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Agenda

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Price pressure in UK merger control: a retrospective

On April 1st 2014 the successor authority to the UK Office of Fair Trading (OFT) and the Competition Commission, the Competition and Markets Authority, takes up the reins of UK merger control (among other responsibilities). 2014 also marks a decade of the use of price pressure analysis by the UK authorities in their scrutiny of mergers. In view of these landmarks, OFT Chief Economist Chris Walters takes stock of the use of these techniques over the last ten years

It is ten years since the first use in UK merger control of what has become known as price pressure analysis.[1] In that time a veritable alphabet soup of different types of this analysis has emerged: IPR, UPP, GUPPI, PPI, CMCR.[2] As the Office of Fair Trading (OFT) and Competition Commission (CC) merge in April 2014 to form the UK's new competition and consumer watchdog, the Competition and Markets Authority, now is a good time to take stock of the use of price pressure analysis in the UK authorities' scrutiny of mergers.

There are already many articles explaining the economic underpinnings of price pressure analysis and discussing its pros and cons, largely in the context of one or a few cases. My goal here is not to repeat what these articles have said. Instead, it is to characterise at a high level some of the oft-heard criticisms and caveats of price pressure analysis, and explain why I do not think they undermine the overall utility of the approach. I begin, though, by giving some background on the UK's merger control regime, by way of context.

The UK's system of merger control

The UK's system of merger control has six features that have contributed to the UK being a fertile breeding ground for the use of price pressure analysis.

First, the UK's system of merger control is voluntary and not mandatory. The OFT scrutinises around 100 mergers a year, of which it refers 10–15 to the CC. This is only a fraction of annual UK merger activity.[3] This means that the OFT and CC are able to target their resources and scrutinise only those mergers that need it.

Second, the UK's system of merger control is administrative and not judicial, so decisions on mergers are made by OFT senior staff and CC panellists and not by courts. This means that decision-makers on mergers are used to speaking the language of economics and that the authorities' substantive assessment of mergers is very economics-focused.

Third, the UK's system of merger control is bicameral and not unitary, with the OFT responsible for 'first phase' assessment and the CC responsible for 'second phase' assessment. Fourth, the interplay of the European Commission's jurisdictional threshold and the UK's means that the OFT and CC have scrutinised a large number of mergers of retailers whose business overlaps across dozens or hundreds of local markets. Taken together, the third and fourth factors mean that conditional clearances at first phase—especially of retail mergers with a local ambit—are an important feature of the UK system.[4] Price pressure analysis has shown itself to be well suited to informing these conditional clearances.

Fifth, comparatively speaking, the OFT and CC are fairly well resourced to conduct their assessment of mergers, having 40 working days at first phase and 24 weeks at second phase—and plenty of professional staff.

Lastly, the OFT lacks compulsory information-gathering powers. This means that the type of detailed quantitative evidence needed to undertake complex empirical analysis such as merger simulation is likely to be unavailable to the OFT. So the OFT's focus has been on simpler quantitative tools.[5]

These are my views and not the views of the OFT. I'm grateful to OFT colleagues Nelson Jung (Director of Mergers), Tim Geer (Deputy Director of Mergers) and Simon Chisholm (Assistant Director (Economics), Mergers) for helpful comments.

Even so, the approach has not been without its detractors. It is convenient to characterise these criticisms in four ways:

- 'market definition is dead!'
- 'price pressure analysis is too hard!'
- 'no-wait price pressure analysis is too easy!'
- 'either way, price pressure analysis is too interventionist!'

There are varying degrees of merit in each, but I discuss below why none critically undermines the utility of the approach.

'Market definition is dead!'

From some comments it would be easy to think that price pressure analysis has completely usurped the traditional market definition and market share approach. Yet the evidence suggests that the OFT has not used price pressure analysis that often.

Between the start of the 2008/09 financial year (FY) and the end of 2012/13, the OFT published 425 merger decisions.[6] The pie in Figure 1 below represents these 425, of which only 21 used price pressure analysis, representing just 5% of published OFT merger decisions. Of these 21 mergers, 20 were subject to the in-depth first-phase assessment of the OFT's case review meeting (CRM) process. The OFT subjected 134 mergers to this CRM process in the period. Even restricting our attention to these, the 20 price pressure analysis cases still account for only 15%.

