

COMPETITION COMMISSION
GROCERIES MARKET INQUIRY

AMENDED

ECONOMISTS' ROUND TABLE ON
SUPPLY CHAIN ISSUES

held at
Victoria House, Southampton Row, London WC1B 4AD
on Tuesday 10 October 2006

PRESENT:

FOR THE COMMISSION

Mr Peter Freeman - Chairman
Ms Barbara Donoghue
Professor Alan Gregory
Professor Alan Hamlin
Professor Bruce Lyons
Dr Peter Davis

FOR THE STAFF

Mr John Davies - Chief Economist
Mr John Kirkpatrick - Inquiry Director
Ms Kate Collyer
Dr Benoit Durand
Ms Kirsten Edwards
Dr Nicola Mazzarotto

INVITED GUESTS

Professor Roman Inderst
Mr Miguel de la Mano
Dr Thibaud Verge
Professor Michael Waterson
Professor Dr Christian Wey

1 John Davies: Good morning everyone. Welcome to the Competition
2 Commission and particularly welcome to our five invited
3 guests who are joining us today to conduct this Economists'
4 Round Table Session on the Supply Chain and buyer power.

5 I am John Davies. I am the Chief Economist on the
6 staff at the Competition Commission and I will be chairing
7 today's session.

8 In a moment I will ask the people on this table to
9 introduce themselves for the sake of the transcript and
10 briefly to describe their relevant expertise in the area in
11 the case of our five panellists. Then I will indicate some
12 of the other people in the room who are on other tables.
13 Then I will make a few housekeeping points about how the
14 business of the day is to be conducted and then we will get
15 straight into the discussion.

16 Could I ask you to introduce yourselves please,
17 starting with Professor Bruce Lyons?

18 PROFESSOR BRUCE LYONS: I am Bruce Lyons. I am a Professor of
19 Economics and also a Member of the Commission sitting on
20 this Inquiry.

21 A. (MR MIGUEL de la MANO) I am Miguel de la MANO. I am a
22 Member of the Chief Economist team at the European
23 Commission.

24 A. (PROF DR CHRISTIAN WEY) My name is Christian Wey. I am a
25 Professor at the Technical University in Berlin. I am also
26 leading a unit at the German Institute for Global Research,
27 which is named Information Society in Competition and I am
28 working on buyer power problems. I started working in 1999
29 on buyer power problems and mergers and supply chains. I
30 work as an academic on these issues.

31 A. (DR THIBAUD VERGE) I am Thibaud Verge. I am a researcher
32 at the centre for Research in Economics and Statistics at
33 the National Institute of Statistics in Paris.

34 MS KIRSTEN EDWARDS: I am Kirsten Edwards. I am a staff
35 Economist at the Competition Commission and I am working on
36 the Groceries Market investigation.

1 MR JOHN KIRKPATRICK: I am John Kirkpatrick. I am the Inquiry
2 Director on the Groceries Market investigation here at the
3 Competition Commission. I think I am the sole non-
4 economist at this table.

5 DR NICOLA MAZZAROTTO: I am Nicola Mazzarotto. I am an
6 Economic Adviser at the Competition Commission.

7 A. (PROF ROMAN INDERST) I am Roman Inderst. I was Professor
8 of Economics and Finance at the LSE until September and
9 from 1 October I am Professor of Banking in Frankfurt.
10 However, my interest is still very much in Retailing and I
11 am still Visiting Professor at the LSE.

12 A. (PROF MICHAEL WATERSON) I am Michael Waterson. I am a
13 Professor of Economics at the University of Warwick and I
14 have done work in the area of buyer power. I am also a
15 member of the Competition Commission but I am not on this
16 Inquiry.

17 John Davies: Thank you, Mike. That is an important point.
18 Mike is here in his capacity as an academic giving
19 evidence, whereas Bruce, who is also an academic and also a
20 member of the Competition Commission is a member of the
21 team receiving the evidence.

22 A. (PROF MICHAEL WATERSON) It is like a supply and demand
23 framework!

24 John Davies: There are five other members of the Competition
25 Commission deciding this case, three of whom are here
26 today: Barbara Donoghue, Peter Freeman, Chairman of the
27 Inquiry and of course also Chairman of the Competition
28 Commission, and Professor Alan Gregory. Also in the room
29 today we have Dr Peter Davis, who is the newly appointed
30 Deputy Chairman of the Competition Commission but not
31 involved in this case, and I will also mention Benoit
32 Durand, who is one of the Deputy Chief Economists here at
33 the Competition Commission and chaired yesterday's session.
34 We had a similar event looking at pricing and market
35 definition. I hope today's session goes as well.

36 We also have a guest in the audience in Dr Stanley
37 Wong from the Irish Competition Authority where he is a

1 director and a member of the Authority. I understand ICA
2 is interested in the grocery market from time to time.
3 Welcome to you, Sir. We are delighted to have you here.

4 I did not ask our panellists to declare any conflicts
5 for the record because you have all submitted full
6 disclosures and as far as I can see there are no conflicts
7 at all, which is good.

8 There are a few housekeeping points. As you will have
9 seen we are taking a transcript today. We intend to
10 publish that transcript. Before we do so, all the
11 participants today will receive a draft copy of the
12 transcript to enable you to correct any mistakes in
13 transcribing what you say. If you want to change or
14 further comment on what you say as opposed to simply
15 correcting the accuracy of the transcript, then you are
16 very welcome indeed to do so but please do that in a
17 separate note rather than by correcting the transcript.
18 That is something we always say in Competition Commission
19 hearings. I think it is probably true that today we are
20 particularly keen that the participants, if they wish to,
21 should jot some thoughts down on paper after the day. It
22 may well be that things come up in discussion but do not
23 fully get resolved in that discussion or thoughts occur to
24 you after the event. If you can put anything down on paper
25 to round off the day I think that would be extremely
26 useful. Again we would ideally be looking to publish that.

27 Now as to how we are going to structure the
28 discussion. I will chair it.

29 Since we are having a transcript clearly only one person can
30 speak at one time but equally we do not want this to be a
31 day in which people are in lecture mode. I think the
32 biggest benefit we can get out of today will come from the
33 interaction between you. You have all written papers.
34 Many of them we have read I think. I have a big pile here
35 and there are other piles around the place, so we can read
36 the unchallenged thoughts relatively easily. But what we
37 do not get from reading papers is the interaction and the

1 challenge. I would particularly encourage you - if you
2 feel that something said is not the full story, for example
3 - to leap in and discuss it with the person. We do not
4 need to be too formal about how we conduct today's events
5 and I hope we will get a good discussion.

6 At this point in our Inquiry we are still entirely in
7 listening mode. The Competition Commission has reached no
8 conclusions whatsoever on the Grocery market at this stage.

