CHAPTER 7

Conclusions

The merger situation

7.1. Under the terms of the reference and the relevant sections of the Fair Trading Act 1973, we are required to investigate and report whether arrangements are in progress or in contemplation which if carried into effect will result in the creation of a merger situation in which the condition set out in section 64(1) of the Act will be satisfied.

7.2. On 4 March 1986 Norton Opax announced that it intended to make an offer for McCorquodale, and on 14 March 1986 an offer was made by Samuel Montagu Ltd on behalf of Norton Opax to acquire the whole of the issued ordinary share capital of McCorquodale. The offer lapsed on reference being made to the Commission, but it is clear that the acquisition of McCorquodale is still in contemplation by Norton Opax.

7.3. The assets of McCorquodale exceed £30 million and the condition set out in section 64(1)(*b*) of the Act is therefore satisfied.

7.4. We conclude that arrangements are in contemplation by Norton Opax PLC for the acquisition of McCorquodale PLC which, if carried into effect, will result in the creation of a merger situation qualifying for investigation.

The public interest

7.5. The two companies are engaged in printing, publishing and packaging, and their activities overlap in certain respects. We have decided that there are only two areas where the overlap raises issues of public interest, namely the printing of cheques, a market of some £45 million, and the less substantial activity of printing tickets for instant lotteries and promotional games, a market of some £7 million to £16 million depending on the particular definition of the market adopted. The other areas do not raise such issues, either because the scale of business carried on by one of the companies is very small, or because a merger would still leave the combined group with a relatively small share of the relevant market.

A. Personalised cheques

7.6. As we explained in paragraphs 2.6 to 2.8, both the companies and the banks draw a distinction between 'personalised' cheques in books issued by banks and other cheque issuing bodies on the one hand, and continuous and 'flat' cheques specially prepared for companies on the other. We accept this distinction. Personalised cheques represent some 80 per cent of the total cheque market. Although each individual book typically has only 25 to 30 cheques and different personal details, the production process is a high volume one with a large number of books printed on each run. There are particular and stringent requirements for reliability, speed of turnaround and delivery. There are 11 main producers of personalised cheques of which three are small in this field serving mainly banks in Scotland.

7.7. Company continuous and flat cheques are more of a bespoke product involving smaller orders for less urgent delivery. The process is simpler and the machinery required less sophisticated. Producers are more numerous. Entry to the market is comparatively easy, so the impact of any merger is likely to be relatively small. We are therefore concerned with these company cheques only in so far as their producers might be able to move into the production of personalised cheques (see paragraph 7.20).

Effects of the proposed merger on the market

7.8. A merger would result in the enlarged company holding over 40 per cent of the personalised cheque market. In its submissions to us McCorquodale argued that the present merger proposal, following a merger earlier this year between De La Rue and Bradbury Wilkinson which gave those merged companies approximately 20 per cent of the market, would accelerate the trend towards concentration in the market which would become increasingly dominated by the technologically and financially stronger producers. McCorquodale foresaw the eventual disappearance of a number of the other suppliers. As for the new entrants, it suggested that there was only a limited number of printing firms which currently had the capability and proven reliability to produce personalised cheques to the standard required by the banks. The market, McCorquodale averred, was unattractive to potential new entrants, given the high risks involved in investment, such as low profit margins and the need for new companies to establish a track record with the banks.

7.9. An increase in concentration in a market can give a powerful operator opportunities to restrict or distort competition to the detriment of the public interest. In considering whether in this case a newly merged company would in practice have the ability to use its market power in this way we have focused our investigation on what we believe to be two main inter-related issues:

(*a*) how far the newly merged company would be able to dominate the market in the sense of being able either to raise prices against the customer or to lower prices to eliminate competitors; and

(*b*) the extent to which customers (in this case the banks) in adapting to the new circumstances might have to incur additional costs or suffer inconvenience or deterioration in service.

