AlixPartners

Submission to the Competition and Markets Authority in Sainsbury's/Asda

The appropriate application of GUPPI

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1 Introduction

1.1 This submission is written in a personal capacity by three economists at AlixPartners UK LLP: Ben Forbes, Mat Hughes and Rameet Sangha. We are not acting for either of the merging parties or any third party and are not being paid for this submission. We have a professional interest in ensuring that UK merger analysis is predictable and grounded in sound economics and facts.

1.2 We have advised on many mergers affecting multiple local retailing and wholesaling markets, including: groceries; food and drink wholesaling; discounted general merchandise; cinemas; electrical goods wholesaling; retailing of outdoor clothing, footwear and equipment; and bingo halls. We have also been heavily involved in key cases where efficiencies have played a major part in securing Phase 2 clearances, including *Shell/Nynas* where the European Commission publicly stated that it expected the merger to lead to lower prices and *Imerys/Goonvean* where the Competition Commission found that the merger would lead to relevant customer benefits. We have written and spoken extensively on the subject of UK and EC merger control, including on retailer mergers, and are co-authors of the leading text book on UK merger control (UK Merger Control: Law and Practice, third edition, Parr, Finbow & Hughes, November 2016).

1.3 A key driver of the Competition and Markets Authority's (CMA) provisional adverse findings in *Sainsbury's/Asda*[1] is the CMA's use of the gross upward pricing pressure index (GUPPI) to identify local areas where a substantial lessening of competition (SLC) may be expected. The CMA has provisionally found SLCs where GUPPIs are at least 2.5% for groceries and 1.5% for fuel.[2] This submission considers the appropriate GUPPI threshold. It also focuses on in-store sales of groceries (since this is the core of the parties' businesses), but the points made also apply to fuel sales and on-line grocery sales.

1.4 The CMA accepts that the GUPPI thresholds adopted need to:

(a) Take account of efficiencies, since mergers only lead to upward pricing pressure if the gross effects exceed offsetting efficiencies.[3]

(b) Ensure that the lessening of competition is substantial,[4] allowing for rivalry enhancing efficiencies.

(c) Take account of the risk of "*false positives*"[5], that is the risk of finding an SLC when in fact there is no SLC.

We agree with the first point. However, we disagree that the GUPPI thresholds proposed by the CMA ensure that any lessening of competition is substantial. Nor do we agree that the proposed

[1] Unless indicated otherwise, all paragraph references in this submission are to the CMA's provisional findings in *J Sainsbury PLC / Asda Group Ltd*.

[2] The CMA has provisionally reached an adverse finding as regards the parties' overlapping petrol filling stations (referred to as fuel in this memorandum) where either GUPPI exceeds 1.5% or the Pricing Indicator is above a 0.75p threshold (see paragraph 82). Paragraph 14.159 indicates that 111 petrol filling stations fail the GUPPI component of the CMA's decision rule and an additional 21 petrol filling stations fail the Pricing Indicator component. Accordingly, it would appear that the GUPPI threshold for fuel is a key driver of the CMA's provisional adverse findings in fuel as well.

[3] Paragraphs 8.236 and 8.280(a).

[4] Paragraphs 8.241-8.243 and 8.280(b).

[5] Paragraphs 8.247 and 8.280(b).

thresholds correctly allow for the uncertainties associated with GUPPI. In our view, these uncertainties do not support the CMA's exclusive reliance on GUPPI.

1.5 Our reasons for these views are explained under three headings:

(a) What do upward pricing pressure tests measure?

(b) What is the appropriate GUPPI threshold for identifying SLCs?

(c) What is the appropriate way of addressing the inherent uncertainties with using GUPPI?

