since in 2010 the vast majority of STS's TMA transactional income was generated from STS's local authority retainer clients.

4. STS disagreed with our attribution of payroll costs. It argued that there were higher numbers of employees providing TMA services. However, in the absence of verifiable data from STS about the proportion of the payroll costs to be attributed to TMA services, we consider that we have used a reasonable approximation of this cost by using a proportion of staff costs that correspond to the proportion of TMA retainer revenues that STS generates (but excluding transactional income which effectively generates [between 90 and 100] per cent margins). This approximation would only be incorrect if we were to find that TMA services had a considerably lower margin (ie considerably higher payroll cost) than other activities undertaken by STS. STS's business plans show clearly that this is not the case.

5. STS also suggested that it would be appropriate to include capital finance data in our estimate of gross variable margins. As we discussed in paragraph 15, we do not consider the inclusion of capital finance to be appropriate. Moreover, when we applied the same methodology to capital finance to establish the costs corresponding to the retainer and transactional revenues that constitute the capital finance business and incorporated this analysis into our estimate of the gross variable margins, we found that this estimate increased (from [25–50]–[75–100] per cent to [50–75]–[75–100] per cent) and thus amplified the potential scope for unilateral effects.

6. In the case of Arlingclose, we noticed that staff numbers were adjusted with the growth in business although not perfectly. It appeared to us that numbers of contracts per staff member had temporarily increased before new staff were hired, leading to a decline in the number of contracts per staff member (see Table 3 below). Arlingclose explained that it often hired staff in advance to avoid future bottlenecks. This would suggest that staff numbers are fixed in the short term and variable in the medium term. Using the medium-term view to estimate the gross variable margins might underestimate Arlingclose's difficulty in adjusting its staff costs to respond to changes in competition.

TABLE 3 **Arlingclose's staff utilization rates**

	Number of retainer contracts	*Number of staff delivering TMA services*	*Number of retainers per staff*
As at the end of 2007	[✂]	[✂]	[✂]
As at the end of 2008	[✂]	[✂]	[✂]
As at the end of 2009	[✂]	[✂]	[✂]
As at the end of 2010	[✂]	[✂]	[✂]
As at April 2011	[✂]	[✂]	[✂]

Source: Arlingclose.

7. In the case of Butlers, staff costs were relatively stable and did not vary with the number of contracts that Butlers' staff were servicing. This was significant as the number of Butlers' contracts has decreased over the period for which we had data (ie 2007 to 2010). We also noticed that while staff numbers did not change, the level of bonuses did (it decreases significantly in the period when the number of contracts decreases). This would suggest that we should not consider staff costs as variable for Butlers (see Table 4 below).

TABLE 4 **Butlers' staff costs and staff utilization rates**

	Number of staff delivering TMA services	*Number of contracts per staff delivering TMA services*	*Fixed payroll costs per member of staff £*	*Bonuses per member of staff £*
In October 2010	[✂]	[✂]	[✂]	[✂]
As at the end of 2009	[✂]	[✂]	[✂]	[✂]
As at the end of 2008	[✂]	[✂]	[✂]	[✂]
As at the end of 2007	[✂]	[✂]	[✂]	[✂]

Source: ICAP.

8. We note that it would appear that there is a certain target 'utilization' rate in terms of contracts per member staff which ensures profitability. We understand from our discussions with the four competitors that this optimal number of contracts per staff member tends to be a range than a fixed number. This may suggest that the variability in the numbers of contracts per staff member that we observed was not sufficient to justify adjusting staff numbers. If so, we might underestimate the variability of staff costs.

The GUPPI analysis

GUPPI for STS assuming that it acquired Butlers

$GUPPI_{SB}$	*Source/comment*	*Value*
P_B	Butlers data request	£[✄]
P_S	STS data request	£[✄]*
DR_{SB}	All data requests cross-checked	[10–20]
M_B	Lower bound (payroll excluded)	[30–40]
	Upper bound (payroll not excluded)	[75–85]
$GUPPI_{SB}=DR_{SB}*M_B*P_B/P_S$	Lower bound	[5–15]
	Upper bound	[15–25]
$GUPPI_{SB}/2$	Lower bound	[0–10]
	Upper bound	[0–10]

GUPPI for Butlers assuming that it has been acquired by STS

$GUPPI_{BS}$	*Source/comment*	*Value*
P_S	STS data request	£[✄]
P_B	Butlers data request	£[✄]
DR_{BS}	All data requests cross-checked	[35–45]
M_S	Lower bound (payroll excluded)	[45–55]
	Upper bound (payroll not excluded)	[85–95]
$GUPPI_{BS}=DR_{BS}*M_S*P_S/P_B$	Lower bound	[15–25]
	Upper bound	[25–35]
$GUPPI_{BS}/2$	Lower bound	[5–15]
	Upper bound	[10–20]

GUPPI for Butlers assuming that it has been acquired by Arlingclose

$GUPPI_{BA}$	*Source/comment*	*Value*
P_A	Arlingclose data request	£[✄]
P_B	Butlers data request	£[✄]
DR_{BA}	All DRs cross-checked	[40–50]
M_A	Lower bound (payroll excluded)	[35–45]
	Upper bound (payroll not excluded)	[85–95]
$GUPPI_{BA}=DR_{BA}*M_A*P_A/P_B$	Lower bound	[15–25]
	Upper bound	[35–45]
$GUPPI_{BA}/2$	Lower bound	[5–15]
	Upper bound	[15–25]

Source: Arlingclose, STS, ICAP.

*STS argued that the average price hid a variety of prices and contract lengths, which we accepted. Using the average value of contracts was the best estimate of price available. The result of the GUPPI calculation is not driven by this result as the average price for all three competitors analysed is similar, making the ratio very close to 1. STS objected to this conclusion, arguing that in a bidding market, contract values varied with each contract and the price ratio used in the GUPPI analysis was therefore likely to vary by contract. There are two elements to this argument: *(a)* applicability of the GUPPI analysis in bidding markets and *(b)* the use of the GUPPI analysis to predict price rises. We address both points in paragraph 22 where we explain that GUPPI is applicable to bidding markets and that it is an indicator of a firm's incentive to worsen its retail offer rather than a predictor by itself of a price rise for an individual contract.
Note: We could not calculate a GUPPI for Arlingclose assuming that it acquired Butlers as this would require an estimate of a diversion ratio from Arlingclose to Butlers. We considered any such estimate too unstable to be used. As shown in Annex 1, it would rely on only [✄] observations.