9 We have three topics that we are going to discuss
10 today, all related to the supply chain. The first is buyer
11 power and how it might arise and manifest itself. The
12 second is how it might affect end consumers and then the
13 third relates to specific practices, such as vertical
14 agreements and a few other specific practices, things like
15 slotting, category captaincy, and so on.

16 We will try to keep the discussion within those three
17 areas. I appreciate that in particular the first two might
18 blend in rather to one another.

19 The way we are going to structure each session is that
20 first of all Kirsten will lead off with a very quick
21 overview of what we think are the issues that we are
22 interested in discussing. I will then hand over to one of
23 you who has been asked to act as the first speaker and
24 speak for five or ten minutes or so on what you see as the
25 key issues in that case. We have also in each case
26 designated one of you to be the first respondent, just to
27 get the discussion going, and from then on we will open it
28 up.

29 We have until 1 o'clock, so we have a bit less than an
30 hour for each topic. We hope to take a coffee break around
31 about 11.45 so we might well aim to do the first two topics
32 before the coffee break, but we will see how it goes. We
33 do not need to be rigid about that.

34 I think those are all the housekeeping points I have
35 to make, so over to Kirsten to talk about the first topic
36 and then I will hand over to Mike Waterson to introduce it.

37 MS KIRSTEN EDWARDS: Thank you.

1 As John has just said, I am going to give a brief
2 introduction to each of the issues for discussion at
3 today's round table and as set out in the discussion paper
4 that was sent to you we would like to discuss three broad
5 topics.

6 First, whether retailer buyer power may distort
7 competition in upstream (procurement) markets. Second, the
8 potential adverse effects of retailer buyer power on the
9 downstream retail market. Finally, whether the nature of
10 certain vertical agreements between retailers and their
11 suppliers may have anti-competitive effects.

12 In each case we are interested in the theoretical
13 support for each relevant theory of harm, its applicability
14 to the UK groceries market and the empirical evidence that
15 the Competition Commission could use to examine each
16 relevant theory.

17 The first issue for discussion today is the effect of
18 buyer power on upstream markets. How does buyer power
19 arise in the UK groceries market(s) and how might it be
20 measured?

21 If retailers have buyer power, they may be able to
22 withhold demand to reduce the market input price. This may
23 reduce consumer welfare if retailers also have downstream
24 market power, as quantity supplied to consumers is reduced.

25 However, if upstream suppliers have market power, there
26 may be some countervailing effect, such that stronger
27 buyers actually improve consumer welfare.

28 Alternatively, if prices are negotiated individually,
29 then retailers' *outside options* - their ability to switch
30 to other sales channels or to backward integrate - may
31 influence the input prices they achieve. Substitution might
32 be more credible for the buyer and less credible for the
33 supplier as the buyer increases in size.

34 When powerful buyers negotiate input price reductions
35 there may be an effect on upstream product variety or
36 process innovation, as the upstream suppliers have less to
37 invest and may expect lower future returns from investment.

1 An alternative view is that suppliers may have more
2 incentive to reduce their cost base so that their larger
3 buyers are less able to switch away their source of supply.

4 The Competition Commission will need to consider - the
5 structure of the industries supplying grocery retailers;
6 the price-quantity setting mechanisms; whether there is
7 evidence either of demand withholding or of price
8 differentials between consumers and, if so, how consumer
9 welfare is affected.

10 Against this background, and in the context of the UK
11 groceries market, the panel may wish to offer their views
12 on the following:

- 13 * What factors contribute towards a greater exercise
14 of buyer power?
- 15 * What are the best measures of buyer power?
- 16 * Can buyer power lead to retailers purchasing less
17 than the competitive amount?
- 18 * Under what conditions could this lead to
19 significant consumer welfare loss?
- 20 * And, finally, does buyer power reduce innovation?

21 John Davies: Thank you, Kirsten. Professor Waterson?

22 A. (PROF MICHAEL WATERSON) I wrote down a number of rather
23 scrappy thoughts which you have got as a sheet of thoughts
24 and a diagram which I thought might be useful to fix some
25 ideas.

26 When I was thinking about this, I was thinking, well,
27 essentially if you look at the groceries market and the
28 firms that the grocers purchase from, there are two
29 different types of groups. There are some areas where they
30 purchase largely from relatively small firms and so you
31 have got a powerful buyer facing essentially a competitive
32 market, or a near to competitive market selling, where
33 there are other areas where there are powerful sellers on
34 the other side of the market and that naturally you would
35 expect different sorts of behaviour in these two cases.
36 Maybe - I do not know - but different sorts of analyses
37 would be appropriate here.

1 If the market upstream is very unconcentrated then you
2 could think of there being a supply curve from the
3 suppliers and then if the buyers recognise that the supply
4 curve is upward sloping, or if it is upward sloping and
5 they recognise that, then the buyers will realise that
6 there will be a marginal supply curve which they can set
7 equal to their derived demand and so they can act in a
8 monopsonistic sort of way, and that is illustrated in the
9 diagram by the relationship.

10 If we think of the supply curve as being marginal cost
11 (MC), then the marginal effective cost as far as a
12 monopsonistic buyer is concerned will be the curve labelled
13 MFC and so the monopsonistic buyer - I am assuming for
14 simplicity that there is just one - will set marginal
15 factor cost equal to marginal revenue product, that is
16 derived demand, and then buy at a price which is on the
17 supply curve and so make a profit in a mirror image to a
18 monopoly sort of buyer. You would get a cut back in
19 demand. If you were thinking about how this might manifest
20 itself in practice, because effectively the buyers are
21 buying less than they otherwise would, then I do not know
22 whether it would be too far fetched but you could think of
23 it as the buyers being very picky about what they will
24 take, so effectively they shade back their purchases in
25 order to get them at a cheaper price. That is one
26 mechanism.

27 Then alternatively, and of course you would not
28 normally get just one buyer, you would normally get several
29 buyers and so you would have to modify the framework to
30 account for that, so you would get an oligopolistic type
31 buying arrangement.

32 Alternatively, if you have got powerful buyers facing
33 powerful sellers, then you would expect some sort of
34 bargaining to take place between the two.

35 I think academic economists are in some considerable
36 difficulty here because we do not really know very much
37 about what is bargained over in general - and different

1 people have different views. I know Thibaud's former
2 supervisor, Patrick Rey, has a very firm view about this,
3 which is not everyone's view, about what is bargained over.

4 But the problem is we do not know whether the bargain is
5 generally just over price or whether it is over price and
6 quantity or, a third possibility, whether it is only over
7 price, but there is some implicit quantity in the back of
8 everyone's mind which would be more or less equivalent to
9 being over price and quantity.

10 The limited experience I have suggests that it is
11 commonly about price, but there are some elements in which
12 you could say it is about price and quantity.

13 The problem is that you get very different results. We
14 are in an unfortunate position here because these sort of
15 things are not normally very observable. I have suggested
16 in the notes that they might be more observable to people
17 in the Commission who see more of the detail of this
18 revealed by parties who come to talk to you than academics
19 generally see.

