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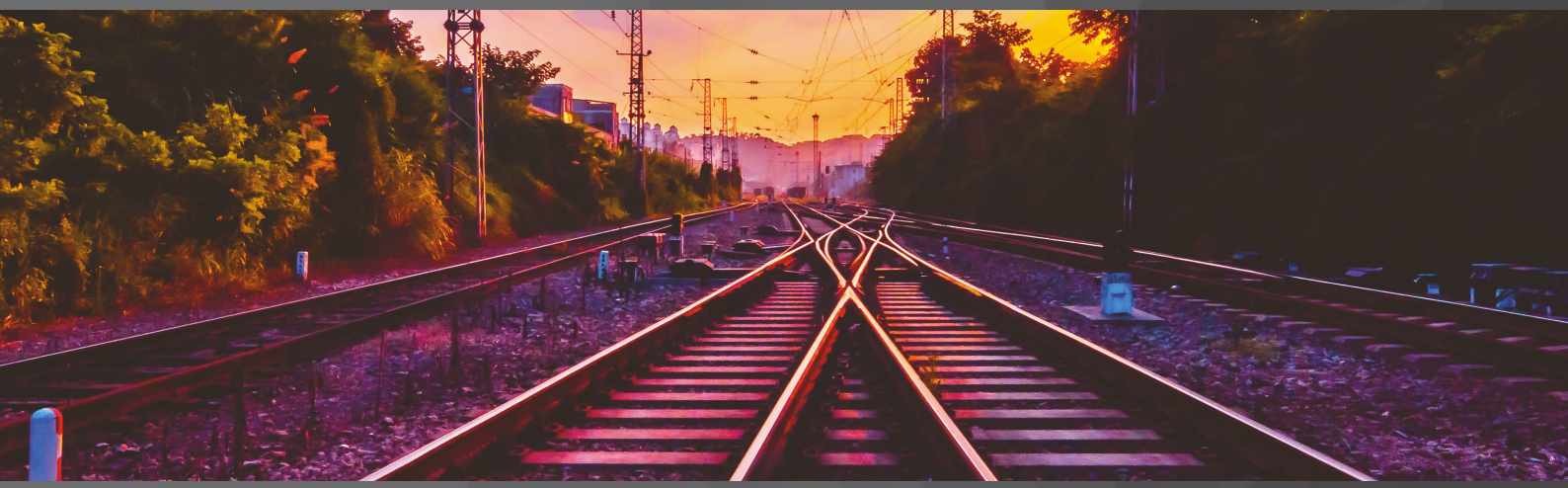

Merger Control 2020

A practical cross-border insight into merger control issues

16th Edition

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Economic Evidence in Retailer Mergers After Sainsbury's/Asda: Death by GUPPI?[1]


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Introduction

This chapter considers the use of economics evidence in retailer mergers following the Competition and Markets Authority's (CMA) 2019 decision to prohibit the merger of Sainsbury's and Asda.

At a superficial level, the CMA's prohibition decision was unsurprising. The groceries sector has been subject to many merger control investigations, with Tesco, Asda and Sainsbury's all being prohibited from acquiring a much smaller Safeway in 2003.

Similarly, the CMA's use of so-called "pricing pressure" tests to assess whether the merged business would have an incentive to increase prices, or worsen quality, range or service (commonly abbreviated to PQRS) locally or nationally is unsurprising. Indeed, UK competition authorities have used pricing pressure tests for many years, going back to the Competition Commission's (CC) 2005 *Somerfield/Wm Morrison* decision.

However, the CMA's decision in *Sainsbury's/Asda* is important for three reasons, which all led to the CMA reaching extensive adverse findings that could not be remedied without the merger being prohibited. First, the CMA set an unprecedented low Gross Upward Pricing Pressure Index (GUPPI) threshold to identify where a substantial lessening of competition (SLC) may be expected locally. It also set no explicit national GUPPI threshold for supermarkets. Second, the CMA's GUPPI calculations and thresholds depended on its measurement of three key variables, namely the extent to which the parties win/lose business between one another, their gross profit margins and merger efficiencies. The parties strongly disagreed with the CMA's measurement of these variables. Third, the CMA relied heavily on GUPPI to reach its key adverse findings, particularly as regards local SLCs.[2]

In the groceries sector, the CMA's decision suggests that future mergers between grocery retailers will be viewed as problematic, unless there are many local rivals in the overlapping areas or the stores in question serve non-overlapping areas. Acquisitions of small overlapping portfolios of stores are likely to be viewed as even more problematic. This is because these are less likely to lead to material efficiencies and the CMA's decision suggests that the GUPPI threshold for intervention would be even lower without merger efficiencies.[3]

This chapter breaks down the issues outlined above by considering the following four key questions:

- What do pricing pressure tests measure?
- Does GUPPI measure incentives to worsen quality, range and service?
- What threshold for GUPPI should be applied?
- What are the key measurement issues associated with calculating GUPPI?

What do Pricing Pressure Tests Measure?

Any assessment of a merger between competitors should start by considering precisely how the parties compete pre-merger. This is because this provides a natural starting point to consider the merger's likely competitive effects, which are likely to be driven by a combination of market-specific demand and supply-side factors.

In differentiated products and geographic markets, demand-side considerations are often of particular significance. This is because demand-side factors may determine the ability and willingness of customers to switch between alternatives, and which alternatives they choose between.

In this scenario, prior to a merger, it may not be profitable for either of the merging parties to increase their prices unilaterally due to the sales they would consequently lose, either to competitors or consumers buying less. However, following a merger with a competitor, the sales previously lost to that merging rival may be retained or recaptured by the merged group. Accordingly, in differentiated markets, mergers between competitors may create incentives to increase prices. This provides the intuition behind pricing pressure tests.[4]

The value of sales recaptured depends on three factors, which can be combined in a formula to estimate the gross upward pricing pressure before offsetting merger efficiencies are taken into account. The three factors are:

- The proportion of sales volumes lost to the competing merger party, which is commonly referred to as a diversion ratio. In terms of notation, D_{12} refers to the proportion of sales volume lost by firm 1 that is captured by firm 2.
- The per unit value of these sales won by firm 2, namely the percentage gross margin of firm 2 (M_2).
- The relative prices of the two firms (P_2 and P_1).