Market share distribution under different scenarios

	Pre-merger situation		*The merger: STS buys Butlers*		*Counterfactual: Butlers closes**		*Arlingclose buys Butlers*	
	Number of retainer contracts	*%*	*Number of retainer contracts*	*%*	*Number of retainer contracts*	*%*	*Number of retainer contracts*	*%*
Arlingclose	[✂]	[10–20]	[✂]	[10–20]	[✂]	[25–35]	[✂]	[45–55]
Butlers	[✂]	[25–35]						
STS	[✂]	[45–55]	[✂]	[75–85]	[✂]	[55–65]	[✂]	[45–55]
Sterling	[✂]	[5–15]	[✂]	[5–15]	[✂]	[5–15]	[✂]	[5–15]
Deloitte	[✂]	[0–10]	[✂]	[0–10]	[✂]	[0–10]	[✂]	[0–10]
Other	[✂]	[0–10]	[✂]	[0–10]	[✂]	[0–10]	[✂]	[0–10]
Total	[✂]	100	[✂]	100	[✂]	101†	[✂]	100

Source: Arlingclose, ICAP, STS, Sterling and CC analysis.

*Based on the diversion ratio obtained from the responses of the four competitors to our data request (see Annex 1 for more details).
†Sums to more than [✂] (100 per cent) due to rounding.

Local authority questionnaire background

1. This appendix explains how we gathered evidence from local authorities using a questionnaire.

Methodology

2. There are 433 local authorities in the UK.[1] In considering how to obtain as representative a picture of their views as possible, we contacted CIPFA, the professional body for public sector treasurers, to understand whether there were any particular types of local authorities or regions with different TMA service requirements. CIPFA advised that we should aim to ensure that responses to our questionnaire covered the various different types of local authority as their requirements could vary significantly.

3. We contacted the Section 151 Officer[2] in all local authorities in the UK and asked them to contribute to our questionnaire. Given the large number of UK local authorities, we used a standardized online questionnaire to make it easier for local authorities to fill it in and for us to process the results.

Outcome

4. One hundred and forty-eight local councils provided a full response to our questionnaire and seven provided incomplete answers. We only used the responses from those that provided a complete answer to all our questions.

5. Our questionnaire responses spanned all types of local authority, with good representation in each category and a spread over the entire UK (see Table 1 below).

TABLE 1 **Spread of local authority responses**

Type of local authority	*No of responses*	*No of local authorities*	*Response rate %*
England	**124**	**353**	**35**
Metropolitan council	17	36	47
District council	68	202	34
London borough council	10	33	30
County council	17	27	63
Unitary council	12	55	22
Scotland	**17**	**32**	**53**
Wales	**6**	**22**	**27**
Northern Ireland	**1***	**26**	**4**
Total UK	**148**	**433**	**34**

Source: Responses by local authorities to our third party online questionnaire, Municipal Year Book, 2011 edition, Volume 2.

*The bidding data indicates that none of the four TMA services providers has a retainer contract with a Northern Irish local authority and the responding Northern Irish local authority appears to have a one-off TMA services contract.

6. We observed that, during the response period for our questionnaire, as the number of local authorities responding increased, the distribution of answers to our questions did not change significantly, which suggested that there were no particular groups of

[1] Municipal Year Book, 2011 edition, Volume 2.
[2] This is a statutory position as the Responsible Financial Officer under section 151 of the Local Government Act 1972.

customers with different views. We also observed little difference between the responses of larger and smaller local authorities. For instance, large metropolitan councils mentioned their lack of specific expertise, their need for an external view and the uneconomical nature of self-supply as reasons for seeking an external TMA service provider, as did small unitary councils.

Entry and expansion

1. In this appendix, we set out our analysis of entry and expansion. We considered whether entry and/or expansion would be *(a)* timely; *(b)* likely; and *(c)* sufficient to prevent an SLC.[1] We looked at:

   (a) the history of entry into and exit from the market;

   (b) Arlingclose's entry experience;

   (c) potential entry (including self-supply by local authorities); and

   (d) possible barriers to entry.

History of entry and exit in the provision of TMA services to local authorities

2. Arlingclose provided us with a timeline of the firms providing TMA services to local authorities (see Annex 1). We were able to confirm most of the information in this timeline.

3. The merging parties are the longest standing competitors in the provision of TMA services to local authorities. Both have competed in this market since the early 1990s. Sterling and Arlingclose entered in 2001 and 2004 respectively.

4. Previously, there were two other competitors in the market, Prebon and King & Shaxson. Prebon's TMA services business appears to have been acquired by STS in 2000. King and Shaxson entered into a non-compete agreement with STS in 2008. King and Shaxson explained that STS approached it to offer introductions to local authorities to become dealing clients in return for King and Shaxson's withdrawal from the TMA services market. As King and Shaxson [✄] and had just lost its specialist adviser, it took the view that its ability to expand into the local authority TMA services market was limited. In addition, it was only ever a very small part of its business and its strengths lay in dealing in the money markets. King and Shaxson explained that [✄].

5. STS told us that King and Shaxson exited unilaterally and that it was not the result of any agreement with STS. The non-compete clause was signed after King and Shaxon had independently decided to exit.

6. We note that there is a difference of opinion between King and Shaxson and STS on how King and Shaxson's exit from the provision of TMA services to local authorities occurred. It was not clear to us why a non-compete clause would be needed between STS and King and Shaxson if King and Shaxson had already taken a decision to exit the market.

7. The data available to us[2] suggests that Arlingclose was the only competitor (other than STS and Butlers) to win a significant share of the tenders since the second half of the 1990s.

---

[1] The Guidelines, paragraph 5.8.3.
[2] Tender information submitted by ICAP to the OFT dating back to September 1997, and other data from Arlingclose, ICAP, STS and Sterling.

