October 2019

RBB Brief 60

RBB | Economics

Sainsbury's/Asda and the CMA's GUPPI decision rule: On the money or basket case?

In April 2019, the UK's Competition and Markets Authority (CMA) issued one of its highest-profile decisions in recent years, prohibiting the proposed merger between the supermarket chains Sainsbury's and Asda.[1] In so doing, it relied solely on Gross Upward Pricing Pressure Index (GUPPI) calculations to determine if local overlaps in the parties' grocery stores were likely to result in a substantial lessening of competition (SLC). This Brief considers the wider implications of the CMA's mechanical use of GUPPI values as a decision rule in this case.

The GUPPI offers a summary measure of the upward pressure on prices arising from a horizontal merger. However, it is a simple theoretical construct, based on a stylised economic model of competition. As such, its use as a substitute for in-depth competitive assessment is troubling. Strikingly, the CMA did not seek to validate the outcomes of its GUPPI rule against the findings of a more comprehensive appraisal of qualitative and quantitative evidence for even a sample of the affected local markets.[2] It is notable that a large number of the mergers that are routinely cleared by the CMA absent a GUPPI rule would fall foul of the GUPPI threshold adopted in Sainsbury's/Asda. In turn, this chimes with long-standing concerns that the use of such summary indicators is liable to result in excessive intervention.[3]

The inconsistency in the CMA's approach threatens a 'two-tier' merger system, whereby deals subject to a GUPPI rule like that adopted in Sainsbury's/Asda will be judged against a more interventionist standard. That can only add to damaging uncertainty regarding the UK's post-Brexit merger control landscape.

GUPPI and the CMA's local assessments in Sainsbury's/Asda

In April 2018, Sainsbury's and Asda announced plans to merge, bringing together businesses operating more than 2,000 grocery stores and over 600 petrol stations, and with extensive online footprints. Sainsbury's and Asda are the second and third largest grocery retailers in the UK – accounting for 15% and 14% of national sales (including online) respectively in the year to 12 August 2018[4] – though still some way behind market leader Tesco's 27% share. Together with Morrisons (10% share), these retailers make up the so-called 'Big 4'. At the same time, there are numerous other significant market participants, including the 'discounters' Aldi and Lidl, the Co-op, and more upmarket brands M&S and Waitrose.

Ultimately, demand for a grocery retailer's offering will depend on the choices available to consumers at the local level, even if some parameters of that offering, such as price, are determined on a national basis. A focus on local competition was rightly, therefore, at the heart of the CMA's assessment of this transaction.[5] However, the CMA's appraisal of local competition effects in groceries relied entirely on simple GUPPI calculations.

The GUPPI draws on a combination of just two principal parameters – the diversion ratio[6] and the gross profit margin earned on those diverted sales – to provide a prediction of the strength of upward pricing pressure.[7] Since the GUPPI is always positive, its use as a decision rule also requires an appropriate choice of threshold value to separate problematic from unproblematic cases. In deriving local GUPPI values, the CMA sought to quantify the local diversion ratios between the parties in every one of the hundreds of areas in which they overlapped.

1. Competition and Markets Authority: 'Anticipated merger between J Sainsbury PLC and Asda Group Ltd: Final report' ('the CMA's Final Report'), 25 April 2019.

2. We discuss further what the CMA might reasonably have done in this regard in this Brief.

3. See 'Lost in Translation: The use and abuse of diversion ratios in unilateral effects analysis', RBB Brief 19, June 2006, and 'The Joint OFT/CC Commentary on Retail Mergers: FAQ', RBB Economics, November 2011.

4. See Figure 4.3 of the CMA's Final Report.

5. That does not preclude the possibility of theories of harm viewed from a national perspective even where there are no (current) overlaps.

6. The proportion of customers lost by one of the merging parties that would switch to the other merging party following a unilateral price increase.

7. Where merging parties A and B have the same price and both operate one store in a local market, the GUPPI for A's store equals the diversion ratio from that store to B's store, multiplied by the percentage gross margin for B's store (i.e. its price less marginal cost, all divided by price). So if the diversion ratio from A's store to B's store is 10% and B's margin is 15%, then the GUPPI for A's store is 1.5% (i.e. 10% multiplied by 15%).

To do this, the CMA started with the results of an extensive store exit survey conducted at a subset of affected stores, which asked consumers about the stores they would use if their current choice was unavailable. Drawing mainly on these survey results, it then identified more general relationships between customer switching preferences and three key store attributes, namely brand, size, and location. Finally, it used these estimated relationships to predict diversion ratios for the parties' stores which were not covered by the survey.[8]

A low threshold for intervention

The CMA calculated the GUPPI for each of the merging parties' stores by combining the diversion ratios derived from its closeness analysis with a measure of gross margins. Critically, an SLC was deemed likely wherever the resulting GUPPI exceeded a before-efficiencies threshold of 1.5%.[9] This threshold, which embodied the CMA's allowance for uncertainty and the required substantiality of any lessening of competition, was adjusted upwards to 2.75% for supermarkets once allowed efficiencies were taken into account.[10] On this basis, the CMA decided that an SLC was likely in relation to supermarket supply of groceries on a local basis in 537 local areas, as well as in relation to convenience store supply in 18 local areas and online delivery in 143 local areas.[11] (It also identified national concerns in relation to in-store and online delivery of groceries.)

