The Economics of Buyer Power and Retail Alliances

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What are RA?

...searching for some general features...

Retail Alliances (in short: RA): characteristics

We focus on RA which aim at enhancing the buying business of member retailers (abstract from industry associations)

RAs have many forms, but share always some features:

- RA is not a merger: members remain independent (supply structure in final consumer markets does not change)
- Members operate parts of the buying business jointly or delegate parts of it to a centralized organization (changes buying structure in intermediary goods markets)
- Members are often heterogenous

Many Formats of RA: *range from small retailer cooperatives to large buying joint ventures*

(see Bailey et al. 1995, OFT/RBB, 2007, for examples)

- *cooperative of small retailers* (power is democratic - not centrally controlled)
- *first party governed centrally controlled buying club* (large founder and small members; membership fee or tax-like payments)
- *third-party governed centrally controlled buying club* ("procurement service provider")
- *buying joint venture* (for example, large national grocery chains/national buyer groups combine to create European wide buyer groups)
- Others: *groups of groups*, *contract specific consortia*, *symbol groups*...

RA: range from "passive" to "active"

Question is whether RA establishes a genuinely new player in the intermediary goods market (like a merger) or whether the RA mainly serves to enhance the option set of its members for *given market data*. Call the former an active RA and the latter a passive RA.

Passive RA: RA enhances option set of members and members keep discretion about their purchasing decisions

- combine purchasing volumes to obtain (posted) rebates (or to secure better terms on product quality, availability, delivery)
- realize efficiencies (e.g., logistics, delivery, marketing services)
- gain size to strenghten private labels

RA: range from "passive" to "active" - cont'd

Active RA: members delegate (parts of) the purchasing business to the central buying office of the RA

- central office of RA becomes negotiating party vis-à-vis powerful suppliers (RA charges service royalty? or negotiates more?)
- members remain typically independent and negotiate decentrally
- Purchasing economies/buyer power mainly through threat of joint decision to stop negotiations.

Again, **different formats/organization structures** to consider...

Interim summary: RA appear as **relatively weak (rather passive than active) organizations** when compared with large supermarket chains or international discounter-chains.

Services of RA to members

At an abstract level, a RA can provide the following services concerning negotiations with suppliers (besides helping to realize other scale efficiencies)

- providing information (e.g., listing of producers' offers; no pooling of volumes/no active RA)
- pooling volumes (to meet suppliers' preferences for large scale buyers/to obtain posted rebates and to coordinate promotions)
- negotiating (delegation of parts of buying business to RA to enhance bargaining position)

Caveat: One should keep in mind that the functioning and effectiveness of the internal structure in terms of its market impact may vary strongly between different RAs. In any case, we cannot expect it to function like it would in case of a merger (meaning that its competitive effects are always limited).

Economic Incentives behind RAs

1. direct negotiation efficiencies

2. response to price discrimination

3. enhance bargaining position as catch-up competition

4. creating buyer power

1. Direct negotiation efficiencies: *transaction costs economics*

- savings of transaction and contracting cost (on both side); economies of standardization
- better coordination among buyers (overcome free-riding problems among buyers) and enhanced vertical coordination (promotions, new product introduction and sales); in addition: make **private label production** possible
- guarantee volume for suppliers (reduce uncertainty): induces productive efficiency by allowing for larger minimum efficient scale
- more efficient logistics, warehousing (avoid duplication of delivery costs)
- reduce switching cost b/o economies of scale in switching/search

1. Direct negotiation efficiencies: *transaction costs economics - cont'd*

- increase contracting efficiency to overcome **double-mark-up inefficiency** because of restriction to linear wholesale price
- non-linear tariffs become feasible for larger volume RA (Marvel/Yang, 2006: positive feedback on supplier competition)

Strong price-theoretic argument for RA:

- large volumes make bilateral contracting feasible which increases output levels and reduces final consumer prices (Tirole, 1988)

2. Response to price discrimination: Volume discounts

Question: Why do suppliers offer better terms to larger buyers? Answers based on price discrimination and bargaining theory.