8. STS disagreed with this conclusion, arguing that Sterling was also a strong competitor. [✂] It further argued that Sterling had recently hired an extra member of staff. We found that Sterling was a weaker competitor on the basis of the following evidence: *(a)* Sterling's average contract value was considerably lower than the average contract value of the remaining competitors suggesting that Sterling was servicing fewer complex contracts, and *(b)* evidence on the evolution of market shares showed that Sterling had not increased its market share substantially since it entered in 2001. Sterling's hiring of an additional member of staff brings its total number of staff delivering TMA services to local authorities to [✂]. While this will make Sterling willing to compete harder for at least some contracts in order to ensure that hiring this person is profitable, it is unlikely to change substantially the strength of the competitive constraint posed by Sterling on the merging parties.

9. In light of the evidence in paragraphs 2 to 8, the TMA services market did not appear to be characterized by frequent entry.

Arlingclose's entry experience

10. Arlingclose was created in late 2004. Its sole source of revenue is the fees from contracts with local authorities. Over the six years of its existence it has grown to have contracts with 85 local authorities.

11. Arlingclose received a boost to its business following the Icelandic banking crisis in 2008. Until then it grew at a rate of about ten contracts a year. After that, it grew at a rate of 15 to 20 contracts a year. Arlingclose believed that typical growth in this market was slow and organic. Arlingclose's growth has slowed since the merger. It believed that this was because of STS's 'low ball pricing'. Arlingclose's long-term concern was that it would be squeezed out of the market. It was also concerned about what it considered to be predatory pricing by STS.

12. The two founding directors of Arlingclose used to work for STS. One of these founding directors told us that he left STS to set up Arlingclose as he considered that STS's cross-selling activities were compromising good advice to clients.

13. Arlingclose told us that it took it six years cumulatively to break even. The data provided by Arlingclose shows that it has been profitable from its second year of operation and that its profitability has increased since then, although it has yet to pay off the initial investment. If the current trend in profitability continues, it will amortize its initial investment this financial year (see Table 1).

TABLE 1 **Arlingclose's path to profitability**

£

Year ended 30 June	*Profit/loss after tax*	*Cumulative profit/loss after tax*
2005	–376,523	–376,523
2006	335	–376,188
2007	9,608	–366,580
2008	66,786	–299,794
2009	156,957	–142,837
2010	103,081	–39,756

Source: Arlingclose.

14. In light of the exceptional boost to Arlingclose's business that it received as a result of the Icelandic banking crisis, and the evidence of the willingness of its owners to

accept an usually long payback period for their initial investment, we did not believe that it was likely that potential entrants could replicate Arlingclose's entry into the relevant market.

15. STS told us that Arlingclose's example showed that low profits did not prevent entry into the TMA services market. STS further told us that one of the key threats to STS was the risk of staff choosing to leave to set up in competition with STS. In STS's view, low profitability encouraged efficiency and innovation. Further, relatively small turnover did not preclude likely entry into a particular area of business.

16. However, our discussions with third parties (outlined below) showed clearly that Arlingclose's entry was unlikely to be repeated by any of them, that low expectations for profitability (however measured) was a key consideration and that the merger did not change this situation. Furthermore, while we consider entry by a group of former employees of any of the remaining competitors possible, we do not consider it sufficiently likely. First, Arlingclose took six years to amortize its initial investment, and second, the decision by ICAP either to close or sell Butlers presented an excellent opportunity for Butlers' staff to set up their own independent business. However, we found that this was not likely to happen.

Potential competition

17. STS told us that its ability to increase its prices (or worsen other aspects of its retail offer) following the merger would be constrained by *(a)* the ability of large accounting firms to supply TMA services to local authorities; *(b)* companies supplying TMA services to other public bodies such as housing association, NHS and education clients starting to supply TMA services to local authorities; and *(c)* the ability of customers to self-supply.[3] We investigated each of these.

Entry and expansion by the large accountancy firms

18. We asked the four large accounting firms (Deloitte, PwC, KPMG and Ernst & Young) whether they were interested in entering or expanding in the provision of TMA services to local authorities.

Deloitte

19. Deloitte started bidding in 2010 and has so far bid for [✂] retainer contracts, one of which was a joint tender by three authorities which ended up being awarded as three separate contracts. [✂]

20. [✂]

21. [✂]

22. Deloitte also bid for two one-off TMA services contracts and [✂]. In one case, it faced STS and Butlers as other bidders. Finally, Deloitte applied to be on the list of

[3] STS considered that the constraints relating to potential competition represented only some of the constraints that would impede STS's ability to worsen the retail offer post-merger. Additional constraints include: *(a)* continuing competition from existing competitors, *(b)* the fact that STS's one-off business would suffer if STS were to worsen its retainer offer, *(c)* [✂], *(d)* buyer power, and *(e)* ability of local authorities to self-supply. These suggestions are either dealt with elsewhere in the report or, given our findings on the counterfactual and competitive effects, have not been pursued here.

preferred suppliers for the Eastern Shires Purchasing Organisation. It passed, together with STS and Butlers, [✄].[4]

23. STS told us that it understood from the summary of the hearing with Deloitte that Deloitte had not been successful in winning TMA services contracts [✄]. This, in STS's view, did not support the conclusion that Deloitte would not enter the TMA services market. The information gathered from local authorities and from Deloitte clearly shows that there were wider reasons that made it difficult for Deloitte to enter this market. [✄]

KPMG

24. KPMG bid only for one three-year retainer contract with Sheffield City Council in 2008. It lost the bid. Its bid was for £790,000.[5] We do not know who the other bidders were but note that STS's data suggests that it bid for a three-year retainer contract with the council in 2007 for an approximate value of £43,500.[6]

25. KPMG also bid for three one-off contracts with local authorities and won two. All of those contracts were linked to dealing with the aftermath of the Icelandic banking crisis and took the form of treasury and investment reviews rather than TMA services as such.

26. KPMG explained that, depending on the fee level, one-off contracts were attractive. Retainer contracts required ongoing support, were more costly to deliver and were less attractive. Given KPMG's business model for providing treasury advisory services, KPMG would need a dedicated team to support such services and need a critical mass of clients to make it financially viable. The fact that local authorities were spread over the UK would put a strain on a small team.

PwC

27. PwC has only bid for three one-off contracts for the provision of TMA services to local authorities and did not win any of them. The range of prices at which it was bidding was £45,000 to £300,000. This data does not go back five years (and excludes engagements performed as part of audits, internal audits or to assist the Audit Commission (and related services) on the basis that these did not relate to bids to provide TMA services).