The GUPPI decision rule applied by the CMA in this case imposed a low threshold for intervention by any yardstick. A diversion ratio between the merging parties of only 14% combined with retail gross margins of 20% would be enough to breach the CMA's efficiency-adjusted 2.75% GUPPI threshold in groceries, for instance. Such a level of diversion could easily arise even in local markets in which Sainsbury's and Asda faced six other, equally-strong competitors.[12] Without efficiencies, a diversion ratio of less than 8% could result in an SLC finding (again, assuming gross margins of 20%). Given the CMA's historical reluctance to place weight on efficiency claims, a merger of two out of as many as 14 equally-strong competitors might trigger SLCs on this measure.[13]

Since the CMA's GUPPI test would likely be failed by most horizontal mergers it assesses, it was unsurprising that this mechanistic approach generated a large number of local SLC findings in this case. Indeed, the outcome of the CMA's investigation was more or less inevitable once these methodological (i.e. the adoption of GUPPI as a decision rule) and threshold (i.e. 1.5%, before efficiencies) choices had been made. The critical issue is therefore whether those choices were justified.

The CMA's GUPPI rule: On the money or basket case?

An in-depth competitive assessment in this case ought to take into account the fact that supermarkets are differentiated by a number of factors, including store location, size and brand. The extensive survey work commissioned by the CMA and the subsequent quantitative analysis it undertook to explore the empirical relationship between these key parameters and the likely patterns of diversion between the parties and their rivals is therefore to be welcomed. Undertaken rigorously, by allowing a richer characterisation of the competitive impacts of rival stores, it offers a step forward from the simple fascia counts of earlier grocery merger investigations.

However, the next step in the CMA's analysis – i.e. converting that evidence into GUPPI measures of upward pricing pressure, and identifying SLCs by reference to a highly interventionist GUPPI threshold – is far more controversial.

8. For example, the survey indicated that Sainsbury's customers would be more likely to switch away from Sainsbury's to Tesco than to Asda. Further, Sainsbury's customers would be more likely to switch to a nearby (or larger) Tesco store than a more distant (or smaller) Tesco store. The CMA assigned weights to these factors (brand, distance, size) so as to measure the strength of competition arising from each store within 15 minutes' drive of a Sainsbury's store. The greater the weighting given to a particular Asda store relative to the weightings given to other stores in the local market, the greater the assumed diversion from a Sainsbury's store to that Asda store. The CMA also allowed for additional, 'out-of-market' constraints.

9. See paragraph 8.296 of the CMA's Final Report. This threshold was applied by the CMA when assessing overlaps between petrol stations, where no relevant efficiencies were identified.

10. The CMA equated these efficiencies to downward pricing pressure of 1.25% in the GUPPI context. See paragraph 8.279 of the CMA's Final Report.

11. In addition, the CMA raised concerns regarding the overlaps in the parties' petrol station operations in 127 areas.

12. With 8 symmetric competitors in a market, the relevant diversion ratio (to each of 7 rivals) would be 14% (=100%/7).

13. With 14 symmetric competitors, the relevant diversion ratio would be 7.7% (=100%/13). 7.7% x 20% = 1.54%, which would exceed the CMA's 1.5% before-efficiencies threshold.

14. See, in particular, paragraphs 8.282 - 8.286 of the CMA's Final Report.

It is straightforward to construct merger scenarios which would not present substantive competition concerns by conventional assessment standards but which would, nevertheless, fail the CMA's GUPPI test. Consider, for example, a situation where one party has a minimal presence in a local area replete with competitors, giving rise to a negligible overlap and share increment. Nevertheless, the relevant local GUPPI for that barely-present party could breach the CMA's threshold. The fact that transactions which would be considered obviously non-problematic when assessed using a comprehensive 'GUPPI-free' framework would nonetheless fail the CMA's GUPPI test calls into question the usefulness of that test for sensibly identifying SLCs. Applying the test inconsistently would also inevitably result in an undesirable 'two-tier' system, whereby the same facts may lead to different outcomes, depending on whether a GUPPI decision rule is deployed or not.