Larger buyers get better deals because...

- they have more elastic (derived) demands (i.e., more able to substitute between products/suppliers) (aggregate demand has to be more elastic than individual demand)
- they avoid "marginalization" in bargaining when supplier costs are increasing (Chipty/Snyder, 1999 and Inderst/Wey, 2003)
- they have better outside options (have the ability to switch suppliers or to integrate vertically) (see Katz, 1987 and Inderst/Wey, 2011)
- suppliers have worse outside options when facing large volume buyers; e.g., because the loss from re-allocating a large quantity increases overproportionally (see Inderst/Wey, 2008).

2. Response to price discrimination: Third-degree price discrimination

A supplier charges to different buyers different prices according to their derived demands. A RA can have a **price-unifying effect** which directly constraints the supplier's pricing power. Two constellations:

- **competing but asymmetric retailers** obtain more equal price: in general ambiguous price effect (Katz 1987; umbrella effect of bargaining power tends to benefit consumers; Baye et al. 2016, welfare improving when retailers are differentiated).
- **retailers in different (national) markets** with different demands/competitive intensity form RA: may limit the extent of third-degree price discrimination which is in general welfare improving (Schmalensee 1981). (see ECB, 2014/2015 for relevance of price discrimination in Euro area)

3. Enhance bargaining position as catch-up competition

RA becomes new player acting on behalf of its member (but still governance issue). Induces strategic buying and active negotiations with suppliers for discounts and better contracting terms.

Develop countervailing power to supplier power:

- Galbraith's (1952) idea: in bilateral bargaining over a linear price countervailing (buyer) power reduces input price and increases output (Aghadadashli et al. 2016)
- counter naked exclusion of efficient suppliers through buyer coordination (Rasmusen et al. 1991): RA helps to invite new entry
- destabilize supplier cartels through strategic buying with large volumes (Snyder 1996)

3. Enhance bargaining position as catch-up competition - cont'd

Catch-up with dominant rival retailers (quasi-vertically integrated international retail/discounter chains)

- creates second sources and invite supplier competition
- invest in setting strengthening private label production
- establish competitive tendering of private labels
- counter raising rivals' costs & waterbed effects induced by (quasi-) vertically integrated rivals (Ordover et al. 1990, Inderst/Valletti 2011)

4. Creating Buyer Power: monopsony (as an irrelevant benchmark)

Assumes optimality of rationing of demand to exert monopsony/oligopsony power to lower uniform wholesale price.

Model requirements:

- perfectly competitive supply with upward sloping supply function & linear market price
- implies under oligopsony lower prices for *all* retailers
- fails when monopsonist's supply is very elastic
- fails when monopsonist can target suppliers for bilateral negotiations (which is the rationale behind buyer power in retailing!)

4. Creating Buyer Power: monopsonistic overbuying

Assumes that monopsonist overbuys to raise wholesale price and to raise rivals' costs downstream

Model requirements are as under monopsony above; in addition:

- rival retailers must be less efficient (higher input-output ratios) (Salop/Scheffman 1983)
- similar raising rivals' cost logic arises without upward sloping supply and single supplier when retailer sets wholesale price and requires most-favored customer clause (Dertwinkel-Kalt et al. 2015)

As the monopsony model, this approach is not instructive to understand buyer power in **bilateral negotiations**.

4. Creating Buyer Power: striving for dominance/monopolization

Prerequisite: Theories of harm rely on assuming almost perfect gatekeeper power of retailer, which is not realistic in many EU markets.

- maximize rent-shifting from suppliers through auction-like mechanism at the expense of variety; for instance, a franco-german RA commits to buy only one sort of sour cucumbers (Inderst/Shaffer, 2007)
- **But:** this requires homogenous interests among members of RA (unlike to be true if RA is international)
- AND the induced allocation is inefficient so that there are strong re-negotiation incentives casting doubt on its stability in the real world.

