UPP: Up and Away?
The rising prevalence of pricing pressure indicators

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Where we were: A counting game!

- **Market definition**
  - Carried out more rigorously…
  - …or (often) less

- **Fascia counting**
  - 5 to 4 okay?
  - 3 to 2 bad?

- **Or market shares**
And now: A giant leap forward!

- IPR/UPP/GUPPI
- All have pros and cons
- But provide a better proxy of merger effects than before
- Much easier than merger simulation!
The basic idea

Merged A/B

Firm B

Firm A

P_A ↑

Firm C

D_{AB}

D_{AC}

Diversion to others
UK Experience of the IPR

- First used CC (2005) second phase inquiry into Somerfield/Morrison

- Instigated two-step process:
  - Define local catchment areas, and count fascias within these to identify potential problem area
  - Within these, calculate IPRs

- Since then, IPR methodology refined and applied by OFT, at first phase, in ten mergers
  - including recent use of asymmetric IPRs (Asda/Netto, 2010)
Implementing the IPR methodology

1. Diversion ratios
2. Gross profit margins
3. Assumed Demand function
4. Intervention threshold
Implementing the IPR methodology

1. Diversion ratios

● Can be derived in various ways:
  - Surveys
  - Econometric analysis of demand
  - Win/loss data
  - Event studies

● OFT most commonly uses the survey question:
  - What would you do if this product (or retailer) was unavailable?
Implementing the IPR methodology

- Costs treated as variable over time period and output increments that reflect competition
- Tricky issues for multi-product firms, where merger only relates to one product (but not insurmountable)
Implementing the IPR methodology

3. Assumed Demand function

**IPR formulae**

- \( \frac{md}{2(1-d)} \) for linear demand
- \( \frac{md}{1-m-d} \) for isoelastic demand

- \( md (=\text{GUPPI}) \) is very general
  - Differences relate to degree of pass-through

- **In practice:**
  - Isoelastic treated as ‘upper bound’ IPR
  - Linear treated as ‘lower bound’ IPR

- **OFT typically employs the former**
  - As appropriate for ‘cautious’ first phase

- **But can ‘pass-through’ be assessed directly?**
Implementing the IPR methodology

● OFT has applied 5% threshold for IPR
● No tolerance for price rises, but arguably allows for:
  - Unmeasured efficiencies
  - Measurement errors
  - ‘Illustrative’ nature of model
● More research would be useful!

Although the CC rationale was simpler:

“The CC defines a 5 per cent price rise to be ‘small but significant’ when defining markets and this therefore seemed a useful benchmark for this purpose”
Interaction of indicators and thresholds

![Diagram showing the interaction of indicators and thresholds with the Diversion Ratio on the x-axis and Gross Margin on the y-axis. The diagram includes lines for different thresholds: 5% Isoelastic IPR, 10% Isoelastic IPR, 5% GUPPI, and 5% Linear IPR.](image-url)
Not everyone likes this!

● **Concerns include:**
  - Too much work/cost involved
  - Too many implicit assumptions being made
  - Over-simplistic: no allowance for competitor reaction, product repositioning, or buyer power
  - Big measurement errors

● Some truth to these concerns - caveats are needed!

● But let’s not let the ‘best’ be the enemy of the ‘good’