2 What do upward pricing pressure tests measure?

2.1 The intuition behind pricing pressure tests is straightforward.[6] In a differentiated goods or geographic market, each party sets price and other aspects of its competitive offering (quality, range or service; commonly abbreviated to PQRS) to maximise its own profits. Accordingly, the pre-merger equilibrium is such that it is not profitable for either of the merging parties to increase their prices unilaterally (or worsen QRS) because the foregone profits on sales they would consequently lose outweigh the extra profits on sales they retain. These sales would be either lost to competitors or from consumers simply buying less. However, following a merger with a competitor, the sales that would have been lost to the merging rival are now internalised by the merged group. This internalisation of rivalry between the merging parties in differentiated markets gives them an incentive to increase price (or worsen QRS). By contrast, merger efficiencies will create a downward pressure on prices as lower costs increase the value of additional volume generated by lower prices.

2.2 The value of sales internalised depends on three factors, which can be combined in a formula to estimate gross upward pricing pressure before taking account of the countervailing effect of merger efficiencies. The three factors are:

(a) The proportion of sales volumes lost to the competing merger party, commonly referred to as a diversion ratio. The notation D_{12} refers to the proportion of sales volume lost by firm 1 that is captured by firm 2.

(b) The per unit value of these sales won by firm 2, namely the gross margin of firm 2 (M_2).

(c) The relative prices of two firms $\frac{P_2}{P_1}$.

2.3 The formula[7] for GUPPI for firm 1 (merging with firm 2) is $GUPPI_{12} = D_{12}M_2\frac{P_2}{P_1}$.

2.4 Accordingly, GUPPI depends on three variables: diversion ratios; gross profit margins; and relative price levels. However, the level of GUPPI does not indicate the likely quantum of any price increases (or worsening of QRS). This instead depends on six factors.

6 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.

7 This is equivalent to the formula used by the CMA, see Appendix E paragraph 73.

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

2.6 Second, whether there would be entry and expansion. In the present case, multiple sources of entry and expansion need to be considered: physical expansion by large existing competitors (namely by Aldi and Lidl); rivals further developing their smaller convenience stores; and further investment in online offerings (by both new and existing rivals). The CMA has recognised the growth in competition from Aldi and Lidl, and the changes in consumer behaviour to shopping more frequently at smaller outlets.[8]

2.7 Third, whether the merged firm would in practice worsen PQRS, even if they have 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 PQRS, and the risks that this could increase entry/expansion by rivals.

2.8 Fourth, whether a price increase by one party would lead to price increases by the other (these are referred to as "feedback" effects). 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 $D_{12}D_{21}M_{1.}$

2.9 This additional term is typically small if GUPPI is small. 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. (The only reason for mentioning this point is that feedback effects involving the parties are sometimes identified as a factor meaning that GUPPI understates the impact on prices.)

2.10 Fifth, how other competitors would respond if the parties worsen PQRS. GUPPI assumes that rivals do not respond by increasing their prices as well, and if rivals increase their prices then this may give the merged firm an incentive to increase prices further. 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 accommodation or coordination between the parties that may have existed, which might lead to GUPPI exaggerating the loss of competition between the parties. In this regard, we note that the CMA has provisionally concluded that the merger would not lead to anti-competitive coordinated effects as regards in-store groceries.[9] The CMA also cites no factual evidence that rivals would respond by appreciably worsening their own PQRS.

2.11 Sixth, the curvature of the demand curve since this affects how changes in incentives are passed through to consumers in the form of price increases. In this regard, the CMA observed that groceries demand has been assumed to be isoelastic since a 2005 merger decision in *Somerfield/Morrison*, and this means any change in incentives measured by GUPPI leads to an even greater price increase (i.e. pass-on exceeds 100%).[10]

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8 Paragraphs 15-16.

9 See paragraph 51.

10 The CMA notes that: "*An isoelastic demand curve has the same elasticity across all price levels – visually, it appears convex to the origin in price/quantity space*" (Footnote 219).