In order to reach conclusions on these issues we have explored whether there is surplus capacity in the market which in the immediate or short-term could be made available to meet any increases in demand or desired change of supplier; whether in the medium term additional capacity could be created; and whether in the longer term there are barriers to entry or scope for imports.

The ability to determine prices

7.10. The price of a personalised cheque has been falling so that it is now a little more than half in real terms what it was five years ago. This is partly due to printers' advances in technology, and partly due to pressure from the banks, the main customers. About 70 per cent of personalised cheques are ordered by the four main clearing banks. The banks saw the investment in new technology by the main producers and the transfer of the bulk of the personalisation and distribution of the cheques from the banks to the printing industry as a means of making a significant reduction in bank overheads. We have explained in Chapter 2 the strategy of multi-sourcing and seeking competitive tenders from a varying range of possible suppliers adopted by the majority of the banks. With one or two exceptions they have tended to switch business amongst their suppliers fairly frequently and with little difficulty. Through this strategy they have been able to maintain security of supply. They have also succeeded in reducing the real price of cheques to its present level.

7.11. The ability of a bank to move business between its producers on a daily basis is generally thought to be necessary to ensure security of its supply. Nonetheless practices among the banks vary (see Table 2.2). The ability of the banks to continue to influence the level of prices depends on there being sufficiently numerous sources of supply to permit the choice of competing bids from among the banks' suppliers. The immediate effect of a merger would be to reduce the number of suppliers—excluding in-house production—from 11 to 10.

7.12. McCorquodale has pointed out that since it and Norton Opax between them are suppliers to all the main clearing banks the result would be that some banks would be very dependent on a merged company as a source of supply and, given the present market shares of the two companies, the impact on choice would be greater than if the merger were to involve two less significant producers. McCorquodale foresees an erosion of the banks' dominant position in that it will be easier for the suppliers, in particular an enlarged Norton Opax, to raise prices.

7.13. We were told that following a merger, the first move of the banks would probably be to reduce their over-dependence on a combined company by transferring some of this business to others. Some banks, customers either of De La Rue or Bradbury Wilkinson, have already switched some business to other suppliers following the merger of these two companies earlier this year. We believe that following the proposed merger there would still remain enough suppliers in the market with spare capacity to enable the banks to switch suppliers as they have done in the past. As long as this remains the case, we are satisfied that the banks, with their in-house capacity as a fall-back protection, would be able to resist moves to raise prices.

7.14. A potential danger is that a merged company might be able to reduce prices in order to drive competitors out of the market, thus, in this case, limiting further the banks' scope for competitive tendering. On this, both Norton Opax and McCorquodale agreed that such a move would be self-defeating. Norton Opax takes the view that the other producers include large companies with adequate resources to withstand a price war. McCorquodale believes that the banks would deny a merged company any increases in market share whilst accepting the lower price. The banks tell us that they attach as much importance to maintaining adequate sources of supply as they do to price. Predatory pricing does not strike us as a plausible long-run strategy for this market, and we accept the views of the parties that a merged company would not engage in it.

Capacity

7.15. The ability of the banks to switch suppliers, other than to their in-house production, depends on there being adequate spare capacity in the market. We gave a great deal of attention to examining what spare capacity was at present available among the existing suppliers and how easily additional capacity could be provided in the longer term either by the present producers or by new entrants to the market. We first asked Norton Opax and McCorquodale to provide their best estimates of the state of spare capacity in the market. They gave us very different views which are set out in paragraphs 5.26 to 5.30. In the absence of any industrial or trade association which might be expected to provide information of this sort we then obtained estimates of their own capacity from six other main suppliers. The results are set out in Appendix 2.4. We are satisfied that at the moment capacity exists in practice to produce about an extra billion cheques a year—some 30 per cent of current supply—by producers either working two shifts instead of one or switching from printing other security products to printing personalised cheques which the companies given the opportunity would be more than willing to do. At least one producer has told us that it considers cheque production to be among the most lucrative work in the security printing business. Norton Opax's own profit margin on personalising cheques as compared to that of other sectors of its business (Table 3.5) lends support to this view.