The formula for GUPPI for firm 1 (merging with firm 2) is:[5]

$$GUPPI_{12} = D_{12}M_2\frac{P_2}{P_1}$$

Accordingly, GUPPI depends on three variables: diversion ratios; gross profit margins; and relative price levels. GUPPI will be higher, the higher are diversion ratios, gross profit margins and relative price levels and *vice versa*.

Before proceeding further, it should be noted that the above formulation of GUPPI assumes that firms face no capacity constraints between them that would affect actual diversion between firms. This assumption may not always apply.[6] More generally, the level of GUPPI does not indicate the likely quantum of any price increases. This instead depends on six factors.

First, whether there are offsetting efficiencies. Even if GUPPI is positive, a reduction in marginal/incremental costs due to merger synergies may offset the incentives to increase prices due to the loss of rivalry.

Second, whether there would be entry and expansion.

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Third, whether the merged firm would in practice worsen prices, despite having some incentives to do so, due to the costs and risks that this would entail. These costs and risks would include costs associated with local or national flexing of prices, and the risks that this could increase entry/expansion by rivals.

Fourth, if these offsetting factors are insufficient, whether there would be "feedback" effects involving the parties. These effects may arise as GUPPI is calculated separately for each firm. However, if one of the merging parties increases its prices, then this may increase the incentives for the other party to raise its prices. These effects can easily be captured by modifying the GUPPI formula for firm 1 by adding the term $D_{12}D_{21}M_1$.

This additional term is typically small if GUPPI is small.[7] Suppose $D_{12}=D_{21}=10\%$, $M_1=M_2=25\%$, and $P_2/P_1=1$. Then $GUPPI_{12}=D_{12}M_2P_2/P_1=2.5\%$, and this additional term would be 0.25%. These feedback effects are most likely to arise where both of the merging parties have significant incentives to increase prices, rather than only one.

Fifth, how other competitors would respond if the parties' worsen prices. GUPPI assumes that rivals do not respond by increasing their prices as well. Accordingly, on the one hand, post-merger accommodation or coordination by rivals may mean that price increases may be greater than the GUPPI formula suggests. However, on the other hand, the merger also removes any pre-merger coordination between the parties that may have existed, which might lead to GUPPI exaggerating the loss of competition between the parties.

Sixth, the curvature of the demand curve as this affects how changes in incentives are passed through to consumers in the form of price increases. In particular, do consumers become more price sensitive as prices increase and, if so, to what extent?

The importance of this latter assumption can be illustrated by using a different measure of pricing pressure referred to as an illustrative price rise (IPR), which also allows for feedback effects between the firms. If demand is assumed to be isoelastic (so that consumers do not become more price sensitive as prices increase) and firms are symmetric (i.e. the two firm's prices, gross margins (M) and diversion ratios (D) are the same), then the IPR formula simplifies to MD/(1-M-D). If demand is assumed to be linear (under which demand becomes somewhat more price sensitive as prices increase), then this formula is MD/2(1-D). The term MD is simply GUPPI.

A worked example is helpful for illustrating the differences between IPRs with isoelastic and linear demand even if GUPPI is low. Suppose that D=10% and M=25%, then GUPPI would be 2.5%. However, the IPR with isoelastic demand would be 3.8% (this is thus a pass-through rate of well over 100% (3.8%/2.5%=154%)), whereas with linear demand the IPR would be 1.4% (this is thus a pass-through rate of 56% (1.4%/2.5%=56%)). Assuming that grocery gross margins are 25%, then the IPR with isoelastic demand would exceed 5% if the diversion ratio is above 14.3%.

As far as we are aware, groceries retailing is the only sector of the UK economy in which the UK competition authorities have found SLCs based on isoelastic demand. In all other markets, linear demand has been assumed.

Does GUPPI Measure Incentives to Worsen Quality, Range and Service?

In *Sainsbury's/Asda*, the CMA used GUPPI to infer that the merger would lead to a worsening of PQRS and without drawing any particular distinction between any of these competitive variables.

However, GUPPI may not provide a good guide to effects on QRS for several reasons.

First, and as highlighted above, any assessment of competitive effects also needs to consider how firms respond to changes in their competitive incentives, particularly where there are costs and risks in flexing their local or national offerings. In particular, retailers/wholesalers may set parts of their offering nationally – such as pricing or the core QRS features of their offering – if this is essential to preserve their national branding and market positioning. For example, restaurant chains or branded fashion retailers may wish to ensure that their offerings are virtually identical in all outlets and as regards their online sites.

QRS standards may also be imposed upon independent retailers by their brand owning suppliers. In particular, in markets governed by selective distribution or similar arrangements, suppliers may recommend retail prices and only supply retailers that meet QRS standards. In addition, in some markets, brand owners increasingly seek to sell their products direct to consumers (DTC) for a variety of strategic reasons, including developing closer relationships and contacts with end-consumers, as means of showcasing their products, ensuring that their brands are promoted exclusively to consumers, and reducing third party-distribution costs (i.e. avoiding paying third parties' retailing/distribution margins). DTC sales thus create further competitive pressure on retailers to offer competitive PQRS as otherwise brand owners and consumers may increasingly switch to the DTC channel.

Second, there is no reason to presume that diversion between alternative retailers is the same irrespective of what element of PQRS is varied. For example, suppose that there are low and high quality retailers, and a high quality retailer increases prices. In this scenario, the high quality retailer might predominantly lose sales to other high quality retailers. (This should not be presumed, because consumers may trade-off price and quality). However, if the high quality retailer reduces its QRS, it might lose sales to both high quality retailers and low quality ones, because reducing its QRS makes its offering more similar to that of lower quality retailers.

Third, price and QRS setting decisions may be quite different. In many markets, firms can vary prices quickly. The profitability of such changes depends on the trade-off between the resulting increase in gross profit margins on the sales volumes they retain and the gross profit margins foregone on the sales volumes lost. However, changing QRS might involve fixed cost changes, such as refitting or relocating a store, increasing staff training or incurring various fixed branding costs, with such changes taking time to implement. GUPPI – based on margins above short run variable costs – may thus not be a good guide to incentives to worsen QRS.