2.12 There is an important distinction between linear and isoelastic demand. Linear demand assumes that customers become more price sensitive as prices increase, which will thus tend to moderate any increase in prices following a reduction in rivalry between the merging parties. Isoelastic (i.e. constant elasticity) demand, on the other hand, assumes that customers' price sensitivity is the same at all price levels, and there is no "choke" point at which demand falls to zero. Accordingly, starting from any particular level of pre-merger prices and elasticities, demand for a product will fall more quickly as prices increase if demand is linear than if it is isoelastic. These peculiarities of isoelastic demand are well known. For example, in *Reckitt Benckiser/K-Y* (2015), where the CMA modelled the risk of price increases using linear demand, the CMA observed that:

> "*Alternatively, we could have assumed a constant elasticity demand curve. However, this demand curve has some counterintuitive properties, such as demand not becoming more elastic as price increases and that there is no price so high that demand falls to zero.*"[11]

2.13 The importance of this assumption of isoelastic demand can be illustrated by using a different measure of pricing pressure referred to as an illustrative price rise (IPR), which allows for feedback effects between the firms and makes an explicit assumption as to the curvature of the demand curve.[12]

2.14 If demand is linear, this results in IPRs that are materially lower than GUPPIs – if the diversion ratio is under 25% then only between 50%-67% of the change in incentives as measured by GUPPI are passed on to consumers in the form of higher prices. If isoelastic demand is assumed, then IPRs are materially higher than GUPPIs – well over 100% of the change in incentives as measured by GUPPI are passed on to consumers in the form of higher prices.[13]

2.15 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.

2.16 Given the points made above, in the next section we consider the merits of the CMA's provisional conclusion that a SLC may be expected in each area where GUPPI exceeds its defined thresholds.

3 What is the appropriate threshold for GUPPI to identify SLCs?

3.1 This section considers where the threshold for GUPPI should be set, such that a loss of competition measured by GUPPI is substantial. For the moment we assume there are no uncertainties

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11 *Reckitt Benckiser/K-Y* (2015), Appendix F, paragraph 7 and footnote 2.

12 If demand is assumed to be isoelastic 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, then this formula is MD/2(1-D). The term MD is simply GUPPI, with the remainder of the expression scaling this term up (in the case of isoelastic demand) or down (in the case of linear demand).

13 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% = 152%)), 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%.

associated with the measurement of GUPPI, which we turn to in Section 4. To address this question, it is necessary to consider a series of related questions:

(a) Why is a threshold needed?

(b) How should efficiencies be treated when setting the threshold?

(c) What net upward pricing pressure is the CMA applying as a threshold?

(d) What market shares does the CMA's threshold for intervention envisage as leading to a SLC?

(e) What is the CMA's factual evidence that GUPPIs as low as 2.5% in groceries may be expected to translate into substantial consumer harm?

3.2 For the reasons explained below, we do not consider it appropriate to set GUPPI thresholds of 2.5% and 1.5% for groceries and fuel respectively. This threshold is too low for intervention, and, if applied more generally, would prohibit a wide range of mergers in differentiated goods markets.

Why is a threshold needed?

3.3 The question of why any threshold is needed raises both legal and economics questions. In brief, at Phase 2 the CMA needs to have an expectation that there is a SLC in each local area identified, in contrast with Phase 1 where a "realistic prospect" test is applied. The economic questions this test poses relate to what is a substantial lessening of competition (as opposed to merely a lessening of competition, particularly given the nature of the GUPPI formula always being positive) and how uncertainty should affect the CMA's assessments.

3.4 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.

How should efficiencies be treated when setting the threshold?

3.5 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 costs and consequently the incentives to increase prices due to the loss of rivalry. The weighting of pro and anti-competitive effects means that mergers are only anti-competitive if they lead to *net* upward pricing pressure (UPP).

