RBB Brief 36

Road-testing UPP:
the Zipcar/Streetcar merger

In December 2010 the UK Competition Commission (CC) cleared the acquisition of Streetcar, the largest provider of car club services in the UK, by Zipcar, a rival car club with operations in London and across North America.[1] The post merger firm would account for some 80% of UK car club vehicles.

The CC analysed the parties' incentives to raise prices using a formulation of the Upward Pricing Pressure (UPP) test. UPP features prominently in the US horizontal merger guidelines and is being promoted heavily as an alternative to market shares as an initial screen for assessing the competitive effects of horizontal mergers.[2] It also shares some common elements with the concept of Illustrative Price Rise (IPR) formulas, which have recently been used by the UK competition authorities to predict the magnitude of price increases that will arise from mergers.

This Brief considers the analysis undertaken by the CC. We identify some of the issues encountered in implementing UPP, discuss the problems associated with determining the appropriate threshold for intervention under this test, and comment on the lessons that can be drawn from the Zipcar/Streetcar case for other mergers involving unilateral effects concerns.

The car club model and the parties

Car club operators offer cars for hire in off-street and on-street parking bays in city centre locations. After paying an annual fee, cars are hired by the car club's members by the hour or (for a discounted rate) the day. Car clubs are a relatively new innovation in the UK. The concept fits neatly within the spectrum of transport alternatives in large city locations which includes taxis, traditional car hire, car ownership and public transport. UK car club fleets doubled in size between 2007 and 2009, and are expected to grow by a factor of 8 or more over the next decade.[3]

Whilst it was not the first to enter, Streetcar is now the largest car club in the UK and the most recognised brand. It operates in 13 UK cities, with a focus on London, where the majority of its 1,300 vehicles are located. Zipcar is the next largest car club in London, with a network of 375 vehicles.

The CC's unilateral effects concern

The CC's primary concern was that the merger would lead to a loss of competition for members and that price and/or non price elements of car club competition would worsen as a result of the merger.

Given the high post-merger share in London car club services, the CC's analysis understandably focused on whether other transport alternatives (such as taxis, traditional car rental and public transport) would act as a sufficient constraint post-merger. It rejected the parties' argument that the market should be defined to include at least car rental operators but asserted that its analysis would be substantively the same even if the market was defined more broadly than car clubs.[4] This is a common mantra in unilateral effects cases, reflecting the extent to which the traditional SSNIP test approach to product market definition has fallen out of fashion when analysing such mergers.

However, it is simply incorrect to state that the appraisal would be the same irrespective of the outcome of the SSNIP test enquiry: had the CC found that even a firm that supplied 100% of car club services would not have been able to impose a SSNIP, then it really would make no sense to worry about the competitive effects of a post-merger firm that controlled 80% of the supply. Further, the market definition analysis actually provided some useful insights on competitive constraints. In particular, the CC's consumer survey evidence indicated that following a unilateral pre-merger price rise by either firm, around 75% of the lost sales would be diverted to alternatives outside the car club segment.[5] This fact itself provides an important pointer that the boundaries of the car club market are extremely 'leaky' and that there is an unusually high degree of competition between these services and the numerous alternative transport modes available to consumers in London.

Incentives to raise prices: a move from IPR to UPP

As in previous unilateral effects investigations the CC used diversion ratios obtained from a survey of customers as a measure of the closeness of competition between the parties. Interestingly, however, it rejected the IPR formulas it had employed in previous cases in favour of a simpler UPP-oriented approach.[6]

The first step in implementing UPP is to calculate a 'value of diverted sales' that would be internalised following an increase in price of either of the merging parties. For example, in the event of a unilateral price rise by Zipcar the commercial value of the additional sales that Streetcar would enjoy is a combination of the diversion ratio from Zipcar to Streetcar, and the margin that Streetcar would expect to earn on those diverted sales. The higher the value of such diverted sales the greater the implied relaxation of competitive constraints and therefore the stronger the incentive to raise prices post-merger.