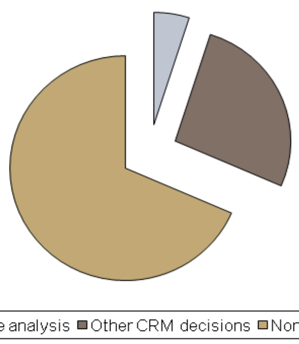
'Price pressure analysis is too hard!'

Some comments suggest that price pressure analysis is too complicated and some that it is too burdensome.

It is not that complicated

A price increase becomes less costly when previously competing products are brought under common control.

Figure 1 Proportion of OFT merger decisions from FY 2008/09 to FY 2012/13 using price pressure analysis



Source: http://www.oft.gov.uk/shared_oft/mergers_ea02/webstats.pdf

This is because profits are recaptured on sales that would otherwise be lost. So, evidence on likely recapture (the diversion ratio) and on profitability tells us about the potential price effects of a horizontal merger. We can use this evidence to implement the hypothetical monopolist test for market definition, or we can use it to implement price pressure analysis, but we cannot just ignore it.

For horizontal mergers in markets where products differ in quality or branding, the OFT and CC have ended up with a focus on price pressure analysis because we realised the importance of this information for market definition; however, we did not like its implications for the narrowness of the markets we would end up with. The focus on diversion ratios and profit margins is therefore not a consequence of the focus on price pressure analysis; it is the cause of it. Seen this way, price pressure analysis is less complicated than market definition, not more so.

It is not that burdensome

Most of the 21 cases where the OFT implemented price pressure analysis used a large-scale consumer survey commissioned and paid for by the merging businesses to get estimates of diversion ratios. Large-scale consumer surveys can be expensive and time-consuming.[7] Yet the price pressure analysis used in these cases greatly facilitated conditional clearances at first phase, meaning that the merging businesses avoided the greater financial cost and time commitment of a second-phase investigation.

Furthermore, in other cases the OFT has measured diversion ratios using internal documents, evidence of where custom diverted in response to supply disruptions, market research and econometric estimates. So it is not the case that the OFT views consumer surveys as the only source of evidence on diversion ratios.

'No-wait, price pressure analysis is too easy!'

Other comments suggest that getting a reliable indicator of a horizontal merger's potential effect on competition by simply bringing together two pieces of information (a diversion ratio and a profit margin) is too good to be true. Some claim that it is easy to poorly measure both, and that the economic models combining them have lots of hidden and unrealistic assumptions.

All economic evidence has measurement errors

The information needed for price pressure analysis is no more likely to have measurement errors than other economic evidence. Measurement errors are a feature of all economic evidence—indeed of all evidence. That we can identify the sources and consequences of

Table 1 21 cases where OFT has used price pressure analysis from FY 2008/09 to FY 2012/13

Merger	Date of OFT decision	Sector	Outcome
Lovefilm/Amazon	15/04/08	Online DVD rental	Clearance
CGL/Somerfield	22/10/08	Grocery retailing	Conditional clearance
Tesco/Brian Ford	22/12/08	Grocery retailing	Clearance
CGL/LBA	06/03/09	Grocery retailing	Conditional clearance
Holland & Barrett/Julian Graves	20/03/09	Health food retailing	Reference
Morrison's/CGL	10/07/09	Grocery retailing	Clearance
Sainsbury's/CGL	09/11/09	Grocery retailing	Clearance
Carpetright/Allied Carpets	13/09/10	Floor covering retailing	Clearance
Asda/Netto	20/09/10	Grocery retailing	Conditional clearance
Asda/CGL	11/01/11	Grocery retailing	Clearance
Unilever/Alberto Culver	18/03/11	Supply of personal care products	Conditional clearance
Princes/Premier Foods	22/06/11	Supply of canned food	Conditional clearance
Amazon/Book Depository	26/10/11	Online book retailing	Clearance
Shell/Rontec	03/02/12	Fuel retailing	Conditional clearance
Jewson/Build Centre	08/02/12	Builder's merchants	Conditional clearance
Edmundson Electrical/Electric Centre	11/05/12	Wholesaling/retailing of electric equipment	Conditional clearance
Sainsbury's/Rontec	07/06/12	Fuel retailing	Clearance
Midcounties Co-op/Harry Tuffin	18/10/12	Grocery retailing	Conditional clearance
Rexel/Wilts	26/10/12	Wholesaling/retailing of electric equipment	Conditional clearance
Booker/Makro	08/11/12	Grocery wholesaling	Reference
Barr/Britvic	13/02/13	Supply of soft drinks	Reference

measurement errors in economic evidence is a virtue not a vice, because it enables us to attach appropriate weight to it.