What Threshold for GUPPI Should be Applied?

This section considers how the threshold for GUPPI should be set, such that a loss of competition measured by GUPPI is substantial. It does this assuming for the moment that there are no uncertainties associated with the measurement of GUPPI, with the next section addressing this issue. To address this question, it is necessary to consider a series of related questions:

- Why is a threshold needed?
- What threshold did the CMA apply in *Sainsbury's/Asda* as regards net upward pricing pressure?
- What level of diversion did the CMA's threshold for intervention envisage as leading to an SLC?
- What evidence was there that this level of upward pricing pressure would lead to an SLC?

Why is a threshold needed?

In brief, at Phase 2 the CMA needs to have an expectation that there is a SLC in each local area identified, whereas in Phase 1 a "realistic prospect" test is applied. Accordingly, it is necessary to allow for uncertainty.

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In addition, it is also necessary to conclude on whether any particular level of GUPPI is associated with a substantial lessening of competition, as opposed to merely a lessening of competition. As a matter of mathematics, any merger between competitors will yield a positive GUPPI. This is because diversion ratios between competitors must be above zero (or they would, by definition, not be competitors) *and* firms will generally not sell goods or services unless they make positive gross margins (or, by definition, their losses would be reduced by them not making sales that do not at least contribute to fixed costs). A threshold of zero would thus suggest that all mergers between differentiated competitors lead to a SLC, which would be inappropriate.

Another reason for not having a GUPPI threshold of zero is that mergers may yield offsetting pro-competitive efficiencies. In particular, merger synergies may reduce marginal/incremental costs and create incentives to increase sales volumes, which may consequently offset the incentives that might otherwise exist to increase prices due to the loss of rivalry. The netting-off of pro- and anti-competitive effects means that mergers are only anti-competitive if they lead to *net* upward pricing pressure (UPP).

What threshold did the CMA set?

It is important to appreciate at the outset that the CMA used national GUPPIs as *supporting evidence of* the existence of a national SLC, whereas local GUPPIs were used to *identify* all local SLCs.

As regards the national SLC, the CMA found a national weighted average GUPPI for supermarkets of 2.5% for Sainsbury's and 3.3% for Asda.[8] The CMA considered that these figures would suggest substantial pricing pressure allowing for efficiencies. It also included that it was irrelevant whether these national figures were lower than the local threshold set (as was the case for Sainsbury's but not Asda) for two reasons. First, GUPPI was only one element of its evidence base as to why there was a national SLC, which included market shares, internal documents, Kantar switching data, and comparisons of in-store offerings.

Second, the CMA concluded that there was less uncertainty as regards the national average estimate of diversion ratios between the parties (since these would be less affected by individual GUPPI estimates, so that errors would balance themselves out to a large extent) and as it considered that national margins were more reliably estimated than local margins.[9]

These national GUPPI levels are very low to be viewed as being consistent with a national reduction in competition. In particular, allowing for groceries efficiencies of 1.25%, this would suggest net upward pricing pressure of 1.25% for Sainsbury's and 2.05% for Asda. The CMA also reached a national adverse finding as regards the online delivery of groceries at all of Asda's supply points (but not Sainsbury's), and made similar points about the national diversion ratio being robustly estimated.[10] The GUPPI figures for Asda are redacted to a 0–5% range. However, the CMA did not reach an adverse finding as regards Sainsbury's, with the GUPPI figure for Sainsbury's being below the estimated efficiencies of 1.25% such that there was no net upward pricing pressure.[11]

The CMA did not reach an adverse finding as regards the national sale of fuel. In this regard, the CMA did not attach any importance to national weighted average GUPPI figures of 0.85% for Sainsbury's and 0.96% for Asda, with this appearing to be largely driven by the parties pricing fuel on a local basis. The CMA also concluded that the merger would increase the parties' incentives to price locally due to the greater variation in local demand and competitive conditions that would arise across the enlarged estate.[12] This conclusion seems sensible as national GUPPI levels are irrelevant if the key elements of a retailer's offer are determined according to local competitive conditions.

Turning to local SLCs, the CMA applied a GUPPI threshold of 2.75% for supermarkets and online groceries deliveries supply points (thus allowing a margin of 1.5 percentage points on top of the allowance for efficiencies to allow for both the SLC to be substantial and uncertainty in the estimates of GUPPI),[13] 3.25% for convenience stores (so as to allow for a greater margin for uncertainty as regards convenience stores),[14] and 1.5% in fuel (where the CMA found no merger efficiencies).[15]

What level of diversion ratio did the CMA's threshold envisage as leading to local SLCs?

The critical level of diversion ratios between the parties depends on their gross margins and relative prices, which were redacted. However, the CMA indicated that the critical diversion ratio as regards supermarkets was 14.3% for Sainsbury's and 11.5% for Asda, with the differences between the two ratios reflecting differences in the parties' average profit margins and relative prices.[16]

This diversion ratio can also be considered in market share terms. If two competitors merge in which each has a market share of 12.5% and diversion ratios are in line with market shares, then the diversion ratio between them would be 14.3% (12.5%/87.5%=14.3%) as was found for Sainsbury's nationally. A combined market share of 25% would be a low threshold for intervention – particularly in circumstances where UPP is only 1.5%.

The CMA considered that these thresholds for intervention were entirely reasonable. In particular, the CMA emphasised that the parties might be close competitors (based on both geographical proximity and their offering) and have multiple shops (which the CMA assumed increased diversion ratios between the parties' proportionately).[17]

The CMA also observed briefly that finding a SLC at a GUPPI of only 1.5% without efficiencies would be reasonable, because in this situation there would be no offsetting efficiencies depressing prices.[18] With a GUPPI threshold of only 1.5%, the critical diversion ratio would thus be 1.5/2.75 times lower at 7.8% for Sainsbury's and 6.3% for Asda. Again, these diversion ratios can be considered in market share terms. If two competitors merge that each has a market share of 7.5% and diversion ratios are in line with market shares, then the diversion ratio between them would be 8.1% (7.5%/92.5%=8.1%). This latter observation suggests that future groceries mergers involving small portfolios of overlapping stores will be problematic, since these are unlikely to generate material merger-specific efficiencies. This is notwithstanding that a combined market share of 15% or less would be an extreme threshold for intervention.

