

COMPETITION COMMISSION



# Buyer Power, Consumers and Competition Enforcement

Peter Davis

Deputy Chairman

Competition Commission

June 2011



## Overview – buyer power arguments in cases

### 1. Mergers

- CC: Stonegate-Deans (Eggs, 2007)

### 2. CC's Groceries Market Investigation (2008)

- NB: “Ongoing” : Draft legislation for Groceries Code Adjudicator recommended by CC (published May 2011)
- Today I will:
  - focus on vertical issues (CC report also examined horizontal issues – eg local market concentration)
  - remind you of some of the evidence CC collected.



## Buyer Power and Theoretical Ambiguities

- “Quantity Reductions” or “Demand Withholding” can be bad for final consumers
  - Buyer exercises monopsony power and reduces quantities of inputs purchased to benefit from lower unit price – and harm consumers. **Example:** Saw-mill
- “Price reductions” can be good for final consumers
  - Buyer power can reduce the unit price paid for inputs which in turn may, **if passed on**, cut final goods prices – and benefit consumers.
- Economics ambiguous about the net welfare effect of the exercise of buyer power - *but economic theory has helpful “if-then” propositions that can be related to specific cases*



## Buyer Power and downstream incentives

- Harm from downstream market power may sometimes be **reinforced** by buyer power exercised on the input markets (see eg Dobson, Waterson and Chu (OFT, 1996))
- Potential for a “double sided” incentive to reduce quantity below competitive levels :
  - Upstream – buy fewer (eg., eggs) to reduce unit input cost paid
  - Downstream – sell fewer (eg., eggs) to reduce output and hence generate monopoly rents
- Each effect tends to increase margin available from exploiting market power - and distortions reinforce each other



## Stonegate-Deans (CC Merger Inquiry, 2007)

- Completed merger of two leading 'egg packers' .
  - Egg packers purchase eggs from farms and put them in egg boxes and sell them to supermarkets .
  - NB: There's a degree of vertical integration/long term vertical contracts
- **Concern1: Downstream market power in sale of packed eggs**
  - Mintel estimates suggest pre-merger share of retail egg market : Deans = 44%, Stonegate =28% so post-merger share = 72%. Fringe suppliers: Fridays, Oaklands , Glenrath (NB: fringe were local players, family owned)
- **Concern 2: Buyer power in upstream markets (eggs)**
  - Upstream buyer power with respect to farmers (in parts of the South-West) who regarded merged firm as having become the 'only route to market'

# COMPETITION COMMISSION

## Countervailing (supermarket) Buyer Power?



- NFU/some farmers said:
  - merger would improve bargaining position vis a vis supermarkets
- Supermarkets said they didn't have bargaining power and in a tough place:
  - Eggs were a KVI / 'must stock' item
  - Hard to switch large volumes to available alternative suppliers – given (i) availability of eggs to other suppliers and (ii) remaining suppliers are local, family run businesses
  - They had a limited ability to import (shell) eggs – because not 'Lion marked' [retailers alternative source of supply unclear]
- CC decisions:
  - Agree supermarkets have some countervailing buyer power but not convinced it's enough to mean egg packer's merger is ok.
  - Parties required to unwind the completed merger.



## CC Groceries Market Investigation

- Six Commissioners – the decision takers
- Staff – up to 30 staff with expertise in competition, economics, business strategy, statistics, law
- Evidence received through hearings, submissions, staff meetings, surveys, company document reviews
- Statutory basis for investigation: Enterprise Act 2002 so we have information gathering powers and also remedies powers – subject to judicial oversight.
- In broad terms we ask:
  - **Stage 1:** Is there a competition problem?
  - **Stage 2:** If there's a competition problem, what is a suitable comprehensive solution (remedy)?