All models have assumptions

Because the real world is complex, all models (not just economic ones) invoke assumptions. These idealise the relationship between the things we are interested in investigating and neutralise this relationship from confounding factors. Consider the iconic London Underground map. It invokes provably false assumptions about how train lines run (North–South, East–West, or at 45 degrees) and the distances between stations. Yet it is a brilliant model, copied the world over because it illuminates the relationships that matter (underground connections) at the expense of what confounds them (over-ground geography).[8]

Price pressure analysis does this by focusing only on the potential price effect of the merger and not on either the level of pre- or post-merger prices (as merger simulation does) or the price effect of a hypothetical monopolist (as market definition does).[9] The potential price effect of the merger depends on the profitability of recaptured diversion between the merging businesses. So price pressure analysis idealises the relationship between diversion ratios and profit margins and neutralises it from the sort of confounding factors that market definition and merger simulation incorporate.[10] What matters is not that price pressure analysis does this, but that any impactful excluded factors are brought back later on so that price pressure analysis is seen in the context of evidence on them.

'Either way, price pressure analysis is too interventionist!'

Further comments suggest that the authorities view price pressure analysis as determinative and that, in comparison to the traditional market definition/market share approach, it leads to more intervention.

It is seen in the light of other evidence

In the 21 cases where it has been used (see Table 1 above), price pressure analysis has always been seen by the OFT in the context of other evidence. A selection of short excerpts from recent decisions serves to show this:[11]

> ...the OFT considers that high diversion ratios and high variable profit margins (outlined below), when considered alongside other evidence, can be probative of unilateral effects... (*Barr/Britvic*)
>
> The results of surveys and any upward pricing pressure calculations derived from them are only part of the relevant evidence base for a determination of the competitive effects of a merger in a given local market. The OFT will assess all the evidence in the round (*Rexel/Wilts*)

> naturally this [price pressure analysis] must be considered in the context of other evidence... (*Jewson/Build Centre*)

It does not lead to more intervention

Table 1 shows that, of the 21 cases where the OFT used price pressure analysis, just three were referred to the CC. This is a reference rate of 14%. The OFT's overall reference rate in that period was 13%.[12] So the evidence is that the OFT is scarcely any more likely to refer to the CC a merger it scrutinises using price pressure analysis than one it does not.

Turning to clearances, Table 1 also reveals that, of the 21 cases where the OFT used price pressure analysis, eight were cleared unconditionally. Seven of these unconditional clearances came through the CRM process. This is a CRM clearance rate of 33%. The OFT's overall clearance rate for mergers taken to CRM in that period was about 27%.[13] Thus, the evidence is that the OFT is no less likely to unconditionally clear a merger taken to CRM that it scrutinises using price pressure analysis than one it does not.

As for conditional clearances, ten of the 21 cases (48%) using price pressure analysis resulted in the OFT accepting divestment of part of the deal in lieu of reference to the CC. This is over twice as high as the OFT's overall conditional clearance rate for mergers taken to CRM in the period, of 22%.[14] In those ten conditional clearances, the price pressure analysis was exculpatory to the traditional market definition/market share approach in eight cases (ie, the cases were cleared where under the traditional approach they might not have been)[15] and corroborative of it in two:

> Further, the evidence on diversion and the GUPPI calculations corroborate this view. (*Unilever/Alberto Culver*)

> Moreover, the OFT notes that this [price pressure analysis] finding is consistent with the results of the OFT's critical loss analysis; that is, it suggests a market no wider than ambient pies (*Princes/Premier*)

Conclusion

The UK's system of merger control has provided a fertile breeding ground for price pressure analysis over the last decade. That has not come at the expense of the traditional market share/market definition approach but instead has been complementary to it. Experience suggests that the approach has not been too hard, too easy or too interventionist.

Chris Walters

[1] The CC's investigation into Somerfield's acquisition of 115 supermarkets from Morrison's—the first UK merger investigation to use these techniques—began in March 2005, so April 2014 will mark nine years and one month's use of them. I hope the reader will forgive the poetic licence.

