Buyer Power, Consumers and Competition Enforcement

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Overview – buyer power arguments in cases

1. Mergers
   - CC: Stonegate-Deans (Eggs, 2007)

2. CC’s Groceries Market Investigation (2008)
   - 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
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**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
- **Concern 1:** 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’
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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.
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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]
GfK Supplier survey:
Interviews with 456 Suppliers (chosen suitably from a supplier population of 3,800 firms on lists of

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

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
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

**Source:** CC analysis – Final Report, Appendix 5.3, Figure 4 (b).

Big 4 get materially lower average prices
1. Big 4 pay 4-6% less
2. Tesco – significant advantage relative to other ‘large’ retailers and wholesalers
3. But some other fascia’s, wholesalers (big and small) and symbol groups pay similarly low prices.

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
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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

<table>
<thead>
<tr>
<th></th>
<th>All grocery retailers</th>
<th>Four grocery retailers covered by the SCOP</th>
<th>Increased frequency over past 12 months %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delays in receiving payments from a grocery retailer substantially beyond the agreed time</td>
<td>48</td>
<td>28</td>
<td>37</td>
</tr>
<tr>
<td>Required to make excessive payments to grocery retailers for customer complaints</td>
<td>48</td>
<td>36</td>
<td>40</td>
</tr>
<tr>
<td>Additional services required in relation to packaging and distribution</td>
<td>37</td>
<td>29</td>
<td>49</td>
</tr>
<tr>
<td>Requested price reductions for products soon before or after delivery</td>
<td>37</td>
<td>26</td>
<td>58</td>
</tr>
</tbody>
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Table 9.3: Suppliers reporting various practices carried out by grocery retailers in past five years
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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 4th February 2010
  • Applies to grocery retailers with annual turnover ≥£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
• **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.
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References

• **CC:** Groceries MIR final report available from:
  http://www.competition-commission.org.uk/rep_pub/reports/2008/538grocery.htm

• **BIS:** Link to UK government draft bill for the Groceries Adjudicator

• **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: