

PUBLIC VERSION

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Simon Pomery
Director, Competition Exemptions
Australian Competition & Consumer Commission
17/2 Lonsdale Street
Melbourne VIC 3000

Miriam Kolacz
Assistant Director, Competition Exemptions
Australian Competition & Consumer Commission
17/2 Lonsdale Street
Melbourne VIC 3000

Dear Mr Pomery, Ms Kolacz,

Proposed merger between Armaguard and Prosegur

Next Payments Pty Ltd (*Next Payments*) welcomes the opportunity to provide a submission in relation to the draft section 87B undertaking and response to the ACCC's Statement of Preliminary Views in relation to the proposed merger of Armaguard and Prosegur (the *Proposed Merger*). Armaguard and Prosegur are referred to in this submission as the *Applicants*.

Confidentiality

Parts of Next Payments' submission that have been highlighted **red** and are preceded by the word "**CONFIDENTIAL:**" contain confidential and commercially sensitive information of Next Payments and could cause harm to Next Payments if disclosed. Next Payments requests that the ACCC treat that information as strictly confidential and not disclose that information to any person without the prior written consent of Next Payments, except that, in accordance with the ACCC's usual confidentiality regime:

- there is no restriction on the internal use, including future use, that the ACCC may make of confidential information consistent with the ACCC's statutory functions;
- confidential information may be disclosed to the ACCC's external advisors and consultants on the condition that each such advisor or consultant will be informed of the obligation to treat the information as confidential;
- the ACCC may disclose the confidential information to third parties (in addition to its external advisors or consultants) if compelled by law or in accordance with section 89(7) or section 155AAA of the *Competition and Consumer Act 2010* (Cth).

Next Payments would be happy to respond to any queries the ACCC may have or discuss any matter in relation to its submission.

Yours sincerely

[Redacted signature]

Tim Wildash
Executive Chairman
Next Payments Pty Ltd

[Redacted contact information]

Supplementary submission by Next Payments – Armaguard and Prosegur merger authorisation application

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1 Summary

If the ACCC authorises the Proposed Merger, including with the proposed undertaking, the merged entity will raise prices, lower service quality, and squeeze out competing ATM deployers.

The Proposed Merger would entrench a market structure with a monopolist CIT services provider that is vertically integrated at every stage of cash delivery – from CIT services, to ATM deployment, to ATM maintenance.

Next Payments competes actively and directly in the independent ATM deployer market. Next Payments currently has [REDACTED] active ATMs in Australia, including [REDACTED] ATMs in regional areas (ie, ATMs deployed outside of state and territory capital cities).

In order to maintain its competitive position, Next Payments attempts to maintain the lowest ATM withdrawal fees in order to be a value for money provider.

A major contributor to the ability of Next Payments to compete effectively is access to CIT services supplied by Prosegur. Prosegur offers Next Payments competitive pricing and cash supply terms. Next Payments considers that the competitiveness of Prosegur's terms is a direct result of Prosegur seeking to win volumes and business from Armaguard.

If the Proposed Merger proceeds and the Applicants are not required to divest their ATM networks, it is highly unlikely that the merged entity will offer competitive pricing or cash supply terms to Next Payments or other independent ATM deployers – the Applicants will favour their own ATM businesses.

Without a divestment of the Applicants' ATM networks, Next Payments will be foreclosed as a competitor in ATM deployment services, and this will result in consumers, especially vulnerable segments of the community who rely on cash, having less access to ATMs and paying more for cash. If the merger is approved without the Applicants' divestment of their ATM networks, Next Payments considers it will need to progressively reduce the number of ATMs servicing regional communities and materially increase the cost of providing cash.

Cash is a fundamental part of the economy. It remains an important means of payment and store of wealth for many parts of the Australian community. As a result of the Proposed Merger, consumers, especially vulnerable segments of the community who rely on cash, will have less access to ATMs and will pay more for accessing this essential service. Consumers need competition in ATM deployment to ensure security of supply and affordable prices. The banks are shutting down cash services – with ANZ announcing on 30 March 2023 that customers would not be able to withdraw cash over the counter at some branches.¹ This leaves consumers reliant on independent ATM networks. If the Proposed Merger is authorised that essential service will be left to a vertically integrated monopolist.

To avoid a dire outcome, Next Payments urges the ACCC not to authorise the Proposed Merger.

If the ACCC does however intend to authorise the Proposed Merger, Next Payments urges the ACCC to reject the proposed undertaking. The proposed undertaking will not prevent the merged entity from foreclosing competing ATM deployers, like Next Payments. The only way that this can be avoided is if the Applicants divest their ATM networks. Only a divestment will avoid the creation of a vertically integrated monopolist with the ability and incentive to squeeze out competing ATM deployers who will rely on the monopolist's CIT services.

¹ 'Cashless ANZ move: now Westpac, NAB, CBA reveal plans', *The Australian*, 3 April 2023.

Next Payments agrees with the concerns raised by the ACCC in its Statement of Preliminary Views. The Applicants' response to that Statement does not address the ACCC's validly held concerns:

- **The counterfactual against which to assess the Proposed Merger is not disorderly exit by one of the Applicants.** Next Payments recognises that the Applicants face challenges in continuing to profitably provide CIT services. However, the Applicants paint a picture of inevitable and imminent disorderly exit which is not consistent with public statements made by Prosegur regarding the state of its business. Further, the Proposed Merger is not the only option to address the challenges faced by the Applicants:
 - The Applicants could raise prices to sustainable levels, without one of them exiting the market. [REDACTED]
 - The Applicants could rationalise costs or take other steps to improve their businesses. [REDACTED] For example, Next Payments understands that Prosegur has delayed rebranding the majority of the approximately 750 Westpac ATMs it acquired in 2019 due to (relatively inexpensive) rebranding costs. For those ATMs that remain Westpac-branded, Prosegur is constrained in the revenue it can earn as it cannot implement transaction fees that it would otherwise charge. Prosegur has also implemented a costly cashless card program in Sydney that is incurring losses for Prosegur and is an area Prosegur has limited expertise in developing.
 - The Applicants could take steps that fall short of a full merger that would sustain their CIT businesses without damaging competition. The Applicants have failed to provide compelling evidence that a joint venture, infrastructure sharing arrangements, or other cost-reductions and efficiencies could not be adopted to avoid entrenching a vertically integrated monopoly.

Next Payments respectfully submits that it is against those counterfactuals that the Proposed Merger should be assessed.

- **The Proposed Merger will result in a substantial lessening of competition and significant public detriments.** The Proposed Merger will create a monopolist that is vertically integrated at every level of the supply chain. Next Payments is not aware of a comparable industry in Australia characterised by such an inherently anti-competitive structure. It is the consumer, and those most vulnerable, who will be the losers – they will lose access to cash and pay more for it.
- **A behavioural undertaking does not address the harm to competition and the public interest.** Behavioural undertakings are fraught. They are not adept at addressing structural competition issues – especially vertical foreclosure risks. They can be gamed and are extremely difficult to monitor and enforce. This merger raises serious competition and public interest concerns. Those concerns cannot be remedied by a behavioural undertaking. The only way to avoid the inevitable vertical foreclosure risks is for the Applicants to divest their

ATM networks. That is the only solution to remove the Applicants' ability and incentive to squeeze out competition in ATM deployment.

- **The Proposed Undertaking is wholly inadequate.** The proposed undertaking will not remedy the competition lost or the public detriments caused by the Proposed Merger.
 - The Applicants have proposed a complex pricing structure which will not protect Next Payments, and other ATM deployers, from being squeezed by the merged entity in favour of the merged entity's ATM network. In particular, the proposed pricing mechanism leaves considerable scope to manipulate the allocation of costs in a way that forecloses competing ATM deployers, and does not conform to more established and transparent 'cost-plus' methods of regulated pricing that specifically link pricing to the costs of the relevant services provided to different customers. The Applicants have also proposed that an independent auditor effectively acts as price regulator for the industry – this is unprecedented.
 - The proposed undertaking sets out three short bullets that are meant to guarantee levels of supply from the merged entity to other ATM deployers (clause 4.36). This is wholly inadequate. The clause reads as if it were an after-thought. The merged entity will not only use price squeezes to foreclose competitors; it will engage in other forms of discriminatory behaviour – reducing the frequency of ATM provisioning, cancelling cash delivery routes, reducing maintenance of ATMs, providing banknotes that cause ATM jams, and providing fewer out of hours services. As soon as an ATM is down, customers cannot use it and they lose confidence. This will be the death knell for competing ATM deployers. Meanwhile, the merged entity will promote its network as the only reliable one that can guarantee consistent cash supply. The proposed undertaking does not address these risks. Indeed, no behavioural undertaking could ever address these risks satisfactorily – this is why divestment is the only solution.
 - The proposed monitoring regime is wholly inadequate. The proposed undertaking contemplates: (i) a yet to be designed complaints handling process (which is not subject to ACCC approval); and (ii) six monthly reporting to the ACCC. By the time any non-compliance is detected, the harm will already have been done to competing ATM deployers.

2 **The counterfactual against which to assess the Proposed Merger is not disorderly exit by one of the Applicants**

Next Payments recognises that the Applicants face challenges in continuing to profitably provide CIT services. However, the Applicants paint a picture of inevitable and near-term disorderly exit which is not consistent with public statements made by Prosegur regarding the state of its business.

Further, the Proposed Merger is not the only option to address the challenges faced by the Applicants:

- The Applicants could raise prices to sustainable levels, without one of them exiting the market.
- The Applicants could rationalise costs within their business.
- The Applicants could take steps that fall short of a full merger that would sustain their CIT businesses without damaging competition.

2.1 **Prosegur's statements to the market do not suggest it is on the brink of exit**

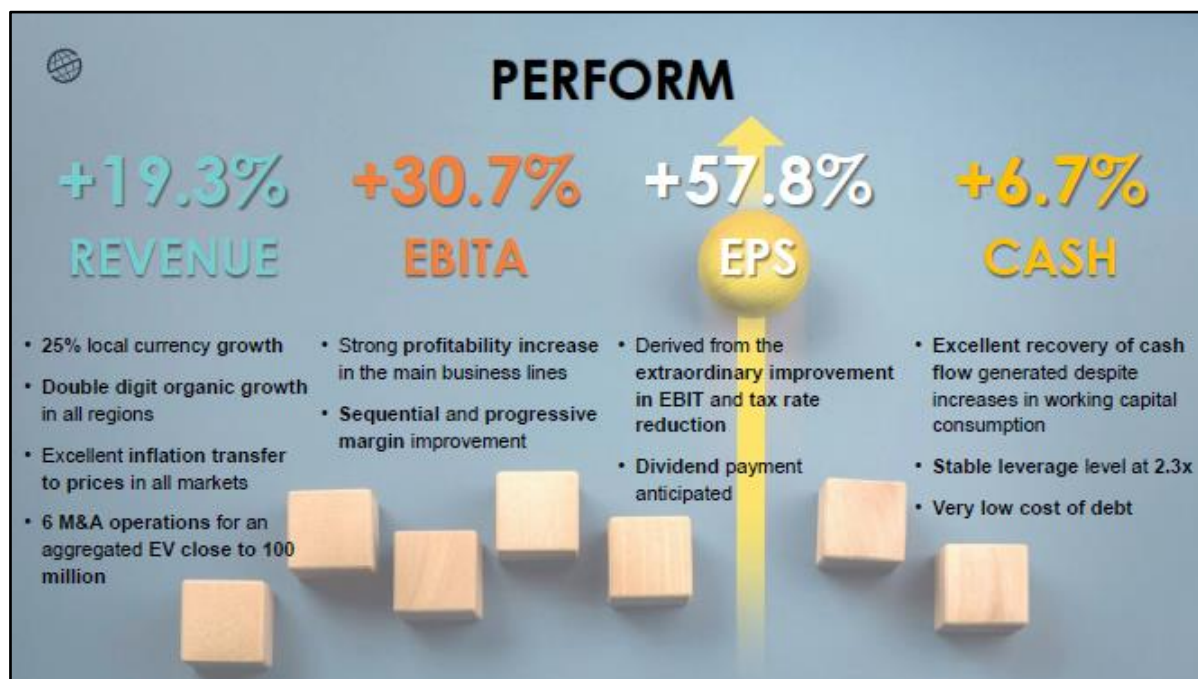
The Applicants rely heavily on the argument that near-term and disorderly exit by one of them is inevitable. This is not consistent with what Prosegur has told the market in recent statements.

(a) Prosegur claims to be growing

Prosegur has indicated that it has experienced recent growth and profitability in relation to FY22 performance across its CIT business.

In its most recent financial results, Prosegur's global management states that Prosegur has experienced 'double digit growth across all regions, with strong volume recovery' (with overall revenue growth of 19.3% for the financial year).² The extract from Prosegur's FY22 Results Presentation in Figure 1 illustrates this.

Figure 1 – Extract from Prosegur's FY22 Results Presentation, p 3.³



(b) Any recent underperformance is influenced by the COVID pandemic

Prosegur has projected growth following the COVID-19 pandemic. On 28 February 2022, Prosegur's CEO, José Antonio Lasanta Luri, stated that:

regarding the operation of Australia, mainly of APAC, but mainly Australia, I have to say that this is going to be the first quarter in which we are going to be without any restrictions in Australia with any pandemia. Hopefully this year, we're going to see all the results of all the measures that we have been taking in the last two years.⁴

This is supported by Prosegur's global FY22 Results Presentation which indicates substantial improvement of Prosegur's financial performance for FY22 when compared to FY20 and FY21, as extracted in Figure 2 below.

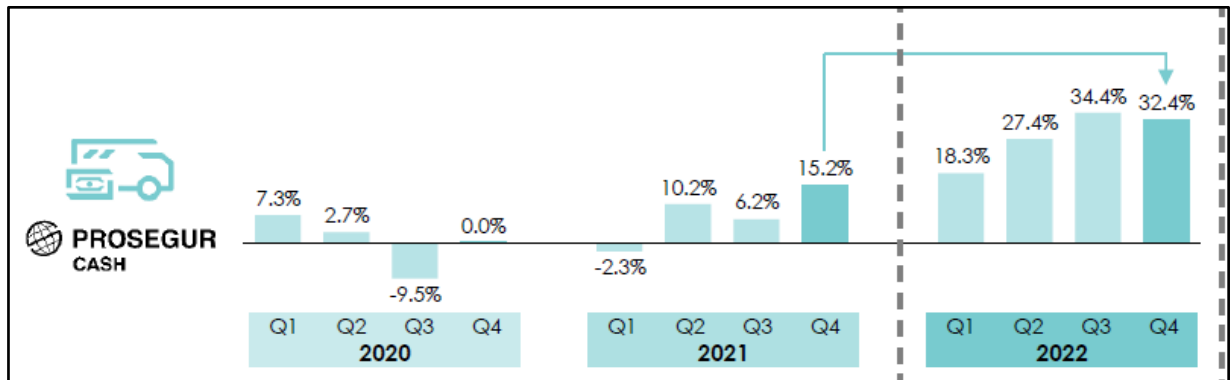
² Prosegur, media release, 23 February 2023. <https://www.prosegur.com/en/media/article/press/prosegur-profitability-up-57-with-consolidated-net-profit-of-65-million>.

³ Prosegur, Results Presentation FY 2022, 28 February 2023, p3.

https://www.prosegur.com/dam/Prosegur/CORP/pdf/accionistas_inversores/informes-trimestrales-ing/2022/230228---Prosegur-FY-2022-Results--1-.pdf

⁴ Prosegur, Q4 2021 Earnings call, 28 February 2022.

Figure 2 – Extract from Prosegur's FY22 Results Presentation⁵



(c) Prosegur's Australian CIT business operations are improving

Prosegur's CEO has also indicated that Prosegur's Australian CIT services business performance is improving:

I think we are improving our numbers or our operation in Australia. But for us, our main plan is to go for this merger with our competitor. And we are in the process that we cannot comment much on it, but we foresee that it's going to be – we are going to have a final resolution before first half of this year, hopefully, will be at the beginning of the second quarter.

And yes, the business in Australia I think is improving because of [transcript unclear] bonus and because of all the actions we have taken. But we keep our strategy of the merger because we believe this is the best outcome for the future.⁶

In recent public announcements Prosegur has not indicated an ongoing decline in its Australian CIT services business or a significant deterioration in market conditions:

In terms of percentages over total sales, these were 21.4% a year ago and have increased by 200 basis points in a year to 23.4%... As it was the case with overall local sales, all regions have contributed to this increasing penetration. Only Europe has not because of the mentioned divestments.⁷

Prosegur's statements are inconsistent with the Applicants' submission that it is facing significant decline and ongoing losses in its Australian CIT business that are likely to lead to disorderly exit in the near-term. Rather, Prosegur's public statements and recent financial reports indicate that its Australian CIT business is recovering following a period of underperformance during the COVID pandemic, and it is experiencing improved growth and a return to profitability.

2.2 The Proposed Merger is not the only option to address the challenges faced by the Applicants

There are alternative steps that the Applicants could take, short of a merger, to address the challenges they face.

(a) The Applicants could increase prices

[Redacted text]

⁵ Prosegur, Results Presentation FY 2022, 28 February 2023, p6.

⁶ Prosegur, Q4 2022 Earnings call, 28 February 2023.

⁷ Prosegur, Q2 2022 Earnings call, 29 July 2022.

- [REDACTED]
 - [REDACTED]
 - [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

(b) The Applicants could rationalise costs within their business

[REDACTED]

[REDACTED] For example, Next Payments has observed delays in Prosegur's re-branding of Westpac ATMs it acquired in 2019, which prevents Prosegur from receiving revenue from non-Westpac cardholders at those ATMs (due to legacy arrangements with these ATMs, Prosegur is only reimbursed by Westpac for Westpac customer transactions, and is constrained from charging non-Westpac cardholders transaction fees). Prosegur has also not rationalised other parts of its business that experience losses – for example, cashless card projects at Royal Sydney Show and Taronga Zoo that Next Payments understands are costly for Prosegur.

To date, Next Payments has not been invited to any constructive discussions with Prosegur as to how Prosegur can reduce costs, or structure its services to Next Payments in a more efficient and sustainable way. For example by:

- rationalising cash replenishment delivery runs for ATMs;
- sub-contracting with a smaller CIT service provider such as Authentic Security in certain areas; or
- working with Next Payments to switch some of the most difficult to reach merchants in regional or rural areas to self-cash their ATMs (ie, Prosegur would continue to provide a range of CIT services to the merchants' ATMs, including maintenance, but the customer would source the cash for their ATM directly from a bank or from other merchants), therefore becoming less reliant on frequent cash delivery.

(c) The Applicants could take steps that fall short of a full merger that would sustain their CIT businesses without damaging competition

There are other structures that could address the Applicants' challenges without result in damaging competition and harming the public interest.

Next Payments considers, as per its initial submission, that this could be achieved through a joint venture or infrastructure sharing arrangements between the Applicants. This would achieve the purpose of increasing efficiency and ensuring a sustainable upstream CIT services supply chain, while preserving competition in price and service delivery to CIT services customers.

A joint venture to share CIT services infrastructure could include the following characteristics to increase efficiency and preserve competition:

- **Shared core CIT infrastructure**, (eg, cash depots and armoured trucks) in the areas where the Applicants experience significant duplication of operations. This would reduce costs and increase efficiency, and is a key rationale for the Proposed Merger submitted by the Applicants. A joint venture at this level would provide access to cash infrastructure and CIT services to the merged entity's own business on the same terms as it would to competing smaller CIT services providers that need access to this cash infrastructure and also to downstream ATM deployers that compete with the merged entity's ATM network.
- **Separate downstream service delivery operations**, so Armaguard and Prosegur continue to vigorously compete for end customers on price and service quality.
- **No merger of ATM businesses**, so as to preserve competition between Armaguard's and Prosegur's ATM networks.

This alternative could be accompanied by a commitment (in the form of an enforceable undertaking to the ACCC) that provides fair and reasonable access and pricing to Armaguard's and Prosegur's shared core CIT infrastructure for smaller CIT services providers that compete with the Applicants.

3 The Proposed Merger will result in a substantial lessening of competition and lead to significant public detriments

The Proposed Merger will create a vertically integrated monopolist free from competitive constraint with the ability and incentive to stamp out competition from ATM deployers.

(a) Creation of a monopolist CIT services provider

The Proposed Merger is a merger to monopoly. It will combine the two largest suppliers of CIT services in Australia with a market share above 90%, and the only suppliers able to support large customers such as banks, ATM networks, and major retailers.

The merged entity will not be constrained by smaller CIT services providers. Such providers do not compete effectively with the Applicants as they do not have the economies of scale, distribution network, or the range of services (including specialised security services) that the Applicants provide.

There is no credible threat of new entry or expansion in CIT services markets post-transaction. There are high barriers to entry to CIT services markets, including significant upfront costs and resources in establishing a network with sufficient scale and range of services to compete with the merged entity. This is extremely unlikely to occur in circumstances where the merged entity will have a 90% market share, which will deter any potential new provider from making the required investment.

As cash is a commoditised product that remains unchanged throughout the value chain to end usage by consumers, a monopoly provider of CIT services (who essentially controls cash once it is distributed from RBA distribution sites) will be able to control all aspects of the cash supply chain in Australia. There is no scope for competing CIT services providers, who rely on access to cash infrastructure, or for downstream providers (eg,

ATM deployers), once access to cash is restricted, to modify their products and services in response, and they will be forced to reduce their service quality, or raise prices, or both.

(b) Entrenching a vertically integrated monopolist

Equally as concerning as the creation of a monopolist at the CIT level is the fact that that monopolist is vertically integrated at every stage of cash delivery – from CIT services, to ATM deployment, to ATM maintenance and related services.

That monopolist will have the ability and the incentive to extinguish competition from independent ATM deployers. The result will be more ATM closures and higher prices for consumers accessing cash. This will have a direct effect on many Australians who continue to use cash for their transactions daily – particularly in a context where banks are already withdrawing from providing cash services (as demonstrated by ANZ's recent decision to cease providing cash withdrawals over the counter at some branches).

Independent ATM deployers who rely on CIT services from the Applicants will have no choice but to deal with the merged entity. The merged entity will have both the ability and incentive to engage in a range of vertical foreclosure strategies to squeeze out independent ATM deployers that compete with Armaguard's and Prosegur's ATM networks.

This will be achieved through price squeezes – the monopolist charging higher prices to independent ATM deployers than it would to its own network. More importantly, the monopolist will engage in other forms of discrimination that will undermine the reliability of independent ATM deployers' networks. For example, the monopolist would:

- withhold or reduce CIT services provision, for example, by reducing the frequency of ATM provisioning and / or cancelling cash delivery routes;
- reduce the quality of CIT services, for example:
 - reducing security quality;
 - slowing ATM provisioning and maintenance;
 - reducing maintenance quality;
 - providing banknotes that do not meet quality standards for use in ATMs, thereby causing ATM jams; and
 - providing fewer out of hours services;
- withhold innovation and service improvements from competitors; and
- leverage its upstream CIT business to create an unlevel playing field in downstream ATM deployment services. The merged entity will have unrivalled competitive advantage by having guaranteed access to reliable CIT services.

The merged entity will have a strong incentive to target Next Payments' or other independent ATM deployer's sites through the above means. The merged entity would gain substantially more profit from ATM sites that are diverted from competing ATM deployers than the revenue it would lose from supplying CIT services to those competing ATM networks.

Furthermore, as soon as an ATM is down, customers lose confidence. Merchants (eg, site owners or operators and shopping centre landlords who want ATMs deployed to their sites) will also quickly lose confidence in ATM deployers whose ATMs are down. This loss of confidence will be the death knell for

competing ATM deployers. Meanwhile, the merged entity will promote its network as reliable and the only one that can guarantee consistent cash supply. In Next Payments' experience, merchants are very sensitive to the issue of ATM reliability and will readily switch ATM deployers following the suggestion that only the merged entity's ATMs will be reliable.

Removing competition at the ATM level will mean vulnerable consumers will have less access to cash and will pay more for that access.

Increases in CIT costs and reduced access to wholesale cash will substantially impact independent ATM deployers' ability to deploy ATMs in less profitable locations, particularly in regional and remote communities where the cost of provisioning ATMs is highest and transaction volumes are generally lower.

(c) Specific claims by the Applicants

The Applicants make a number of claims without properly addressing the vertical foreclosure risk.

Applicants' submissions	Next Payments' comments
<p>The Applicants claim that post-merger there is a credible threat of new entry or expansion in CIT services, including through sponsorship by banks.</p>	<ul style="list-style-type: none"> • This claim is not accurate and cuts across the very rationale for the Proposed Merger. The Applicants say the market cannot sustain two CIT services providers but also claim there will be a credible threat of new entry. • There are significant barriers to new CIT services providers entering, or existing smaller providers expanding, to compete with the merged entity, requiring: <ul style="list-style-type: none"> • sufficient scale to offset the high fixed costs associated with maintaining a CIT network, and to ensure high levels of security and reliability (eg, a national network of cash depots, armoured trucks, and specialised and armed security guards); • access to capital to fund sufficient banknotes to operate a CIT business on a profitable scale; • significant investment in quality sorting and handling equipment and expertise; • expertise in the operational and accounting aspects of managing a large-scale CIT services business; • significant time and resources in obtaining Approved Cash Centre Operator accreditation; and • strict security and insurance requirements required to deliver cash on a wholesale basis. • To date, no alternative provider has been successful in overcoming the above barriers to effectively compete with the Applicants.
<p>The Applicants claim that customers could insource CIT services or use smaller 'soft skin' competitors.</p>	<ul style="list-style-type: none"> • Insourcing CIT services is not an option, as it would require significant capital investment to develop a national CIT services network with the requisite breadth and depth of coverage, equipment, and specialised skills. In addition, Next Payments would lack the demand to justify insourcing CIT services at an efficient scale and scope. Insourcing would accordingly cost significantly more than what Next

	<p>Payments currently pays for CIT services, and a monopolist supplier of CIT services could set its prices up to that level.</p> <ul style="list-style-type: none"> • Smaller 'soft skin' competitors are not a viable alternative because they: <ul style="list-style-type: none"> • are more expensive than the Applicants, as they lack economies of scale; • do not have the national distribution network required to supply CIT services across an ATM network with nationwide or significant geographic coverage; • cannot provide the level of security required for cash delivery to ATM deployers; and • [REDACTED] • As a result, independent ATM deployers and other large customers of CIT services have no choice but to use the Applicants for CIT services.
<p>The Applicants claim that any attempt to increase prices or reduce service levels to CIT services customers will result in an accelerated decline in the usage of cash by end-consumers.</p>	<ul style="list-style-type: none"> • Cash remains an essential method of payment for parts of the Australian community. This is particularly true of older or more vulnerable members of the Australian community, persons with lower household income, limited access to internet or digital forms of payment, or in regional or remote areas, who continue to rely on cash. These consumers will continue to rely on cash even if the Applicants charge higher prices or reduce service quality to CIT customers and such costs are passed on to end customers.
<p>The Applicants claim that they would be constrained from increasing prices or reducing service levels by the theoretical threat of the RBA intervening.</p>	<ul style="list-style-type: none"> • The theoretical threat of regulatory intervention is not a sufficient constraint on anti-competitive conduct post-transaction. • Anti-competitive conduct can take subtle and covert forms, including discrimination in service quality and frequency, imposing more onerous contractual terms, pricing, and foreclosure or delays in access to essential CIT services. It is too difficult for any regulatory agency to effectively identify and enforce against all such conduct on an ongoing basis. • Even if a regulatory agency could identify some anti-competitive conduct, there would inevitably be significant delays in enforcement and further regulatory action. There would be even more significant delays and issues in introducing corrective regulations to undo harms after they have occurred.
<p>The Applicants claim it would be irrational for the merged entity to discriminate by vertically foreclosing ATM competitors.</p>	<ul style="list-style-type: none"> • The merged entity will have the ability to vertically foreclose independent ATM deployers as, post-merger, ATM deployers will have no alternative but to rely on the merged entity for crucial CIT services to operate their respective ATM networks.

	<ul style="list-style-type: none"> The merged entity would also have significant incentives to engage in vertical foreclosure, in areas such as shopping centres and high street locations where the merged entity competes most closely with Next Payments and other independent ATM deployers. The merged entity would earn profits on any ATM sites diverted from Next Payments that would exceed any loss in revenue from supplying the relevant Next Payments' (or other independent ATM deployer's) sites. The result would be an entrenchment of market power for the merged entity in ATM deployment in addition to CIT services supply.
<p>The Applicants claim that the Proposed Merger would create resilience and certainty in the cash supply chain.</p>	<ul style="list-style-type: none"> A merger to monopoly would reduce resilience in the cash supply chain. The cash supply chain would be dependent on one supplier which increases the risks associated with that supplier experiencing business failure or service interruptions.
<p>The Applicants claim that the Proposed Merger would Preserve the complimentary expertise of each Applicant, including Prosegur's global knowledge and experience in innovation, such as smart safes, together with Armaguard's deep understanding of local conditions and logistics expertise.</p>	<ul style="list-style-type: none"> Armaguard's and Prosegur's distinct expertise, knowledge, experience, and innovation currently spurs the Applicants to vigorously compete with each other. This competitive tension will be lost with the Proposed Merger.

4 A behavioural undertaking does not address the harm to competition and the public interest

Behavioural undertakings are fraught. They are not adept at addressing structural competition issues – especially vertical foreclosure risks. A behavioural undertaking cannot remedy the serious competition concerns and public detriments that the Proposed Merger will create.

A structural solution is required. That is, either the Proposed Merger does not proceed, or the Applicants divest their ATM businesses – this is the only way to ensure competitive ATM deployment.

Behavioural undertakings such as the one proposed by the Applicants are generally ineffective in addressing competition concerns of a merger. The ACCC has noted that (emphasis added):

*The ACCC has a strong preference for structural undertakings — that is, undertakings to divest part of the merged firm to address competition concerns. **Structural undertakings provide an enduring remedy with relatively low monitoring and compliance costs.***

On occasion, behavioural undertakings — that is, undertakings by the merged firm to do, or not do, certain acts (for example, meet specified service levels) — may be appropriate as an adjunct to a structural remedy. Behavioural remedies are rarely appropriate on their own to address competition concerns.⁸

Next Payments also notes the ACCC's joint statement with the UK Competition and Markets Authority and the German Bundeskartellamt, that (emphasis added):

*The increasing complexity of dynamic markets and the need to undertake forward-looking assessments require competition agencies to favour structural over behavioural remedies. **It is***

⁸ ACCC, Merger Guidelines (2017), page 59.

*widely acknowledged that complex behavioural remedies that create continuing economic links and dependencies are unlikely to recreate the pre-merger competitive intensity of the market, can raise significant circumvention risks, and can quickly become outdated as market conditions change. In some circumstances they can also distort the natural development of the market. Behavioural remedies also place a burden on competition agencies and businesses by necessitating extensive post-merger monitoring of companies and their conduct.*⁹

Those concerns hold true in this case, especially as the merged entity could easily circumvent behavioural obligations and engage in a range of subtle discriminatory tactics.

As noted in the ACCC's review of the *Pacific National and Linfox / Aurizon* transaction, which also involved significant vertical issues, '[a]n owner or operator has so many subtle ways of discriminating against, or damaging [a competitor]'.¹⁰

In line with the ACCC's guidance, the only way the Proposed Merger could proceed without extinguishing competition at the ATM level would be for the Applicants to divest their ATM businesses. A structural divestment remedy would:

- Remove the merged entity's ability and incentive to foreclose competitors.
- Avoid the creation of an anti-competitive market structure.
- Remove the need for the ACCC to monitor and enforce behavioural commitments.
- Increase competition in ATM markets. A divestiture undertaking may facilitate increased competition in downstream ATM deployment services through the entry or expansion of another participant in these markets, and preserve choice for merchants and consumers.

A behavioural undertaking could be implemented to temper the creation of a monopolist of CIT services but only as an adjunct to divestment of the Applicants' ATM networks.

5 The proposed undertaking is wholly inadequate

The proposed undertaking will not remedy the competition lost or the public detriments caused by the Proposed Merger:

- **The pricing mechanism will not prevent the merged entity squeezing competing ATM deployers.** The pricing mechanism is very complex and lacks transparency, with poorly defined variables. It relies on a form of revenue cap that purports to address the horizontal competition concerns in relation to the supply of CIT services, without directly regulating the prices that the merged entity would charge. This complexity together with the scope the merged entity has to determine prices within the revenue cap increases the risk that the merged entity could 'game' the pricing mechanism or exploit loopholes to increase its prices for CIT services over the long term. Customers of CIT services face an information asymmetry in how the price would be calculated and face the burden of raising the issue through the merged entity's complaint handling process, with no access to independent oversight or dispute resolution. In order to address the vertical concerns, the Applicants propose attributing a share of the overall revenue cap to the merged entity's own ATM deployment business. There are more established and transparent methods of regulating pricing to prevent margin squeeze. For example, a 'cost-plus' method that links prices to ATM deployers to the costs of the services provided to those customers and which is separate to the costs of providing

⁹ CMA, ACCC, Bundeskartellamt, Joint statement on merger control enforcement (20 April 2021), page 4.

¹⁰ Court dismisses ACCC proceedings opposing rail freight consolidation (ACCC media release, 15 May 2019).

other CIT services. The revenue attribution approach in the proposed undertaking leaves considerable scope for the merged entity to manipulate that allocation of costs in a way that may foreclose competing ATM deployers.

- Inadequate safeguards to prevent discriminatory conduct, particularly qualitative discrimination.** The proposed undertaking lacks measures to prevent discriminatory conduct and ensure continuity of service quality in the supply of CIT services, particularly to independent ATM deployers. Most concerning, the proposed undertaking does not mitigate the risk that the merged entity could withhold, reduce, or delay CIT services that independent ATM deployers rely on, eg, cash replenishment and secure cash transport, first line maintenance, and escorting by security guards for second line maintenance. Independent ATM deployers rely on these critical service inputs to provide reliably functioning ATMs. Contrary to the Applicants' claim (at paragraph 113 of their Response to the ACCC's Statement of Preliminary Views) the proposed undertaking does not require the merged entity to deal with independent ATM deployers on a non-discriminatory basis. It also does not include any measures to keep the upstream CIT services business of the merged entity separate from its downstream ATM business (including through separate management teams, and ring-fencing measures) to further mitigate discriminatory conduct.
- Lack of safeguards to ensure fair access to crucial inputs.** The proposed undertaking lacks mechanisms to ensure fair and equitable access to critical CIT infrastructure for third party CIT services providers – other than a vaguely described promise to supply on 'reasonable commercial terms'. This is insufficient to ensure access on fair and reasonable terms, and provides no obligation to negotiate in good faith, so as to mitigate the risk of foreclosure of smaller CIT services providers. In the event of an access dispute, smaller CIT services providers will not have access to any independent dispute resolution measures and are in the hands of a complaints handling process controlled by the merged entity.
- Significant monitoring and enforcement risk.** The complexity of the pricing mechanism and lack of objective and measurable standard of service obligations would make it difficult for customers, the independent auditor, and the ACCC to identify and enforce non-compliance with the proposed undertaking. Although remedies are available for breaches of the proposed undertaking, enforcement will be time consuming, resource intensive and given their retrospective nature will not proactively prevent discriminatory conduct from occurring.

Proposed measures	Deficiencies in the proposed undertaking
<p>Price of CIT services [CI 4.1 to 4.31]: The undertaking proposes to regulate the price of CIT services through a complex formula.</p>	<ul style="list-style-type: none"> <p>Pricing mechanism is complex, providing opportunities for misconduct: The pricing mechanism is very complex with a number of variables that are not clearly defined. This increases the risks that the merged entity will seek to use loopholes in the pricing mechanism to engineer anti-competitive pricing outcomes (eg, by artificially inflating variables). The pricing mechanism that is proposed purports to address vertical foreclosure in a way that is open to manipulation rather than adopting a more conventional and transparent cost-plus method of setting prices.</p> <p>Information asymmetry: There are no mechanisms to correct the inherent information asymmetry in pricing CIT services. The merged entity will have wide-ranging discretion in the price-setting process. There are no mechanisms to ensure customers are provided information regarding the price setting process so as to verify compliance and to inform equitable and good faith negotiations.</p>

- **Independent audit of pricing is inadequate:** The proposed independent audit is ill-equipped to identify and prevent non-compliance as: (i) an independent auditor will not have the resources and expertise to monitor complex pricing issues, which is conventionally the task of a regulatory agency such as the ACCC or RBA; and (ii) even if the independent auditor were to identify non-compliance, it will not prevent customer detriment given the retrospective nature of identifying, reporting, and then taking enforcement action against non-compliance.

Service offering [Cl 4.32, 4.33, 4.35 and 4.36]: The undertaking proposes that MergeCo will continue to supply 'CIT services' to customers in accordance with existing standards of service and that MergeCo will continue to offer 'ATM specific services' to independent ATM deployers.

- **Scope of service offering commitments is ill-defined and too narrow:** Neither 'CIT services' nor 'ATM specific services' adequately cover the range of CIT services that Next Payments and other independent ATM deployers rely on as critical inputs to continue operating ATM networks, and that cannot be provided by an alternative provider or in-sourced by Next Payments (these are set out more fully in Next Payments' initial submission), such as:
 - Secure transport of cash to and from ATMs, in addition to cash replenishment;
 - First line maintenance to fix minor operational faults, eg, cash / card reader jams;
 - Escorting by security guards to ensure Next Payments' technicians can securely conduct second line maintenance; and
 - Installation and maintenance of remote locking mechanisms.
- **Lack of robust standard of service obligations:** The proposed undertaking does not include service quality commitments that would mitigate the significant risk of a reduction in the frequency and quality of CIT services to independent ATM deployers / other customers. The proposed commitments to maintain services in accordance with existing service standards to customers is vague and unenforceable, given service standards may vary significantly between customers and there is no readily observable benchmark.
- **Risk of subtle discrimination is high:** There are no non-discrimination obligations to mitigate the risk of discrimination between customers, particularly vertical foreclosure against independent ATM deployers that compete with the Applicants' ATM networks. The proposed undertaking does not address risks of subtle and covert forms of discrimination such as:
 - Imposing onerous contractual terms for CIT / ATM services on competing ATM deployers;
 - Favouring the merged entity's own ATM business with faster / more frequent / higher quality cash replenishment, first line maintenance, and other crucial services. This would provide a subtle but significant competitive advantage of vertical integration that other ATM deployers could not compete with; and
 - Withholding, delaying or reducing the crucial services to independent ATM deployers, eg, reduced or delayed cash replenishment, reduced security levels, fewer out of hours services, providing banknotes that cause ATM jams, or failing to restore services in a timely manner following service interruptions.
- **Risk of exploiting transaction or other commercially sensitive data:** The proposed undertaking does not include any ring-fencing or other keep separate measures to mitigate the risk of commercially sensitive information obtained through CIT services delivery (ie, from independent ATM deployers) being used to advantage the merged entity's own ATM business. Undertakings accepted by the ACCC to address vertical foreclosure and discriminatory practices have included robust confidentiality and ring-fencing measures, including ring-fencing of employees. There is a significant risk that the merged entity's CIT business exploits confidential data obtained from independent ATM deployers (eg, through cash replenishment and reconciliation of ATMs) to advantage its own downstream ATM networks.