4. Creating Buyer Power: striving for dominance/monopolization - cont'd

Require exclusivity and impose raising rivals costs externalities on rival buyers (foreclosure and waterbed effects).

- **But:** renegotiation problem with foreclosure argument
- AND waterbed effect can only occur when the supplier finds it optimal to charge a higher price from the rival retailer which is now disadvantaged in the final product market (rather the opposite is realistic so that rivals are likely to get better prices).

4. Other (theoretical) arguments against buyer power

- **harming supplier's outside options** so to make **suppliers dependent** (for instance, RA becomes gatekeeper and very large; or, RA requires specific investments)
- If true, then the result is a lower input price which should benefit consumers because of pass-through even in case of downstream monopoly power.
- **But** competition law prevents RA which create gatekeeper power. Why should a supplier agree to make specific investments when expecting hold-up?
- AND Dependency can also backfire, when buyer becomes pivotal for the supplier's viability (Raskovitch 2003)

4. Other (theoretical) arguments against buyer power - cont'd

- harms **innovation incentives of suppliers**
- **But:** more competition increases incentives due to the replacement effect (see Tirole 1988)
- Inderst/Wey (2003, 2007, 2011) show how large buyers induce larger incentives by dominant suppliers: for instance, by avoiding marginalization in bargaining, the supplier bears a larger share of marginal costs creates incentives to lower them.)

4. Other (theoretical) arguments against buyer power - cont'd

- induces a **spiral of monopolization**: assume unlimited economies of scale.
  But: neglects decreasing economies of scale and the incentive effect of competition on productive efficiency in retailing. When competition among retailers is harmed, then the incentive to achieve purchasing efficiencies is by large absent.

Conclusions: Recall Background Developments in the Food-Retailing Business

- Emergence of large retail chains (*"Walmart" phenomenon*)
- Emergence of (international) discounters chains with quasi-backward integrated private label business: (*"Aldi"-phenomenon*)
- Low barriers to entry in retailing (or: absence of gatekeeper power): continuous entry and exit as well as emergence of online retailing (*"Amazon"-phenomenon*)
- Strong food supplier conglomerates with must have brands (*"Nestle"-phenomenon*)
- Restructuring of brick-and-mortar-retailing (*One-stop-shopping-phenomenon*)

Conclusions: RA as catch-up competition

–> strong competitive pressure on traditional stationary retailing

–> need for restructuring investments (larger outlets, parking space, logistics etc.)

–> increase in minimum efficient scale

–> need for efficient buying organization

RA by large respond to competitive environment:

- transaction cost economies
- response to volume discounts and price discrimination practices by suppliers
- pass-on of cost savings is guaranteed b/o strong competition in retailing
- competition law allows for a balanced assessment

Conclusions on Economics of RA & Buyer Power

- RA induce more efficient contracting (transaction cost economics) which is to some extent even in the interest of suppliers and unambiguously benefits consumers
- RA are response to existing size advantages in procurement and to powerful suppliers' price discrimination strategies; which is again to the benefit of consumers
- RA are a form of catch-up competition which levels the playing field on the buying side; again with mostly pro-competitive effects
- Even if RA create genuine/dominant buyer power, existing theories of harm are either irrelevant (monopsony) or highly speculative (auction mechanisms; foreclosure/waterbed effects)
- Even when RA creates strong buyer power then there should be positive effects on supplier investment/innovation incentives.

Conclusions on Agribusiness

- profitability of farming depends on the entire value chain (this includes input markets for agricultural production like seeds, feed, fertilizer, pesticides)
- RA do not exert monopsony power but allow for negotiations
- RA increases the ability to contract with innovative agricultural businesses to contain powerful suppliers
- worst case appears to be the small passive retailer selling branded goods supplied by some few firms

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