The CMA's decision also discussed various previous cases in which pricing pressure tests were used, but concluded that a case-specific approach should be taken based on the available evidence.[19] However, it is important to be clear that the CMA applied an unprecedented low threshold for the upward pricing pressure test and even where diversion between the parties is low.

In particular, in *Somerfield/Morrison*, the Competition Commission (CC) identified three thresholds that all needed to be satisfied before a SLC was found, whereas in *Sainsbury's/Asda* the CMA only considered upward pricing pressure:[20]

- the merger reduced the number of competing fascia from four to three or fewer;
- the diversion ratio must also be at least 14.3%. This is based on the diversion ratio that would be expected if two firms with a 12.5% market share were to merge and diversion ratios are in line with market shares (12.5%/87.5%

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=14.3%). As noted above, even this would be a low threshold for intervention, since a post-merger market share of 25% would not normally be viewed as presumptively leading to a SLC; and

- the IPR based on isoelastic demand was at least 5%, which the CMA highlighted would be a GUPPI of 3.2%.[21] However, this was in the scenario that no rivalry enhancing efficiencies were identified by the CC, and thus this figure should be compared with the CMA's threshold of 1.5% for supermarkets excluding efficiencies. The CMA also did not comment on the fact that in *Asda/Netto* (2010) the Office of Fair Trading (OFT) took into account certain merger efficiencies in calculating IPR, thus effectively increasing the gross IPR threshold applied above 5% (albeit this did not make any difference to the number of local SLC findings).[22]

The CMA also cites three cases in which the OFT found that there is a "realistic prospect" of a SLC where GUPPI was below 5%.[23] It should be noted that these are Phase 1 cases, where the test is whether there is a "realistic prospect" of an SLC, not the Phase 2 test of whether an SLC is expected. It is also relevant to consider why these adverse findings were reached. In *Jewson/Build Center* (2012), the OFT had concerns about the quality of the survey data to derive the diversion ratios, and the OFT only found SLCs if GUPPI was below 5% where the parties were particularly close rivals and few other nearby rivals existed, which could be expected to lead to high diversion ratios.[24] In *MRH/Esso* (2015), the OFT only found SLCs if GUPPIs were below 5% where diversion ratios exceeded 40–50%.[25] Similar high diversion ratios were relied on by the OFT in *Shell/Rontec* (2012) in reaching a SLC findings if GUPPI was below 5%.[26] Accordingly, these cases do not seem to justify a low upward pricing threshold (net of efficiencies) being set in the grocery market, because in *Sainsbury's/Asda* the CMA found SLCs in local grocery markets even where diversion ratios are low.

In short, it is striking that in *Sainsbury's/Asda* the CMA found an SLC in all overlapping areas where UPP exceeds 1.5% (absent imminent material entry) even if there are many competitors in the catchment area and diversion ratios are low.

The CMA dealt briefly with the question of whether efficiencies should lead to a higher gross threshold (i.e. GUPPI) being specified by simply asserting that they should not. In support, the CMA referred to arguments advanced by two US economists, Farrell and Shapiro, who suggested that the threshold chosen might vary if higher or no efficiencies could be proved.[27] What the CMA has done in practice is set a low GUPPI threshold without efficiencies and increased it slightly by its estimate of proven efficiencies. Accordingly, the means that the scale of the CMA's adverse findings as regards groceries and fuel also depend sensitively on the assessment of merger-specific and proven variable cost efficiencies, with this also being another area of disagreement between the CMA and the parties.

What evidence was there that this level of upward pricing pressure would lead to an SLC?

The previous sub-sections made the following points:

(i) some threshold for GUPPI is required as GUPPI will always be positive;

(ii) the CMA set no specific GUPPI threshold as regards national competition;

(iii) the CMA set an unprecedented low GUPPI threshold as regards local overlaps and notwithstanding the CMA's acceptance that there were merger specific efficiencies; and

(iv) this threshold would be failed absent merger efficiencies, even if the parties' combined local market shares are low.

This begs the question of what evidence the CMA had that a low level of national and local GUPPIs would lead to appreciable adverse effects on consumers.

As noted above, the CMA found a national weighted average GUPPI for supermarkets of 2.5% for Sainsbury's and 3.3% for Asda.[28] Whilst the CMA does not make this point, allowing for groceries efficiencies of 1.25% would suggest net upward pricing pressure of 1.25% for Sainsbury's and 2.05% for Asda. It is striking that the CMA cited no evidence that any specific level of national GUPPI would translate into appreciable consumer harm. Instead, the CMA merely stated that the estimated national levels of GUPPI it found were "*consistent*" with its views as to the closeness of competition between the parties and there being insufficient post-merger constraints – and even after taking into account efficiencies. In making these points the CMA also referred to the high geographical overlap in the parties' estates and that it found over 500 local SLCs, although it emphasised that its national assessment did not rely on the number of local SLCs.[29]

This in turn raises the question of whether static, national GUPPI measures provide a good guide to the dynamic national competition that the parties face, particularly those associated with the growing competition and market share losses that the parties had suffered to Aldi and Lidl.

Turning to the threshold for local SLCs, the CMA advanced a number of arguments as to why low levels of upward pricing pressure would represent a SLC and harm to consumers.

The CMA observed that groceries are non-discretionary expenditure that account for a significant share of household spend, particularly for poor households.[30] However, this observation does not demonstrate any actual harm to consumers. Instead, the CMA sought to ask itself the question as to whether there were reasons why small but positive levels of GUPPI would not lead to consumer harm. Apart from efficiencies, the CMA stated that this could arise if incentive changes would not be passed on to consumers in the form of higher prices, or the merged entity would not adversely affect PQRS in practice either due to the costs of doing so or if the gain in profits would be insufficient.[31]

However, the CMA found that none of these factors would apply.