3.6 In *Sainsbury's/Asda*, for groceries the CMA provisionally rules out any anti-competitive effects from GUPPIs below 1% because of its provisional efficiencies estimate of 1%.[14] Accordingly, the CMA's analysis of efficiencies is a key driver of the threshold set. We agree that any GUPPI threshold should be increased where there are efficiencies, but cannot comment on the CMA's assessments of efficiencies due to the extensive redactions from the provisional findings.

[14] See paragraph 8.236.

What threshold is the CMA applying?

3.7 The CMA applies a GUPPI threshold of 2.5% in groceries and 1.5% in fuel. This is effectively an upward pricing pressure (UPP) threshold of 1.5% in both due to the acknowledged efficiencies of 1% in grocery retailing.

3.8 This is a low threshold for intervention. We are not arguing that a small deterioration in PQRS is somehow acceptable. However, any threshold set must recognise that all mergers between differentiated competitors lead to a positive GUPPI. As noted at paragraph 3.4 above, GUPPI will only be zero if the parties are not competitors (in which case there will be no loss of rivalry) or they operate on zero gross margins (in which case they will fail as their sales revenues will fail to make any contribution to their fixed costs).

3.9 The next sub-section considers what a GUPPI threshold of 2.5% equates to in terms of local market shares and diversion ratios.

What does a GUPPI of 2.5% mean in terms of local market shares and diversion ratios?

3.10 The CMA has redacted its estimates of the parties' gross margins. However, for the purpose of illustration in this submission we assume a gross margin of 25% for groceries. If this is the case, then a diversion ratio of only 10% will generate a GUPPI of 2.5%.[15] A diversion ratio of only 10% would mean that 90% of sales are lost to other competitors or consumers buying less. This diversion ratio can also be considered in market share terms.[16]

3.11 If two competitors that each have a market share of 10% merge, and diversion ratios are in line with market shares, then the diversion ratio between them would be 11.1% (10%/90%=11.1%). A combined market share of 20% or less would be a low threshold for intervention – particularly in circumstances where UPP is only 1.5%.

3.12 In *Somerfield/Morrison*, the Competition Commission (CC) identified three thresholds that all needed to be satisfied before a SLC was found[17]:

(a) The merger reduced the number of competing fascia from four to three or fewer.

(b) 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% = 14.3%). 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.

(c) The IPR based on isoelastic demand was at least 5%.

3.13 It is striking that the CMA now envisages finding a SLC in all overlapping areas where UPP exceeds 1.5% even if market shares and diversion ratios are low.

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15 This illustrative calculation assumes that the prices of the merging parties are equal (i.e. the ratio of their relative prices equals 1).

16 If, instead, gross margins were 20% (or 30%) then diversion ratios of 12.3% (or 8.4%) would generate GUPPIs of 2.5%. If gross margins were 25%, but the ratio of prices was 0.9 (or 1.1) instead of 1, then diversion ratios of 11% (or 9%) would generate GUPPIs of 2.5%.

17 See Chapter 7 of *Somerfield plc / Wm Morrison Supermarkets plc* merger inquiry (CC).

3.14 The CMA also cites three cases in which the Office of Fair Trading (OFT) found that there is a "realistic prospect" of a SLC where the GUPPI was below 5%. 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 relevant to consider why these adverse findings were reached:

(a) 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.[18]

(b) In *MRH/Esso* (2015), the OFT only found SLCs if GUPPIs were below 5% where diversion ratios exceeded 40-50%.[19]

(c) In *Shell/Rontec* (2012), the OFT relied on similar high diversion ratios to reach a SLC finding if GUPPI was below 5%.[20]

Accordingly, these cases do not seem to provide a good analogy that would justify a low GUPPI threshold being set in the grocery market, because the CMA appears to envisage finding a SLC in grocery markets even where diversion ratios are low.

Are adverse effects on consumers likely with an UPP of 1.5%?