28. PwC did not provide or seek to provide TMA services to local authorities on retainer contracts as the profitability of those services did not warrant providing them. In one recent example, the fee was very significantly below what PwC was looking for and what it already considered to be fairly unattractive. Its current business model was not configured to deliver these services [✄].

Ernst & Young

29. Ernst & Young has not provided any TMA services to local authorities to date. It did not consider this type of work commercially attractive for the investment required. It

[4] Deloitte.
[5] The bid included 'Advice on Treasury Management Policy and Strategy' totalling £115,000 over three years. The tender also included, over the same period: Strategic financial overview; Forecasting and Economic Advice; Advice on Portfolio Structure; Advice on Debt Restructuring; Technical Advice; Advice on Investment Policy; Training and Support; and Review meetings.
[6] This value was extrapolated from the extension of the contract that took place in 2010.

considered that it was well placed to provide selected aspects of TMA services but not the full range that local authorities may require.

30. For Ernst & Young, fees would need to be commensurate with the quality of the personnel it employed and the support and training it gave them for it to start supplying TMA services to local authorities. It believed that it was more likely that a small niche firm would be better suited to undertake these projects.

CC analysis

31. We found that, to date, none of these firms had won a retainer contract for the provision of TMA services to local authorities and only two had ever bid (KPMG once and Deloitte [✂] times). Three of these firms had bid for one-off contracts (PwC three times, KPMG three times and Deloitte [✂]), but only KPMG and [✂] had ever won [✂]. In the case of KPMG, these one-off contracts took the form of treasury and investment reviews following the Icelandic banking crisis, rather than the provision of any aspect of TMA services.

TABLE 2 **Comparison of the value of contracts of the four existing providers and the bids of the large four accounting firms***

		£
	Average value of retainer contract (per year in the past five years)	*Average value of one-off contract (in the past five years)*
Arlingclose	[✂]	[✂]
Butlers	[✂]	[✂]
STS	[✂]	[✂]
Sterling	[✂]	[✂]
Deloitte [✂]	[✂]	[✂]
PwC [✂]	[✂]	[✂]
KPMG [✂]	[✂]	[✂]
Ernst&Young [✂]	[✂]	[✂]

Source: Arlingclose, ICAP, STS, Sterling, Deloitte, PwC, KPMG and Ernst and Young.

*Sterling told us that its average retainer contract value reflected its low pricing strategy to enter the market initially and the high number of rollovers since when it had not been able to increase prices significantly. It also reflected a number of contracts with limited scope of services.

32. The views of the large accounting firms regarding the low pricing of local authority TMA services are consistent with the difference between their bids and those of the existing providers. The data set out in Table 2 above shows that, on average, the bids of these firms are significantly higher than the contract values of the four existing providers.

33. STS told us that large accounting firms constrained STS's activities in the provision of one-off TMA services and were in a position to enter the retainer market quickly if prices were to increase or quality decline. We disagree with STS for the following reasons: *(a)* [✂] not been successful to date in winning TMA services retainer contracts and we do not consider it likely that [✂] would alter [✂] business model in a way that would allow [✂] to succeed; and *(b)* the remaining [✂] large accounting firms are unlikely to enter primarily because the profitability of this business is far below their expectations at current prices.

34. The evidence we gathered did not suggest that the four large accounting firms exercised or were likely to exercise a strong competitive constraint on the current providers of TMA services to local authorities.

Entry by operators from adjacent markets

35. STS gave us a list of 21 potential competitors, many of which were providing TMA services in adjacent markets such as housing, or provide wider consultancy services to local authorities. STS argued that consultancy firms specializing in the provision of TMA services in the housing, education or NHS sectors had the necessary skills and expertise to provide TMA services to local authorities as the services were broadly similar.

36. We sent questionnaires to all the additional potential competitors identified by STS:

    (a) Ten companies provided a 'nil' response, suggesting that they were not providing TMA services to local authorities and that they did not have any direct interest in the TMA services market for local government. These were: Amtec, Atos Origin, Booz, Grant Thornton, [✂], Methods Consulting, Mott MacDonald, Insight Investments, RSM Tenon and Murja.

    (b) Beha Williams Norman told us that it might from time to time consider providing certain services to local authorities through an existing established advisory firm. This would be where Beha Williams Norman's skills were considered appropriate by the advisory firm and the local authority.

    (c) Mouchel told us that it was supplying TMA services to one local authority, Lincolnshire County Council, as part of a wider bundle of services on a retained basis. Mouchel further told us that it would not be interested in providing TMA services to local authorities other than as part of a wider bundle and that its position had not changed post-merger. However, we found that Lincolnshire County Council also retained STS as its TMA services provider.

    (d) Savills told us that it did not supply TMA services to local authorities but could do so as it had recently established a treasury team to supply TMA services to social housing organizations. Regular market and economic information that forms part of this service could be provided to local authorities as well. In April 2012, there are going to be major changes to the way in which local authority social housing is funded. Local authorities with housing stock will have to create self-funded Housing Revenue Accounts. Savills saw an opportunity to provide TMA services to those new organizations.

37. Arlingclose told us that engagement with housing associations on TMA services was completely different to that with local authorities because the way in which housing associations were funded, the amounts of cash that they carried and the balances and reserves were different. There were also different restrictions imposed upon them by the housing regulators. Arlingclose further told us that the NHS and education markets appeared to it to be very small.

38. JC Rathbone told us that a provider of TMA services to housing associations would be well-placed to provide TMA services to local authorities. It further told us that there were some differences between the two markets, in particular: *(a)* the sophistication of TMA services required by local authorities was relatively minor in comparison to housing associations; and *(b)* housing associations could use derivatives while this instrument could not be used by local authorities.

39. GriffithsMorley told us that the barrier to entry for companies providing TMA services in adjacent markets was not one of skill (GriffithsMorley believed that TMA services used by housing associations were more advanced than those used by local

authorities), but one of culture. It was very difficult for a company without a track record of providing TMA services to local authorities to break through.