<p>National coverage [CI 4.34]: The undertaking proposes that MergeCo will offer CIT services on a national basis.</p>	<ul style="list-style-type: none"> • Scope of national coverage commitment is too narrow: There is no national coverage commitment for ATM services to independent ATM deployers.
<p>Third party access to cash centres [CI 4.37 to 4.40]: The undertaking proposes that MergeCo will supply cash processing and related services to third party CIT providers at its Access to Cash Centres across Australia.</p>	<ul style="list-style-type: none"> • Smaller CIT providers not a strong constraint: It is unclear whether the commitments will enable third party CIT providers to effectively compete with the merged entity, as: <ul style="list-style-type: none"> • The price, or pricing methodology, at which third party CIT providers will be charged for access is undefined; • There are no non-discrimination obligations with respect to the terms of access to third party CIT providers; and • Third party CIT services providers that rely on access will be forced to negotiate with the monopolist merged entity with no defined, independent dispute resolution or oversight mechanism to prevent the merged entity from withholding or delaying access to CIT infrastructure, or only providing access on unfavourable terms. • Lack of robust standard of service obligations: Beyond supplying third party cash services on 'reasonable commercial terms and conditions', the commitments do not include any standard of service obligations to ensure fair and equitable access.
<p>Complaint handling process [CI 4.41 to 4.43]: The undertaking proposes that MergeCo will have a complaint handling process.</p>	<ul style="list-style-type: none"> • Process is undefined and inadequate: The commitments do not set out in any detail the proposed complaint handling process. In particular, the commitments do not outline any processes for independent dispute resolution or include any commitments to investigate and respond to complaints within a reasonable timeframe. • Does not require ACCC approval: The complaint handling process is left entirely to the merger parties to design and is not subject to ACCC approval. Customers have no assurance that the complaint handling process that is designed by the merger parties will be adequate or effective. • Unlikely to prevent discriminatory conduct: Even if the merged entity investigates and responds to complaints, or complaints are escalated to the ACCC through the independent audit process, this is likely to be too slow to prevent discriminatory conduct from occurring.
<p>Compliance auditing and monitoring [CI 4.44 to 4.60]: The undertaking proposes an independent audit process and self-reporting obligations to the ACCC.</p>	<ul style="list-style-type: none"> • Difficult to monitor compliance: The commitments are unlikely to enable the independent auditor and ACCC to effectively monitor the merged entity's compliance. The complexity of the pricing mechanism, the nature of CIT services markets, and vague obligations to provide services at existing levels, are difficult to audit effectively. The auditor will also be reliant on information and cooperation from the merged entity. • Significant burden on auditor and ACCC: The long-term nature and complexity of the undertaking places a considerable burden on the independent auditor and ACCC to monitor and address non-compliance. It will be too difficult for the independent auditor or the ACCC to identify the myriad of subtle discrimination methods that are likely to occur. • Reporting and audits are too infrequent: Six-monthly reporting to the ACCC and 12-monthly audits are too infrequent and would not effectively mitigate the risk of harm occurring and then subsequent delays in identifying, reporting, and then enforcing against non-compliance. • High burden of enforcement: Whilst court action can deter breach of a section 87B undertaking, it is time consuming and uses significant public resources.

Linfox Armaguard / Prosegur

Comments on the Applicants' Response and Proposed Undertaking

Prepared for

Allens
Level 37
101 Collins Street
Melbourne VIC 3000
AUSTRALIA

Prepared by

Dr Geoff Edwards
Suite 2201, Level 22, Tower 2
101 Grafton Street
Bondi Junction NSW 2022
Australia
Date: 6 April 2023

CRA Charles River
Associates

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EXECUTIVE SUMMARY

1. On 21 December 2022, the ACCC issued its Statement of Preliminary Views (SOPV) on the proposed merger of Linfox Armaguard Pty Ltd and Prosegur Australia Holdings Pty Limited (the Proposed Merger) and on 9 March 2023 the Applicants (Armaguard and Prosegur) lodged their response to the SOPV (the Response) and a proposed undertaking (the Proposed Undertaking).

Risks of vertical foreclosure

2. As explained in my Initial Report, in addition to horizontal issues in each of the cash-in-transit (CIT) markets, the Proposed Merger raises a vertical input foreclosure issue in relation to ATM deployment. This arises because the Proposed Merger brings together the two main suppliers of the CIT services required by independent ATM deployers (IADs) in a context in which the Merged Entity will also compete downstream with those IADs in ATM deployment markets.
3. As also explained in my Initial Report, this is not the only vertical input foreclosure issue that the Proposed Merger generates. Another relates to the supply of cash and cash processing at approved cash centres (ACCs) to third-party CIT providers that will be in competition with the Merged Entity in at least the second CIT market (i.e., the market for the supply of CIT services to retail customers that require a full-service solution).
4. The Application overlooked both vertical issues and the Proposed Undertaking does not remedy these vertical concerns. In particular, the Proposed Undertaking does not eliminate the Merged Entity's ability to foreclose IADs and third-party CIT providers, and ATM deployment and CIT service markets are likely to be less competitive as a result, with adverse consequences for customers in these markets and ultimately consumers.

Alternatives and counterfactuals

5. In my Initial Report I considered the following two structural alternatives to the Proposed Merger that have the potential to achieve the stated rationale and public benefits claimed for the Proposed Merger (by addressing the excess capacity and under-recovery issue being experienced by the Applicants in their duplicated cash infrastructures) *with less anti-competitive effect*.
 - a. The Proposed Merger, but with divestment of the Applicants' downstream ATM deployment businesses; and
 - b. A joint venture or other form of infrastructure sharing limited to ACCs, or limited to ACCs and the transport networks involved in wholesale cash distribution, with the Applicants retaining separate CIT service operations downstream of ACCs and separate ATM deployment operations.
6. The benefit of the first alternative compared to the Proposed Merger with the Proposed Undertaking is that it would completely address the vertical foreclosure concern with respect to ATM deployment services: severing the merged entity's vertical integration between CIT services and ATM deployment will remove any incentive to foreclose IADs.
7. The second alternative, if feasible, and if combined with suitable undertakings, would offer a number of benefits for competition, customers and end-consumers compared to the Proposed Merger with the Proposed Undertaking.

- a. First, it would completely address the vertical foreclosure concern raised by the Proposed Merger in relation to ATM deployment services.
 - b. Second, open access for third-party CIT providers to the JV's services on transparent auditable FRAND terms (ensuring no discrimination between third-party CIT providers and the Applicants' own CIT service operations) would address the vertical foreclosure concern raised by the Proposed Merger in relation to the supply of cash and cash processing at ACCs to third-party CIT providers.
 - c. Third, this alternative would improve on the Proposed Merger in relation to horizontal price and non-price effects, by limiting the concentration to, at most, ACCs and other wholesale cash infrastructure, and retaining competition between the Applicants in CIT services downstream of ACCs.
8. The second alternative may also be a likely counterfactual to the Proposed Merger with the Proposed Undertaking, should the ACCC decline to authorise the Proposed Merger with the Proposed Undertaking. Compared to this counterfactual, the Proposed Merger with the Proposed Undertaking would be likely to result in substantial anti-competitive horizontal and vertical effects with limited or no additional public benefit.
9. Before accepting the Proposed Merger with the Proposed Undertaking the ACCC should be satisfied that the two alternatives I have raised are not feasible and preferable and are not likely counterfactuals to the Proposed Merger with the Proposed Undertaking. The Response ignores both alternatives. The Applicants therefore cannot have satisfied the ACCC that these alternatives are not feasible and preferable alternatives to the Proposed Merger with the Proposed Undertaking.

Comments on the Proposed Undertaking

10. The Proposed Undertaking is entirely behavioural in nature. As the ACCC already appreciates, behavioural undertakings tend to be problematic for a number of reasons and structural undertakings – such as divestments or the creation of an arms-length JV – are generally preferred by competition authorities.
11. What is more, as behavioural undertakings go, the Proposed Undertaking is particularly ambitious, opaque and unenforceable. The Proposed Undertaking is therefore the sort of behavioural undertaking a competition authority should be particularly reluctant to accept, as the scope for manipulation, exploitation and discrimination is high. In particular, the Proposed Undertaking will not remedy the horizontal and vertical issues raised by the Proposed Merger for the following reasons.
- a. **The pricing commitment in the Proposed Undertaking does not adequately address the horizontal concerns identified in the SOPV in relation to price.** The pricing commitment allows for Target Revenue to be inflated above efficient costs in a number of ways and there is a substantial risk that it will result in overall revenues that are persistently above the efficient costs of CIT services. The pricing commitment also allows for wide discretion in the pricing of specific services and/or the prices charged to specific customers within an overall revenue target, which provides scope for the Merged Entity to charge higher prices for certain services or to specific customers where the Merged Entity faces the least competition following the merger. A regime in which prices for CIT services are determined by an independent expert based on cost-plus pricing principles would be a more suitable behavioural remedy to address the horizontal price concerns.

- b. **The pricing commitment also does not adequately address the vertical concerns raised by the Proposed Merger in relation to price.** Firstly, the pricing commitment contains no mechanism whatsoever to protect third-party CIT providers from foreclosure in the form of a margin squeeze. Secondly, while the pricing commitment includes a mechanism that may impose an opportunity cost on the Merged Entity if it raises prices to the three largest IADs, the mechanism does not eliminate the ability to engage in margin squeeze and incentives to foreclose may remain. The same cost-plus pricing regime mentioned above would be an alternative and preferable behavioural remedy to address the vertical pricing concerns.
- c. **The service quality commitment appears wholly ineffectual.** The Merged Entity would be largely unfettered in its discretion to degrade service quality across the board (reflecting the loss of competition due to the merger) and discriminate in quality in favour of its own downstream operations and against its competitors in both ATM deployment and CIT service markets. Even if the pricing commitment were revised to address the horizontal and vertical concerns with respect to price, a high likelihood of a substantial lessening of competition would remain in the form of service quality degradation and discrimination against competitors. Only structural remedies can fully address the quality degradation and discrimination concerns raised by the Proposed Merger, for example a joint venture limited to the Applicants' ACCs and the transport networks involved in wholesale cash distribution, or divestment of the Applicants' ATM deployment businesses.

1. INTRODUCTION

1.1. Instructions

12. In October 2022 I was engaged by Allens on behalf of Next Payments Pty Ltd (Next) in the context of the application seeking authorisation (Application) of the proposed merger of Linfox Armaguard Pty Ltd and Prosegur Australia Holdings Pty Limited (Proposed Merger).
13. In November 2022, Allens submitted to the ACCC a report (my Initial Report) that contained written expert economic opinions and reasons for those opinions in respect of the following matters:
 - a. The relevant markets for assessing the Proposed Merger;
 - b. Whether the Proposed Merger raises a risk of vertical foreclosure effects in relation to ATM deployment services; and
 - c. Whether there might exist alternatives to the Proposed Merger that would be likely to realise the public benefits claimed in the Application.
14. My engagement letter and letter of instruction from Allens are included in **Appendix A** to this report.
15. On 21 December 2022 the ACCC issued its Statement of Preliminary Views (SOPV) on the Proposed Merger, and on 9 March 2023 the Applicants (Armaguard and Prosegur) lodged their response to the SOPV (the Response) and a proposed undertaking (the Proposed Undertaking).
16. In this context, Allens has requested that I review and consider the Applicants' Response and Proposed Undertaking and provide a written opinion and my reasons for those opinions in respect of the matters covered by my Initial Report, including addressing the extent to which the Proposed Undertaking addresses the issues raised in the ACCC's SOPV. The letter of further instruction from Allens is also included in **Appendix A** to this report.

1.2. Documents and assumptions

17. In preparing the expert economic opinions presented in this report I have reviewed and rely on the following documents:
 - a. The Application to the Australian Competition and Consumer Commission for Merger Authorisation submitted by Linfox Armaguard Pty Ltd and Prosegur Australia Holdings Pty Limited on 26 September 2022 (Application);
 - b. A report by RBB Economics titled "Armaguard and Prosegur: Competitive effects and public benefits, dated 26 September 2022 (RBB Economics report);
 - c. A list of factual assumptions provided to me by Allens (these are attached as Appendix B to my Initial Report);
 - d. The Applicants' Response and Proposed Undertaking; and
 - e. Next's Supplementary Submission dated 4 April 2023.

1.3. Compliance with the Expert Evidence Practice Note and the Harmonised Expert Witness Code of Conduct

18. I have read, understood, complied with and agree to be bound by the Federal Court of Australia's Expert Evidence Practice Note (GPN-EXPT) supplied to me by Allens. I have

also read, understood, complied with and agree to be bound by the Harmonised Expert Witness Code of Conduct (Annexure A to the GPN-EXPT) also supplied to me by Allens.

19. All the opinions and views expressed in this report are my own and are based wholly or substantially on specialised knowledge arising from my training, study or experience. My CV is attached as Appendix C to my Initial Report.
20. I have made all inquiries that I believe are desirable and appropriate and no matters of significance that I regard as relevant have, to my knowledge, been withheld from my report.

1.4. Organisation of this report

21. The remainder of this report is organised as follows.
 - a. In Section 2 I recap the vertical concerns identified in my Initial Report. These concerns were overlooked in the Application and will not be remedied by the Proposed Undertaking. It is important that these vertical issues remain prominent in the ACCC's considerations together with the horizontal issues.
 - b. In Section 3 I observe that the Applicants have failed to explain why the two alternatives to the Proposed Merger that I presented in my Initial Report are not feasible and preferable alternatives to the Proposed Merger with the Proposed Undertaking.
 - c. Section 4 provides some general comments on the Proposed Undertaking, and Sections 5-8 provide more detailed comments on the pricing commitment, the service quality commitment, the IAD commitment and the third-party access to cash centres commitment, respectively.

2. RISKS OF VERTICAL FORECLOSURE

22. As explained in my Initial Report, in addition to horizontal issues in each of the CIT markets,¹ the Proposed Merger raises a vertical input foreclosure issue in relation to ATM deployment. This arises because the Proposed Merger brings together the two main suppliers of the CIT services required by independent ATM deployers (IADs) in a context in which the Merged Entity will also compete downstream with those IADs in ATM deployment markets.²
23. This is not the only vertical input foreclosure issue that the Proposed Merger generates. As also explained in my Initial Report, another relates to the supply of cash and cash processing at ACCs to "third-party" CIT providers. Pre-merger, third-party CIT providers that do not have their own ACCs can source cash from and have cash processed at the ACCs of either Armaguard or Prosegur and there will be competition between Armaguard and Prosegur to supply these services. Post-merger, the Merged Entity will be the only

¹ Horizontal issues arise not only in the three CIT markets identified by the Application and the RBB Economics report, but also in the additional markets that I identified in my Initial Report (i.e., markets for the supply of CIT services to IADs and for the supply of cash and cash processing at ACCs to CIT providers). Horizontal effects are likely to be substantial given that the Proposed Merger represents a "two to one" in national CIT providers with ACCs, the critical role the merging parties play in wholesale and retail cash distribution, and the reliance of a range of customers on them.