3.15 The CMA's provisional findings considered whether adverse effects on consumers would not be expected despite some small positive pricing pressure. 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.[21]

3.16 The CMA emphasises that in *Somerfield/Morrison* the CC found demand for groceries was isoelastic, such that pass-through would likely be over 100%. The CMA also adds there is "*no reason*" for feedback effects to "*be particularly low*".[22] Both of these statements warrant comment.

3.17 First, the CMA cites no evidence that the demand for groceries in the UK is isoelastic and we are unaware of any such evidence. 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 some 13 years ago in *Somerfield/Morrison*.) In addition, isoelastic demand means that cost pass-through would be substantially greater than 100%. Both of these points are factual matters that the CMA could and should explore.

3.18 In addition, if demand is isoelastic, then more than 100% of efficiencies would also be passed on.

3.19 As regards feedback effects, the CMA seems to be justifying adopting a low UPP threshold of 1.5% as there is "*no reason*" for feedback effects to "*be particularly low*". Logically, the CMA would

18 *Jewson/Build Center* (2012), paragraphs 177-178.
19 *MRH (GB) / Esso Petroleum Company* (2015), paragraphs 64 and 77.
20 *Shell UK Limited / Rontec Investments LLP* (2012), paragraphs 104-106.
21 Paragraph 8.241.
22 Paragraphs 8.242-8.243.

need instead to have compelling evidence that feedback effects are particularly high, in order to justify a low threshold for intervention. In fact, the CMA cites no evidence of this.

3.20 As regards feedback effects between the parties, these are likely to be small (see paragraph 2.9 above). Moreover, in any event, 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. Similarly, if the CMA is concerned that competitors might respond by increasing their prices and this would increase the merged entity's incentives to increase its prices, it should advance evidence that appreciable effects can be observed in practice.

3.21 Finally, the CMA does not consider in any detail what operational consequences would arise if the parties were to allow PQRS to deteriorate. Nor does the CMA consider whether this would further accelerate the growth of Aldi and Lidl, who would have obvious incentives to target their efforts against now poorer performing rivals, or whether smaller convenience stores would expand. These considerations could offset small incentives to allow PQRS to deteriorate. These matters warrant detailed analysis.

Conclusions

3.22 In light of the above, we do not consider that setting upward pricing pressure thresholds at 1.5% for both groceries and fuel is appropriate to identify whether there is a SLC in local groceries and fuel markets, even if there was no uncertainty associated with measuring GUPPI. Section 4 considers the appropriate way of addressing the inherent uncertainties with using GUPPI to identify SLCs.

4 What is the appropriate way of addressing the inherent uncertainties with using GUPPI?

Introduction

4.1 The CMA has said that it is also concerned about "*false positives*" – that is the risk that it finds an SLC in an area, when in fact no SLC arises. Accordingly, the CMA states that it has set the GUPPI threshold at 2.5% and 1.5% for groceries and fuel respectively also to allow for some degree of uncertainty.[23] This section addresses the appropriate way of addressing these uncertainties and comments on some specific sensitivities associated with the CMA's estimation of GUPPI. In particular, the CMA appears to make a number of important assumptions that increase GUPPI, but without indicating how these individually and cumulatively affect the number of areas where it finds a SLC. Moreover, the CMA does not cite factual evidence to support these assumptions.

How should uncertainty be assessed and addressed?

4.2 Uncertainty cannot be assessed by simply asserting that estimates have been derived carefully. Uncertainty is also a function of how sensitive results are to small changes in assumptions and measurements, and how appreciable any potential errors might be.

4.3 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

[23] Paragraphs 8.247, 8.280(b), and 14.154.

measuring one variable are multiplied by the other variables. Second, estimating each of these variables is difficult however careful one is. If each component of GUPPI were to be overstated (understated) by only 10% (not ten percentage points), then GUPPI will be overstated (understated) by 33%.[24] Uncertainty may lead one to worry about false positives, false negatives and also simply being unable to distinguish between the two.

4.4 Turning to how appreciable errors might be, small differences in the estimated level of GUPPI make a substantial difference to the scale of the CMA's adverse findings. For example, if GUPPI for in-store groceries were to be overestimated by 0.5 percentage points (which is equivalent to the threshold being set even slightly higher at 3%, instead of 2.5%), this would reduce the number of local SLC findings by about 19 of the parties' convenience stores[25] (out of 65 where the CMA has found a SLC), and about 95 of the parties' larger supermarkets (out of 629 where the CMA has found a SLC).[26]

4.5 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 provisional decision to rely solely on GUPPI in identifying local SLCs as regards in-store groceries. 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 finding based on a careful review of local competitive conditions.

Sensitivities

4.6 It is good practice to test how sensitive the 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, and this may also highlight where more evidence needs to be gathered. Three striking areas where sensitivity testing at the level of individual stores seems appropriate are:

(a) The CMA's treatment of own-brand diversion and how this affects estimated Asda-Sainsbury's diversion.

(b) The accuracy of the CMA's weighted share of shops (WSS) methodology to estimate diversion ratios.

(c) Whether the CMA should adjust grocery gross margins to allow for the contribution made on general merchandise.

The CMA's treatment of own-brand diversion

4.7 In estimating diversion ratios, the CMA needs to decide how it treats own-brand diversion, which arises where consumers respond to the closure of a supermarket by switching to another local supermarket operating under the same brand (in-market diversion) and to other businesses

[24] $1.1^3 - 1 = 0.33$. If estimated relative prices are too high/low this will increase the GUPPI for one firm and reduce it for the other.

[25] See Figures 8.11-8.12.

[26] See Figures 8.9-8.10.

trading under this brand (supermarkets in other areas, convenience stores or online groceries, out of market diversion).

4.8 As regards in-market diversion, the CMA has excluded own-brand diversion to the parties' supermarkets[27] for the following reasons:

(a) Where the parties have multiple local stores, these might jointly worsen their PQRS, and thus the CMA argues that it is appropriate to exclude own-brand diversion.[28] However, the CMA actually has no factual 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.

(b) The CMA observes that if PQRS were to worsen at one store consumers 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 that the CMA should note. The CMA goes on to argue that, as a consequence, reported diversion between the parties will be understated as own-brand diversion reduces Asda-Sainsbury's diversion.[29] However, again the CMA has no factual evidence that these consumers would in fact divert to the other merging party, as opposed to other rivals.

(c) 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 the marginal diversion of consumers between the parties.[30] This statement is incorrect. Forcing consumers to switch stores will mean that all the diversion information 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 who 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 the diversion ratios for small changes in PQRS. (This is quite apart from the question of whether actual diversion ratios are the same as those based on consumers' stated responses to survey questions).

4.9 The CMA argues that its approach does not materially affect its estimate of national GUPPI, but that it had allowed for some overstatement of diversion ratios in setting its GUPPI threshold.[31] These statements are opaque. The CMA should report how this affects individual area GUPPIs and the diversion ratios applied.

4.10 In addition, the CMA takes a similar approach as regards out of market diversion, where the CMA allocates two additional percentage points of diversion in overlapping areas to the parties to capture out of market diversion to some combination of the parties' convenience stores, online groceries businesses or more distant supermarkets.[32] The premise that is being implicitly advanced here is that a consumer experiencing a deterioration in PQRS in a local Sainsbury's

27 Paragraph 8.185.
28 Paragraph 8.183(a).
29 Paragraph 8.183(b).
30 Paragraph 8.183(c).
31 Paragraphs 8.185 and 8.186.
32 Paragraph 8.176(c).

supermarket would switch to another Sainsbury's or Asda business. Again, this a questionable proposition for which the CMA advances no evidence, and it would be appropriate for the CMA to report how this affects individual area GUPPIs and the diversion ratios applied.

Survey evidence vs WSS

4.11 For non-convenience stores groceries sales, the CMA surveyed 100 of the parties' stores, with 80 of these being in concentrated overlapping areas.[33] 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.[34]

4.12 However, for all of the parties' other stores, the CMA estimated diversion ratios using a weighted share of shops (WSS) methodology.[35] This WSS approach is, at best, an approximation that may not well reflect consumers' actual choices, and this is a material source of uncertainty as to whether the estimated GUPPIs are accurate.[36] Accordingly, comparing actual diversion ratios from the surveys with the WSS methodology[37] would serve two useful purposes:

(a) First, it could illustrate whether the inherent uncertainties in the CMA's WSS methodology create potential for it to give inaccurate results.

(b) Second, it would identify areas in which anomalous results arise, and enable the CMA to identify potential improvements to its methodology if required.

Margin calculations

4.13 The gross margins used by the CMA include margins on complementary sales of general merchandise that the CMA estimates arise due to the parties' grocery sales.[38] The CMA describes

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33 Paragraph 8.101.

34 Paragraph 8.180.

35 This is described in some detail in Chapter 8 from paragraph 8.95 onwards.

36 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 stores trading under that fascia. However, this assumption appears to be untested, notwithstanding that the CMA has survey data across 100 stores. Second, consumers' choices of fascia do not depend solely on the fascia 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 5 minutes' drive. However, suppose that there is a large Tesco between these two stores. In this 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 fascia 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 observes 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).

37 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. Surveyed responses may, of course, differ from actual responses and 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 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.

38 Paragraphs 8.198-8.206.

this increase in estimate gross margins as "*material*". By increasing margins, this will increase GUPPI.

4.14 The implicit premise behind this margin assumption is that – when setting groceries' PQRS pre-merger – the parties take account of margins across groceries and complementary general merchandise sales. 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 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 look across the parties' store portfolio and test whether individual stores' unadjusted groceries margins *fall* materially as individual stores' general merchandise sales increase.

4.15 Given that GUPPI results would appear to be sensitive to the inclusions of these non-grocery margins, we would expect to see a sensitivity analysis and support for the inclusion of these margins. If groceries gross margins do not fall as general merchandise sales increase, then the CMA should not apply this adjustment to increase gross margins.

Conclusions

4.16 To sum up, concerns as to setting an UPP threshold of 1.5% are increased further by our additional concerns relating to the inherent uncertainties associated with the measurement of GUPPI and the CMA's reliance on GUPPI.

5 Conclusions

5.1 This submission has set out our concerns relating to the CMA's use of GUPPI in the *Sainsbury's/Asda* provisional findings in reaching its conclusions on SLCs in local areas.

5.2 We are not acting for any party in this merger. We have made this submission as we are in favour of predictable decisions where all conclusions are based on sound economics and industry-specific facts. Without this, future mergers may be deterred, even if they generate material pro-competitive efficiencies to the benefit of consumers. Many retailers are facing challenging market conditions, and merger efficiencies may be important to their survival and their ability to deliver value to consumers.

5.3 The CMA's GUPPI threshold for groceries (2.5%) is unreasonably low to identify SLCs. The threshold equates to upward pricing pressure of only 1.5% (as the other 1% is accounted for by efficiency savings recognised by the CMA). Moreover, this decision rule would – if applied in other markets - equate to prohibiting mergers between firms with market shares of perhaps as low as 10% each, even if gross margins are relatively low.[39]

5.4 Quite apart from a threshold of upward pricing pressure of 1.5% being too low to identify substantive competition concerns, this also does not reflect the inherent uncertainties associated with GUPPI. These concerns are increased by the CMA relying solely on GUPPI to identify local

[39] Assuming symmetry, and gross margins of 25%.

SLCs and various conceptual issues associated with its estimation of diversion ratios and its adjustment of groceries gross margins for general merchandise sales.

5.5 Accordingly, we encourage the CMA to revisit its GUPPI findings, and in particular the threshold applied, prior to reaching a final decision in this merger.