20 There are potentially two rather different mechanisms
21 and you might hope or think that one would collapse to the
22 other as market power on the selling side, say, reduces to
23 a low level.

24 That is one challenge for academics. I would argue
25 that one challenge for academics is that we build these
26 models, but actually I was reminded yesterday about
27 Sherlock Holmes. "It is a capital mistake to theorise
28 without data", but actually a lot of us do that.

29 John Davies: Let's try not to do too much of it today then!

30 A. (PROF MICHAEL WATERSON) No. I am just being frank, in a
31 way, as an academic economist.

32 I think that in a sense you will know more about the
33 nature of the bargaining process than we are likely to do
34 so you will be able to use appropriate tools, given that
35 you know what the supermarkets have told you and what the
36 sellers have told you about the way in which bargaining
37 goes on. As I say, it is quite important because results

1 can be significantly affected by this.

2 I have also put down there that I do not think there
3 is actually a very good structural measure of buyer power.

4 People did play around some years ago with various
5 measures of buyer power. I remember doing so some years
6 ago, or a little while ago when I was a boy! But it is
7 difficult to think of an appropriate measure. You could by
8 analogy with selling markets have some sort of Herfindahl
9 type index, but I do not think there is any very good
10 theoretical reason to do that in this area. Other people
11 may take a different view.

12 Another thing I was thinking about - as I say these
13 are to quite a large extent random thoughts that occurred
14 to me - was one of the main reasons why you might get
15 bargaining power is because people have incurred costs *ex*
16 *ante*, so if people have not incurred costs *ex ante*, they
17 are actually in a relatively strong position. But if they
18 have incurred costs then they have to find some way of
19 recovering that and because they have to find some way of
20 recovering that, that puts them in a relatively weak
21 position because they have got to try and gain something
22 back. It seems to me that the greater the extent to which
23 the firms have sunk costs prior to the bargain, the more
24 awkward the position they get themselves into.

25 The last point I would make is the issue about buyer
26 power and innovation.

27 This is very reminiscent to me of quite an old debate
28 about monopoly, competition and the incentive to invent.
29 In that debate there was a long argument - a rather futile
30 argument - about whether it was better to invent in a
31 monopoly industry or to invent in a competitive industry.
32 The argument was about how you could capture the rents. I
33 think one way to see the resolution of that debate was that
34 if you have a mechanism for capturing the benefits of your
35 intellectual property, like a patent or whatever, then
36 actually your inventing for a competitive industry is
37 probably better than inventing for a monopolistic one.

1 It depends crucially not on anything particular to do
2 with buyer power, but much more to do with the extent to
3 which you have ownership of your intellectual property. In
4 a market where you are one amongst a number of sellers
5 there are potentially very powerful incentives to reduce
6 costs if you can keep hold of that technology which enables
7 you to do that and I guess that is the crucial thing, so
8 what does it consist in rather than what the structure in
9 that market is.

10 Anyway, as I say, those are my somewhat random
11 thoughts about the various issues.

12 John Davies: Thank you, Mike. That is a really good start. I
13 think we have asked Christian Wey to be the first
14 respondent - without any sight of Mike's presentation.

15 PROF DR CHRISTIAN WEY: Thank you.

16 I think Mike has already touched on several points
17 which are clearly important. First of all, one has to
18 distinguish the supply side, whether it is fragmented or
19 whether it is concentrated and then rather different
20 models, in a sense, apply. On the one hand one may apply
21 the monopsony/oligopsony picture. On the other hand one
22 really has to dig into bargaining issues and then all the
23 trouble comes with what do they bargain about. What about
24 distribution of information? What do they know? And the
25 problems. Then it starts to become hard.

26 Let me start a little bit differently. With buyer
27 power they must have changed something in the economic
28 environments, so their buyer power emerges. One has to
29 ask, first, where does it come from. Of course size plays
30 an important role and, as was mentioned in your own paper,
31 the marginalization of the other bargaining party plays an
32 important role. In a sense, large retailing creates a lot
33 of efficiencies in kinds of scale and scope and on the
34 input market side of course the larger retailer is able
35 somehow to make the supply side more substitutable. In
36 particular in groceries we often have local market power in
37 the upstream segment and the larger retailer becomes the

1 more you invest into his distribution system, into his
2 procurement organisation and the more he is more able to
3 substitute these suppliers. This of course gives some
4 power. This allows them also to squeeze the suppliers, so
5 overall size in a sense translates into better deals and we
6 are then also in a very very different role when we compare
7 this to the oligopsony picture. This is where we really
8 have discrimination, in a sense. It only makes sense to
9 talk about buyer power when we allow for discrimination, so
10 there are large buyers who get better deals.

11 John Davies: Can I ask you to expand on that point. I would
12 not otherwise interrupt, but are you saying that if there
13 were only three large retailers and they all, in a sense,
14 had buyer power to the extent that they could squeeze
15 suppliers, you would not consider that to be buyer power?
16 Because buyer power, by its definition, is a relative
17 thing? I mean from the oligopsony model.

18 PROF DR CHRISTIAN WEY: In this sense, yes. I would say it is
19 a relative thing.

20 Another source, of course, of buyer power is concentration of
21 retail markets. The monopolisation of local markets
22 creates gatekeeper power, in a sense, and this allows
23 buyers also to auction off scarce shelf space.

24 Then there are also other sources which may create
25 buyer power, or which create buyers more inclined to reduce
26 input prices. For example, one important change is of
27 course also one-stop shopping behaviour which has been
28 investigated in many studies. This of course changes also
29 the structure of the downstream market. In a sense this
30 creates competition for the consumer and makes, first of
31 all, competition tougher in the downstream market. This
32 may translate also into more aggressive behaviour of large
33 retailers in input markets.

34 Then the exercise of buyer power depends a lot on
35 modernisation strategies, I would call them. For example,
36 of course the introduction of own label products may
37 marginalise other suppliers' products.

1 Standardisation strategies, standardised products.
2 The larger you become you perhaps will only sell one type
3 of grocery or one type of food.

4 Then of course large retailers may invest more into
5 new supply sources. I do not know whether it is true, but
6 if Walmart were a country then it would be the fifth
7 largest importer from China. There is also of course a lot
8 of investment going on to open up new supply sources.

9 I have already mentioned more professional
10 procurement, and so on.

11 Overall larger retailers say there is a lot to it vis-
12 a-vis their suppliers, so in this sense buyer power is bad
13 news for suppliers. I would say this should become the
14 normal.

15 This is not saying that it is bad from an efficiency
16 point of view, so one has to keep that in mind. First of
17 all, buyer power translates, in a sense, into lower profits
18 of suppliers.