On the basis of its consumer survey, the CC estimated that the diversion ratio between the parties was around 23%, i.e. that for every £100 of bookings revenue that Zipcar would lose following a price rise, £23 would be re-booked instead with Streetcar.[7] The CC and the parties held very different views as to the appropriate margin at which to value these diverted sales. The CC favoured a gross margin which captured the short run benefit to additional revenues assuming very few additional costs would need to be incurred by the recipient of this extra demand. In contrast, the parties contended that a longer term view should be taken, consistent with the time horizons over which actual pricing decisions were made, in which the revenue benefits of extra demand would be tempered by the need to incur additional costs such as the acquisition of new vehicles. To reflect these divergent views, the CC quoted a range of estimates but concluded that on any view the value of diverted sales was sufficient to support the conclusion that the parties would have at least a 'moderate' positive incentive to raise prices.[8]

This very crude approach to UPP analysis, which does no more than measure the impetus towards a price rise, is inherently less ambitious than the IPRs that have previously been calculated by UK competition authorities. It is also simpler than the General UPP Index (GUPPI) approach which imposes more structure on the analysis.[9]

Thus, the CC's approach avoids some of the criticisms that have been justifiably made of IPRs,[10] but the fact that the UPP approach taken by the CC has more modest pretensions than GUPPI or IPR also emphasises that it is a very incomplete tool. Since both diversion ratios and margins are invariably positive in a horizontal merger, the CC's diverted sales calculation will inevitably yield a positive number. Clearly then

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See Annex E to the CC report. The key evidence here is heavily redacted in the published version, and the CC's conclusion was contested by the merging parties.

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See for example the CC's Somerfield/Morrisons and JBB/Sports Direct reports. The OFT has also used IPR analysis in numerous retail merger cases, including Co-Op/Somerfield and Asda/Netto.

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The other £77 would be diverted to various alternatives, almost all of which comprised transport options other than car clubs.

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However, neither the published nor the confidential version of the CC conclusions reveals an answer to the critical question of how big the diverted sales need to be to create an SLC concern.

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With GUPPI, internalised sales are characterised as an 'opportunity cost' associated with low prices and an estimate of the scale of pricing effects is based on the rate of 'cost pass-through'. The predicted price effect under symmetry is given by pdm where p is the level of firm specific cost shock pass through, d is the diversion ratio, m is the percentage margin.

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See 'Lost in Translation' RBB Brief 16, June 2006, for further discussion. In Somerfield/Morrisons, the CC's IPR calculations famously included a predicted price rise of 1,894.4% in one small grocery store on the edge of Glasgow, Scotland.

there needs to be some significance threshold or offsetting factor in order to avoid the prescription that all such mergers are anti-competitive, but the CC report provides no guidance to explain its 'moderate' price rise conclusion.

The contentious issue of thresholds

The leading proponents of the US merger guidelines' approach have suggested a standard efficiency credit of 10% as a way to overcome this problem.[11] They suggest that mergers that generate UPP below 10% would not be challenged by the US agencies on the grounds that this assumed efficiency gain will outweigh any anti-competitive tendency towards price increases. But no real rationale is provided for this approach.

In considering the appropriate threshold for intervention in the UK regime, it is interesting to assess the approach that has traditionally been pursued in the context of market share assessments. In particular, as noted by the OFT and CC Joint Merger Guidelines the OFT has rarely been concerned about mergers that reduce the number of firms in the market from five to four (or above).[12] In a symmetric case in which market demand was always re-distributed between the remaining firms, the expected diversion ratio of such a merger would be 25%.[13] By the same logic, it might be presumed that the UK authorities would rule out SLC concerns where the diversion ratio was below 33%, the value (assuming symmetry and no leakage) associated with a four to three merger.

As noted above, in the Zipcar case the CC's survey indicated a diversion ratio between the parties of some 23%, suggesting that they were not particularly close competitors despite being the main car club operators. The fact that the diversion ratios were this low despite the high segment shares of the merging firms serves to reveal the extent to which car clubs face effective competition from alternatives that are located outside this narrowly defined market – the result that was revealed in the SSNIP test analysis.