7.16. McCorquodale has pointed out that some of this spare capacity is to be found on the Siemens laser machine which prints cheques most efficiently to a format not favoured by all banks. But as we show in Appendix 2.4 there is spare capacity in every cheque personalising system except McCorquodale's ACPs and, perhaps, Checktronics. It has been put to us that the amount of business which the banks following a merger might switch from the merged company to other suppliers could be as much as 14 per cent of the merged company's share, ie some 170 million cheques. This is well short of the total capacity available even excluding any capacity on Siemens laser machines.

7.17. In the longer term, the capacity of existing suppliers could be further increased if the circumstances warranted it by investment in new machinery or the recruitment of extra labour and working a third shift. This could take several months. There are, however, already precedents (eg Norton Opax's present contract with National Westminster) for banks to award contracts on the basis that suppliers will invest in the plant required to fulfil them. Moreover, the move by banks towards fixed term contracts makes it easier for the producers to anticipate when contracts will become available, thus enabling them to make the necessary incremental investment in sufficient time. We have learned that at least one producer is planning such incremental investment, and the views we have heard from others about their commitment to staying in the market lead us to believe that the sources of supply following any merger would continue to be sufficiently numerous to cope with any changes the banks would wish to make.

7.18. Extra production could also be created within a similar timeframe by the banks themselves increasing their in-house printing. Lloyds for example retains a machine which was formerly used to personalise its own cheques and which is presently being used for other printing work. Barclays and National Westminster already produce cheques on a scale roughly equivalent to the average tranche they let out to competitive tender. Expanding in-house production would probably involve investment in extra or more modern equipment, the installation of which would take some months, but the cost in terms of the banks' total overheads would be small.

New entry to the personalised cheque market

7.19. We explained in paragraph 2.20 and 2.21 and in Appendix 2.3 that the technology required to enter this market is readily available and that producers have a choice between various methods of production. Only the National Westminster Bank currently specifies that its cheques be produced according to a particular system. The others appear not to be concerned about the method used, provided that the suppliers produce cheques of the quality required and meet their standards of speed of turnaround and reliability of service.

7.20. The first kind of new entry envisaged would be by a company already active in the security printing market which is likely to have installed machinery suited to some of the processes of cheque production. We were told that the incremental cost of investment to produce cheques would be no more than £1 million and perhaps as little as £200,000, depending on the relevant machinery already owned by the company in question. Moreover such a company is likely already to be engaged in similar or related work (eg printing share certificates or bank credit slips). It is thus likely to be known to the clearing banks and would be well placed for assessment by them as a potential supplier. Barclays has 69 suppliers of company flat cheques and believes that given time a number of these could be up-graded to produce personalised cheques. If necessary the banks could offer incentives to such companies to make the necessary changes. At least one bank has told us that it would be willing to pay a premium to attract a newcomer to the market in this way, if circumstances required it.

7.21. Incremental investment of this kind need not necessarily be dedicated to the production of cheques: it could be for the purpose of expanding production of security documents generally. This explains why some companies are able to survive in the market with a share of less than the 5 per cent generally thought necessary (see paragraph 2.37) to make new entry worthwhile, and it is the means by which Kenrick and Jefferson entered the market in 1981. We believe that entry by means of incremental investment would be less difficult than McCorquodale has suggested.

7.22. We were told that, for a completely new entrant to the market, the cost of investing in the necessary equipment from scratch would be £1 million–£1·4 million and as much as three years would be necessary to reach profitability. On this basis we accept that the market for a completely new entrant would not be very attractive.

Imports

7.23. At present none of the banks invites tenders from overseas suppliers. They expressed doubt as to whether even European companies relatively close at hand would be able to meet the banks' standards of speed of turnaround. They did not regard the postal system across the Channel as sufficiently reliable for their purposes. They admitted, however, that this was not a matter to which they had given a great deal of thought because they saw at present no need for it. One bank had considered ordering high security stationery items such as bankers' drafts from overseas suppliers and might if necessary seek quotations from European suppliers for personalised cheques. It seems to us that the practical difficulties could be overcome if the banks ever felt obliged to look to imports as a means of ensuring security of supply.