² For further explanation see Section 3 of my Initial Report.

option for these cash supply and processing services, and at the same time the Merged Entity will be in competition with these CIT providers in at least the second CIT market (i.e., the market for the supply of CIT services to retail customers that require a full-service solution).

24. The Application overlooked both vertical issues and the Proposed Undertaking does not remedy these vertical concerns. As explained later in this report (and summarised below), the Proposed Undertaking does not eliminate the ability of the Merged Entity to foreclose both IADs and third-party CIT providers that currently compete with the Applicants.
- a. Although the Applicants claim that the Proposed Undertaking will provide protection from margin squeeze to IADs,³ the pricing scheme in the Proposed Undertaking in fact allows considerable scope for prices to be manipulated within an overall revenue cap, and for the Merged Entity to squeeze the margins of IADs by raising the prices that they must pay for CIT service inputs that only the Merged Entity can provide.
 - b. The Proposed Undertaking does not even attempt to offer protection from margin squeeze to third-party CIT providers that require access to cash and cash processing services at ACCs.⁴ The Proposed Undertaking only commits the Merged Entity to supply "Third Party Cash Services" on "reasonable" commercial terms and conditions.⁵ The Merged Entity will therefore have considerable ability to increase prices to third-party CIT providers and squeeze their margins in the supply of services in the second CIT market.
 - c. Even if the scope for margin squeeze were to be addressed in some way, the Proposed Undertaking provides no protection for IADs and third-party CIT providers in relation to service quality. In particular, the service quality commitment in the Proposed Undertaking is not monitorable or auditable, and it is unenforceable, leaving ample scope for the merged entity to discriminate in a myriad of ways between the service quality supplied to its own ATM deployment and CIT operations on the one hand and the service quality supplied to competing IADs and third-party CIT providers on the other. Therefore, even if the Merged Entity were constrained from margin squeezing IADs and third-party CIT providers, it would have ample scope to foreclose them by discriminating in terms of the quality of the services supplied to them. Any effort by the Applicants to address the margin squeeze concerns with revised pricing commitments would be of little value if the Merged Entity were to retain unfettered discretion in relation to service quality.
25. As explained in my Initial Report, the Merged Entity is likely to have incentives to foreclose IADs such as Next. The Merged Entity may also have incentives to foreclose third-party CIT providers. For the reasons summarised above, the Proposed Undertaking does not eliminate the Merged Entity's ability to foreclose IADs and third-party CIT providers. As a result, ATM deployment and CIT service markets are likely to be less competitive, with adverse consequences for customers and ultimately consumers.

3 Response, Annexure A, paragraph 3.34.

4 It is not clear why the Proposed Undertaking treats third-party CIT providers differently to IADs in this regard, given that the Proposed Merger raises similar risks of vertical foreclosure in relation to both.

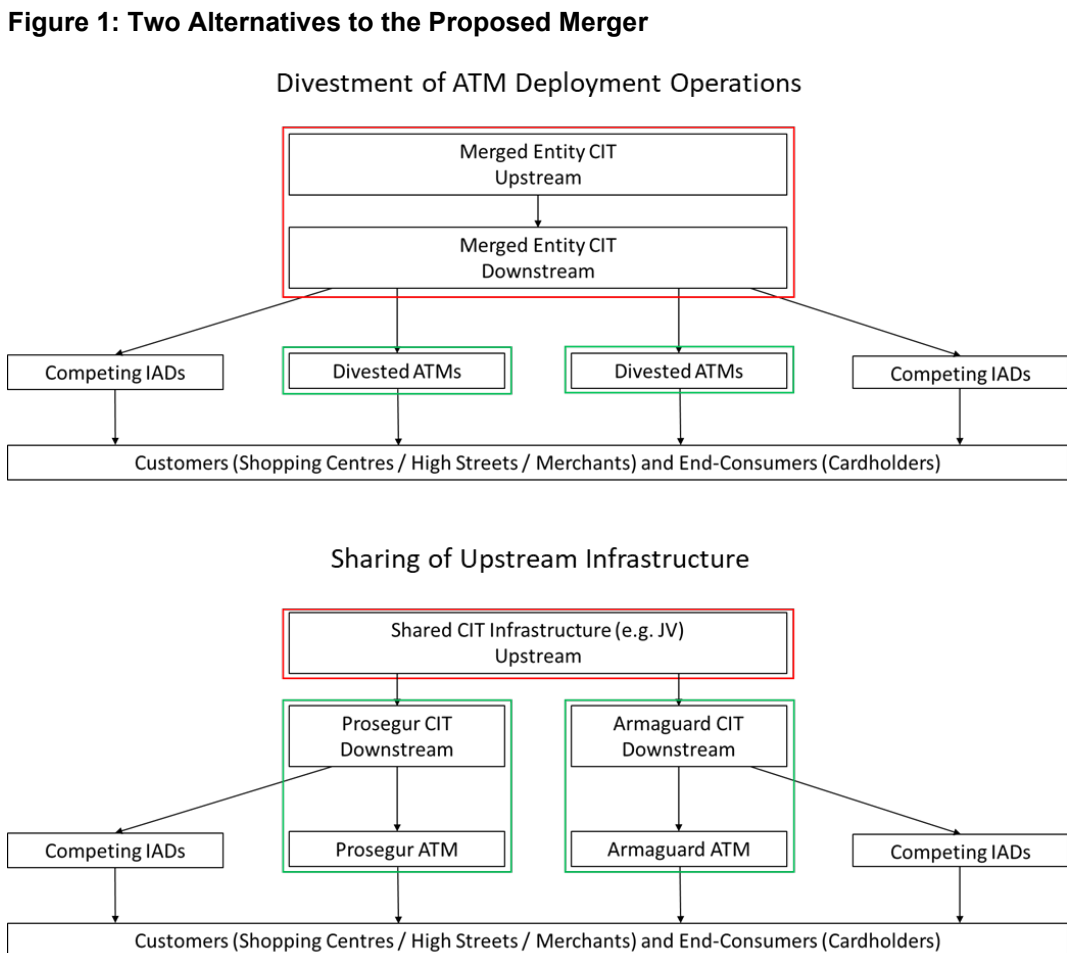
5 Proposed Undertaking, paragraph 4.40.

3. ALTERNATIVES AND COUNTERFACTUALS

26. In my Initial Report I presented the following two alternatives to the Proposed Merger that have the potential to achieve the stated rationale of the Proposed Merger by addressing the excess capacity and under-recovery issue being experienced by the Applicants in their duplicated cash infrastructures and deliver the same public benefits as those claimed by the Applicants for the Proposed Merger, but *with less anti-competitive effect*.

- a. The Proposed Merger, but with divestment of the Applicants' downstream ATM deployment businesses; and
- b. A joint venture or other form of infrastructure sharing limited to ACCs, or limited to ACCs and the transport networks involved in wholesale cash distribution, with the Applicants retaining separate CIT service operations downstream of ACCs and separate ATM deployment operations.⁶

27. These alternatives are illustrated in the figure below (which is reproduced from my Initial Report).



28. The first alternative should realise the rationale and the public benefits that the Application claims for the Proposed Merger because the Applicants will still be allowed to consolidate and de-duplicate high fixed cost CIT operations that they claim are causing their financial

⁶ See Section 4 of my Initial Report.

- difficulties. The benefit of this alternative compared to the Proposed Merger with the Proposed Undertaking is that it would completely address the vertical foreclosure concern with respect to ATM deployment: severing the merged entity's vertical integration between CIT services and ATM deployment will remove any incentive to foreclose IADs.
29. The second alternative, if feasible, and if combined with suitable undertakings, would offer a number of benefits for competition, customers and end-consumers compared to the Proposed Merger with the Proposed Undertaking.
- a. First, it would completely address the vertical foreclosure concern raised by the Proposed Merger in relation to ATM deployment services, as under this alternative Armaguard and Prosegur would continue to compete to supply CIT services to IADs (downstream of ACCs).
 - b. Second, open access for third-party CIT providers to the JV's services on transparent auditable FRAND terms (ensuring no discrimination between third-party CIT providers and the Applicants' own CIT service operations) would address the vertical foreclosure concern raised by the Proposed Merger in relation to the supply of cash and cash processing at ACCs to third-party CIT providers.⁷
 - c. Third, this alternative would improve on the Proposed Merger in relation to horizontal price and non-price effects, by limiting the concentration to, at most, ACCs and other wholesale cash infrastructure, and retaining competition between Armaguard and Prosegur in CIT services downstream of ACCs. Pricing and service quality commitments may still be required to counter horizontal incentives to charge excessive prices and lower service quality, however these commitments would be less extensive and could be much less complicated.
30. The second alternative may also be a likely counterfactual to the Proposed Merger with the Proposed Undertaking, should the ACCC decline to authorise the Proposed Merger with the Proposed Undertaking. Compared to this counterfactual, the Proposed Merger with the Proposed Undertaking would be likely to result in substantial anti-competitive horizontal and vertical effects with limited or no additional public benefit.⁸
31. Before accepting the Proposed Merger with the Proposed Undertaking the ACCC should be satisfied that the two alternatives I have raised are not feasible and preferable and are not likely counterfactuals to the Proposed Merger with the Proposed Undertaking. The Response ignores both alternatives. The Applicants therefore cannot have satisfied the ACCC that these alternatives are not feasible and preferable alternatives to the Proposed Merger with the Proposed Undertaking.
32. This blind spot in the Response is surprising given that:
- a. Divestment of the Applicants' ATM deployment operations represents a clean and obvious structural solution to the vertical foreclosure issue in relation to ATM deployment; and

⁷ Without open access on FRAND terms there may be concerns that the JV (like the merged entity if the Proposed Merger were to proceed) would have the ability and incentives to fully foreclose, raise prices to or reduce the quality of services to third party CIT providers, reducing competition compared to the current situation in which third party CIT providers have two options for cash sourcing and processing at ACCs.

⁸ See paragraph 87 of my Initial Report.

- b. The Application described a number of international examples where it appears that ACCs are operated independently of CIT transport operations, suggesting that it should be feasible to create an "ACC JV" in Australia that provides services in a non-discriminatory fashion to all CIT providers downstream of ACCs (including the Applicants as well as third-party CIT providers).
33. The Response prefers to tilt at windmills by addressing two other alternatives: sub-contracting and a joint venture in regional and remote areas.

4. GENERAL OBSERVATIONS ON THE PROPOSED UNDERTAKING

34. The Proposed Undertaking is entirely behavioural in nature. As the ACCC already appreciates, behavioural undertakings tend to be problematic for a number of reasons, including that:
- a. They tend to come with risks of circumvention and are less assured to remedy structural changes in an industry than structural remedies;
 - b. They may lead to ossification of markets and not cope well with dynamic events; and
 - c. They impose monitoring and enforcement burdens and costs on regulators or the industry.
35. For these reasons, structural undertakings – such as divestments or the creation of an arms-length JV – are generally preferred by competition authorities, and behavioural undertakings are typically rejected unless they are merely an adjunct to a structural undertaking.
36. What is more, while behavioural undertakings that are relatively modest, transparent and enforceable may be acceptable on their own, the Proposed Undertaking is not of that kind. The Proposed Undertaking is instead particularly ambitious, opaque and unenforceable.
- a. First, the Proposed Undertaking is essentially seeking to implement sector regulation of a monopoly utility with respect to price, quality and access, but without a sector regulator, relying largely on a "self-executing incentive mechanism" in relation to price and the faithfulness of the Merged Entity in relation to access and quality.
 - b. Second, the "self-executing" Target Revenue Model that is at the core of the Proposed Undertaking's pricing commitment is a novel and tremendously complex Rube Goldberg machine, with arcane and almost impenetrable formulas⁹ that frequently serve to inflate Target Revenue above efficient costs. The pricing commitment is therefore a long way from a transparent easily comprehended undertaking that inspires confidence among customers (including competitors) that prices reflect efficient costs and are fair and non-discriminatory.

⁹ A textual description of the way in which the Target Operating Expenditure forecast is calculated serves to illustrate the complexity and opacity of the Model. The Target Operating Expenditure forecast is calculated as the average of Actual Operating Expenditure in the previous period and a "corrected" Target Operating Expenditure in the previous period, multiplied by an indexation factor based on inflation measures and changes in the value of cash carried by the Merged Entity, where the "corrected" Target Operating Expenditure is itself the average of Actual Operating Expenditure and the "corrected" Target Operating Expenditures from two periods earlier, multiplied by the same indexation factor. Other inputs into the model are calculated in similarly complex fashion.