40. STS told us that the fact that none of the firms it proposed as potential entrants wished to enter only showed that the market for the provision of TMA services was competitive. STS argued that these potential competitors would enter if prices in the market increased or quality reduced. However, our discussions with the potential competitors that STS identified included the question of whether the merger had changed their view about entry. They responded that it had not. We also asked what would change their view. Responses indicated that only a radical change in market conditions might induce some of them to enter and that others simply had no interest in the market. This finding also applied to JC Rathbone, GriffithsMorley and three of the large four accounting firms.

Growth of firms Sector identified as existing competitors

41. STS told us that JC Rathbone was a well-resourced company which already supplied one very large public sector customer, Transport for London, with TMA services and it would expand following any significant lessening of competition by the merging parties.

42. STS told the OFT that GriffithsMorley was a new entrant into the provision of TMA services to local authorities and that it expected to face direct competitive pressure from GriffithsMorley post-merger. This is because GriffithsMorley recently stopped being just a provider of TMA training and had positioned itself as a TMA services provider. In response to our first day letter, STS mentioned GriffithsMorley as one of 21 potential competitors.

JC Rathbone

43. JC Rathbone told us that it currently provided TMA services to housing associations and did not provide TMA services to local authorities other than in the cases of public-private partnerships or private finance initiatives benchmarking services generally as a subcontractor to a primary financial adviser. The main reasons for this were *(a)* low returns in comparison with other sectors, and *(b)* the fact that public sector procurement regulations disadvantaged small businesses and required a large amount of time to prepare the tender document (for example, over six months of preparation for a two-year contract).

44. JC Rathbone also told us that it would consider providing TMA services to local authorities if returns were acceptable and if local authorities took a more pragmatic approach to tendering for lower-value assignments. In the few instances when JC Rathbone was invited to bid to provide TMA services to local authorities, it was advised that its services were too expensive and was not awarded any contracts. JC Rathbone believed that competition in the provision of TMA services to local authorities took place mainly on price.

45. Finally, JC Rathbone told us that it operated on a time-based fee model, similar to law and accounting firms. Its hourly rates were set so that 50 per cent of standard hourly charges covered employment costs, 35 per cent covered indirect costs and 10 to 15 per cent represented normal pre-tax profit. JC Rathbone generally discounted its public sector work by about 20 per cent from its commercial rates. This meant that, while its public sector activities may not generate a normal profit, they would contribute to the company’s overheads and utilize spare capacity within the company. This, however, also meant that it would not make commercial sense to add

extra capacity to serve the public sector market. JC Rathbone also told us that it benchmarked its returns against its core markets which were the commercial real estate and leveraged private equity sectors. Finally, JC Rathbone explained that it operated an independent advisory model and did not accept any commissions.

GriffithsMorley

46. GriffithsMorley was set up in 2009 and is run by Mike Griffiths and Peter Morley. Messrs Griffiths and Morley have been involved in local authority TMA for the past 30 years. They are semi-retired. Their goal was to improve the quality of treasury management practices that local authorities employed and they described themselves as a think tank. They told us that they did not have the same commercial rationale as the other private operators in the TMA services market.

47. GriffithsMorley told us that it did not see itself competing with Arlingclose, Butlers, STS and Sterling for retainer contracts. It only offered one-off contracts and focused on high-level strategic advice. It also offered treasury management training for local authorities through a joint venture with Arlingclose.

48. The evidence we gathered did not suggest that either GriffithsMorley or JC Rathbone exercised or were likely to exercise a strong competitive constraint on the current providers of TMA services to local authorities.

Self-supply by local authorities

49. Tables 3 and 4 below summarize the key findings relating to self-supply from the responses of local authorities to our online third party questionnaires (see Appendix G).

TABLE 3 **The proportion of local authorities using retainer contracts**

Do you use external TMA services advisers for retainers?	*Yes*	*No*
Base: 148 local authorities	139	9
	94%	*6%*
If you don't use external TMA services advisers on retainer:	*Yes*	*No*
Base: 9 local authorities		
Do you use TMA services advisers on a one-off basis?	1	8
	Has in-house expertise and buys one-off services as and when needed	Does not use external TMA services at all
Why don't you use any TMA services advisers?	Base: 8 local authorities	
Too small or no need	5	
No need now, but will appoint someone in the future	2	
Not cost effective	1	
What do you use instead of TMA services advisers?	Base: 8 local authorities	
We use our own in-house resources	7	
We use our in-house resources and financial information such as credit ratings	1	

Source: Local authorities.

TABLE 4 **Attractiveness of self-supply**

How easy or difficult do you think it would be to use your own in-house resources rather than use an external supplier for TMA services?	*Easy*	*Difficult*	*Unsure*
Base: 139 local authorities	9%	77%	14%
Have you ever self-supplied TMA services?	*Yes*	*No*	*Unsure*
Base: 139 local authorities	19%	71%	11%
Why do you retain an external supplier of TMA services rather than using in-house resources?			
Base: 134 local authorities			
(a) Ticking an answer from a list of answers	*Applies*	*Doesn't apply*	*Unsure*
We don't have the right treasury expertise in-house	50%	30%	20%
We like having a second opinion on treasury matters	66%	19%	15%
We are obliged to have an external opinion on treasury matters as part of good governance	32%	46%	22%
(b) Writing in an answer	*No of mentions*	*% of mentions*	
External advisers have specialist or additional knowledge that local authorities don't have	81	60%	
External advisers provide an independent expert view	24	18%	
It isn't economical to hold such specialist knowledge in house	54	40%	
External advice is a good value for money	12	9%	
It is a governance requirement/good practice/prudent	5	4%	

Source: Local authorities.

50. 94 per cent of the local authorities that responded to our questionnaire had a retainer contract with an external provider of TMA services. The remaining 6 per cent mostly did not have the need for such services.

51. A significant majority of the local authorities that responded to the questionnaire (77 per cent) found self-supply difficult and never attempted it (71 per cent). When asked to provide reasons why self-supply was not a viable option, the following reasons were key: *(a)* local authorities did not have the required expertise in-house; *(b)* it was not economical to develop such expertise in-house; and *(c)* external advisers provided a second opinion. The evidence from local authorities also indicated that a substantial price rise above pre-merger levels would be required for local authorities to find it economical to start supplying TMA services in-house.

