

# **OFT Response to the review of impact estimation methods**

January 2010

OFT1164r

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# 1 INTRODUCTION

- 1.1 This paper sets out OFT's response to some of the key issues raised by Professor Stephen Davies in his report that reviews OFT's impact estimation methods.<sup>1</sup>

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<sup>1</sup> See OFT1164, A review of OFT's Impact Estimation methods, January 2010.

## 2 OFT RESPONSE TO KEY FINDINGS OF THE REVIEW

- 2.1 The OFT would like to thank Professor Stephen Davies for the insightful points raised in his review of OFT's impact estimation methods.
- 2.2 Overall, the review provides a very positive endorsement of the bulk of the OFT impact estimation methodology. One of Professor Davies's conclusions is that, 'work in this area puts the OFT amongst the leaders worldwide. The (OFT) methodology is well-informed by the academic literature. Inspection of the detail of the methodology, when applied to individual cases, reveals due rigour and prudence.' The report also suggests some possible modifications to the OFT methodology.
- 2.3 Below we set out OFT's response to some of the key points raised in the review.

### High level issues

- 2.4 'It is assumed throughout that **no intervention had a negative impact**. This is justified as follows: 'all interventions..., not overturned on appeal, are warranted, we implicitly assume that the institutional structure is sufficient to ensure that any incorrect decisions or planned decisions are identified and corrected' (Positive Impact 08/09 para 1.12). While this could also be justified by pointing to the otherwise conservative nature of the methodology, it does presume a zero probability of Type 1 errors (false 'conviction').'

### Response

We welcome Professor Davies's views. However our current approach, in our opinion, is a reasonable one as doing otherwise would amount to second guessing appeal decisions. Should a particular decision get overturned on appeal, we will exclude it and revise our impact estimates accordingly.

- 2.5 'I recommend that OFT should conduct some internal research exploring the feasibility of establishing upper and lower bounds, to supplement the existing emphasis on a single point estimate...The lower bound might be

equated to the traditional rule of thumb values (one per cent in mergers, 10 per cent in cartels), but extended to all areas of policy if possible, the upper bound, more controversially, might include an allowance for deterrence. One virtue of this approach is that there would no longer be the need to constrain the 'best' estimates to be 'conservative'.

#### Response

We will consider reporting a range of estimates in future Positive Impact notes.

### **Mergers**

- 2.6 'My main concern is with the assumptions made about the magnitudes of the industry elasticity... With demand relatively inelastic, predicted price increases will tend to be potentially very high. I suggest that the spirit of conservatism would be better captured by employing the most elastic value in the elasticity range, and/or by extending the range beyond -1.5, perhaps to -1.75 or -2... Furthermore, no allowance is made for efficiency savings from the mergers. My own preference would be to include a ball-park assumption of say a 3 per cent efficiency saving reflected in marginal cost.'
- 2.7 'This (above) is off-set by two other questionable assumptions which work in the opposite direction: (i) a 20 per cent transfer of impact to CC even for mergers in which CC is not involved, and (ii) a 35 per cent scaling down to allow for the possibility that an SLC would not have been found had mergers been referred to the CC.'

#### Response

The OFT will consider presenting the mergers impact estimates as 'reasonable' rather than conservative in future Positive Impact notes. We will explore the possibility of doing further work in this area by reviewing academic literature for meta-analysis of magnitudes of estimates of demand elasticities. We do not expect this to materially affect our methodology. We will also consider the suggestion of taking into account efficiency savings in our merger simulation model.

We welcome Professor Davies's comments about the transfer of impact and scaling down assumptions. We recognise that this raises a number of questions, but these assumptions were agreed after in depth discussions with relevant CC and OFT Economists. We, therefore, do not intend to revise them.

### **Competition enforcement**

- 2.8 '...a 10 per cent default might be interpreted either as a practical lower bound, or as a **very** conservative estimate. For the sake of argument, 15 per cent might be a more appropriate figure ... OFT's recent modification for (estimating duration of) older cartels is imaginative and in keeping with its policy of drawing on the results of academic research... bearing in mind that most survey articles suggest a median lifespan of cartels of between five and eight years (for example, Levenstein and Suslow, 2007), I am unconvinced that this modification is really necessary. On a practical note, it has yet to be applied in the Positive Impact since no cartel uncovered in this period has been sufficiently long-lived.'

#### Response

We will consider revising the default price rise to 15 per cent for future cases where case specific information is not available and also our assumption about longer expected future duration for longer established cartels.

### **Consumer protection**

- 2.9 'OFT has introduced a new methodology based on the effects of the interventions on the numbers of complaints. While this is innovative and imaginative, the practical experience from 08/09 suggests that this should be interpreted with caution. The overall impact, as estimated, is very small and inspection of the data reveals that the methodology does not work for a large proportion of cases.'

## Response

We consider this method as work in progress and will continue to develop it. We will draw from the recent London Economics evaluation report on Consumer Protection case studies<sup>2</sup>. We are piloting a consumer toolkit that aims to gather more case specific information to estimate impact of our consumer enforcement work, with the intention of moving away from a method that relies solely on complaints data.

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<sup>2</sup> See OFT1139, Evaluation of a Sample of Consumer Enforcement Cases, October 2009.