- c. Third, in striking contrast to the level of specification of the pricing commitment, the service quality commitment is grossly under-specified, lacking both non-discrimination commitments and KPIs that may be used for monitoring, auditing and ensuring compliance.
37. The Proposed Undertaking is therefore the sort of behavioural undertaking a competition authority should be particularly reluctant to accept, as the scope for manipulation, exploitation and discrimination is high. In particular, as I explain in the following sections, the Proposed Undertaking will not remedy the horizontal and vertical issues raised by the Proposed Merger.
- a. The pricing commitment in the Proposed Undertaking does not adequately address the horizontal concerns identified in the SOPV in relation to price. It allows for Target Revenue to be inflated above efficient costs in a number of ways and there is a substantial risk that it will result in overall revenues that are persistently above the efficient costs of CIT services. The pricing commitment will therefore not effectively constrain the Merged Entity's market power. It also allows for wide discretion in the pricing of specific services and/or the prices charged to specific customers within an overall revenue target, which provides scope for the Merged Entity to charge higher prices for certain services or to specific customers where the Merged Entity faces the least competition following the merger. A regime in which prices for CIT services are determined by an independent expert based on cost-plus pricing principles would be a more suitable behavioural remedy to address the horizontal price concerns.
- b. The pricing commitment also does not adequately address the vertical concerns raised by the Proposed Merger in relation to price. Firstly, the pricing commitment contains no mechanism whatsoever to protect third-party CIT providers from foreclosure in the form of a margin squeeze. Secondly, while the pricing commitment includes a mechanism that may impose an opportunity cost on the Merged Entity if it raises prices to the three largest IADs, the mechanism does not eliminate the ability to engage in margin squeeze and incentives to foreclose may remain. The same cost-plus pricing regime mentioned above would be an alternative and preferable behavioural remedy to address the vertical pricing concerns.
- c. Finally, the service quality commitment appears wholly ineffectual. The Merged Entity would be largely unfettered in its discretion to degrade service quality across the board (reflecting the loss of competition due to the merger) and discriminate in quality in favour of its own downstream operations and against its competitors in both ATM deployment and CIT service markets. Even if the pricing commitment were revised to address the horizontal and vertical concerns with respect to price, a high likelihood of a substantial lessening of competition would remain in the form of service quality degradation and discrimination against competitors. Only structural remedies can fully address the quality degradation and discrimination concerns raised by the Proposed Merger, for example a joint venture limited to the Applicants' ACCs and the transport networks involved in wholesale cash distribution, or divestment of the Applicants' ATM deployment businesses.

5. THE PRICING COMMITMENT

5.1. General observations on the pricing commitment

38. The Applicants propose that, while there will be an Independent Auditor (IA), the IA will not make subjective assessments as to the prudence of expenditures, the appropriateness of the allowed return and the accuracy of forecasts.¹⁰ The suggestion is that regulation by an external third party is unnecessary because the Proposed Undertaking provides “a self-executing incentive mechanism compatible with efficient outcomes”.¹¹ In fact, as explained below, the Proposed Undertaking is likely to allow the Merged Entity to inflate its CIT revenues above efficient costs in a number of ways, exploit the reduction in competition created by the Proposed Merger by raising prices where competition is most limited and lowering prices where competition is more intense, and raise prices for CIT services relied on by IADs and third-party CIT providers that are in competition with the Merged Entity downstream, risking foreclosure via margin squeeze.
39. Given the complexity of the pricing commitment, and the reliance placed on its self-execution to address the horizontal and vertical concerns raised by the Proposed Merger, one would expect that the Applicants would have provided:
- a. Examples where similar pricing schemes have been implemented and where such schemes have ensured both that prices have reflected efficient costs over time and that competitors were not foreclosed; and
 - b. A simulation of future prices based on reasonable assumptions, illustrating how the various mechanisms would work, the prices that would result for the various CIT services and customers, and the degree to which the Target Revenue reflects actual costs over time.

5.2. Horizontal price concerns are not adequately addressed

40. The ACCC's preliminary view, as set out in the SOPV, is that competition concerns are likely to arise in the supply of: (i) integrated wholesale and retail CIT services for the Major Banks; and (ii) full-service retail CIT services for retail customers (i.e., both transportation and processing services).¹² The ACCC observes that the Applicants' estimated combined market share in these services will be greater than 85% and that the Proposed Merger will combine the two largest suppliers (and the only two national suppliers) in an already concentrated area of competition.¹³ The ACCC's preliminary view is that the Merged Entity would likely have the ability and incentives to substantially raise prices for these services above current levels and that there would likely be a decrease in service quality from current levels.¹⁴ There may also be a reduction in innovation.¹⁵

10 Response, Annexure A, paragraph 3.5(b).

11 Response, Annexure A, paragraph 3.5(b).

12 ACCC SOPV, paragraph 3.5.

13 ACCC SOPV, paragraphs 3.6-3.7.

14 ACCC SOPV, paragraph 3.13.

15 ACCC SOPV, paragraph 3.12.

41. The Applicants have previously acknowledged that prices may rise following the Proposed Merger.¹⁶ They effectively do so again in their Response, observing that a single provider of CIT services on a national basis “will be less constrained in setting the price at which it supplies CIT services and the nature of the services it provides”.¹⁷
42. The pricing commitment does not adequately address these horizontal concerns. For the reasons given below, the pricing commitment will not effectively constrain the Merged Entity’s market power and there is a substantial risk that it will result in overall revenues that are persistently above the efficient costs of CIT services. The pricing commitment also allows for wide discretion in the pricing of specific services and/or the prices charged to specific customers within an overall revenue target, which provides scope for the Merged Entity to charge higher prices for services or to customers where the Merged Entity faces the least competition following the merger.

5.2.1. The Target Revenue may be inflated above efficient costs in a number of ways

43. The Target Revenue is to be determined using the Target Revenue Model presented in Appendix 1 to the Proposed Undertaking. According to this model, the Target Revenue will be set based on Target Expenditure, which is itself the sum of a Target Operating Expenditure forecast, Budgeted Depreciation, Budgeted Common Costs attributed to CIT services and a Variation amount. The following paragraphs explain how, under the Target Revenue Model, the Target Revenue may be inflated above efficient costs in a number of ways.
44. First, calculating the Target Operating Expenditure forecast requires an initial Target Operating Expenditure forecast to be provided by the Joint Business Advisor (JBA) for the first period. The Merged Entity, as the sole party providing information to the JBA, without any regulatory oversight or other critical analysis, may have scope to inflate the initial Target Operating Expenditure forecast, which would have the effect of inflating Target Operating Expenditures and Target Revenues for all subsequent periods.¹⁸ The Merged Entity would have strong incentives to “game” the system in this way, and its ability to do so is not obviously constrained by the terms of the Proposed Undertaking.
45. Second, there is further scope to “game” the system in relation to common costs. The Merged Entity is free to inflate the common costs that enter the model in two respects.
- a. First, the Merged Entity may identify costs that are driven solely by non-CIT services (and that are therefore not genuinely common) as common costs, without any auditing (the JBA is only tasked in relation to operating expenditure).
 - b. Second, the Merged Entity may allocate a large proportion of the identified common costs to CIT services (where competition does not constrain its pricing) and have these included in the Target Revenue, as there are no specific terms within the

16 Application, page 16.

17 Response, Annexure A, paragraph 1.8.

18 Under the Proposed Undertaking’s “Target Revenue Model”, a period’s Target Operating Expenditure contributes to the next period’s Target Operating Expenditure. Therefore, while the effect of an inflated initial Target Operating Expenditure would reduce over time, it would never fully cease.

Proposed Undertaking determining the allocation, and there will be no auditing or regulatory determination of the allocation.

46. Third, under the “prudency mechanism” that aims to provide the Merged Entity with incentives to reduce its operating expenditure, Target Operating Expenditure in year T+1 is an average of the Actual and Target Operating Expenditures in year T. This means that the Merged Entity will not only retain for itself any operating expenditure savings it makes in year T, but also 50% of that saving in year T+1, 25% of it in year T+2, 12.5% of it in year T+3 and so on. While it is desirable to include incentives for the Merged Entity to reduce its operating expenditure, by only passing on a portion of the savings each year revenue will exceed efficient costs in future years by more than if the Merged Entity were only allowed to benefit from cost savings in year T.
47. Fourth, as the Response explains, the prudency mechanism is not extended to common costs.¹⁹ The Applicants argue that there is no need to extend the prudency mechanism to common costs because the Merged Entity will anyway have incentives to minimise common costs as it is exposed to competition in other services that incur costs in common with CIT services and for which there is “a high degree of competition (e.g., ATM deployment services)”.²⁰ This is not a strong argument for a number of reasons.
- a. First, while the Merged Entity will internalise the share of common cost savings not allocated to CIT services and hence have some incentive to achieve them, the part of the common costs allocated to CIT services will enter into a mechanism under which the Merged Entity will be reimbursed for that allocation with an additional margin. This may dampen incentives to reduce common costs below the level provided by the prudency mechanism for CIT operating expenditure, and will surely dampen them compared to a counterfactual in which those costs must be recovered entirely from competitive services.
 - b. Second, this muting of incentives will be exacerbated by the ability of the Merged Entity to allocate a large proportion of the common costs to CIT services. The larger the proportion of common costs allocated to CIT services (for which the Merged Entity will be reimbursed with a guaranteed margin), the more muted the incentives will be.
 - c. Third, as explained below, the Merged Entity will have scope to leverage its market power in CIT services into other services (including ATM deployment services) by discriminating in price and non-price terms against its competitors. It therefore should not be assumed that a “high degree of competition” will remain in services like ATM deployment services.
48. For these reasons, incentives to reduce common costs are likely to be muted compared to the counterfactual, and by not extending the prudency mechanism to common costs Target Revenues are likely to be further inflated each year above efficient costs.
49. Fifth, the indexation for inflation applied when calculating Target Operating Expenditure may substantially overstate operating expenditure increases due to inflation. The Proposed Undertaking proposes to index based on consumer price inflation (CPI) and average weekly earnings (AWE). While AWE may be a relevant predictor of the Merged Entity’s labour

¹⁹ Response, Annexure A, paragraph 3.23.

²⁰ Response, Annexure A, paragraph 3.23.

- costs, it is not obvious that CPI would be a relevant predictor of other costs, and there are likely to be more relevant indices for cost adjustment (e.g., a fuel cost index).²¹ If the Merged Entity's operating expenditure inflates more slowly than CPI and AWE, the Merged Entity will each year be allowed to realise a Target Revenue that exceeds its efficient costs.
50. Sixth, the cost sensitivity term in the indexation formula is particularly problematic. While reductions in cash volumes will likely not give rise to equivalent cost reductions (due to fixed costs which cannot be reduced to the same extent as variable costs), the initial level of the cost sensitivity of 40% seems extremely low and is not justified by a cost breakdown or any other analysis. Moreover, a low value of the cost sensitivity parameter will be highly persistent in this pricing model, as the updating mechanism of the sensitivity parameter does not ensure convergence of this parameter to its true value. For instance, if a 10% reduction in cash volumes would trigger an operating cost reduction of 5%, reflecting a true "cost sensitivity" of 50%, the updating mechanism would imply a further reduction of the cost sensitivity parameter (abstracting from inflation and potential forecasting errors) despite the fact that the initial value of 40% was too low already compared to the true value of 50% in the example. Precisely, the parameter would reduce to $\frac{0.9}{0.95} < 1$ of the original parameter value in the example (e.g., from 40% to 38% after the first year).²² The cost sensitivity parameter is the key determinant of how cash volume reductions are reflected in the Target Operating Expenditure, and too low a sensitivity parameter will imply a too high Target Operating Expenditure. The flawed formula used to update the parameter combined with a low initial value for the parameter will perpetuate excessive Target Operating Expenditures and excessive Target Revenues.
51. Seventh, the "Unders and Overs" Balance, which is supposed to track deviations between Actual Revenue and Target Revenue (to feed these deviations into an Adjusted Target Revenue) is defined not simply as a difference between Actual Revenue and Target Revenue in a year (inflated by WACC). Instead, it is defined as the difference between Actual Revenue and the average of the Target Revenue in that year and the Target Revenue in the previous year. This seems to be an excessive averaging of targets. If Target Revenues are declining over time, the effect will be to reduce the "Unders and Overs" Balance and inflate the Adjusted Target Revenue that the Merged Entity will be allowed to earn.
52. Eighth, the Balance Adjustment formula that limits the extent to which the "Unders and Overs" Balance is included in Adjusted Target Revenue has the effect of allowing the Merged Entity to retain a share of overcharges accrued in a year, rather than return the full overcharge as soon as possible to customers in the form of a reduction in the Target Revenue for the following year. There is no obvious reason why the Merged Entity should retain overcharges for any longer than the year in which they are accrued.

21 As an aside, it is not clear why the ratio of CPIs in consecutive years is *multiplied* by the ratio of AWEs in consecutive years and then divided by two. This will produce a number substantially less than one (closer to 0.5 than to one), which is presumably not the intention. It is not clear why a simple average was not taken (i.e., the sum divided by two, rather than the product divided by two).

22 To give a more extreme example, but one that illustrates more starkly the formula's flaw, if percentage reductions in cash volumes were associated with equal percentage reductions in operating costs, reflecting a true "cost sensitivity" of 100%, the updating mechanism (abstracting again from inflation and potential forecasting errors) would retain the cost sensitivity parameter at 40% forever (60 percentage points below its true level).