52. In light of this evidence, it appeared that self-supply was unlikely to be an effective constraint on STS following the merger—most local authorities regarded it as uneconomic and/or wanted an independent expert view which self-supply could not provide.

53. STS told us that our evidence confirmed that self-supply was a realistic possibility for some local authorities. According to STS, in order for self-supply to exert constraint on the merged entity, there needed to be a sufficient number of local authorities at the margin that were able to bring their supply of TMA services in-house; the majority of local authorities did not need to be able to self-supply for the merged entity to be constrained.

54. STS's comment is correct in markets where customers purchase products at posted prices. In the TMA services market, each local authority obtains TMA services through tendering rather than purchasing anonymously from the market at posted prices. This means that, even if there were a small number of local authorities that would choose to self-supply following a worsening of the retail offer, this would not constrain worsening of the retail offer for local authorities that are unable to self-supply. Further, we did not find major differences in reasons for not using self-supply or greater willingness to self-supply between different types of local authorities.

Other barriers to entry

The ease of recruiting expert staff

55. STS told us that appropriate staff could always be hired at the right price. STS considered that there was a very high degree of fluidity in qualified staff providing TMA services. STS had lost a number of staff to competitors: [✂] members of staff to Arlingclose and [✂] members of staff to Butlers.

56. Arlingclose told us that the availability of expert staff was the most significant barrier to entry into the provision of TMA services to local authorities. This was because the business was based on relationships and without such staff a start-up company did not have credibility with local authorities.

57. Arlingclose further told us that the number of people with sufficient experience to deliver TMA services to local authorities was limited. The merger provided a brief opportunity to acquire such staff. Arlingclose hired one member of staff from Butlers at that point which may not have happened otherwise.

58. Arlingclose explained that when it was hiring staff from competitors it faced non-compete clauses which prevented the new staff member from contacting their previous clients for a period of time. This made it difficult to adapt quickly and meant that Arlingclose would put resources in ahead of time to avoid bottlenecks.

59. Arlingclose told us that it only recently started to close the gap between what it could offer to local authority employees and what they were being offered by local authorities.

60. Sterling told us that it found it difficult to hire an extra person recently. The process was time-consuming and the quality of the majority of candidates it attracted was not high enough. It took Sterling months to get to a situation when it could start considering offering some of the candidates a position.

61. Sterling also told us that it tried to hire staff from local authorities. It anticipated that in the current climate, some treasury experts from local authorities might be made redundant. However, that had not happened.

CC analysis

62. Arlingclose told us that it put resources in ahead of time to avoid bottlenecks. We noticed that there were changes in the numbers of contracts per staff member which would correspond to Arlingclose’s argument that it cannot adjust staff levels quickly (see Table 5).

TABLE 5 **Evolution of Arlingclose's staff and contract numbers**

Year	*Total number of retainer contracts*	*Staff used for delivering TMA services*	*Number of retainers per staff member delivering TMA services*
As at April 2011	87	11	8
As at the end of 2010	81	7*	12
As at the end of 2009	61	6	10
As at the end of 2008	40	4	10
As at the end of 2007	31	4	8

Source: Arlingclose.

*This number is different from the figure provided by Arlingclose. This is because Arlingclose's financial year finishes in the middle of the calendar year and we made an adjustment for this.

63. We found that Arlingclose's average expenditure per staff member including bonus was around £[✂] since its inception.[7] The same figure for Butlers was £[✂].[8]

64. However, while Butlers' yearly expenditure per staff member decreased over time, Arlingclose's expenditure per staff member increased over time. The average numbers therefore mask a gap between the payroll costs of the two companies that has narrowed over the past five years. This picture would be consistent with Arlingclose's statement that it was improving the pay of its staff, and with Butlers' recent drop in business which was reflected by a sharp fall in bonuses (see Annex 2 for more details).

65. We did not request comparable information from Sterling. We also do not have sufficiently granular information for STS that would allow us see the average payroll cost per member of staff delivering TMA services (this is due to the fact that STS only provided aggregate data for its whole business and not just TMA services as we requested).

66. Out of the 11 Arlingclose employees that deliver TMA services to local authorities, six have worked at some point for STS, four for one or more local authorities and one was recruited from Butlers. [✂] Sterling employees have worked at some point in a local authority in an accounting or treasury capacity. Out of the [✂] Butlers employees that used to deliver TMA services to local authorities, [✂] have worked for STS [✂] and [✂] worked for a local authority as [✂] treasury manager. Excluding the Butlers staff, out of the [✂] STS staff that we believe focus on delivery of TMA services to local authorities,[9] [✂] have previously worked for a local authority and [✂] worked for [✂].

67. In our view, it appeared likely that a new entrant would experience difficulties in obtaining sufficient staff with the right expertise and experience to become a credible bidder in the relevant market.

[7] Derived from data supplied by Arlingclose.
[8] Derived from data supplied by Butlers.
[9] STS disagreed with our estimate of the number of staff that delivered TMA services. We continue to use this number for the following reasons. First, use of STS's data would result in an implausibly low ratio of contracts to staff, based on the data of the other three competitors in the market and what they told us was optimal. Second, when we analysed the structure of the STS business, we were able to isolate parts of the organization (and the corresponding staff) that were unlikely to be involved in the provision of TMA services to local authorities. Finally, in its response to our data request, STS explained that it had not provided us with the detailed breakdown of staff data we asked for and instead had provided us with more aggregate data on the staff engaged in the provision of TMA to both local authorities and other customers.

Importance of a strong track record

68. The reputation of the TMA services provider is important for local authorities. Most local authorities find it difficult to appoint a provider of TMA services that other local authorities do not use (see Table 6).

TABLE 6 **Criteria used by local authorities to appraise bids**

			per cent
How important is the reputation of the supplier in deciding who you award contracts to for TMA services	*Important*	*Unimportant*	*Neither*
Base: 139 local authorities	96	2	3
How easy or difficult is it to award TMA services contracts to providers that other local authorities do not use?	*Easy*	*Difficult*	*Unsure*
Base: 139 local authorities	9	62	29

Source: Local authorities.

69. However, reputation or track record is only one criterion that local authorities use to appraise bids and not the most important one (see Table 7).