In terms of pass through of incentives to consumers, the CMA observed that the parties had repeatedly argued that pass-through of merger-specific cost savings would be high, and the CMA noted that pass-through in the groceries sector was previously considered to be high.[32] In particular, the CMA noted that this was because groceries demand has been assumed to be isoelastic since *Somerfield/Morrison* (2005), which generates more than 100% pass-through of changes in incentives into price changes.[33]

However, since this assumption of isoelastic demand has been long standing, it is not obvious why this justifies a *lower* threshold for intervention now being set and despite the CMA finding merger efficiencies.

Moreover, the CMA cited no evidence that the demand for groceries is isoelastic in 2019. If this were true, then one would expect profit margins to be very high in local markets where there are few local competitors. (In this regard, it should be noted that the CC did not find this to be the case in *Somerfield/Morrison*.) Similarly, small changes in national competition would have a similarly disproportionate effect on profit margins. In addition, isoelastic demand means that cost pass-through would be substantially greater than 100%. These are factual matters that the CMA could have explored further.

The CMA also observed that GUPPI does not capture feedback effects as between the parties and third parties. In

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particular, the CMA seems to seek to justify adopting a low UPP threshold of 1.5% for supermarkets as there is "*no reason*" for feedback effects to "*be particularly low*".[34] Logically, the CMA would need instead to have compelling evidence that feedback effects are particularly high since such effects will always exist, in order to justify a low threshold for intervention. However, the CMA cited no evidence on feedback effects.

As regards feedback effects between the parties, these are likely to be small where GUPPI itself is low (as noted above). Moreover, in any event, arguably the better course would be to set a higher GUPPI threshold and then consider again the assessments of SLCs in those areas where GUPPIs are close to this threshold for *both* of the parties' stores, since feedback effects are most likely to be material in such areas.

Similarly, if the CMA was concerned that competitors might respond by increasing their prices as well, it should arguably have advanced evidence that such effects can be observed in practice. It would also need to address the point that pre-merger coordination/accommodation could have occurred between the parties, such that GUPPI overstates the change in merger incentives. Moreover, the CMA would also need to explain how these concerns fit with its finding that there is no risk of anti-competitive coordination as regards in-store groceries sales.[35]

Turning to the question of costs and incentives to worsen PQRS, the CMA notes that it is not envisaging any change in how the parties set PQRS and that small price increases or worsening of QRS could materially increase their profits.[36] In this regard, the CMA indicated that it had factored into its assessment of local SLCs new store openings over the next two years, but that it should not take into account uncertain future developments.[37]

This position would seem cautious given that Aldi and Lidl had collectively opened over 500 new stores since 2010, and the CMA accepted that "*this growth is set to continue*".[38] This raises the question of whether any worsening of PQRS by the merged business would further accelerate the growth of Aldi and Lidl, which would have obvious incentives to target their efforts against poorly performing rivals, and to lead to consumers' preferences increasing for shopping at smaller stores. These considerations could offset small incentives to allow PQRS to deteriorate.

As to actual evidence of competitive effects associated with low levels of GUPPI, the CMA sets out some highly redacted analysis in Appendix E of whether entry by a new rival supermarket led to the parties responding locally where there were impacts that were equivalent to its net upward pricing pressure threshold of 1.5%. The CMA concluded that its analysis suggested that "*the Parties often react to impacts above the GUPPI threshold*".[39] This analysis may have been highly informative as to the existence of local SLCs with low levels of GUPPI.

However, the CMA does not appear to attach particular weight to this analysis, and the redactions and summarised reporting mean that it is difficult to follow what the CMA has done. In particular, the CMA does not indicate how and the extent to which the parties improve their local store offering in response to entry (e.g. how appreciable are the changes to QRS consequently made?). Nor does the CMA indicate how "*often*" (or more precisely how frequently – 20% of the time or 70% of time?) the parties respond to entry that had led to the parties only losing limited sales following entry equivalent to a low level of GUPPI.

Finally, the CMA also concluded that the GUPPI thresholds it set as regards local overlaps would also allow for the uncertainties associated with measuring local GUPPIs (as well as the loss of competition being substantial),[40] with this being addressed in the next section.

What is the Appropriate Way of Addressing the Inherent Uncertainties With Using GUPPI?

Why does uncertainty matter?

This section addresses the appropriate way of addressing these uncertainties and comments on some specific sensitivities associated with the CMA's estimation of GUPPI.

Uncertainty is a function of how sensitive results are to small changes in assumptions and measurements, and how appreciable any potential errors might be. GUPPI is sensitive to small measurement errors for two reasons. First, GUPPI is calculated by multiplying together diversion ratios, gross margins and relative prices, and thus any errors in measuring one variable are multiplied by the other variables. Second, estimating each of these variables is difficult. If each component of GUPPI were to be overstated (understated) by only 10% (not 10 percentage points), then GUPPI will be overstated (understated) by 33%.[41] Uncertainty may lead one to worry about false positives, false negatives and also simply being unable to distinguish between the two.

Moreover, small differences in GUPPI estimates would have changed the scale of the CMA's adverse findings. For example, if GUPPI for supermarkets were to be reduced by 0.25 percentage points (which is equivalent to the threshold being set even slightly higher at above 3%, instead of 2.75%), this would reduce the number of local SLC findings by about 85 of the parties' supermarkets.[42]

The sensitivity of the CMA's findings to the GUPPI threshold underscores the need to have an appropriate threshold in the first place. However, it also highlights the risks of false positives associated with the CMA's decision to rely solely on GUPPI in identifying local SLCs. There are obvious risks with this approach, since it disregards all other relevant local information. Accordingly, it would seem sensible to look more closely at a number of overlapping areas where there are near misses and fails (e.g. if estimated GUPPI is within 0.5 percentage points of the CMA's threshold GUPPI level), and then assess the reasonableness of the SLC given local competitive conditions.

Sensitivities

It is sensible to test how sensitive results are to particular assumptions when several potentially reasonable approaches are available. The more sensitive the results, the more carefully one needs to weigh up the choice made. This may also highlight where more evidence could be informative. In *Sainsbury's/Asda*, some of the key arguments related to:

(a) The best way of assessing diversion between the parties.
(b) The CMA's treatment of own-brand diversion (e.g. where consumers divert from one Sainsbury's supermarket to another) and how this affects estimated Asda-Sainsbury's diversion.
(c) The accuracy of the CMA's weighted share of shops (WSS) methodology to estimate diversion ratios.
(d) Whether the CMA should adjust grocery gross margins to allow for the contribution made on general merchandise.[43]

The best way of assessing diversion between the parties

Diversion ratios seek to measure the proportion of business that is lost by one of the other merging parties if it worsens its PQRS that is won by the other. There will thus always be two diversion ratios, one from firm 1 to firm 2 and firm 2 to firm 1.