For its part, the CMA strongly disputed that its decision rule was either inappropriate or inconsistent, asserting that: (i) even a small price rise would be "substantial" in a market like grocery retailing which accounted for a material share of consumer expenditure, especially for lower income households; and (ii) given the characteristics of this industry, even a small degree of pricing pressure (as measured by the GUPPI) was likely to translate into actual price increases, or equivalent deteriorations in quality, range or service, that would be consistent with an SLC.[14]

This justification is not convincing. In particular, while it is reasonable to worry that even a small rise in price would be harmful, the CMA did not establish that modest levels of predicted upward pricing pressure would translate into actual price increases in practice.

Inevitable price increases?

The GUPPI is a simple theoretical construct based on a stylised economic model of competition. It does not take account of the broader range of economic factors that can affect the impact of a merger on competition and prices. Evidence of how competition works in practice can only come from a detailed analysis of the market in question. In reality, firms may not base their pricing decisions on textbook theoretical models. For instance, they may be reluctant to increase prices (or worsen other aspects of their grocery offer) at small stores which generate limited profits due to the wider negative effect on their brand that may result. Equally, in areas with many competitors, firms may worry that worsening their competitive offering would leave them vulnerable to one or more of their rivals competing harder and capturing customers that would not otherwise have switched. The inability of GUPPI to capture these (and other) nuances of competition in practice should give pause for thought as to its appropriateness as a decision rule in mergers.

Significantly, whilst simple (static) theoretical models predict that all horizontal mergers will result in price increases (absent offsetting efficiencies), the reality of the UK merger control regime is that only a small fraction of transactions are ultimately judged to be bad for consumers. That is explained by a recognition that where there are a number of strong actual or potential competitors, or where the rivalry being removed from the market is modest, any static loss of competition is likely to be effectively made good through the (hard to model) dynamics of competition, ensuring that consumers are protected from increases in price or equivalent reductions in quality. The CMA's decision to depart from this approach and instead rely – without more detailed cross-checks – on simplistic GUPPI calculations is troubling, and risks creating a fundamental inconsistency at the heart of the UK merger regime.

An unjustified short-cut

The CMA justified its streamlined, GUPPI-based approach on the grounds that *"reviewing a range of evidence … on an area-by-area basis in around 1,000 local areas would clearly be impracticable in the time available for [its] enquiry"*.[15] But was such a limited assessment of the evidence really unavoidable? It certainly raises worrying questions about the CMA's ability to review multi-faceted transactions of this scale within the allotted timeframe, just when it is due to assume oversight of many more large mergers post-Brexit.

15. See paragraph 8.16 of the CMA's Final Report.

The CMA could surely have undertaken a comprehensive, GUPPI-free assessment of a broader range of quantitative and qualitative evidence, in line with the approach it takes in many other cases, for a selection of the local areas affected by the proposed Sainsbury's/Asda transaction. Such an exercise could have focused on areas for which the CMA's GUPPI rule, and the specific threshold it embodied, resulted in borderline SLC decisions. It might also have usefully considered a sample of areas yielding GUPPIs above and below this threshold, to test the overall consistency of the GUPPI rule. This would have provided the CMA with a grocery-specific cross-check on the conclusions delivered by its GUPPI decision rule, offering a test of whether the chosen GUPPI thresholds consistently identified local overlaps that, on more detailed assessment, would justify concern. Such a calibration exercise would also have allowed the CMA to sense-check its results against the standards and methods it applies in other cases, ensuring a broader consistency in approach.

If the GUPPI cocktail of diversion ratios and margins truly captures the key features of local competition, then this would be borne out by closer scrutiny of competition in the sampled areas. On the other hand, if the decision rule failed to distinguish problematic and non-problematic areas effectively, then this would point to a need to change the threshold or even the metric itself; e.g. replacing GUPPI with indicators that might better reflect the true nature of competition.

Conclusions

It is understandable, when faced with a merger giving rise to many hundreds of overlaps, that the CMA would seek to streamline its competitive assessment. In this regard, the techniques that the CMA has developed to assess closeness of competition in differentiated local markets are helpful. However, whilst a GUPPI decision rule offers one means of achieving a truncated assessment, its application in this case undoubtedly delivered a highly interventionist merger standard and resulted in clear inconsistency with assessments in other cases where this approach is not applied.

Whilst a change in approach may sometimes be warranted, the CMA's use of a GUPPI decision rule in this case was not justified. Without cross-checking and calibration against the results of more comprehensive assessments, this short-cut approach threatens unsound decisions.

The absence of guidance on whether this standard will be applied more generally, and, if so, where, also adds significantly to the uncertainty that firms now face when contemplating UK mergers. The CMA should clarify and justify its position and, in particular, confirm whether its decision in the Sainsbury's/Asda case was a one-off (reflecting the particular circumstances of this case) or whether other types of cases are also likely to be subject to this tougher merger standard. A failure to do so will only serve to increase the costs and risks associated with the merger control process in the UK going forward.