TABLE 7 **Criteria used by local authorities to appraise bids**

	Price	*Quality*	*Innovation*	*Track record*	*Reputation*	*Other*	*Total*
Most important	20	60	1	4	1	2	88
criterion	*23%*	*68%*	*1%*	*5%*	*1%*	*2%*	*100%*
Second most	38	22	4	13	5	6	88
important criterion	*43%*	*25%*	*5%*	*15%*	*6%*	*7%*	*100%*
First or second most	58	82	5	17	6	8	176
important criterion	*33%*	*47%*	*3%*	*10%*	*3%*	*5%*	*100%*

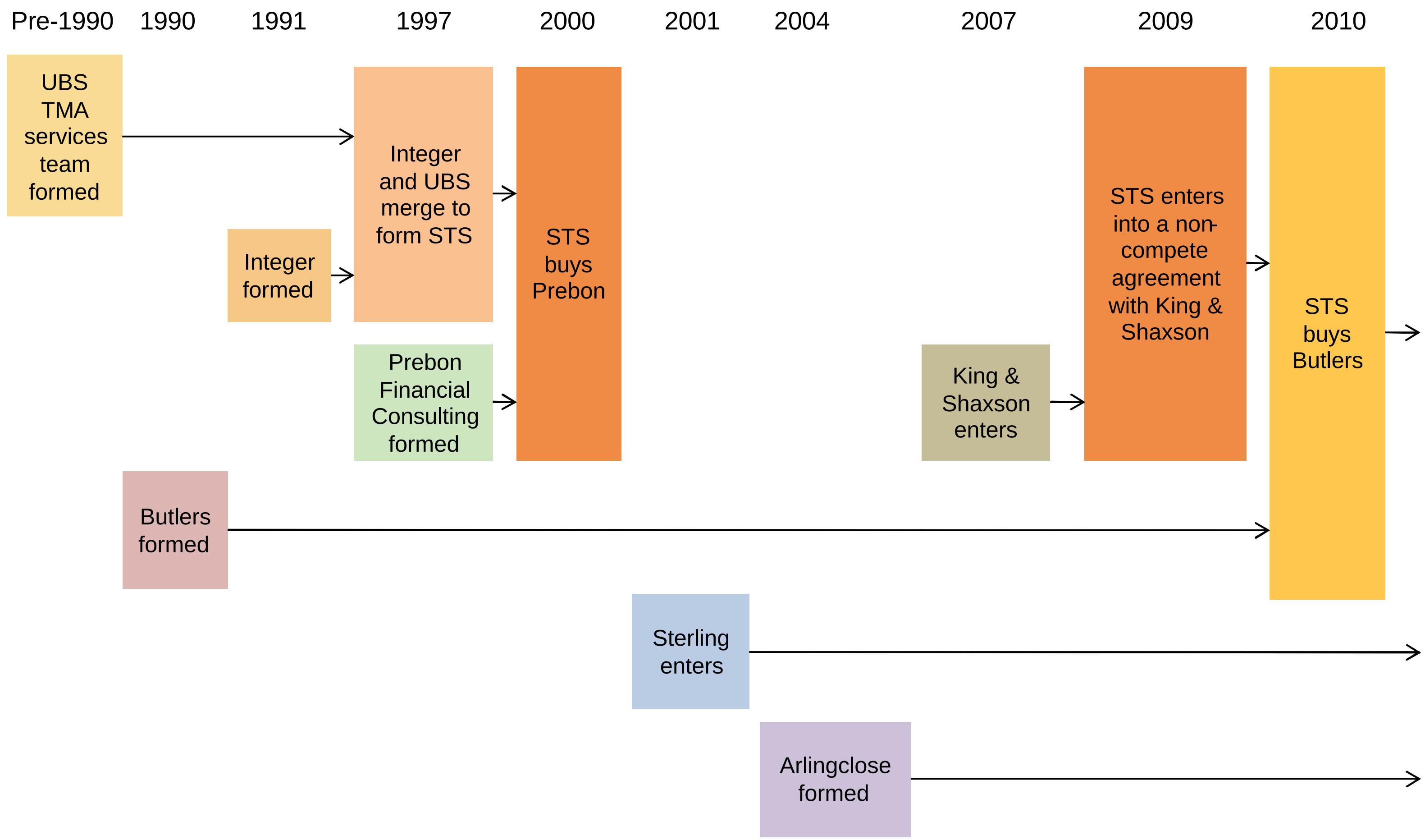
Source: Local authorities.

70. STS considered that we had overestimated the role of reputation. STS told us that Arlingclose's entry demonstrated that the reputational barrier was not significant. In STS's view, this was further evidenced by the bidding of JC Rathbone and Deloitte to provide TMA services. STS argued that the evidence suggested that these bids were lost primarily on price and quality, and that local authorities considered reputation as the least important criteria in assessing bids.

71. We did not agree with STS's assessment. First, we found that JC Rathbone had not bid for any TMA services contracts for local authorities. Second, although we accepted that evidence from the local authority questionnaire showed that reputation was less important for local authorities than quality, when we assessed [✂] unsuccessful bids [✂], reputation featured prominently among the reasons why local authorities ranked [✂] bids last. Finally, Arlingclose benefited from the reputation of its founders who had experience of providing TMA services at STS before Arlingclose existed.

72. We considered it likely that a firm attempting to enter the relevant market would face a barrier as a result of not having a track record in that market. Although this might in part be addressed by the recruitment of suitable experienced staff, this in itself would not be easy (see paragraphs 55 to 67).

History of the firms providing TMA services to local authorities



Source: Arlingclose.

The staff costs of Arlingclose and Butlers

TABLE 1 **Arlingclose staff costs**

	Fixed payroll costs per member of staff £	*Bonuses per member of staff £*	*Total payroll costs per member of staff £*	*Number of staff delivering TMA services*
Period ended April 2011	[✂]	[✂]	[✂]	[✂]
Year ended 30 June 2010	[✂]	[✂]	[✂]	[✂]*
Year ended 30 June 2009	[✂]	[✂]	[✂]	[✂]
Year ended 30 June 2008	[✂]	[✂]	[✂]	[✂]
Year ended 30 June 2007	[✂]	[✂]	[✂]	[✂]
Average	[✂]	[✂]	[✂]	[✂]

Source: Arlingclose.

