

CRA Competition Memo



Buyer Power

Buyer power is a recurrent issue in competition investigations. Depending on the context, it can be seen in either a positive or a negative light. In the former category, it is often argued (sometimes not very convincingly) that customers could use buyer power to resist attempts by a merged firm to increase prices. This memo focuses on the latter category, which involves the possibility that the superior purchasing power of large firms can distort market outcomes. Worries over excessive buyer power are closely linked to increasing concentration in a number of retail markets across Europe. There has been a concern that large retailers can act as 'gatekeepers' to scarce shelf space, allowing small suppliers only limited leverage in negotiations.

The impact of buyer power on competition has been explored in two recent competition inquiries. First, the UK Competition Commission (CC) has recently published the results of its 18 month inquiry into competition in the domestic supermarket sector.¹ Second, the European Commission has issued its Decision in the *Carrefour/Promodes* merger. We examine below the analysis of buyer power undertaken in each case.

What is 'buyer power'?

First, however, it is necessary to explore what is meant by buyer power. The textbook approach in economics is to use the pure monopsony model, in which a single buyer purchases from a number of small and identical sellers. This produces the standard result that the monopsonist restricts its purchases to suppress the input price to below the competitive level. This provides the insight that a firm with complete buyer power might be able to reduce the purchase of inputs to below the (more economically efficient) competitive level. Monopsony power can be seen as the 'mirror image' of seller market power: both involve a net loss to the economy as a result of a restriction in output. But the textbook monopsony model offers little predictive power for the analysis of real world situations.

More useful definitions have focused on a firm being able to achieve 'more favourable terms' from suppliers than other buyers. This is a reasonable starting point but again offers only a limited insight and it tells us nothing about the impact of buyer power on economic efficiency. For example, does a large purchaser have buyer power because it gets a better deal from a supplier than a smaller purchaser? If so, this tells us little about either economic efficiency (the discount might be cost related) or the potential detriment to the

supplier firm (the supplier might prefer to sell all of its output to a single purchaser). Thus the impact of buyer power needs to be assessed on a case-by-case basis. The analysis should involve a detailed assessment of the likelihood of a distortion of competition in both upstream and downstream markets. There should be no presumption that the existence of buyer power *per se* is detrimental to competition.

The UK supermarket inquiry

Concern over excessive buyer power was one of the factors that prompted the CC investigation into the UK supermarket sector. The CC's analysis covered both the supermarkets' relationships with suppliers and the extent to which the downstream market was competitive. The investigation of the latter included an analysis of price trends over time, international price comparisons, profitability and consumer satisfaction. The CC concluded that there was no evidence of excess prices or profits and that the market was 'broadly competitive'.

The CC's analysis of supplier relations was equally comprehensive. One of the chief complaints against the supermarkets had been that lower wholesale prices in certain product categories (particularly meat products) had not been passed on to consumers and this was cited as evidence of the adverse impact on consumers of the large retailers' buyer power. For meat products, the CC found that cost reductions at the supplier level had been passed through to retail prices or, where they had not, that there had been cost increases elsewhere in the supply chain. The CC acknowledged that in a competitive market most of the impact of shocks to the farming industry (such as the loss of confidence of consumers in the safety of British beef) would fall on the farming industry rather than retailers.

In other areas, however, the CC was critical of the large supermarkets in their dealings with suppliers. It identified a number of practices (such as requiring suppliers to pay for better product positioning within stores) which it believed could be detrimental to competition in supplier markets. The CC recommended that a mandatory Code of Practice (with provisions for independent dispute resolution) be drawn up to address its concerns. The impact that the Code will have on the functioning of the market remains to be seen. However, any Code that leads to continued recourse to third parties to resolve disputes would impose costs on both parties which would be passed on to consumers. It is conceivable that a system designed to protect suppliers from excessive buyer power could lead to consumers paying higher prices.

¹ Lexecon Ltd acted as economic consultants to Asda.