19 Then we have also talked already a little bit about
20 all our problems and innovation on the supplier side.

21 When one looks at incentives to invest at the upstream
22 level, one has to distinguish between the overall profits
23 of the supplier and what he gains from making an
24 investment, from the additional gains he will get when he
25 makes an investment. It turns out that reducing the
26 supplier's profit not necessarily means that his gain from
27 innovation is reduced. There are a couple of reasons - and
28 I did something with Roman on that - to believe that with
29 buyer power these additional gains from making investments
30 in fact increase on the supplier side.

31 One way to think about it is that of course these
32 models always depend on the assumptions and therefore it is
33 also important to distinguish whether one has a fragmented
34 upstream supplier structure, or whether there is a
35 bargaining relationship. For the models we developed we
36 assumed that there is some power at the upstream level,
37 that there is bargaining going on. In these models it

1 turns out that there is more power for retailers. The
2 incentives to invest actually increase.

3 At the very end we will talk about the overall
4 assessment of the anti-competitive effects, but first of
5 all it is clear that suppliers are hurt, in a sense. Their
6 profits go down and therefore it is also clear who was
7 against buyer power. But whether it is good or bad is a
8 very delicate question, so let us perhaps talk about these
9 things.

10 Let me also make one final point, that the exercise of
11 buyer power also depends very much, as I have already
12 mentioned, on the downstream market structure. It very
13 much depends on whether there are other outlets in the
14 local markets, other large outlets, and it also depends on
15 fringe competition. Actually it has been shown that where
16 buyer power increases and there is even fringe competition,
17 this larger buyer power translates into lower input prices
18 for fringe firms and the other therefore goes out.

19 John Davies: What is the intuition for that?

20 PROF DR CHRISTIAN WEY: The intuition for that is that the
21 upstream firm, in a sense, by setting lower prices to
22 fringe firms reduces the bargaining power of the large
23 retailer in turn. This is, in a sense, that strategically
24 he makes good deals to fringe firms and to improve his own
25 bargaining position vis-a-vis a large retailer. So there
26 are a lot of strategies going on. There is a power game
27 going on and one has to look at both sides, of course. For
28 example, one important sort of buyer power is the ability
29 to integrate backward, or to introduce own label products.

30 Of course, similar strategies are sometimes also available
31 for the suppliers. They also can open up new retail
32 channels. It is a very complex issue and one of course has
33 to look at the detailed characteristics of the industry.

34 This is some food for thought.

35 John Davies: That is a very useful structure. It is Roman
36 Inderst now, I think.

37 A. (PROF ROMAN INDERST) Do you want to start the discussion?

1 John Davies: We've started the discussion. Anyone can speak,
2 and you volunteered first, I think.

3 A. (PROF ROMAN INDERST) I may have asked whether I could be
4 first. You incidentally asked two people to prepare the
5 first talk on this topic. I am going to give the first
6 talk on the other topic; so only have sketchy notes. Maybe
7 you would like to confirm that given that you have chosen
8 two speakers on this topic does not mean you are going to
9 give priority to this topic?

10 John Davies: No, not necessarily! (laughter)

11 A. (PROF ROMAN INDERST) Not necessarily - okay.

12 I would like to maybe kick off the discussion with one
13 chunk of remarks. Maybe there is time later on for a
14 second chunk.

15 The first chunk of remarks, the first bit, is going to
16 focus on the sources of buyer power. And later on
17 hopefully, if time permits, I can make another couple of
18 remarks on innovation.

19 All the remarks I am making on buyer power sources and
20 measures relate to the second paradigm, so basically the
21 buyer power equal to bargaining power paradigm. This does
22 not mean that the other paradigm, the monopsonistic
23 paradigm, is not that important. It depends, as Mike has
24 worked out in detail now, very much on the upstream market.

25 So I am very much focusing, you could say, on a less
26 concentrated upstream market, or an upstream market with
27 supplier-buyer relationships where it is clear from the
28 evidence that there are negotiations going on and in
29 particular with individual discounts for particular buyers.

30 If we equate buyer power with bargaining power I think
31 this focuses a little bit our attention on how we define
32 it, namely as relative dependency. This does not mean that
33 the bargaining framework only allows to look at bargaining
34 power through dependency, which is the "outside options",
35 the "inside options", the "breakdown points" etc. (All
36 this is formal language.) There are, of course other
37 channels as well, like collusion. If suppliers collude a

1 larger retailer may simply break up collusion more easily.

2 But I do not think this is going to be a priority for you.

3
4 Or what is sometimes interesting as well, information
5 asymmetry. Maybe large buyers, particular buyers or
6 retailers with private labels have an information advantage
7 compared to suppliers. Or the information advantage offers
8 suppliers power; and this gives the bargaining power as
9 well. I completely abstract from these issues and focus
10 completely on the issue of buyer power where bargaining
11 power is basically dependency through "outside options".

12 If we have to focus very much on this dependency,
13 which is my understanding, then this is now the point I
14 want to make, on which I really have to first focus. The
15 Commission has suggested somehow to focus on size, ie that,
16 size seems to be potentially a good proxy for buyer power.

17 And this is indeed very often, you could say, the case.
18 In many different ways - and I think this is very important
19 - we choose different measures for size. First, the total
20 size of the buyer, because if you are large as a retailer
21 you may more easily substitute. It is more credible for
22 you, for instance, to then invest, let us say, in going to
23 China and finding a different supplier. But equally
24 important, you could say, is the share the buyer has of the
25 national potential market, for instance for mass marketer,
26 or also of the current business that a particular supplier
27 is doing.

28 However, this is not really the point. Even if you focus
29 on size, whether absolute size or relative size, this
30 should not indicate that it is size by itself that creates
31 buyer power. It is always size with something else.

32 Negotiating over two unrelated pies at the same time does
33 not give me a larger share of either pie. For instance, it
34 is a supplier's precarious financial situation which gives
35 me, as a buyer, more clout if I can withdraw 30 or 40 per
36 cent of his business. If the supplier has other
37 conditions, if you could say he is part of a big

1 conglomerate, maybe then it does not matter that much.
2 Though with gatekeeping size really comes into play again,
3 you could say. If there is gatekeeping! If I can
4 basically sidestep a particular buyer by simply channelling
5 my supplies through another retailer and still getting 80
6 to 90 per cent of the same consumers, then current size, if
7 you just look at the data at the moment, will not give you
8 a good picture.

9 So the first point is that size may be very relevant
10 but it is always size "not in itself" but with something
11 else.

12 The second one is that size may a little bit distort the
13 picture. If you only look at size you may lose out on a
14 lot of other variables, a lot of other proxies, which are
15 important for buyer power. Size sometimes, you could say,
16 are perfectly correlated (but not always!) with buyer
17 power.

18 For instance private labels. My understanding of the
19 grocery situation in the UK is that there are other
20 retailers who rely very much on private labels but who are
21 by size not that important. Retailers will even have
22 exclusive private labels. How should we treat them? Maybe
23 it is not important for this inquiry. But, of course, they
24 would be treated differently, it could be suggested, when
25 just looking at their overall size.