## Context – UK grocery retailing

- Many different types of grocery retailers:
  - 8 large grocery retailers (Asda, Sainsbury's, Morrisons, Tesco, Co-op, M&S, Somerfield, Waitrose) with national chains that include large, mid-sized and convenience stores
  - 3 major discount chains (Aldi, Lidl and Netto) that sell a limited range of goods (Limited Assortment Discounters)
  - numerous symbol group retailers (franchise-type operators) such as Spar and Costcutter that primarily operate convenience stores
  - many smaller retailers, particularly in convenience store sector
- Annual UK grocery sales in 2006-07 was approx £110 billion
  - 85% of sales by the national grocery retailers, including 65% by the four largest (Asda, Sainsbury's, Morrisons, Tesco)





## Summary of CC's findings

- Groceries market is basically delivering a good deal for consumers.
- But ...
  1. **Horizontal Issue:** Areas of high local market concentration and barriers to entry resulting in local market power
  2. **Vertical Issue:** The effect of buyer power combined with ex-post hold-up and contractual incompleteness can lead to a misalignment of incentives for investment in supply chain
  3. **CC Decided targeted remedies** were appropriate
    - Vertical: Imposed GSCOP and Recommended: Adjudicator
- NB: Obviously CC's Findings should not lightly be 'read across' to other jurisdictions (or indeed to other retail markets within the UK)



## Vertical Issue: Role of Buyer Power

- Must construct a potential ‘Hypothesis of Harm’ and confront the hypothesis with evidence.
- CC Examined three “Hypotheses of Harm” around buyer power
  - **Hypothesis 1:** “Demand Withholding” (reduction in quantity)
  - **Hypothesis 2:** “Share shifting waterbed effects” - bigger retailers buyer power means they get lower prices and smaller retailers pay higher prices – which in turn drives ever bigger share of retail market to bigger retailers and the cycle continues.
  - **Hypothesis 3:** Buyer Power adversely affects incentives for investment within the supply chain [The focus today]



## Supplier Pricing Evidence (1)

### GfK Supplier survey:

Interviews with 456 Suppliers (chosen suitably from a supplier population of 3,800 firms on lists of

<i>Customers from whom the <u>lowest</u> gross margins are received</i>		<i>Customers from whom the <u>highest</u> gross margins are received</i>	
Any of four largest grocery retailers	53%	Any of four largest grocery retailers	22%
Any other grocery retailers	17%	Any other grocery retailers	27%
Wholesalers/buying groups	8%	Wholesalers/buying groups	12%
Independent retailer	6%	Independent retailer	34%

Source: Table 9.1 CC final report

1. Clearly big-4 getting lowest supplier margins from lots of suppliers
2. But – also providing highest margins to a material number of other suppliers

# COMPETITION COMMISSION

## Supplier Pricing Evidence (2)



### Emails – Review of circa 100,000 emails

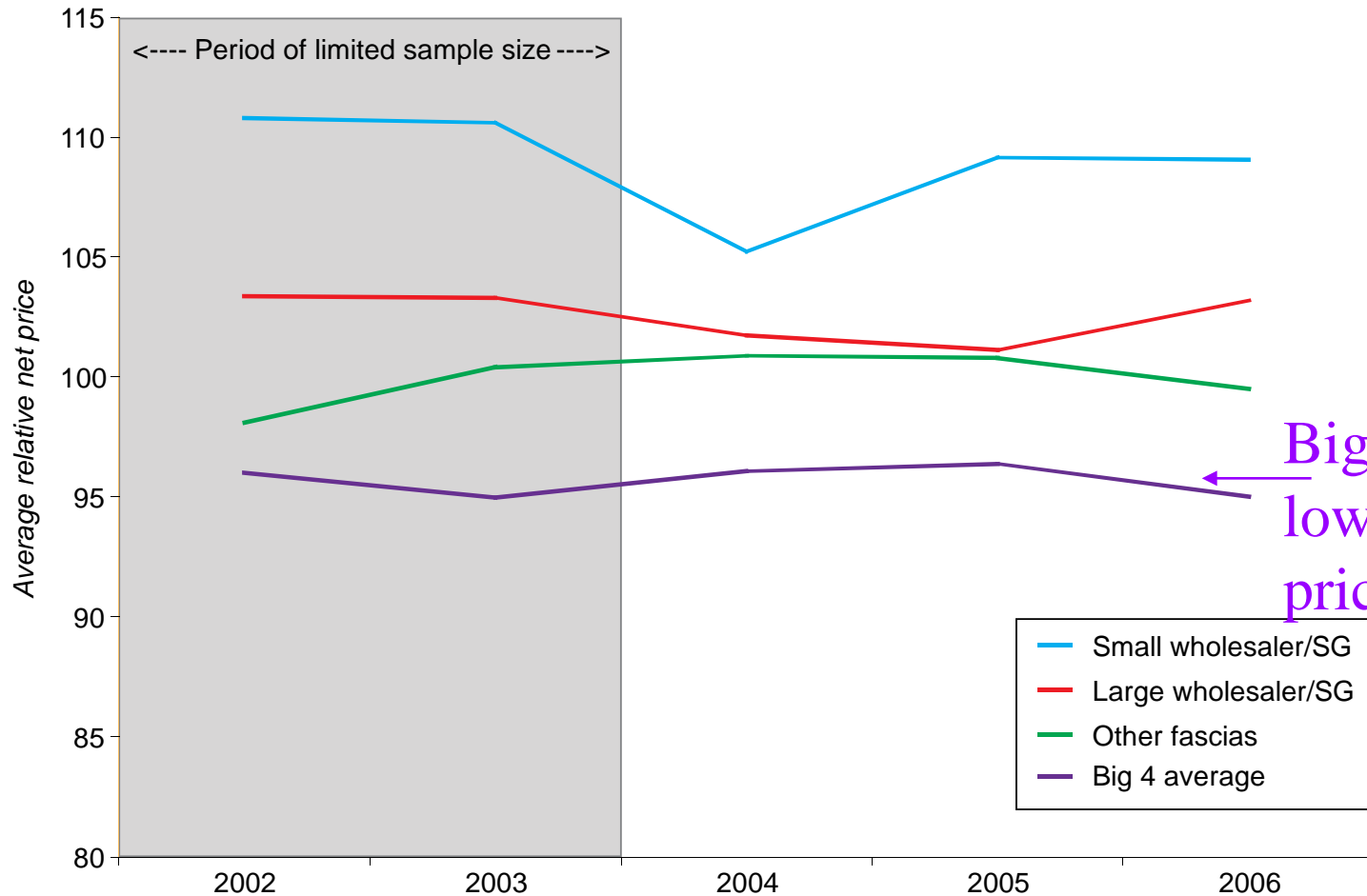
between ASDA/Tesco and their suppliers suggested that they were in a strong position when negotiating with their suppliers.