[2] These stand for illustrative price rise, upward pricing pressure, gross upward pricing pressure index, pricing pressure index, and compensating marginal cost reduction.

[3] According to the Office for National Statistics (ONS), the number of domestic acquisitions by UK companies (the type of deal over which the OFT may have legal jurisdiction) has averaged 550 a year over the last decade (ranging from over 850 in 2007 to around 250 in 2013). The ONS records only deals above a certain value and only those involving a change in outright voting control, but the Enterprise Act 2002 casts the OFT's jurisdictional net over mergers wider than this, so this likely represents a lower bound. The OFT has scrutinised 115 mergers a year on average over the same period (source: http://www.oft.gov.uk/shared_oft/mergers_ea02/webstats.pdf). This is one in five of those 550 deals.

[4] The Competition and Markets Authority will retain the two-phase system of merger control but within one organisation.

[5] This is not to say that the CC has not used price pressure analysis. On the contrary, recent examples are *Zipcar/Streetcar* (2010), *Sports Direct/JJB* (2010) and *Thomas Cook/CGL/Midlands* (2011).

[6] Although price pressure analysis was first used by the CC in 2005, the OFT's use of price pressure analysis was sporadic before mid-2007. After then, its use became more systematic. So FY 2008/09 is a sensible base year from which to examine how intensively the OFT uses price pressure analysis.

[7] For this reason merging businesses are advised to consult the OFT when designing any surveys they conduct so that the OFT can place appropriate evidential weight on them.

[8] For an excellent animated illustration of this point, see the morphing real tube map at http://www.fourthway.co.uk/realunderground/.

[9] The substantive test used in the UK to scrutinise mergers is whether they give rise to a substantial lessening of competition (against a 'realistic prospect' legal standard for the OFT and a 'balance of probabilities' legal standard for the CC). That substantive test does not ask how much competition there is to begin with, only whether the merger will substantially lessen it. Arguably then, price pressure analysis answers that test more directly than market definition and merger simulation because it focuses only on the change arising from the merger.

[10] Broadly speaking, these confounding factors relate to assumptions or information about what businesses other than the two merging are doing.

[11] These cases represent one reference to the CC and two conditional clearances (one of a merger at the wholesale level, one of a merger at the retail level).

[12] See http://www.oft.gov.uk/shared_oft/mergers_ea02/webstats.pdf. In the period FY 2008/09 to FY 2012/13 the OFT referred 46 mergers to the CC of the 348 that it found to qualify for investigation (425 decisions less 77 found not to qualify). As a merger that does not qualify for investigation cannot be referred to the CC, it would not be appropriate to take these into account when measuring the OFT's propensity to refer.

[13] See http://www.oft.gov.uk/shared_oft/mergers_ea02/webstats.pdf. In the period FY 2008/09 to FY 2012/13 the OFT took 134 mergers to CRM. This includes the great majority of mergers referred to the CC (46), all those in which the OFT accepted undertakings in lieu of reference (30), and the great majority of those in which the OFT applied its 'de minimis exception' to its duty to refer (22). So the OFT found a realistic prospect of an SLC in approximately 46+30+22=98 of the 134 mergers taken to CRM, meaning that it unconditionally cleared around 134 – 98=36 of them, a clearance rate of about 27%. On a handful of occasions and at the merging businesses' request, the OFT has 'fast-tracked' a merger reference to the CC without a CRM, or has applied its de minimis exception to its duty to refer without a CRM. Because this handful of cases is included in the 46 references and 22 de minimis clearances, the calculation here will underestimate the OFT's CRM clearance rate.

[14] See http://www.oft.gov.uk/shared_oft/mergers_ea02/webstats.pdf.In the period FY 2008/09 to FY 2012/13 the OFT accepted undertakings in lieu of reference 30 times in the 134 mergers it took to CRM.

[15] The eight retail mergers in Table 1, where the OFT's practice has been to use a two-step approach. First the OFT identifies potentially problematic overlaps between the merging businesses using the market definition/market share approach. It then uses price pressure analysis and other evidence to determine which overlaps among these give rise to a realistic prospect of a substantial lessening of competition. See OFT/CC Commentary on Retail Mergers (OFT1305/CC2com2), March 2011 available at http://www.oft.gov.uk/shared_oft/mergers/oft1305-ccV1a.pdf.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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