26 Another thing. Consumers, prices and products. Their
27 practice of changing stores or products may depend very
28 much on the particular product. If it is a low-value item,
29 for instance, then not that much. So size in itself,
30 again, may provide here a little bit of a misleading
31 picture, because it distorts a little bit (or it takes
32 away) attention from other sources which are maybe
33 correlated but not always necessarily identical to buyer
34 power.

35 They are my two points: Is it basically size that is
36 important because you ask completely for a "matrix" of
37 buyer power? However, not in itself. Secondly, size may

1 be correlated with other factors that give rise to buyer
2 power but not necessarily so. So you have to cast your net
3 quite wide.

4 John Davies: Would I be right in thinking from those two
5 comments that what size might be correlated with - or what
6 the causes of buyer power could be divided into - are the
7 degree of substitutability from the point of view of the
8 buyer and the degree to which the buyer can inflict damage
9 upon the supplier? A lot of them seem to fall into those
10 two categories, although perhaps not all?

11 A. (PROF ROMAN INDERST) Yes.

12 I would guess that most of these factors which then
13 affect buyer power would fall into categories affecting
14 "outside options". And this exactly would be inflicting
15 harm on another party, which may be very often connected to
16 size but not always.

17 A. (PROF MICHAEL WATERSON) In a more general way, it is
18 another way of making the point that I made, that if your
19 supplier has not incurred costs, then you are not powerful
20 against them. It is when they have incurred costs and you
21 have the power to hurt them essentially.

22 A. (PROF ROMAN INDERST) Yes. I am sorry you had to repeat
23 a little bit.

24 A. (PROF MICHAEL WATERSON) No, no. You did it more
25 clearly, in a way.

26 John Davies: Would anyone else like to comment?

27 A. (MR MIGUEL de la MANO) I should maybe first say that my
28 comments are of my own and not of the European Commission.

29 I would argue that we should only be concerned with
30 situations where buyer power is exercised in a context
31 where the dominant buyer has or intends to acquire seller
32 power. We should not really worry that much about the
33 exercise of pure monopsony power. The reason is that I
34 think, first of all, monopsony power is rare and probably
35 that is because there are very few specialised resources
36 out there. Second, pure monopsony power arises only where
37 a large dominant buyer is facing a very fragmented upstream

1 market and upstream suppliers have very little influence in
2 price. It is very hard to find situations where resources
3 are actually specialised in the supply of a particular
4 good, to such an extent that an upstream supplier is unable
5 to move out of that market when being squeezed by a
6 dominant buyer.

7 That said, if you do find a situation of monopsony
8 power, I would still be very careful when intervening in
9 any way if monopsony power has been acquired legitimately.

10 However, it should not be legal to exercise monopsony
11 power if you haven't achieved a monopsony position through
12 innovation or good efforts.

13 You also need to deal with a number of factors that
14 reduce the harmfulness of monopsony power. You need to
15 figure out what is the real world significance of these
16 factors in the context of supermarkets. For instance, is
17 the supply curve actually upward sloping? In many
18 instances, particularly in the case of manufacturing goods,
19 it may just be flat due to economies of scale, in which
20 case, of course, a monopsonist has no ability to influence
21 input prices, no matter how much market share it has from
22 the upstream suppliers.

23 I would speculate that in the context of groceries,
24 probably for prepared goods, for foods and this type of
25 ready made foods that you have, there might well be a
26 perfectly flat supply curve.

27 At the opposite extreme, of course, the aggregate
28 supply curve might be perfectly inelastic or relatively
29 vertical, in which case you have the alternative situation,
30 in which dominant buyers could really exercise monopsony
31 power. They can extract huge rents from their suppliers,
32 but there might be very little impact in output.
33 Therefore, whether or not intervention is justified depends
34 on your welfare standard. Are you worried about rent
35 distribution upstream, or are you just worried about what
36 happens in the downstream market ultimately?

37 I would again speculate that in the context of

1 groceries, perishable goods, for example, might be
2 candidates for relatively inelastic supply curves. Under a
3 consumer welfare standard you may then conclude that this
4 is an area where unless output is ultimately restricted,
5 you might have to allow monopsonists to exploit that
6 monopsony power.

7 Other issues, of course, which have been discussed are
8 whether or not monopsony power is unrestrained or not.
9 Clearly in many markets for branded goods upstream
10 suppliers have seller power and the bargaining processes
11 that result when facing a dominant buyer may lead to
12 different outcomes.

13 Another issue is that of efficiencies. You might
14 want to consider the efficiencies that monopsony power
15 might bring about, particularly because we observe
16 opportunities for significant purchasing efficiencies in
17 the grocery sector, for instance in warehousing, in
18 transportation costs and in reducing transactions costs.

19 I have observed, from experience, in the context of
20 dominance cases in Europe that sellers are actually anxious
21 to offer volume discounts which would enable them of course
22 to achieve scale economies and maximise capacity
23 utilisation, reduce transaction costs and so on. If
24 monopsony allows for many of these volume discounts to
25 accrue then that is probably a good thing.

26 The last remark I would add here is even if you have a
27 situation where there are a lot of inefficiencies as a
28 result of the exercise in monopsony power - I am talking
29 about monopsony power alone, not buyer power in the context
30 of bargaining - it would seem to me that after a while two
31 things can happen. One is that often suppliers might just
32 have an incentive to sell off the company to the dominant
33 monopsony, the dominant buyer. This is clearly a way of
34 eliminating a lot of inefficiency and as a way of improving
35 wealth for everybody. It should be a very optimal decision
36 to make. It is just a matter of time before you have
37 vertical integration, even in cases where you have pure

1 monopsony. Even if that does not happen, for whatever
2 reason, one can argue would a monopsonist have a long
3 running incentive to exploit its suppliers given that this
4 might lead them to exit, it might lead them to reduce
5 innovation, to have less incentive to innovate? This goes
6 back to my very early point that very few productive
7 resources are specialised.

8 John Davies: A monopsonist presumably not, but presumably for
9 an oligopsony there is a potential free-rider problem?

10 A. (MR MIGUEL de la MANO) Yes. However, one remark to that
11 is that when you consider the context of oligopsony, where
12 oligopsonists are also competing in a downstream market,
13 one wonders whether oligopsony power can be truly exercised
14 if there is very tough competition downstream or actually
15 any kind of competition downstream. The oligopsonists are
16 competing upstream for inputs. They are competing and
17 offering the best possible price to suppliers. If the
18 input that they are trying to get is relatively
19 homogeneous, this might drive prices up for suppliers quite
20 fast. Hence, in the case of oligopsony I wonder whether or
21 not really there is room for exploiting oligopsony power.
22 That may be different if oligopsony has managed to segment
23 the upstream market geographically or by customer in a way
24 that can achieve purchasing power in that particular area,
25 but that would depend on the circumstances.

26 John Davies: Your earlier comment that you later developed,
27 that one might worry more about the 'bargaining' type of
28 buyer power - with an upstream supplier who presumably has
29 some degree of supply power, or at least getting some sort
30 of rent. That one might be more worried about the latter
31 situation than monopsony is a bit counter-intuitive. You
32 gave some reasons for it, but isn't the negotiation game
33 potentially just a matter of the distribution of rents
34 between two suppliers with market power, particularly if
35 pricing is an issue?

36 A. (MR MIGUEL de la MANO) The reason I think - and I will
37 come to it later in the second or third part of the Round

1 Table - is that ultimately in monopsony situations the
2 markets self-corrects either because the supplier
3 reallocates its productive resources to another market or
4 the monopsonist realises that it is not in his best
5 interests to push suppliers out of the market. So the
6 source of consumer harm or welfare harm in the case of
7 buyer power, I would think derives either from a situation
8 where monopsony arises in combination with downstream
9 seller power, so monopsony might exacerbate the exercise of
10 downstream monopoly, or more importantly, I would say, when
11 it leads to exclusionary effects relative to other
12 downstream competitors. Here is where the bargaining
13 framework plays a significant role. In situations where
14 the dominant buyers are facing upstream dominant suppliers,
15 there might be scope for engaging in practises which would
16 lead to the exclusion of downstream rivals with benefits
17 for the upstream suppliers and the dominant buyers. It is
18 in those instances that I would think that most of the harm
19 to consumers may materialise.

20 John Davies: I think we are going to talk about those issues
21 later.

22 A. (MR MIGUEL DE LA MANO) We are going to talk about that
23 later, yes.

24 John Davies: Can I fairly quickly bring in Thibaud, who I know
25 wanted to speak.

26 A. (DR THIBAUD VERGE) Continuing what Miguel said, I think
27 there are two issues in this bargaining. First, if we
28 abstract from all this long term process and innovation, if
29 buyer power is just increasing bargaining power and the way
30 the total pie is allocated between the suppliers and the
31 retailers, I do not really see why we should care. If it
32 has no impact on prices, if we care about consumer surplus
33 then we do not care about the way the pie is allocated and
34 if it is on total welfare it is still the same.

35 The second effect is that increased buyer power might
36 lead to better deals for the bigger suppliers. Unless we
37 believe there is strong collusion in the downstream markets

1 then some of the lower prices should be passed on to
2 consumers and that is good for consumers. So again, if we
3 abstract from the innovation and long term evolution of the
4 set of products that are available, it looks like this
5 could be good for consumers unless a big buyer getting a
6 good deal means that the other suppliers would get a worse
7 deal. For most of the big chains I do not really see how
8 big retailers, like Tesco or Sainsbury's, will accept to
9 see their competitors get a much better deal than them and
10 would not react to that by trying to extract the same rent
11 from the suppliers.

12 If we are talking about being identical retailers on
13 the market, waterbed effects, i.e. that one will get a
14 better deal and the others will get worse deals and that in
15 the end that might be bad for consumers, I think it is
16 unlikely to happen. In that sense maybe buyer power looks
17 good.

18 Briefly on buyer power and innovation, again to go
19 back to Mike's point, you have a much better data set than
20 any empirical IO economist could think of. You have these
21 two inquiries.

22 John Davies: But we have to ask the right questions!

23 A. (DR THIBAUD VERGE) You have the 2000 inquiry and this
24 inquiry

25 so you can really see what has been going on in the past
26 five or six years and see whether we observe that big
27 manufacturers have been delisted by some of these big
28 chains. Whether there is an increase in the set of private
29 labels that have been introduced and whether this really
30 goes towards reducing innovation from the suppliers. On
31 that side you seem to have much better information, again,
32 than we could have, not only on the bargaining side but on
33 the type of products that have been introduced.

34 John Davies: Thank you.

35 I think we are straying a bit into the second topic
36 and I think that is perhaps inevitable. Before we go
37 there, and we will go there very soon, I would just like to

1 ask the panel a very practical question, which is how we
2 distinguish problematic buyer power. I do not really mean
3 by 'problematic' that it has welfare effects as opposed to
4 buyer power that does not have welfare effects. I mean
5 that it is big and significant as opposed to being
6 insignificant. Because a lot of what I am hearing about
7 buyer power sounds like you could say the same about almost
8 any market in which there is price discrimination going on,
9 that people who have got better outside options get better
10 deals. But although in a pure sense one could perhaps
11 describe that as different degrees of buyer power, it is
12 not very helpful for a Competition Authority. We need to
13 be able to say, in a sense: "buyer power is here and it is
14 a problem, or it is not".

15 Perhaps it is coming back to the question that Mike
16 had a rather depressing answer to: that there is no good
17 structural measure of buyer power. Does anyone else think
18 there might be a good structural measure of buyer power?
19 Or how might we say, in effect, that buyer power is a
20 problem or it is not a problem?

21 A. (PROF ROMAN INDERST) I think this is very important. The
22 most important point in all of this is the issue of how we
23 define buyer power. This is basically informed by a theory
24 of harm. Harm done, let us say, to consumers which must be
25 relevant in the particular circumstances of this case.
26 I do not think it is like an 'anything goes' situation
27 here. Even so I am sticking again basically to the
28 bargaining situation. Even though we have come up with
29 tens of thousands of models and different effects --

30 A. (PROF MICHAEL WATERSON) Give me time, Roman! (laughter)

31 A. (PROF ROMAN INDERST) -- I think despite this myriad of
32 models we have, and the different effects. It is because
33 (!) we have them. They give us some structure on this.

34 We start, for instance, with a hold-up problem, saying
35 that large buyers that have maybe more power extract more
36 rents. But then we qualify this and say why are you
37 extracting more rents. And what does this mean, for

1 instance, that a supplier may invest less? What is
2 basically the problem at the first stage?

3 The first stage is a problem of incomplete contracting
4 because it is a complex world, because of the free-riding
5 problem of retailers... - you name it. Therefore, the
6 rents I am getting, the profits, and that I am making them
7 later on affects my incentives to innovate right now.
8 Large buyers extract more. You could think this is why
9 this stifles incentives.

10 On the other hand, of course, large buyers are good in
11 the sense like they help to overcome these contracting
12 frictions in the first place. They reduce public good
13 problems. They potentially allow for shared information,
14 etc etc, and, on top of it, as Christian has made very
15 clear, we should not for incremental investments confuse
16 profit levels with profit increments.

17 But these theories which basically are then formalizations
18 of the issues I have just raised, they help now to come up
19 with a partial answer to the question of when, looking to
20 and focusing on innovation, buyer power could be more or
21 less harmful. For instance, they allow one to distinguish
22 between the sources of buyer power.