### Supplier Data

- CC collected detailed pricing, volume and (where possible) cost data from 29 suppliers recorded at the SKU level for a period of up to five years. The data covered 141 branded-SKUs, representing £1.8bn annual sales at wholesale prices. This was equivalent to approximately 2 per cent of total UK groceries sales.
- Examined various pricing measures: eg 'raw' unit prices and average prices 'net' of lump-sum discounts



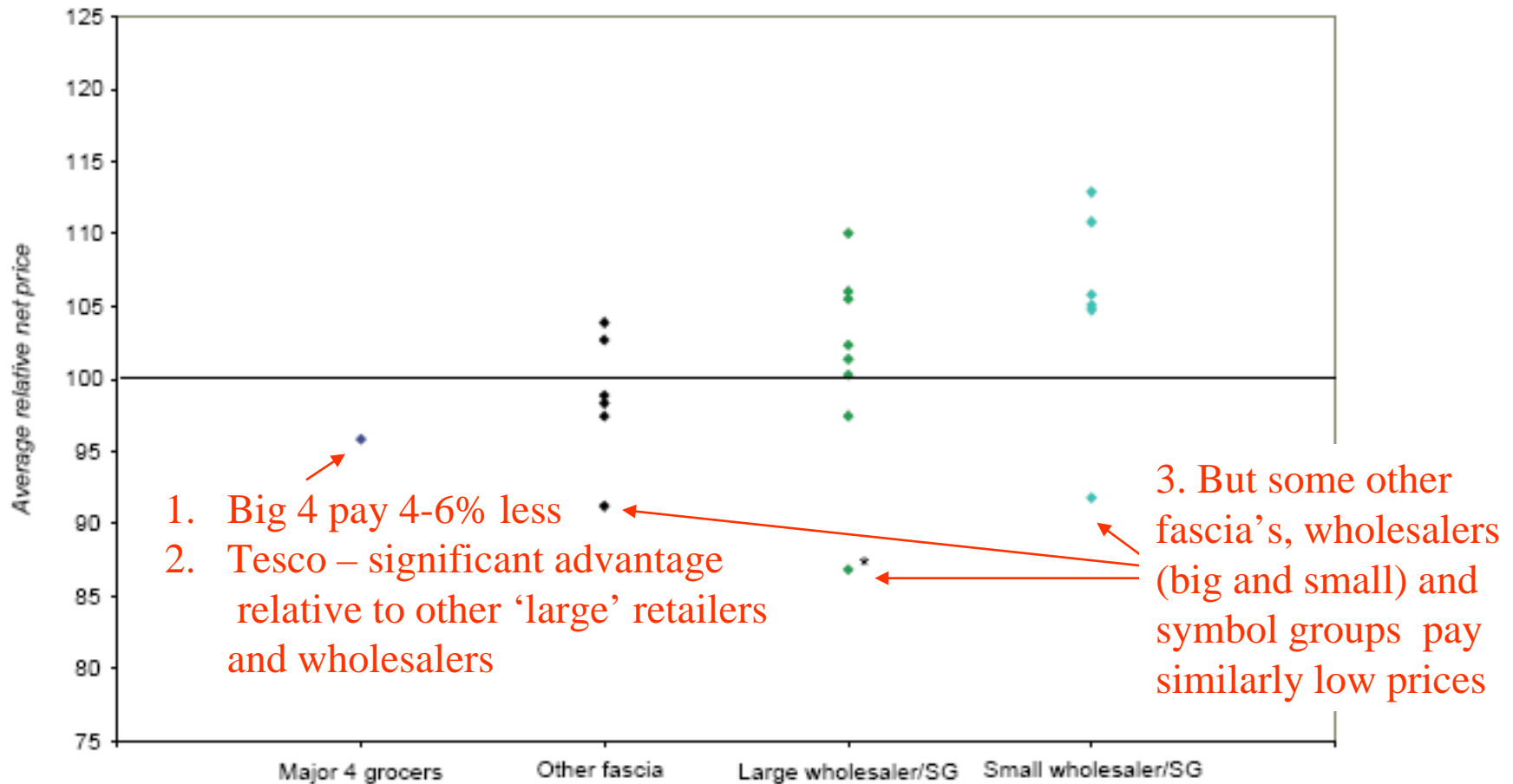
## Average net supplier price by grocery retailer