Technology

7.24. As we have said in paragraph 7.19, the technology required for entering this industry is readily available. McCorquodale told us that it, together with Norton Opax and De La Rue, had been in the main responsible for introducing new technology to the market and that one consequence of the proposed merger would be the reduction in the number of innovative companies from three to two. With the exception of McCorquodale, which has developed and produced its own ACP and MCP5 machines dedicated to cheque personalisation, the producers have brought in the technology from elsewhere in the printing industry and adapted it to the requirements of cheque personalisation. Such technology can be used, to a greater extent than the ACP, for the printing as required of security documents other than personalised cheques, thus offering the producer greater scope for making best use of his available capacity. We do not think that the mere reduction of 'innovative' producers from three to two will have a material effect on advances in technology in the cheque personalising market: the strategy of adapting technology imported from elsewhere in the printing industry is likely to continue to be the dominant one in the market for personalised cheques.

Summary—the personalised cheque market

7.25. McCorquodale has suggested that, in assessing possible detriment to the public interest, we should give greater weight to the certainty of concentration in the market which a merger would bring than to the uncertainties (as it sees them) about the measures needed to counteract that concentration. We have not found evidence that a merger between Norton Opax and McCorquodale could be expected to bring about the restriction and distortion of competition in the market that McCorquodale fears. The most significant feature of this market, the power of the banks as customers, is not likely to be impaired. We believe that the banks would be able, at little or no cost or inconvenience to themselves, to maintain security of supply by switching business from producers on which they had become over-dependent to those existing producers where their dependence was less, because the necessary capacity is currently available in the market. There would still be enough competition to render monopolistic price rises or price reductions by the enlarged company hazardous. Even if a merger were to be followed by others, scope remains for the exercise of a number of countervailing measures by the banks to preserve their market power, albeit some at a limited cost. This we believe explains the relative lack of concern about the merger expressed by the banks. They have made it clear that they would use the leverage that they have to preserve their position and so ensure that the market remains competitive. We conclude therefore that a merger of the cheque printing interests of Norton Opax and McCorquodale may be expected not to operate against the public interest.

B. Lotteries and promotional games

7.26. In paragraph 2.39 we explained that instant lotteries and promotional games have similarities. Some producers, including Norton Opax and McCorquodale, make tickets for both, but they are designed for different purposes and for different customers.

7.27. The United Kingdom market for instant lottery tickets is small (about £4 million) and circumscribed by the gaming laws. The erosion of the real value of prize money over the last decade has made this form of fund raising less attractive to promoters. As a consequence the size of the market has been static for some years and looks likely to remain so. Many of the early entrants have since left it. Entry is neither technically difficult nor expensive in terms of investment. We are not convinced by McCorquodale's argument (paragraph 5.42) that a new entrant needs to acquire a library of ideas such as McCorquodale itself has developed. There seems to be about six main types of games acceptable to promoters. We have been told that there is little or no chance of any copyright being enforced. The artwork on tickets can either be done in-house or commissioned from outside. In a domestic market of this size it is not surprising that the number of producers is small. Entry in the present circumstances is not particularly attractive unless combined with an intention to realise the considerable potential which exists for exports.

7.28. Norton Opax and McCorquodale are the established market leaders. A merger between them would give the enlarged company a share of over 40 per cent. It would reduce customers' choice of supplier. Customers tend to be sporting and social clubs, charities and local authorities operating on a small scale. They are fragmented and the only power they have is whether or not to run instant lotteries at all. McCorquodale has suggested that in these circumstances the producers could, within the legally permitted ceiling on expenses, raise the price they charge for printing these lottery tickets. But given the ease of entry which we have mentioned above the prospect of price rises improves the attractiveness of this market to a new entrant. Indeed Norton Opax has drawn our attention to a new company about to enter the market, we presume in the expectation of taking some of the market share from an enlarged company.