Had the CC translated this 23% diversion ratio to its market share analogue, this evidence alone would place the merger below the normal significance thresholds. However, the CC concluded that this diversion ratio, when allied to its range of undisclosed margin projections, yielded a modest but significant UPP influence that would cause the parties to raise prices post-merger. The margin details behind this key assessment are redacted from the CC decision, but by way of illustration if the diverted sales are valued at a margin of 18% they would yield upward pricing pressure in excess of 5% whereas any margin greater than 30% would indicate upward pricing pressure in excess of 10%.

Many merging firms will find that they have sufficiently high margins to fall foul of such calculations. Hence, were the UK authorities to employ a significance threshold (or an assumed efficiency credit) anywhere below the 10% level, there is a clear implication that the UPP-oriented approach adopted in the Zipcar case, perhaps unwittingly, heralds a significantly more interventionist standard to merger review.

It is therefore vitally important to understand what factors, beyond marginal cost efficiencies, can be invoked to counteract this very interventionist presumption. The most promising answers lie in the fact that UPP models are entirely static, taking no consideration whatsoever of market dynamics such as entry and expansion, product repositioning and the exercise of buyer power, all of which have the potential to overturn the assumptions on which the UPP (and IPR) approaches rely. However, it is not simple to persuade competition authorities to allow such factors to outweigh 'static' assessments of the constraints facing firms, which can be more easily evidenced.

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See Joseph Farrell & Carl Shapiro (2010), Antitrust Evaluation of Horizontal Mergers: An Economic Alternative to Market Definition http://faculty.haas.berkeley.edu/shapiro/alternative.pdf. Under symmetry merging parties will have positive UPP overall if the 'positive price incentive', given by $dm/(1-m)$, is greater than the incentive to lower prices resulting from merger efficiencies (E) where d is the diversion ratio, m is the percentage margin and E is the percentage reduction in marginal costs.

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See OFT/CC Merger Assessment Guidelines, paragraph 5.3.5. The guidelines refer specifically to retail cases. However it is uncontroversial that the large majority of cases referred to and eventually blocked by the CC would involve a reduction in significant competitors of four to three or less.

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Each Party assumed to have a market share of 20% giving a diversion to each other party of 25% (20%/(100%–20%)).

Hence, the risk remains that the UPP approach will in practice mean a shift in the burden of proof against merging firms.

In the Zipcar case, marginal cost efficiencies did not play a prominent role. It was instead the dynamic supply-side factors that came to the parties' rescue. The CC declared that the post-merger price increases suggested by its UPP calculations would be offset by the likelihood of market entry. This assessment was made somewhat easier by the predictions of exponential demand growth over the coming years, and by the evidence that two other car clubs had declared an intention to commence operations in London. It would indeed have been perverse for the CC to have ignored such exceptional market dynamics in favour of a purely static analysis.

Conclusions and implications

In assessing the Zipcar merger the CC chose to adopt a simplified UPP-oriented approach in preference to the IPR calculations that the UK authorities have previously used when conducting unilateral effects analysis. Given the severe problems with the over-prescriptive IPR approach, it is at least welcome that the CC has taken this course.

However, there are many problems with the CC's UPP approach. It is inherent in the CC's diverted sales calculations that they always yield a positive result in horizontal mergers. Moreover, the way the UK authorities have chosen to calibrate their use of UPP (and, in other cases, IPR) calculations means that very modest competitive overlaps can reveal an apparently 'significant' incentive to raise price, which means that merging parties will very often face a strong burden of proving the existence of offsetting factors. Until the authorities find a robust way to define a more realistic threshold for UPP concerns, this problem will remain.

In the Zipcar case, this offsetting factor was found not in the efficiency arguments that have been suggested in the literature as an ad hoc way to offset the adverse predictions of static unilateral effects models on their own grounds, but in the entry and supply-side dynamic factors that are ignored completely by UPP models. Evidence on leaky boundaries to the market also played a key role in dismissing unilateral effects concerns, though this important fact was almost lost in the dismissive approach that the CC took to market definition. However, firms involved in future unilateral effects cases might not find such a rich source of dynamic evidence, so the risk remains that the CC's interest in UPP will continue to place an unjustifiably tough burden of proof on merging parties, and make it more likely that regulators will draw SLC conclusions on comparatively thin grounds.