In principle, switching between firms can be assessed in a number of ways: assessing the degree of customer switching (for example, Kantar Worldpanel directly tracks switching between supermarkets across a panel of households who scan the products they purchase); consumer surveys that ask where else consumers would have shopped if a store were not be available

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or if prices were higher; and entry/exit impact analysis (i.e. the extent to which firms lose business to other rivals when they enter/exit nearby).

The CMA considered all three categories of switching/diversion analysis. As regards the parties' supermarkets, the CMA surveyed a sample of the parties' stores and asked consumers where they would have shopped instead if the store had closed and also their responses to a 5% price increase.[44] The CMA's GUPPI calculations were based on a combination of its surveys where it did surveys[45] and then it extrapolated from these survey based diversion ratios into other non-surveyed areas using its so called "weighted share of shops" (WSS) methodology. This WSS analysis gave "weight" to competitors based on information from the survey responses, the number of stores, and their proximity, and it also had regard to the impact analysis to determine (with some subjectivity) the weights applied to different competitors.

The parties submitted unadjusted Worldpanel switching data as a measure of the extent to which the customers switched between the parties relative to other competitors.[46] Whilst the precise figures are not cited, it seems reasonable to assume that it indicated that relatively little net switching had occurred nationally between the parties due to the growth of Aldi and Lidl (as noted above).

The CMA, however, adjusted these figures to strip out the impact of store openings, which then showed that national diversion between the parties based on losses was in the range of 10–15%. The CMA considered that this was appropriate as stripping out the impact of store opening was important as it wanted to assess the ongoing constraint of existing stores.[47] The CMA also used this analysis to support its view that there are national competition concerns, because this analysis supported a finding that Aldi's and Lidl's existing stores are less close competitors relative to rivalry from the other merging party, Tesco and Morrisons.[48]

An alternative view would be that national competition concerns should have regard to dynamic competition, which has included the large scale and ongoing expansion of Aldi and Lidl. Returning to a point made earlier, any worsening of PQRS by the merged business may have further accelerated the growth of Aldi and Lidl. In other words, unadjusted Worldpanel data including customer loses to new stores, may have provided the best guide to the parties' (presumably much smaller) national incentives to worsen PQRS post-merger.

The CMA's treatment of own-brand diversion

In estimating diversion ratios, the CMA needed to make a decision as to how it treated own-brand diversion, that is consumers responding to the closure of a supermarket by switching to another local supermarket operating under the same brand (in-market diversion) and to other businesses trading under this brand (supermarkets in other areas, convenience stores or online groceries) (out-of-market diversion).

As regards in-market diversion, the CMA excluded own-brand diversion to the parties' supermarkets for a number of reasons.[49]

First, where the parties have multiple local stores, a number of these might jointly worsen their offering, and thus the CMA argued that it is appropriate to exclude own-brand diversion. However, the CMA actually had no information on what consumers would do in this event. An alternative scenario is that all of these consumers indicating that they would switch from say one Sainsbury's supermarket to another would, in fact, respond to a deterioration in Sainsbury's PQRS across several local Sainsbury's stores by choosing a wholly different fascia and not Asda.

The CMA observed that if PQRS were to worsen at one store they are less likely to switch to another store trading under that fascia. This is highly plausible, and indeed is a competitive constraint against local PQRS flexing - particularly as consumers may also periodically visit supermarkets in different areas. The CMA went on to argue that, as a consequence, reported diversion between the parties based on store closure will be understated as own-brand diversion reduces Asda-Sainsbury's diversion. However, again the CMA had no evidence that these consumers would instead divert to the other merging party, as opposed to other rivals.

Finally, the CMA observes that, as it bases its survey analysis of consumers' responses on store closure (which it refers to as forced diversion, as consumers can no longer purchase at the store), including own-brand diversion will understate the likely marginal diversion of less brand loyal customers between the parties. This statement is incorrect.[50] Forcing consumers to switch stores mean that the diversion will include the responses of both marginal consumers (that the CMA wants to capture to measure GUPPI accurately) and inframarginal consumers (who would continue to purchase in any event, and thus are not relevant to firms' marginal PQRS setting decisions). The only statement that can be safely made is that diversion ratios from the CMA's surveys may not capture accurately true diversion ratios for small changes in PQRS.

The CMA argues that its approach does not materially affect its estimate of national GUPPI, and that it had (to some undefined extent) allowed for some overstatement of diversion ratios in setting its GUPPI threshold. These statements would be much more compelling if the CMA reported how this affected individual area GUPPIs.

Survey Evidence *vs* WSS

For supermarket groceries sales, the CMA surveyed 100 of the parties' stores, with 80 of these being in concentrated overlapping areas.[51] The CMA estimated actual diversion ratios based on the stores that consumers said they would switch to in the event that the Sainsbury's/Asda store that they were shopping at were to close. For these stores, these diversion ratios were directly used to calculate GUPPI.[52]

However, for all of the parties' other stores, the CMA estimated diversion ratios using its WSS methodology.[53] This methodology is, at best, an approximation that may not well reflect consumers' actual choices.[54]

In particular, the parties observed that the WSS methodology systematically produced higher diversion ratios relative to the actual survey results: in the vast majority of cases when the actual surveyed diversion was below 15%; and where there are multiple stores and the diversion ratio is below 25%. The CMA dismissed this by arguing that this may arise purely by chance, with the survey results also being affected by local idiosyncratic factors and sampling errors, rather than proving that the WSS methodology is systematically biased.[55] The CMA's explanation is not particularly compelling and comparing actual diversion ratios from the surveys with the WSS methodology would serve two useful purposes:

- First, it could illustrate whether the inherent uncertainties in the CMA's WSS methodology create potential for it to give inaccurate results. Given the parties' observations, the CMA could have tested whether the WSS methodology fits the actual survey data well where diversion is low and/or the parties have multiple stores.
- Second, it would identify areas or circumstances in which anomalous results arise, and enable the CMA to identify potential improvements to its WSS methodology if required.