Big 4 get materially lower average prices



## Average net supplier price by grocery retailer



Source: CC analysis – Final Report, Appendix 5.3, Figure 2(b).

\*This result is only underpinned by 13 observations.



## Buyer Power and Supplier Pricing: Conclusions

1. Overall, bigger retailers pay lower unit prices to their suppliers
  - E.g., very small customer (10% of average volume) expected to pay 3.4 per cent above the average price whereas a very large customer (3 times average volume) expected to pay 7.4 per cent below the average price. (Statistically significant differences)
2. But retailer size isn't everything – some smaller retail chains and also wholesale groups manage to get lower supplier prices!
3. The estimated effects are much smaller for leading branded goods:
  - No relationship for one of the price measures ('unit price')
  - Much smaller differential between very large and very small buyers using 'net price' than for the pooled data
  - Consistent with the idea that producers of primary branded products are strong enough to resist countervailing buyer power



## HoH3: Requires Buyer Power, Contractual Incompleteness and Ex-post Hold-up

- Refined Hypothesis of Harm 3: Retailers can engage in ex-post holdup – renegotiation of contractual terms (eg prices) after investments are ‘sunk’. Suppliers know this and the consequence is under-investment by suppliers.
- Typical market led Solutions (reasons HoH3 may not hold water)
  1. Vertical integration or long term contracts (eg., coal mine and electricity generator)
  2. Reputation - if holdup by retailer is possible, both retailers and suppliers would value a retailers reputation for not doing it. Retailers’ long-term interest is in supplier’s investing and innovating – but short term incentives may dominate...





## A wide variety of specific concerns were raised by suppliers

- From 380 specific concerns raised by suppliers and supplier associations
  - Circa 50% related to the transfer of **excessive risks** or **unexpected costs** from grocery retailers to suppliers
  - Circa 30% about requirements for **retrospective payments** or other adjustments to previously agreed supply arrangements
- Examples
  - **Excessive risk**: Eg., if retailer imposes liability on suppliers for 'shrinkage' (eg theft) of stock at depots or stores – a supplier cannot easily improve security at a retailers depot!
  - **Unexpected costs**: Eg., retailers sometimes imposed sizable charges on suppliers due to customer complaints without giving any opportunity to verify basis of complaint (or that responsibility was suppliers)
  - **Retrospective payments** : Retrospective price adjustments or retrospective financing of promotions