23 In the research I did with Christian, which is a bit
24 theoretical I think, we made the point that if buyer power
25 comes from size, then maybe it could be very much helpful
26 to stimulate more competition upstream. It is a little bit
27 like keeping the suppliers on their toes. Basically, if
28 there is a large buyer trying to reduce the option of the
29 supplier, then he will take countervailing measures.

30 On the other hand, if the source of buyer power comes
31 from private labels, it could well be different.
32 Basically the source of buyer power could be very much an
33 indication of the potential harm. In the second one, and
34 this is what our theory says, it all has to distinguish on
35 the different supplier. If I am looking at, say, a branded
36 good supplier who is top-tier, a top tier branded good
37 supplier, then maybe the theoretical idea is that

1 countervailing power by a strong buyer basically spurs
2 innovation. This maybe, then, the right idea. With a
3 second-tier supplier, maybe it goes in the opposite
4 direction; maybe this supplier's incentives are very much
5 stifled by the presence of strong private labels because
6 the qualitative difference he would have to make in order
7 to still have some bargaining power is just too far away.

8 I would say that one way of coming up with the right
9 matrix is to look at what is the potential harm to each
10 manufacturer is, we can distinguish and basically through
11 which source of buyer power. And this allows us to come up
12 with a matrix where basically we can have a plus and minus.

13 Of course it is not a complete picture of reality but more
14 like an indication.

15 Coming back to Mike's point. Mike raised a very
16 interesting point on the side. It is the relationship to
17 the literature on horizontal competition; basically whether
18 more competition is better or worse for innovation. A huge
19 literature, with a 'U'-shaped function that people have
20 come up with in the end. We could be mistaken, of course,
21 because it is not that easy. But depending on
22 circumstances we can come up with some (!) answers. Maybe
23 we could then borrow this statement, this idea, for our
24 discussion. Maybe we should use here a little bit of the
25 idea of vertical competition. Vertical competition - I
26 borrowed this from (inaudible) and Steiner. And I like
27 this idea very much. It basically says that retailers and
28 suppliers - it has not been formalised etc - are competing
29 against each other. Not only competing about how we share
30 a given pie but competing about the functions we perform in
31 order to grow the pie, like the function of certifying the
32 quality of it, the umbrella branding, where the UK of
33 course the retailers have very much built up a reputation
34 of having a strong brand, maybe even as strong as some of
35 the big suppliers. Another function, of course, is
36 innovation. My understanding, but I do not know very much
37 about it, is that some retailers' private label goods are,

1 even, you could say, at the cutting edge of innovation.

2 This, for me, sounds suddenly very much like the
3 models of horizontal competition. We are basically
4 innovating. We are basically investing in our branding in
5 order later on to compete on how we split up the margin.
6 We are determining the roles we are playing. And suddenly
7 all the insights from these models you could, say --
8 potentially you could borrow them from these horizontal
9 models and then come up with an idea of what the right
10 process is like.(Inaudible) That is an idea which just came
11 to me.

12 Summing it up, it is very complex but I think the
13 literature at the moment gives us some guidance of when
14 buyer power could be more harmful or less harmful depending
15 on the characteristics of suppliers, the sort of buyer
16 power etc.

17 John Davies: Inevitably that will actually be different for
18 different suppliers when one thinks of the range of goods
19 that retailers buy.

20 First Bruce, and then I think we should move on to
21 topic two. We can pick up all these things in topic two as
22 well.

23 PROFESSOR BRUCE LYONS: There are a couple of things. I was
24 going to say one thing, but I have got to say two things
25 now because of what Roman just said.

26 This idea of the competition between the brands and
27 the retailers because of the own labels I think is a big
28 issue. For instance, one of the things that might
29 naturally happen is that a brand owner will tell a retailer
30 that 'we are going to have this new product out in the
31 market' and this will therefore give information in advance
32 to a potential competitor.

33 The issues of horizontal differentiation between the
34 supplier and the retailer, I wonder if there has been more
35 work done on that sort of issue.

36 The second question that I was going to ask about is
37 this. Mike brought Sherlock Holmes into the picture, so I

1 am talking about the dog that has not barked yet. That is
2 vertical integration between retailing and wholesaling.

3 I have not seen a great deal of work on this but it
4 seems to me that potentially it is a big issue in the
5 bargaining power, in particular in relation to the
6 gatekeeper role that we were talking about earlier, that if
7 a wholesaler, let us say a cash and carry type wholesaler,
8 is negotiating with a supplier, then you cannot necessarily
9 guarantee delivering a market because a retailer can either
10 go to that cash and carry or to another cash and carry. Of
11 course there are various models in between. Whereas if you
12 are buying at an integrated supermarket, a wholesaling
13 supermarket, then you can guarantee that it is going to go
14 onto the shelves of that particular supermarket chain and
15 therefore to consumers.

16 I wondered if there has been any work, or if the panel
17 has had any thoughts about the importance of vertical
18 integration between wholesaling and retailing for buyer
19 power?

20 John Davies: That is an interesting question, because in a
21 sense it is a more relevant question than the potential
22 vertical integration with the suppliers - which given the
23 range that a large supermarket undertakes, would not be
24 possible and certainly not desirable.

25 Does anyone want to comment briefly on that?

26 PROF DR CHRISTIAN WEY: This was, in a sense, a key question,

27 Theoretically what turned out to be very important, as
28 Michael mentioned at the very beginning, was of course
29 whether we are sharing a cake. Then buyer power is not a
30 big problem and it is like differential price
31 discrimination.

32 When we come into the role of linearity where we have
33 linear prices, then buyer power translates into a strategic
34 advantage. Then it can be harmful in a sense because it
35 changes the downstream market structure. If buyer power
36 really changes the downstream market structure, then it
37 creates harm.

1 What I think we can perhaps also learn from large
2 literature on unions and collusion is when buyer power
3 translates into vertical collusion. In a sense when buyer
4 power creates some joint collusion between upstream firms
5 and the large retailer so that other retailers do not get
6 the same deals and perhaps are kicked out of the market,
7 then buyer power becomes a very dangerous thing.

8 John Davies: Thank you. I will make one comment and then I
9 think we will move on to Item 2 on the downstream market.

10 My comment is that it is difficult when theories hinge
11 in an important manner on things that are not particularly
12 fundamental. It seems to me that if the Competition
13 Commission - just for illustration - were to find that
14 buyer power were a problem and say 'of course, it is a
15 problem because we have got these models with linear
16 pricing', the supermarkets would be within their rights,
17 wouldn't they, to turn around and say 'okay, well we will
18 stop doing linear pricing then and then there won't be a
19 problem'. Some of these things are rather ephemeral such
20 as whether everyone is bargaining over prices and
21 quantities.

22 I would like perhaps to come back to that, but let us
23 move on to the second topic because it is not very
24 different from the first topic so we can continue to
25 discuss all of these things.