Margin Calculations

The gross margins used by the CMA included margins on complementary sales of general merchandise that the CMA estimated arise due to the parties' grocery sales. By increasing

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margins, this will increase GUPPI. Appendix E discusses this issue at some length,[5][6] but there are some broader conceptual issues that warrant particular emphasis.

It is certainly plausible that sales of complementary goods may incentivise firms to set lower prices (or offer superior QRS) for goods that drive these complementary sales. (By analogy, firms may sell printers cheaply to capture profitable follow-on ink sales.) However, it is a factual question as to the nature and extent of any such linkages, and the answer to these factual questions should determine whether and how margins should be adjusted for the purpose of calculating GUPPI.

For example, if margins on general merchandise affected groceries price setting, then one would expect firms with more extensive general merchandise businesses to set lower groceries prices nationally pre-merger, so as to attract customers into their stores nationally. The CMA, however, did not assess this issue.

Similarly, the fact that distributing general merchandise or Argos products in-store might boost Sainsbury's grocery sales cannot demonstrate that there is any appreciable effect on Sainsbury's decisions as regards local PQRS setting for groceries. Logically, if local flexing occurs on this basis and if the CMA were correct, this would imply that the parties would operate their groceries stores with systematically lower gross groceries margins where these stores have higher associated general merchandise sales. This is a testable proposition since the CMA could have looked across the parties' store portfolio, and tested whether individual stores' unadjusted groceries margins *fall* materially as individual stores' general merchandise sales increase.

Given that GUPPI results would appear to be sensitive to the inclusions of these non-grocery margins, we would have expected to see a sensitivity analysis and more support that national and local PQRS are set based on these higher margins.

To sum up, our concerns as to setting the CMA setting a very low UPP threshold are increased further by our concerns relating to the inherent uncertainties associated with the measurement of GUPPI and the CMA's reliance on GUPPI.

Conclusions

As noted at the outset, it is not surprising that the CMA reached an adverse finding in *Sainsbury's/Asda*. However, what was surprising was the extent of the adverse finding, with this being driven in large part by the CMA's application of GUPPI.

If the CMA's methodology were to be applied more widely then future retailer mergers may be deterred, even if they generate material pro-competitive efficiencies to the benefit of consumers. This may be a cause for concerns as many retailers are facing challenging market conditions, and merger efficiencies may be important to their survival and their ability to deliver value to consumers.

Endnotes

1. The authors of this chapter and one of their colleagues, Rameet Sangha, responded to the CMA's provisional findings. We were not paid by anyone to write that response. (See https://assets.publishing.service.gov.uk/media/5c926af9ed915d07aab51544/Alix_Partners_response_to_PFs.pdf). This article closely tracks many of the points made in that response. Unless indicated otherwise, all paragraph and endnote references in this chapter are to the CMA's Final Report and Appendices.
2. In particular, the CMA used GUPPI to justify its adverse findings as regards the retail supply of groceries covering the parties' supermarkets, convenience stores and online deliveries. In addition, it is also noteworthy that, for only the second time since the Enterprise Act 2002 came into force in June 2003, the CMA also reached an adverse finding at Phase 2 relating to coordinated effects (the only other case being *Anglo American/Lafarge* (2012)), specifically as regards the retail supply of online delivered groceries where Ocado is entirely absent. As regards fuel, the CMA found SLCs where either GUPPI exceeded 1.5% (this threshold reflected that the CMA found no efficiencies as regards fuel) or its defined Pricing Indicator variable exceeded 1p per litre (this variable was based on the application of the parties' pricing rules where they both serve the same local area and if that site were to be ignored). The CMA found 119 SLCs relating to fuel using its GUPPI threshold and an additional eight SLCs using its 1p per litre Pricing Indicator threshold (paragraph 14.156).
3. The CMA estimated merger-specific efficiencies as regards groceries of 1.25 percentage points, which led to it increasing the local GUPPI thresholds for areas where an SLC would be found for supermarkets by this amount to 2.75% and for convenience stores to 3.25%. Absent these efficiencies, the thresholds would have been 1.5% for supermarkets and 2% for convenience stores.
4. This section draws heavily on paragraphs 9-079 to 9-102 of UK Merger Control: Law and Practice, third edition, Parr, Finbow & Hughes, November 2016. These paragraphs contain extensive references to the economics literature on pricing pressure tests. It should be noted that these tests can also be used to assess mergers in differentiated goods markets more generally (see, for example, the European Commission's use of pricing pressure tests in *T-Mobile/Tele 2* (2018) and the CMA's use of such tests in *Reckitt Benckiser/K-Y* (2015)).
5. This is equivalent to the formula used by the CMA, see Appendix E paragraph 171.
6. Two good articles on this subject are: Neurohr, Bertram, 'Upward pricing pressure under capacity constraints, kinked demand and other cases of a constrained pre-merger equilibrium', Economic Letters 139 (2016) 49–51; and Greenfield, Daniel and Sandford, Jeremy, 'Mergers of capacity-constrained firms', Federal Trade Commission Working Paper No. 338, December 2018.
   These articles show that capacity constraints may change price effects. In particular, if firms are capacity constrained pre-merger and continue to be capacity constrained post-merger, the merger will not affect prices (at least not in the short term). If the parties are capacity constrained pre-merger, but the merged entity is no longer capacity constrained post-merger, the GUPPI formula must still be adjusted. A formula, which depends on the own price elasticity of demand, may be derived allowing for these factors.
7. In *Sainsbury's/Asda*, the CMA accepted that second-order effects are generally smaller than first-order effects, but argued that the omission of such effects was relevant to assessing whether a given GUPPI gives rise to competition concerns (footnote 376). This line of argument rather misses the point: feedback effects cannot justify setting a low threshold for GUPPI unless there is evidence that they are likely to be high.
8. Paragraph 8.93.
9. Paragraphs 8.93–8.95 and 8.101–8.111.
10. Paragraph 11.56.
11. Paragraph 11.55.
12. Paragraphs 14.46–14.59.
13. Paragraphs 8.296 and 11.107.
14. Paragraphs 8.352–8.355.
15. Paragraph 14.153.
16. Footnote 386.
17. Paragraphs 8.302–8.307.
18. Paragraph 8.308.