# COMPETITION COMMISSION

## GfK Survey Evidence of suppliers



- Interviews with 456 Suppliers (chosen suitably from a supplier population of 3,800 firms on lists of suppliers to 11 largest grocery retailers )
- Retailer behaviour reported to be common – and less so among retailers covered by SCOP

	<i>All grocery retailers</i>	<i>Four grocery retailers covered by the SCOP</i>	<i>Increased frequency over past 12 months %</i>
Delays in receiving payments from a grocery retailer substantially beyond the agreed time	48	28	37
Required to make excessive payments to grocery retailers for customer complaints	48	36	40
Additional services required in relation to packaging and distribution	37	29	49
Requested price reductions for products soon before or after delivery	37	26	58

*Source: GfK, Research on suppliers to the UK grocery market, A report for the Competition Commission, January 2007.*

**Table 9. 3: Suppliers reporting various practices carried out by grocery retailers in past five years**



## Other Evidence

- Not all evidence pointed towards the combination of buyer power, contractual incompleteness and ex-post hold-up being a problem
  - **Supplier profitability:**
    - No indication of a systematic problem with the financial viability of food and drink manufacturers
    - Evidence from UK farming sectors far less clear cut – significant exit observed, although as a result of a variety of possible causes
  - **Evidence on product innovation:**
    - Did not indicate a declining trend in recent years – although difficulty is ‘counterfactual’ - remains possible the level of innovation would be even higher in a well-functioning market.

## Conclusion on HoH3



- In summary, the CC did find evidence of:
  - Buyer power
  - Contractual incompleteness (unspecified contractual contingencies)
  - Ex-post renegotiation of contractual terms (eg prices) paid to suppliers
  - Apparently sometimes poorly aligned incentives in supply relationships
- In consequence the CC decided it was appropriate to:
  - i. Impose an Order to introduce an enhanced Groceries Supplier Code of Practice (GSCOP) , and
  - ii. Recommend the government legislate to introduce an Ombudsman/Adjudicator to resolve disputes under GSCOP

## Conclusions



- As often the case – at a high level there’s theoretical ambiguity about welfare effects of buyer power
- But economic theory is helpful in outlining the ‘if-then’s’ needed to establish harm in a given case
- The details will matter when deciding whether a case for ‘harm’ is properly made out
- Important remaining question about the proper threshold for competition agency intervention – eg., should standard be to show incentives or effects (on eg., investment.)



## Notes: Vertical Remedies 1 - GSCOP

- The Groceries Supplier Code of Practice (GSCOP) – is a strengthened version of the previously existing Supermarkets Code of Practice
  - Came into force on 4<sup>th</sup> February 2010
  - Applies to grocery retailers with annual turnover  $\geq$ £1bn
  - Provisions of GSCOP must now be included in every contract between major grocery retailers and their suppliers
    - Overarching fair dealing provision
    - Written records of agreements on terms of supply
    - Prohibition on retrospective changes to terms of supply
    - Prohibition on suppliers' liability for shrinkage
    - Dispute resolution with binding arbitration and compensation/liquidated damages

## Notes: Vertical Remedies 2 – Ombudsman/Adjudicator



- **February 2009:** CC formally recommended the establishment of an Ombudsman/Adjudicator to UK government to:
  - Act as a binding arbiter between retailers and suppliers in relation to disputes arising under GSCOP (NB: Retailer must submit to independent arbitration at the suppliers request if the dispute cannot be resolved inter-party.)
- **August 2010:** UK Government publishes the response to its consultation on the topic – and announced an intention to bring forward primary legislation to implement the Groceries Code Adjudicator (GCA)
- **May 2011:** Publish draft bill.

## References



- **CC:** Groceries MIR final report available from:  
[http://www.competition-commission.org.uk/rep\\_pub/reports/2008/538grocery.htm](http://www.competition-commission.org.uk/rep_pub/reports/2008/538grocery.htm)
- **BIS:** Link to UK government draft bill for the Groceries Adjudicator  
<http://www.bis.gov.uk/assets/biscore/business-law/docs/d/11-936-draft-groceries-code-adjudicator-bill.pdf>
- **Academic Article:** May also be helpful to look at the summary (primarily of the evidence relating to the CC's adverse findings) in the journal article:  
**Davis, P. and Reilly, A. (2010)** "Market power, market outcomes, and remedies in the UK groceries market", *Agricultural Economics*, Vol. 41, No. s1.