7.29. We received no complaints about the proposed merger from promoters of instant lotteries. But we carried out a survey based on lists of their customers sent to us by Norton Opax and McCorquodale. We detected from this survey no widespread concern at the consequences of a merger for the promoters. They seem to regard reputation and reliability of supplier as being more important than the price of the ticket. Given the relative ease of entry to this market we think that the proposed merger of instant lottery ticket interests may be expected not to operate against the public interest.

7.30. Orders for promotional games tend to be placed singly but in large quantities, often for several million items. Some promotional games are like instant lotteries in that they incorporate a 'scratch-off' or 'tear-open' feature which offers an instant prize. Others, such as newspaper promotional games, do not provide an instant prize but in Norton Opax's view form part of the same market. Confining the market to instant promotional games, McCorquodale estimates its size at about £3 million; Norton Opax, including all promotional games, estimates it at £12 million or more. However defined, this market is in our judgment an open one. There are 12 operators in it, and competition for these large contracts has been strong. Moreover the customer, typically a large company, has considerable power to dictate the design and influence the price of the ticket as well as the future of the market, since market growth will depend on how far these large companies continue to use this particular method to promote their products. There is an important element of customer power in the market for promotional games, and as a consequence we consider that a merger of these activities by Norton Opax and McCorquodale may be expected not to operate against the public interest.

C. Other issues

7.31. In their submissions to us the two companies have explained their reasons for or against the merger, their views on the future of the merged company, its financing and its management, exports and employment. We have looked at these carefully but only reflected them in our report in so far as they seemed likely to touch on issues of public interest. The only areas where this applies are exports and employment.

7.32. McCorquodale told us that its overseas earnings would suffer because Norton Opax lacked experience in managing maufacturing operations overseas. Norton Opax has hitherto regarded direct exports from the United Kingdom as a major plank in its strategy. It pointed out that the objective of the merger was not primarily to acquire McCorquodale's cheque and lottery ticket printing interests. The principal aim was to build on McCorquodale's involvement in overseas markets to achieve international growth over the whole range of the combined group's products. We have not found evidence which would enable us to conclude that on grounds of export performance the proposed merger would operate against the public interest.

7.33. McCorquodale was concerned that Norton Opax's plans for the merger included significant disposals of parts of McCorquodale's business and pointed out that the expected loss of some cheque printing business following any merger would create a gap which would be hard to fill. This disregards the possibility which we believe exists of Norton Opax expanding business in other perhaps similar sectors. Norton Opax's record to date on rationalisation of companies it has acquired tends to bear out its contention that disposal is a last resort and that it disposes only of those companies peripheral to its core interests. It has grown by acquisition, but it has also produced evidence of some organic growth both in turnover and in employment. The printing unions expressed concern to us that the merger might result in some loss of employment. Norton Opax told us that it had no plans for redundancies. Its enthusiasm for expanding its business overseas does not suggest to us a company bent on asset stripping or large scale redundancies. We have not therefore found evidence that on these grounds the merger would operate against the public interest.

Conclusion

7.34. We have considered the operations of the two companies in the substantial market for personalised cheques and the smaller markets for lotteries and promotional games. The banks' dominance of the cheque market is such that they would be able to counteract any concentration following a merger by switching a proportion of their business at little or no cost to themselves from the enlarged company to other producers who have the available capacity. We believe that they also have scope for taking countervailing measures against any further moves towards concentration which might take place subsequent to a merger, although we expect that some of these would involve limited costs to themselves, costs which, banks told us, they would be willing to bear. In the market for lotteries a merger may result in some limitation of choice, but we have found that entry into the market is relatively easy. As for promotional games, the important feature is the power of the customer. In these activities and in other matters, such as technological advance, export earnings or employment, we have not found evidence that a merger would have implications detrimental to the public interest.

7.35. We therefore conclude that a merger between Norton Opax and McCorquodale may be expected not to operate against the public interest.

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S N BURBRIDGE (*Secretary*)
5 September 1986