53. Finally, the mechanism that imputes to the Merged Entity's own ATM deployment operation revenues that are related to the Merged Entity's prices to IADs provides incentives for the Merged Entity to reduce prices for CIT services that are predominantly consumed by the Merged Entity's own ATM deployment operation and increase prices for CIT services that are predominantly consumed by IADs (to the extent that the Merged Entity's own ATM deployment operation consumes CIT services in different proportions to IADs). This may result in the sum of revenue from IADs and the imputed revenue declining, which would provide scope for the Merged Entity to charge higher prices to other CIT customers (e.g., banks; supermarkets; third-party CIT providers) while remaining within the overall Target Revenue cap.²³

5.2.2. Wide pricing discretion

54. The Merged Entity will be free to price as it pleases the many CIT services it provides and to the various customers it serves, constrained only by the overall Target Revenue and the "Special Pricing Conditions". This will provide the Merged Entity with scope to raise prices for some CIT services and/or to some customers and to lower prices to others. In particular, the Merged Entity will have scope within the overall Target Revenue, and notwithstanding the "Special Pricing Conditions", to raise prices in relation to services and/or customers where it faces the least competition following the merger (e.g., in the first CIT market, in the market for the supply of CIT services to IADs and in the market for the supply of cash and cash processing at ACCs to third-party CIT providers). At the same time, the Merged Entity will have scope to set prices at low, possibly predatory levels for services and/or customers where it faces greater competition (e.g., in the second and third CIT markets).

5.2.3. An alternative behavioural remedy to address the horizontal price concerns

55. An example of a mechanism that would be more robust in addressing the horizontal price concerns, more transparent, and simpler to implement, is in the undertaking accepted by the Federal Court in *ACCC v Pacific National*. That undertaking imposed a cap on access fees at the pre-merger rates until 30 June 2019, after which Pacific National has been able to propose higher fees, but any Terminal User can object to a proposed fee increase and an independent expert will then determine what the fee will be, with reference to cost-plus pricing principles.²⁴
56. In the context of the Proposed Merger, it should be feasible for the Applicants to similarly undertake that an independent expert will be appointed with the power to determine the prices of CIT services (including the CIT services supplied to IADs and access to cash and cash processing services at ACCs supplied to third-party CIT providers) based on a cost-plus methodology. This would both: (i) ensure an adequate return to the Merged Entity for

²³ The incentive to incentive to distort prices in this way is strengthened by the fact that this distortion may be used for foreclosure purposes as it may allow the Merged Entity to increase the costs of CIT services consumed by rivals while reducing the revenue imputed for self-supplied CIT services – see paragraph 61 for further discussion of this.

²⁴ The independent expert determines whether the fee is "reasonable and appropriate" having regard to a number of principles, including that charges should "generate expected revenue for Terminal Services that is at least sufficient to meet the efficient costs of providing the Terminal Services" and "include a return on investment commensurate with the commercial risks involved". Charges should also be set taking into account "all efficient input costs; an appropriate allocation of Pacific National's relevant overhead costs; [and] depreciation of, and a return on, the prudent level of capital invested by Pacific National at the Terminal".

the supply of these services; and (ii) ensure that the Merged Entity is not able to exploit the market power it will obtain through the Proposed Merger in the form of prices that do not reflect efficient costs.

5.3. Vertical price concerns are not adequately addressed

57. The Response claims that the Proposed Undertaking contains a commitment that would prevent foreclosure or discrimination in relation to the supply of CIT services to IADs.²⁵ That commitment, which I will refer to as a “revenue allocation” mechanism, is expressed in the Proposed Undertaking in the following terms.

*The revenue that MergeCo assesses to be earned from its Internal Customer must be no less than if it charged itself the highest Price it charges to any of the 3 largest Independent ATM Deployers for the supply of CIT Services.*²⁶

58. There is no corresponding commitment in relation to the prices the Merged Entity will charge to third-party CIT providers for cash and cash processing services at ACCs.²⁷ The Proposed Undertaking only commits the Merged Entity to supply “Third Party Cash Services” on “reasonable” commercial terms and conditions.²⁸ The Merged Entity will therefore have considerable ability to increase prices to third-party CIT providers and squeeze their margins in the supply of services in the second CIT market.
59. Returning to foreclosure of IADs, the proposed revenue allocation mechanism is a novel and non-standard approach to dealing with vertical price foreclosure (margin squeeze) concerns. Regulators concerned to eliminate the risk of vertical foreclosure through the pricing of inputs to downstream competitors will typically use pricing mechanisms such as price caps in relation to the services required by the competitors (where prices may be determined based on pre-merger prices²⁹ or using a cost-plus calculation) or retail-minus pricing (where the prices of the inputs must allow for an efficient margin between the input prices and the prices of the regulated firm's downstream services).³⁰
60. The Response asserts that the revenue allocation mechanism will ensure “that MergeCo does not have an incentive to charge a higher price to ATM Deployers it may compete with in downstream markets” and “that competition in the downstream market cannot be

25 Response, page 31, paragraph 58.

26 Proposed Undertaking, paragraph 4.16.

27 It is not clear why the Proposed Undertaking treats third-party CIT providers differently to IADs in this regard, given that the Proposed Merger raises similar risks of vertical foreclosure in relation to both.

28 Proposed Undertaking, paragraph 4.40.

29 With adjustments over time for cost inflation and anticipated efficiency gains.

30 For example, the ACCC, in common with many other authorities around the world, has used cost-plus and retail-minus methods of determining regulated prices for telecommunications services when the purpose has been to address the classic access (or “essential facility”) problem (where downstream competitors require access to inputs from a vertically integrated operator that they are also in competition with). Similarly in the broadcasting sector, where regulators have sought to ensure access to the premium channels of vertically integrated operators for competing retailers, cost plus and retail-minus pricing methodologies have been considered. For example, in its 2010 *Pay TV Statement*, Ofcom (the UK's communications regulator) imposed a wholesale must-offer remedy in relation to a number of Sky's sports channels and set wholesale prices for these channels using a retail-minus methodology with a cross-check against prices derived using a cost-plus methodology.

harmed".³¹ The revenue allocation mechanism does not ensure these things. While the mechanism *may* impose an opportunity cost on the Merged Entity of raising prices to IADs (since higher prices to IADs may increase the revenue assessed to be earned by the Merged Entity's own ATM deployment operation, which would reduce the revenue that can be earned from other CIT customers within the overall revenue cap)³² it does not eliminate the ability of the Merged Entity to engage in a margin squeeze. This is evident simply from the fact that the mechanism contains no reference to the prices or the downstream costs of the Merged Entity's own ATM deployment operation. It therefore leaves open an ability to charge IADs prices for CIT services that would leave an insufficient margin between the prices of the Merged Entity's own ATM deployment operation and the CIT service costs to cover downstream costs. At the same time, incentives to foreclose may remain.

61. Moreover, suppose that the Merged Entity's own ATM deployment operation and IADs consume a number of CIT services in different proportions. This would provide the Merged Entity with an incentive to charge high prices for services more predominantly used by IADs and low prices for services more predominantly used by the Merged Entity's own ATM deployment operation. The marginal cost to IADs of increasing the quantity of ATM deployment services they supply would then exceed the marginal (opportunity) cost to the Merged Entity of its ATM deployment operation increasing the quantity of ATM deployment services it supplies. The effect could be to both increase the costs of rival IADs (potentially leading to their foreclosure) and reduce the revenue allocation to the Merged Entity's own ATM deployment operation, without reducing the revenues that can be earned from other customers (i.e., without any opportunity cost).
62. The revenue allocation mechanism also has the potential to become far more complex than the formula in the Target Revenue Model suggests, and it may even be incapable of implementation. It might be reasonably tractable if there will be a high degree of consistency in the CIT services supplied to each of the three largest IADs and to the ATM deployment operation of the Merged Entity, and if all pricing is reasonably standardised across IADs and variable in nature. However, complications will arise:
 - a. If pricing terms vary across IADs (e.g., if one IAD is charged in terms of number of ATMs serviced, while another is charged in terms of number of replenishments, as then it will not be clear which volume measure to use);
 - b. If there are fixed price elements as well as variable price elements (the mechanism appears to assume that all prices are variable and does not explain how a unit price will be determined if there are fixed price elements); and
 - c. If the Merged Entity's own ATM deployment operation consumes a CIT service that IADs do not purchase from the Merged Entity³³ (as in that case there will be no reference price to apply to the volumes of that service consumed by the Internal Customer).

31 Response, Annexure A, paragraph 3.34.

32 The word "may" is used here in recognition of the observation in paragraph 61.

33 For example, a CIT service that IADs self-supply or purchase from third-parties rather than from the Merged Entity.

63. The alternative behavioural remedy described in Section 5.2.3 above (prices determined by an independent expert based on a cost-plus methodology) would be far more robust in preventing vertical foreclosure via margin squeeze.

6. THE SERVICE QUALITY COMMITMENT

64. The service quality commitment in the Proposed Undertaking is expressed as follows.

MergeCo will continue to supply CIT Services to Ongoing Customers in accordance with the standard of service that those customers were supplied the CIT Services in the period immediately preceding the Commencement Date, with any optimisation to be agreed between MergeCo and the Ongoing Customer.³⁴

65. This commitment is striking in its *lack of commitment* to ensuring that a competitive level of service quality is maintained and that the Merged Entity will not discriminate in terms of service quality between its own ATM deployment and CIT service operations on the one hand and competing IADs and third-party CIT providers on the other.
- a. The commitment does not provide any mechanism to incentivise quality improvements that may be possible over time as technology and processes develop and which could be expected in a highly competitive environment absent the Proposed Merger.
 - b. The commitment provides no protection at all for new customers, nor for existing customers that seek to purchase CIT services that they were not purchasing from the Merged Entity immediately prior to the Commencement Date. These customers will be exposed to service quality levels that reflect the loss of competition between the Applicants, and cannot expect to obtain the same level of service quality as in the counterfactual.
 - c. The commitment does not preclude the Merged Entity from supplying superior service quality to its own downstream operations (its ATM deployment operation and its CIT service operation downstream of ACCs) compared to the service quality it supplies to IADs and third-party CIT providers.
66. Moreover, the Proposed Undertaking does not include any KPI metrics or any other means by which to measure and report on the quality of service being provided by the Merged Entity to its customers (and to itself). The service quality commitment is therefore not monitorable, auditable or enforceable, providing ample scope for the Merged Entity to degrade the quality of service it supplies even to existing customers (including its competitors) in relation to the services that they purchase at the Commencement Date.
67. This scope for service quality discrimination is a particularly concerning aspect of the Proposed Undertaking.
- a. Discrimination in service quality between the Merged Entity's own ATM deployment operation and IADs could take many forms including more onerous contractual terms or favouring of the Merged Entity's own operations in a myriad of ways (e.g., in terms of the speed and/or frequency of cash replenishment or the quality of security, first-line maintenance services, banknotes, etc.).

³⁴ Response, Annexure A, paragraph 4.2.

- b. There would be similar scope for the Merged Entity to discriminate in service quality between the Merged Entity's own CIT service operation downstream of ACCs and third-party CIT service providers that access cash and cash processing services from ACCs, including more onerous conditions that must be satisfied to obtain access to ACCs.
68. Therefore, even if the Merged Entity were constrained from using pricing to foreclose IADs and third-party CIT providers, it would have ample scope to foreclose them by degrading the quality of the services supplied to them. Any effort by the Applicants to address the margin squeeze concerns with revised pricing commitments would be of little value if the Merged Entity were to retain unfettered discretion in relation to service quality.
69. There is a stark contrast between the limited nature of the service quality commitment in the Proposed Undertaking and the non-discrimination provisions, KPI measures and non-price dispute resolution process included within the undertaking accepted by the Federal Court in *ACCC v Pacific National*.
- a. Clause 5 of that undertaking contains a number of explicit provisions prohibiting discrimination by Pacific National in the treatment of its own rail haulage operations compared to third party rail haulage operators, and Clause 2 of Schedule 1 provides that Pacific National:
 - i. Must offer Terminal Services to any Applicant on terms no less favourable than terms offered to other Terminal Users;
 - ii. Must not discriminate between different Applicants and Terminal Users when offering and providing Terminal Services;
 - iii. Must not engage in conduct that prevents or hinders a Terminal User conducting its business using Terminal Services, including the supply of any services by the Terminal User to third parties; and
 - iv. Must not engage in conduct in relation to its management or operation of the Terminal that prevents or hinders a third party acquiring any services from, or supplying any services to, a Terminal User.
 - b. Schedule 3 of the undertaking sets out eight KPIs, details regarding measurement of those KPIs and targets ("objectives") for each KPI. The KPIs include the percentage of trains ready for on time departures, truck turnaround times, freight availability after train hand over, confidentiality and ring-fencing performance and complaints. The purpose of this KPI reporting is to allow the independent auditor (and customers) to monitor Pacific National's compliance with its obligations under the undertaking.
 - c. Clause 11 of the undertaking establishes a non-price dispute resolution process involving either an independent expert or independent arbitrator, as well as scope for complaints to be raised with the independent auditor about Pacific National's compliance with the undertaking and for ad hoc independent audits to be conducted by the independent auditor at the request of a complainant.
70. As explained, the Proposed Undertaking contains no non-discrimination provisions, no KPI commitments and no means of auditing of the Merged Entity's service quality, and it offers only an internal complaint handling process. If any behavioural undertaking on quality is to be accepted, it should at least include explicit non-discrimination provisions and KPI commitments that cover all of the key performance and service quality dimensions

associated with each CIT service provided by the Merged Entity (including the CIT services supplied to IADs and the cash and cash processing services supplied to third party CIT providers) as well as robust non-price dispute resolution process with a third-party arbiter. Even then, there would likely remain scope for the Merged Entity to degrade service quality and discriminate in subtle ways that are not easily measured. Only structural remedies can fully address the quality degradation and discrimination concerns raised by the Proposed Merger, for example a joint venture limited to ACCs and the transport networks involved in wholesale cash distribution, or divestment of the Applicants' ATM deployment operations.

7. THE IAD COMMITMENT

71. The Response claims that the objective of the commitment to supply CIT services to IADs is to ensure that the Merged Entity will offer "ATM Specific Services" to IADs on a "non-discriminatory basis".³⁵ The commitment itself, however, only states that the Merged Entity will offer "ATM Specific Services" to IADs "in accordance with the terms of this Undertaking". As explained above, the pricing and service quality commitments in the Proposed Undertaking do not ensure the supply of CIT services on a non-discriminatory basis. The IAD commitment in the Proposed Undertaking is therefore an empty commitment.

8. THE THIRD-PARTY ACCESS TO CASH CENTRES COMMITMENT

72. Similarly, the commitment to provide access for third-party CIT providers to "Third Party Cash Services" does not ensure non-discriminatory pricing or service quality for third-party CIT providers compared to the pricing and service quality provided to the Merged Entity's own CIT service operation downstream of the ACCs, and does not eliminate the risk of foreclosure of third-party CIT providers. The Proposed Undertaking only commits to "reasonable" commercial terms and conditions and prices that comply with the pricing process, which, as explained above, provides the Merged Entity with wide pricing discretion.
73. At the same time, the commitment adds a further avenue for discrimination and foreclosure of third-party CIT providers by providing that to access the ACCs, third-party CIT providers will need to:
- a. Comply with all relevant MergeCo policies and procedures including as to safety and security which may include a time based slot booking system; and
 - b. Be subject to a risk assessment/audit by MergeCo prior to the Third Party Cash Services being provided.
74. The Proposed Undertaking does not clarify whether access to ACCs for the Merged Entity's own CIT service operation will be on the same terms, and nothing in the Proposed Undertaking ensures that the Merged Entity's own CIT service operation will be dealt with by its ACC operation on genuine arms-length terms as if it was a third-party CIT provider.

35 Response, page 44.



Geoff Edwards
6 April 2023

APPENDIX A: ENGAGEMENT LETTER AND LETTERS OF INSTRUCTION

20 October 2022

Dr Geoff Edwards
Vice President, Charles River Associates
Suite 2201, Level 22, Tower 2
101 Grafton Street
Bondi Junction NSW 2022

[REDACTED]

Dear Dr Edwards

Letter of engagement

Allens acts for Next Payments Pty Ltd (**Next Payments**) in relation to the proposed merger of Linfox Armaguard Pty Ltd (**Armaguard**) and Prosegur Australia Holding Pty Ltd (**Prosegur**) (the **Proposed Merger**).

On 26 September 2022, Armaguard and Prosegur lodged an application with the Australian Competition and Consumer Commission (**ACCC**) seeking authorisation in relation to the Proposed Merger pursuant to section 88 of the *Competition and Consumer Act 2010* (Cth) (the **Application**). Armaguard and Prosegur together are referred to in this letter as the **Applicants**.

We are instructed to engage CRA International (UK) Ltd (d/b/a Charles River Associates) (**CRA**) for its services, and specifically for your services as an independent expert in relation to the Proposed Merger, to provide your expert opinion based on your knowledge and experience.

This letter sets out the terms of CRA's engagement with Allens and the scope of your obligations under it. The terms of this letter shall apply to all Charles River Associates staff who may be required to perform work in connection with this engagement.

1 Scope of work

We would like you to prepare an expert economic report that can be submitted to the ACCC in connection with the Proposed Merger (**initial report**). We will separately provide you with the instructions as to the matters you are to address in your initial report and the documents and materials relevant to those matters.

You may also be required to respond to questions or requests from us, Next Payments, or the ACCC. This may include attending meetings with the ACCC and engaging with any other experts or consultants retained by the ACCC or third parties. You may also be asked to prepare a supplementary or further report.

In the event the ACCC's decision with respect to the Proposed Merger becomes the subject of proceedings before the Australian Competition Tribunal (**Tribunal**), you may be required to give evidence in the Tribunal.

2 Fees

[REDACTED]

If you intend to use the services of any other person, including any additional research assistant or analyst, to support your role, please advise us and provide us with their details, including their name, position and fees before doing so. Any person working under your supervision in relation to the Application must maintain the confidentiality requirements set out in this retainer and comply with the Federal Court's Harmonised Expert Witness Code of Conduct (referred to below at section 4) at all times.

We request that your invoices itemise the time spent on this matter and all reasonable expenses, together with a copy of receipts for any expenses incurred. Expenses such as taxis, flights, accommodation, parking, couriers, printing etc are to be billed at cost. Please invoice Allens in respect of this matter.

You should present your memoranda of fees on a monthly basis.

3 Confidentiality and privilege

Your engagement and all information given to you in connection with it are confidential and will be kept secret and confidential by you.

In connection with the engagement (whether before or after the date of this letter), you are likely to receive or produce confidential or privileged information of Next Payments, or confidential or privileged information relating to Next Payments. Such confidential or privileged information, the nature and terms of this letter, your instructions and the nature and terms of your engagement by Allens, are referred to in this letter as **Information**.

In accepting the engagement, CRA agrees to the following.

- (a) To keep all Information confidential, and not directly or indirectly use any such Information except as required in the course of the engagement. The position in relation to confidentiality will be reviewed with you if you are asked to give evidence in the Tribunal, whether by way of a report, oral evidence or both.
- (b) To not disclose or communicate any Information to any third person or entity (other than Allens or Next Payments) except as Allens or Next Payments may specifically request.
- (c) Except as Allens or Next Payments may direct, to maintain the confidentiality of all reports and documents (including any drafts, notes or working papers) prepared by you or at your direction and all other correspondence, emails, file notes, memoranda and other records of communications between us, you and Next Payments in connection with the engagement.
- (d) To ensure that all such documents prepared by you or at your direction (including correspondence sent to you by Allens or Next Payments) for the purpose of the engagement contain the header 'Confidential and Subject to Legal Professional Privilege'.

- (e) The obligations contained in sections 4(a) to 4(c) continue to apply notwithstanding that the engagement may have come to an end.
- (f) The obligations of confidentiality in this letter do not extend to information that (whether before or after the date of this letter):
 - (i) is public knowledge (other than as a result of a breach of this letter);
 - (ii) is disclosed to you by any third party which you reasonably believe was entitled to disclose such information; or
 - (iii) is required by law to be disclosed. To the extent permitted by law, you will notify us immediately on becoming aware of a requirement to disclose Information (including if you receive any subpoena, notice or request concerning production of any documents connected with the Application or to give evidence which may include your opinions in this matter) and will consult with us regarding any claim of privilege. Next Payments may wish to make in connection with Information you are required by law to disclose.
- (g) All such documents prepared by you or at your direction (including correspondence sent to you by Allens or Next Payments) for the purpose of the engagement, together with any other documents which may be provided to you in relation to the engagement, and any copies made of those documents, will be returned or destroyed on the termination of your engagement. Notwithstanding the foregoing, CRA may retain a secure electronic copy of any such materials that is created by its automated backup processes in the ordinary course of business, provided that such material is not accessed and provided further that such material “ages off” from such backups within a reasonable period of time.

4 The role of an independent expert

We enclose a copy of Expert Evidence Practice Note GPN-EXPT of the Federal Court of Australia, issued on 25 October 2016, which includes the Federal Court's Harmonised Expert Witness Code of Conduct (the **Code**).

Please read the Code and comply with it when preparing your report. In acknowledgment of having done so, we request that you insert the following passage at the end of any report you prepare:

I, Dr Geoff Edwards, have read and understood the contents of the Expert Witness Code of Conduct supplied to me by Allens. I agree to be bound by the contents of that code.

I have made all the inquiries that I believe are desirable and appropriate and no matters of significance that I regard as relevant have, to my knowledge, been withheld from my report.

We also note your role as an independent expert is to provide an independent expert opinion. Accordingly, you are expected to be objective, professional and to form an independent view as to the matters in respect of which your opinion is sought.

5 Conflicts of interest

As an independent expert, it is important that you are free from any possible conflict of interest in the provision of your advice. You should ensure that you have no connection with any other party which would preclude you from providing your opinion in an objective and independent manner.

We note you have informed us that you do not have any relevant conflict of interest in this matter. Please inform us immediately if at any time in the course of this engagement you become aware of an actual or potential conflict.

6 Your obligations to our client

We will rely on you to let us know if any aspect of this matter is outside your area of expertise and experience and if so, to let us have your recommendations as to an expert who may be able to assist in that area.

You will inform us of any matters which might be said to affect your independence. You will not take any action which will compromise your independence in any way.

You will not, without the written consent of Next Payments:

- (a) provide any advice, opinion or information in relation to the Application to any third party; or
- (b) accept any instructions in relation to the Application from any third party.

7 Liability

We acknowledge and agree that the total liability of CRA shall be limited to the total amount of fees paid to CRA under this retainer and that you shall have no personal liability in connection with this retainer. Under no circumstances shall you or CRA be liable for consequential, punitive, incidental or special damages or claims in the nature of lost profits, lost revenue or lost opportunity costs. The terms of this paragraph shall survive termination and/or the expiration of this retainer.

Please sign and return a copy of this letter to confirm CRA's agreement to the terms of the engagement. We look forward to working with you on this matter.

Yours sincerely

[Redacted signature]

Robert Walker

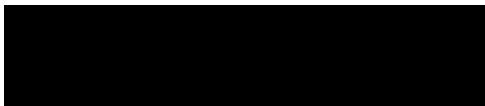
Partner

Allens

[Redacted contact information]

Confirmation and acceptance of the terms of engagement and confidentiality provisions

I accept the terms of the engagement and the conditions as to the use and disclosure of Information as set out in this letter:

A large black rectangular redaction box covering the signature area.

**Dr Geoff Edwards,
Vice President, Charles River Associates**

Date: 20 October 2022

Allens

101 Collins Street
Melbourne VIC 3000 Australia

GPO Box 1776
Melbourne VIC 3001 Australia

T +61 3 9614 1011

F +61 3 9614 4661

www.allens.com.au

ABN 47 702 595 758

Allens

24 October 2022

Dr Geoff Edwards
Vice President, Charles River Associates
Suite 2201, Level 22, Tower 2
101 Grafton Street
Bondi Junction NSW 2022

[Redacted]

Dear Dr Edwards

Letter of Instructions

We refer to our letter dated 20 October 2022 retaining you as an independent expert in relation to the proposed merger of Linfox Armaguard Pty Ltd and Prosegur Australia Holdings Pty Ltd (the **Proposed Merger**).

This letter sets out instructions to be taken into account as part of your engagement.

Please continue to comply with all obligations set out in our 20 October 2022 letter in addition to the obligations set out in the Federal Court's Expert Evidence Practice Note provided to you with our letter.

Background

On 27 September 2022, Armaguard and Prosegur lodged an application with the ACCC seeking authorisation of the Proposed Merger (the **Application**). An expert report prepared by RBB Economics was filed with the Application (the **RBB Report**).

Instructions

Having regard to the materials briefed to you (including the Application and the RBB Report), and based upon your training, study and experience, you are requested to provide a written opinion in respect of the following matters and your reasons for those opinions:

- 1 The relevant markets for assessing the Proposed Merger.
- 2 Whether the Proposed Merger raises a risk of vertical foreclosure effects in relation to ATM deployment services.
- 3 Whether there might exist alternatives to the Proposed Merger that would be likely to realise the public benefits claimed in the Application.

Please let us know whether you have any queries about the questions above or the engagement more generally.

Yours sincerely

[Redacted signature]

Robert Walker

Partner

Allens

[Redacted contact information]

[Redacted contact information]

Allens

101 Collins Street
Melbourne VIC 3000 Australia

GPO Box 1776
Melbourne VIC 3001 Australia

T +61 3 9614 1011

F +61 3 9614 4661

www.allens.com.au

ABN 47 702 595 758

Allens

30 March 2023

Dr Geoff Edwards
Vice President, Charles River Associates
Suite 2201, Level 22, Tower 2
101 Grafton Street
Bondi Junction NSW 2022

Dear Dr Edwards

Letter of Instructions

We refer to our letter dated 20 October 2022 retaining you as an independent expert in relation to the proposed merger of Linfox Armaguard Pty Ltd and Prosegur Australia Holdings Pty Ltd (the **Proposed Merger**), and our letter of instructions dated 24 October 2022 (the **October Letter**).

This letter sets out instructions to be taken into account as part of your engagement.

Please continue to comply with all obligations set out in our 20 October 2022 letter in addition to the obligations set out in the Federal Court's Expert Evidence Practice Note provided to you with our letter.

Background

On 27 September 2022, Armaguard and Prosegur lodged an application with the ACCC seeking authorisation of the Proposed Merger (the **Application**). An expert report prepared by RBB Economics was filed with the Application (the **RBB Report**).

On 21 December 2022, the ACCC issued their Statement of Preliminary Views (the **Statement of Preliminary Views**).

On 9 March 2023, Armaguard and Prosegur lodged their response to the ACCC's Statement of Preliminary Views, including a proposed undertaking (the **Applicants' Response** and the **Proposed Undertaking**).

Instructions

Having regard to the materials briefed to you and based upon your training, study and experience, you are requested to provide a written opinion in respect of the following matters and your reasons for those opinions, could you please:

- 1 Review and consider the Applicants' Response and the Proposed Undertaking.
- 2 In so far as the Applicants' Response and Proposed Undertaking concern the matters in relation to which your expert opinion was sought in the October Letter, prepare a report commenting on the Applicants' Response and the Proposed Undertaking (including addressing the extent to which the Proposed Undertaking addresses the issues raised in the ACCC's Statement of Preliminary Views).

Please let us know whether you have any queries about the questions above or the engagement more generally.

Yours sincerely

[Redacted signature]

Robert Walker
Partner
Allens

[Redacted contact information]