*This figure is derived from Arlingclose's response but takes into account that Arlingclose's financial year ends in the middle of the calendar year.

TABLE 2 **Butlers staff costs**

	Fixed payroll costs per member of staff £	*Bonuses per member of staff £*	*Total payroll costs per member of staff £*	*Number of staff delivering TMA services*
In October 2010	[✂]	[✂]	[✂]	[✂]
As at the end of 2009	[✂]	[✂]	[✂]	[✂]
As at the end of 2008	[✂]	[✂]	[✂]	[✂]
As at the end of 2007	[✂]	[✂]	[✂]	[✂]
Average	[✂]	[✂]	[✂]	[✂]

Source: ICAP.

Results of [✂] bids for the provision of TMA services to local authorities on retainer contracts

Bid no	*Local authority*	*Bid ranking by local authorities (bid value per year)*				*Reasons for [✂] ranking*
		Winner	*2nd*	*3rd*	*4th*	
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]		[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
[✂]	[✂]	[✂]	[✂]	[✂]		[✂]
	[✂]	[✂]	[✂]	[✂]		
	[✂]	[✂]	[✂]	[✂]		
[✂]	[✂]	[✂]	[✂]	[✂]		[✂]
[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: Coventry County Council, [✂], Monmouthshire County Council, North Norfolk District Council.

Glossary

2003 Act	Local Government Act 2003.
2003 Scotland Act	Local Government in Scotland Act 2003.
Act	Enterprise Act 2002.
Arlingclose	Arlingclose Limited, provider of **TMA** services.
ARROW	Advanced Risk-Response Operating frameWork; a framework used by the **FSA** to conduct risk-based regulation.
Butlers	A trading division of **ICAP**, formerly a provider of **TMA** services.
Capita	Capita Group plc, a UK-listed company that focuses on providing business process outsourcing services to the UK public sector. The owner of **STS**.
CC	Competition Commission.
CIPFA	Chartered Institute of Public Finance Accountancy, the professional body for practitioners of public finance.
DCLG	Department for Communities and Local Government.
Diversion ratio	The proportion of customers lost from one service that switch to a competing service.
FSA	Financial Services Authority.
FSMA	Financial Services and Markets Act 2000.
FY	Financial year.
Guidelines	*Merger assessment guidelines, CC2 (revised)*, September 2010.
GUPPI	Gross Upward Price Pressure Index, which combines diversion rations, variable margins and relative prices to estimate the degree to which merging parties have an incentive to worsen their retain offer post-merger.
HMT	The hypothetical monopolist test. This test is satisfied if a monopoly supplier of the products or services in question would find it profitable to increase prices.
ICAP	ICAP plc, a UK-listed interdealer and broker and provider of post-trade risk and information services. Owner of **ISL**.
IMS	ICAP Management Services, which provides **ISL** (formerly including **Butlers**) with certain central functions.
ISL	ICAP Securities Limited, a wholly-owned subsidiary of **ICAP** which contained the trading division known as **Butlers**.

LOBO — Lender Option Borrower Option transaction. A loan in relation to which the lender (usually a bank) has the option to change the interest rate during the loan period. A LOBO provides the borrower with access to financing of greater maturity than it could usually obtain, whilst also giving the borrower the option to repay the loan early without penalty in the event that the lender opts to change the interest rate.

Local authorities — Metropolitan councils, district councils, London borough councils, borough councils, county councils and unitary authorities. For the purposes of this inquiry this definition does not extend to housing associations, police authorities, fire authorities or any other public or private sector organizations.

MBO — Management buyout.

MyTreasury (ICAP) — A subsidiary of **ISL** which provides an electronic multilateral trading facility for money market funds. MyTreasury users included **Butlers**' **TMA** customers.

Non-banking desk (ICAP) — A business of **ICAP** that carries out certain brokerage services for non-bank institutions.

OFT — Office of Fair Trading.

One-off (TMA) — Services, products or other support that is available to **TMA** customers on a unique or bespoke basis outside the scope of any retained services that a **TMA** customer may already have. A one-off service may or may not be subject to a formal tender process or can be purchased as an additional service from the incumbent supplier of **TMA** services. One-off services are typically charged on a daily charge-out rate or on a fixed-fee basis.

Prudential Code — The **CIPFA** 'Prudential Code for Capital Finance in Local Authorities' to which local authorities are required by legislation to have regard.

PWLB — The Public Works Loan Board is a statutory body operating within the UK Debt Management Office, an executive agency of Her Majesty's Treasury. The PWLB's function is to lend money from the National Loans Fund to local authorities and other pre-scribed bodies and to collect the repayments.

RAO — Regulated Activities Order. The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

Regulated investment advice — Defined in the **RAO** as advice given to a person in his capacity as an investor or potential investor (or in his capacity as an agent for such a person) on the merits of his buying, selling, subscribing for or underwriting a security or relevant investment or exercising certain rights conferred by such investment. For the purposes of the **RAO**, loans and deposits are not 'securities or relevant investments' and therefore providing advice in respect of them is not a regulated activity.

Retainer (TMA)	Fixed-term contracts with **TMA** service providers that include regular support and advice. The content of the retainer contract is determined as part of the tendering process. Additional services outside the scope of the retainer may be available on a one-off basis.
The Review	A review requested by the **FSA** of **ISL** in April 2010.
Select Committee	The Communities and Local Government Select Committee, which launched an inquiry into local authorities' investment practices on 13 October 2008.
SLC	Substantial lessening of competition.
Sterling	Sterling International Brokers Limited, provider of **TMA** services through its Sterling Consultancy division.
STS	Sector Treasury Services Limited, trading as 'Sector', provider of **TMA** services.
TMA	Treasury management advisory service.
TM Code	The **CIPFA** Code of Practice on 'Treasury Management in the Public Services', to which local authorities are required by legislation to have regard.
TOH	Theory of harm.
Transactional income	The share of income received by the **TMA** service provider generated from the arrangement and execution of financial transactions requested by the **TMA** services provider's customers.
Treasury management	Treasury management is the process by which public and private sector bodies manage their cash flows associated with financial risks. It includes deciding when, for how long and with whom to invest surplus funds and/or from whom to borrow additional funds and on what terms.