The Carrefour/Promodes merger

Buyer power was also a central issue in the European Commission's assessment of the merger of the supermarket chains Carrefour and Promodes. With a combined share of around 30% of food retail distribution in France, the merger did not raise issues of single firm dominance. Collective dominance was also ruled out. The Commission argued, however, that the buyer power which the merger would create could distort competition. It identified two related mechanisms: the 'spiral effect' and the 'threat point'.

- **The 'spiral effect'**

The 'spiral effect' stems from volume-related discounts. The greater size of the merged firm would lead to a larger volume-related discount. This would enable it to offer lower prices, undercutting those offered by smaller rivals. This in turn would increase the merged firm's market share, which in turn would raise the volume of its purchases, which would enhance its buyer power through a higher volume-related discount and so on. However, the Commission's concerns appear hypothetical. No attempt was made to assess the magnitude of the discounts on offer. Such an assessment would determine the extent to which the merged firm could cut prices and would also give an insight into the likelihood of market exit by smaller firms. Also, no convincing explanation seems to have been provided to explain why the 'spiral effect' had not occurred pre-merger: if the Commission's hypothesis were correct, the largest firm pre-merger would have expanded rapidly to the detriment of smaller players.

- **The 'threat point'**

Having noted the possibility of the spiral effect, the Commission then attempted to test the likelihood of buyer power having a detrimental impact on the upstream market by identifying the 'threat point'. This is defined as the maximum share of revenues that a supplier can afford to lose without a very serious risk of being driven to bankruptcy. Survey evidence indicated an average threshold of 22%. The Commission argued that a supplier is in a position of 'economic dependence' on a buyer when this threshold is exceeded as loss of this business could lead to bankruptcy. Again, this proposition is unconvincing. Any supplier who risked losing a substantial contract would investigate whether alternative buyers could be found or, if options were limited, would consider the feasibility of downscaling its business. Even if it exists, the 'threat point' is likely to vary widely even within a product category and is only a very loose proxy for relative bargaining power. Bargaining power is clearly not proportional to market share: once a buyer could force the seller into bankruptcy, further increases in the size of the buyer do not increase its bargaining power.²

² From the supplier's perspective, the first lethal bullet is the only one that matters. In other words, the buyer's threat does not become *more* credible after the point at which bankruptcy of the supplier is possible.

The whole approach departs from established modern analysis of bargaining, where it is Party A's potential loss relative to that of Party B, if bargaining should break down, that is crucial.

Overall, neither the 'spiral effect' (which concerns the possible downstream effects of buyer power) nor the 'threat point' (which concerns the possible upstream impact) provides a robust approach to assessing the impact of buyer power on competition. In both cases the Commission has used these devices as a means of raising competition concerns arising from a merged firm's relative size at market share levels below those associated with single firm dominance.³

Conclusion

Buyer power is often claimed to give rise to competition concerns, particularly in relatively concentrated retail markets, but the economic basis for these claims is often weak. In both cases cited above there was little or no evidence of consumer detriment resulting from buyer power. This is not to suggest that the behaviour of large buyers should be of no concern to competition authorities. There are several ways in which purchasing behaviour by large firms can have adverse effects on competition. One example is powerful retailers making purchase conditional on the supplier not providing the same product to a downstream price discounter. Another is buyer behaviour which increases entry barriers at the supplier level. Both of these could have a serious detrimental impact on consumers. But in practice this is not where the recent focus has lain, which gives rise to a concern that the analysis of buyer power by competition authorities has not placed sufficient emphasis on the likelihood of consumer detriment.

This is particularly relevant to the analysis of mergers. As a broad rule of thumb, if downstream markets remain competitive post-merger and competition in upstream markets is not distorted, then consumers should benefit from buyer power. In the *Carrefour/Promodes* case, most of the Commission's concerns essentially related to the absolute size of the merged entity: no convincing argument was presented to suggest that buyer power would adversely affect either downstream competition or the functioning of the supply market. Buyer power arguments were used to suggest that a post-merger market share of 30% could still raise serious dominance concerns. Whatever the drawbacks of this approach, this case suggests that in future greater emphasis is likely to be placed in merger cases on possible anti-competitive effects arising from increased buyer power.

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³ The merger was approved by the Commission with conditions, including structural commitments which addressed concerns raised about buyer power.