

Critical loss analysis using customer surveys

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*Views expressed are mine only

Outline

- **Use of “low-tech” empirical analysis (i.e. critical loss analysis) for market definition in first phase UK merger control, using customer surveys**
- **Structure**
 - Critical loss analysis (CLA)
 - Three recent case examples, each of which highlights some issues implementing CLA using customer surveys
 - Conclude that CLA with customer surveys is simple & useful but not without complications

Three recent case examples

- Dunfermline Press/Berkshire Trinity Mirror (February 2008) – completed acquisition of portfolio of 6 local newspaper series & 5 other publications, cleared subject to divestment of one local newspaper
- Homebase/Focus (April 2008) – completed acquisition of 27 DIY stores investigated under own initiative, cleared subject to divestment of one DIY store
- Lovefilm/Amazon (April 2008) – anticipated acquisition in online DVD rental, cleared unconditionally on the basis of qualitative evidence from documents prepared in the normal course of business

CLA for market definition

- 'Critical loss' is percentage decrease in output that just makes a SSNIP by a hypothetical monopolist unprofitable
- 'Actual loss' is predicted percentage decrease in output in response to a SSNIP by a hypothetical monopolist
- If actual loss exceeds critical loss, market may be wider
- Advantage in first phase merger control: simplicity
 - Critical loss related to margins, which are simpler to measure than elasticities
 - Critical loss simple to calculate, i.e. $SSNIP / (\text{margin} + SSNIP)$
 - Actual loss can be inferred from margins (Lerner condition)
 - Actual loss can be measured using other (qualitative) sources, e.g. customer surveys

Dunfermline Press/Trinity Mirror – is the market only local newspaper advertising?

- **Estimate of critical loss [less than 13%]**
 - From parties' own detailed estimates of costs saved in response to loss of business
- **Estimate of actual loss greater than 13%***
 - From telephone survey by parties of over 300 advertisers in overlap areas (Slough, Windsor & Maidenhead) who were asked what they would do if all local newspaper advertising prices rose by 10% (SSNIP)
 - *13% would stop advertising, 48% would reduce advertising but survey did not reveal by how much
- **Actual loss exceeds critical loss, so market wider than newspapers**
- **Critical loss analysis in two-sided markets**
 - Actual loss cannot necessarily be inferred from margin data
 - How to capture "price" increase to readers for free titles?

Lovefilm/Amazon – is the market only on-line DVD rental (ODR)?

- Estimate of critical loss [20-30]% based on margins
- Estimate of actual loss [30-40]%.
 - From on-line surveys by parties of over 2,000 ODR customers who were asked what they would do if all ODR prices rose by 10% (SSNIP)
- Actual loss exceeds critical loss, so market wider than ODR
- But would a “one price” SSNIP be more appropriate?
 - Lovefilm + Amazon combined 93% ODR market share
 - Amazon’s customers had their cheaper ODR tariffs “grandfathered” into the deal
 - Critical loss is higher for a “one price” SSNIP because some sales divert to Amazon when Lovefilm’s prices go up
 - Estimate of “one price” SSNIP critical loss [30-40]%, no longer less than actual loss of [30-40]%

Homebase/Focus— is the market only local DIY “sheds”?

- **Two market definition questions**
 - Product (“sheds” only or also category specialists?)
 - Geographic (local or national?)
- **Estimates of critical loss based on margins by product category (e.g. DIY, decorating, garden, furniture)**
- **Estimates of actual loss from face-to-face surveys of around 1,700 shoppers in 12 local overlap areas who were asked what they would do if the Focus DIY shed had been shut**
 - Survey asked about DIY shed shutting rather than about SSNIP because “consumers do not understand percentages”
 - Survey did not ask about all local DIY sheds closing, only Focus shed. However this “aggregate diversion ratio” can also be used in CLA
- **Actual loss does not exceed critical loss for all product lines in 10 overlap areas out of 12, so market no wider than local DIY sheds**

Conclusions

- **CLA using surveys is a simple & informative tool for market definition**
 - Important in 3 recent OFT clearances
- **However, examples illustrate complications**
 - CLA in two-sided markets
 - CLA with “one price” SSNIP
 - CLA with “aggregate diversion ratio”
 - Hypothetical questions in customer surveys
- **Consequently, CLA always considered in the context of other evidence**