The great GUPPI debate: *Topical issues*

Dr Amelia Fletcher
Chief Economist, OFT

BIICL 17th March 2011
Four topical issues

- The 2-step process in retail mergers
- Choice of price pressure indicator
- Use of thresholds
- Role of efficiencies
The 2-step process in retail mergers

**Step 1:**
Filter out unproblematic areas

- Identify catchment areas
  - Typically using customer location data
  - But other techniques too
- Ideally re-centring on:
  - Acquirer store
  - Target store
  - Population centres
- Identify potentially problematic overlap areas (eg ‘4 to 3’ or less)

**Step 2:**
Price pressure analysis

- Surveys (outside both parties’ stores) to find area-specific diversion ratios
  - Typically using question: ‘what would you do if this retailer were not available?’
- Collect store-specific gross margins for both parties stores
- Use diversion ratios & margins to derive price pressure indicator

**Key benefit:** Reduces time and cost involved in survey and margin analysis, while minimising risk of missing problematic overlaps
Choice of price pressure indicator

<table>
<thead>
<tr>
<th>GUPPI formula</th>
<th>Symmetric IPR formulae</th>
</tr>
</thead>
<tbody>
<tr>
<td>margin x diversion ratio</td>
<td>md/(2(1–d))</td>
</tr>
<tr>
<td></td>
<td>md/(1–m–d)</td>
</tr>
<tr>
<td></td>
<td>for linear demand</td>
</tr>
<tr>
<td></td>
<td>for isoelastic demand</td>
</tr>
</tbody>
</table>

- Numerator of IPR formula = GUPPI
- Difference relates to denominator = degree of pass-through
- Effectively GUPPI = IPR if 100% pass-through

Pros and cons:
- GUPPI is very simple and measures the key element of interest (the value of diverted sales internalised by the merger). More easily applied in mergers between multi-product firms
- IPR is intuitive and ‘gives body’ to the GUPPI concept, albeit at the cost of requiring information/assumptions on demand/pass-through
Choice of indicator in Asda/Netto (2010)

- **IPR SLC criteria**
  - IPR ≥5%

- **Competitive relationship**
  - Symmetric
  - Asymmetric

- **Curvature of the demand curve**
  - Isoelastic
  - Linear

- **Input variables**
  - Relative costs
  - Relative prices
  - Margins

- **Input choices**
  - Equal
  - Netto 5% cheaper
  - Asda 5% cheaper
  - Or more?
Use of thresholds

- ‘Thresholds’ can be useful in indicating what sorts of mergers are relatively less likely/more likely to lead to an SLC.

- Do not indicate tolerance for price rises, but rather allows for:
  - Credit for unmeasured efficiencies
  - Measurement errors
  - ‘Illustrative’ nature of model

- No ‘rebuttable presumption’
  - Albeit we get close to this, for pragmatic reasons, in major retail cases
  - Best employed as useful indicator alongside other evidence

- OFT has typically adopted a 5% ‘threshold’ (unweighted) for IPR but worth noting that…
…interactions of indicators and thresholds
Role of efficiencies

- Marginal cost efficiencies feed easily into IPR/GUPPI
- In Asda-Netto, parties put forward detailed efficiency arguments in respect of:
  - Lower input prices due to improved buyer power
  - Store repositioning
- OFT accepted former (to limited extent that evidence met compelling standard required), but not latter
- Key question: what is appropriate threshold when efficiencies are incorporated?
  - OFT did not have to address this issue due to limited extent of savings. We would welcome views!
NB Much of this and more...

- ...is discussed further in the OFT/CC retail merger commentary

- This is **not** guidance, but answers 3 questions, based on experience in past mergers:
  - How do you use catchment areas, both to identify which of our stores overlap and to eliminate unproblematic areas from further analysis?
  - What if we compete nationally - all our stores offer the same products at the same prices with the same service quality?
  - How do you use simple quantitative techniques to assess how mergers might affect retail prices?

- And it is out imminently!
The great GUPPI debate: *Topical issues*

Dr Amelia Fletcher
Chief Economist, OFT

BIICL 17\textsuperscript{th} March 11