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19. Paragraphs 8.258–8.269.
20. See chapter 7 of *Somerfield plc/Wm Morrison Supermarkets plc*.
21. Paragraph 8.264. The CMA stated that a 5% IPR based on linear demand would be a GUPPI of 8%, thus highlighting again the sensitivity of the assumption that demand is isoelastic (see footnote 345). The CMA also refers to two Phase 1 grocery cases where the OFT considered an IPR lower than 5%. The first is *GLG/Somerfield* (2008) where the OFT also considered lower thresholds of IPRs of one and two percentage point as a sensitivity check, albeit that this did not make any difference to the results (paragraph A.14). This does not seem to provide any basis to justify a low GUPPI threshold in a Phase 2 case. The second is *Midcounties/Tuffin* (2012). In that Phase 1 case, there was a difference between the parties' and the OFT's calculation of asymmetric IPRs in areas where there were multiple stores. In one area, the OFT's measurement of IPRs was 5–10%, whereas the parties' measure was lower at 0–5% and the OFT noted that there were only two other competitors and one was 19 minutes' drive-time away (paragraphs 147–151). Again, this does not seem to provide any basis to set a low GUPPI threshold.
22. *Asda/Netto* (2010), paragraph 76.
23. Paragraph 8.265.
24. *Jewson/Build Center* (2012), paragraphs 177–178.
25. *MRH (GB)/Esso Petroleum Company* (2015), paragraphs 64 and 77.
26. *Shell UK Limited/Rontec Investments LLP* (2012), paragraphs 104–106.
27. Paragraph 8.268 and footnote 358.
28. Paragraph 8.93.
29. Paragraphs 8.109–8.110.
30. Paragraphs 8.283–8.284.
31. Paragraph 8.285.
32. Paragraph 8.286(a) and (b), and footnote 374.
33. Paragraph 8.286(b).
34. Paragraph 8.287.
35. Paragraph 55.
36. Paragraph 286(c) and (d).
37. Paragraph 8.289.
38. Paragraph 4.8.
39. Paragraphs 137–146 of Appendix E.
40. See, for example, paragraphs 8.290–8.295 as regards supermarkets.
41. 1.1^3-1 = 0.33. If estimated relative prices are too high/low this will increase the GUPPI for one firm and reduce it for the other.
42. See Figures 8.7–8.8. This estimate is derived by counting the number of the parties' supermarkets for which the CMA estimated a local GUPPI of 3.0%, with these figures being approximated from two bar charts.
43. This is a far from exhaustive list of all the points of dispute between the parties and the CMA, and we have focused on those that may be most likely to apply in other cases.
44. Paragraphs 8.141–8.142.
45. The CMA rejected all of the parties' survey evidence and internal, pre-merger "gravity" models that sought to assess diversion. It is presumed that these suggested lower levels of diversion between the parties.
46. This data is discussed in Appendix D.
47. Paragraphs 8.54–8.64.
48. Paragraph 8.105.
49. Paragraphs 106–117 of Appendix E. The CMA did include own-brand diversion to the parties' convenience stores (as the CMA concluded that these stores face a wider range of competitive constraints), and also included own-brand diversion to the parties' on-line business (which might understate diversion between the parties) (see footnote 306).
50. The CMA observed that the surveys reported own-brand diversion was slightly lower for customers who would switch in response to a 5% price increase (see footnote 24 of Appendix E). However, that does not answer the question as to whether diversion between the parties would otherwise be higher. On this point, the CMA omitted to link its observations to the contrary fact that these customers of Asda were materially less likely to choose Sainsbury's than the average customer in the survey (12% compared to 17%), but that these customers of Sainsbury's were slightly more likely to choose Asda (20% *vs* 18%) (footnote 231).
51. Paragraphs 4 and 5 of Appendix B.
52. Paragraph 8.219.
53. This is described in some detail in chapter 8 from paragraph 8.112 onwards.
54. There are a variety of issues with the CMA's WSS methodology. First, the methodology assumes that the probability of a consumer switching to any one fascia increases proportionately with the number of nearby stores trading under that fascia. However, this assumption appears to be untested, notwithstanding that the CMA had survey data across 100 stores. Second, consumers' choices of fascia do not depend solely on the fascias available and the distance between them, but their positions relative to one another. For example, suppose that the Sainsbury's and Asda's stores in an area are located within a five minute drive. However, suppose that there is a large Tesco between these two stores. In that scenario, diversion between Sainsbury's and Asda may be materially lower. There appears to be no consideration of these locational issues, which are most appropriately addressed by assessing the position in individual local areas. Third, the methodology assumes that population densities and the appeal of different fascias are constant across areas, whereas these will vary. Fourth, the WSS methodology estimates average diversion ratios across rural and urban areas and across certain brands, and assumes no diversion after 15 minutes (despite this being found by the surveys). All of these factors can be expected to lead to actual diversion ratios in individual areas differing from those estimated under the CMA's WSS methodology. Indeed, the CMA observed that using survey data has the advantage of taking into account a wide range of other factors that influence diversion in local areas than those considered by its WSS methodology (paragraph 8.180).
55. Paragraphs 8.243–8.244. In this regard, diversion ratios from surveys will at least reflect the actual responses of consumers reflecting their specific preferences and the locations and identities of stores available to them. This is not to dispute that survey responses may differ from actual responses, nor that there will be sampling errors (as those surveyed may differ from the population as a whole). However, the entire WSS methodology is based on these imperfect survey results. Moreover, the WSS results are based on a sample of the parties' stores (particularly those in concentrated areas), and this sample may not be representative of the parties' overall store portfolios and there was disagreement between the parties and the CMA on this point.
56. This is discussed in some detail at paragraphs 118–133 of Appendix E. It is noteworthy that there appears to be no discussion as to whether variable profit margins – as opposed to much lower net margins – provide the best basis to assess whether the parties have incentives to flex national or local QRS.

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