26 Once again Kirsten is going to introduce the topic. I
27 should extend an apology to Roman Inderst who, through a
28 mistake entirely on the Competition Commission's part, was
29 asked to prepare a different topic from the one that he is
30 now going to speak on. He got precisely three minutes'
31 notice before walking into the room and very kindly did not
32 refuse, but he is going to make a few comments on
33 downstream market effects of buyer power and then I think
34 our first discussant is Miguel de la Mano.

35 MS KIRSTEN EDWARDS: Thank you. Just before we move on,
36 just to clarify, I am going to read a statement from our
37 Issues Statement, which says:

1 "The CC is required to determine whether any feature
2 or combination of features of the market prevents,
3 restricts or distorts competition. If this is so
4 there will be an adverse effect on competition and we
5 will seek to identify the detriment to consumers
6 resulting from the adverse effect of competition."

7 We are actually looking at the effect on consumer welfare
8 of buyer power as opposed to total welfare.

9 The second issue for discussion is the effect of
10 retailer buyer power on downstream markets.

11 A frequently cited argument is the waterbed effect.
12 This assumes some interdependence between buyers' prices,
13 so that when strong buyers negotiate an input price
14 reduction, suppliers increase the prices that they charge
15 to other buyers to compensate. This effect might lead to
16 some consumer welfare loss.

17 In the longer term, if greater buyer power confers a
18 significant commercial advantage to larger retailers
19 through input price differentials, either smaller retailers
20 or wholesalers may be unable to compete and may thus exit
21 the market. Ultimately, the contention is that a few
22 larger retailers will be left operating in the downstream
23 market and will therefore be able to raise retail prices.

24 The CC will consider whether buyer power can harm
25 consumers through a waterbed effect or in the longer term
26 through an increase in concentration in the downstream
27 retail market. In the context of the UK groceries market,
28 the panel may wish to discuss the following:

29 * How realistic is the concept of a waterbed effect?

30 Under what conditions would this effect be
31 detrimental to consumer welfare?

32 * Could upstream buyer power harm consumers through
33 an increase in concentration in the downstream
34 market? If so, how can we identify whether this
35 is occurring and when it reduces consumer welfare?

36 John Davies: Thank you. Roman.

37 A. (PROF ROMAN INDERST) Again all my excuses for the fact

1 that this is going to be rather sketchy. I prepared my
2 presentation based on the questions which you had in your
3 brief: on whether upstream buyer power could harm
4 consumers, lead to an increase in concentration. And then
5 how realistic the waterbed effect is. And your third point
6 how this applies to the UK grocery market.

7 Regarding the effect of buyer power on the downstream
8 markets, if we now hold, because I think that we should do
9 and I should do for now, constant the input of the
10 wholesale prices of other retailers, because that is going
11 to be an issue of the waterbed effect, then the two most
12 important potentially negative effects could be exit of
13 other retailers simply because the market is squeezed; Or,
14 these guys could stay in the market but they cut corners on
15 other characteristics that are important for consumers -
16 variety, quality, opening hours, service etc. Potentially
17 you may have a trade-off. Short-term gains, if these
18 advantages are passed on and if (inaudible) the smaller
19 retailers also have to compete. In this scenario there are
20 short term gains but maybe long term losses for consumers
21 if there is no competition in the long run. This is quite
22 a boring story because we know it. It is like a story we
23 have in very many different circumstances.

24 What you would like to hear, I think, is more like
25 when the long term gains are more likely, or when the long
26 term losses for consumers are more likely and when not. I
27 have a little bit of, not wisdom, but some comments on this
28 one.

29 I think you should answer two questions here. The
30 first one is whether it can be expected that efficient
31 retailers, I am talking now more like the smaller retailers
32 and maybe I have a bit too much in mind the issue of
33 convenience stores, so the smaller independent convenience
34 stores and maybe less have in mind one-stop shopping market
35 whether the efficient small retailers can react to the
36 increased price competition on some goods in a different
37 way other than just keeping the same products on the

1 shelves and lowering the price. For instance, changing the
2 variety of the products they are offering, or competing on
3 service, offering better service, better products to the
4 market.

5 The second one is, even if these guys - and suppose
6 now we consider less efficient ones - drop out of the
7 market what does that mean? Does this mean there is going
8 to be a certain concentration of the markets in the long
9 run? Or are barriers to entry, particularly the
10 convenience store market, so low that an equally efficient
11 player, than the big multiple one, could just enter and
12 then ensure that in the long run competition will again be
13 higher?

14 In trying to summarise and weigh them up against each
15 other I would like to do a bit more lazy job and refer you
16 to a very interesting paper. It is a paper of Anthony
17 Dukes. I think he is now in Copenhagen. I am not quite
18 sure about this, I must admit, but it is given on Thursday
19 at Imperial College. Somebody just informed me about it.
20 It is a very interesting study. I forget all the details.

21 It is a study about some city in the States or in Canada
22 where the following happens:

23 A big multiple enters two local markets. Because he
24 distinguishes between these two local markets. The effect
25 of these entries was markedly different. In one local
26 market, if I can recall correctly, it was but a negative
27 effect, you could say, particularly on the profit of the
28 other retailer. His margins were squeezed (inaudible).

29 More interesting maybe is the other story. In the
30 other story as well this multiple entered. I think it was
31 a shopping mall. But the effects on the smaller retailer
32 were positive. What the big marketeer did in the end: it
33 basically raised and increased the traffic into the mall.
34 How did the other retailer, the small one, respond? It
35 responded by changing its variety that it was offering. It
36 moved up-market.

37 This is a true story okay, because I really tried not

1 to make it up. (laughter) Not really, but given three
2 minutes and given that I did not have access to a computer,
3 I think this is the correct story.

4 The interesting stuff is then the following, that in
5 the second scenario you would have potentially for
6 consumers a positive benefit. More variety, at the lower
7 end cheaper prices potentially by the big multiple and
8 extension of the range of products up to the higher end.

9 On which story you are, on average in the case you are
10 considering, I think this is quite important. It is quite
11 important then to know how the retailers, who are
12 potentially negatively affected, will respond because the
13 response function is quite important.

14 Moving on to the second question of the waterbed
15 effect, you are asking how realistic is the concept of the
16 waterbed effect. What does 'realistic' now mean?

17 First of all, can you prove its existence in theory?
18 Well I would have a very stark very extreme answer to this.
19 It is only logical. To be logically consistent, if you
20 believe in volume discounts you have to believe in the
21 waterbed effect.

22 If one thinks - let us keep the market size constant at 100
23 units - if I am thinking that a guy who purchases 50
24 instead of 40 getting a discount, or if he gets 50 at 40
25 then the other guy is getting not 60 but 50. (Maybe I
26 should have taken a different example.) Then of course we
27 should also suspect that he has to pay a higher price. If
28 one expands the volume and if the total market does not
29 expand, another person would lose this volume. If you
30 think that the discount formula applies everywhere, then of
31 course there would be the waterbed effect.

32 This is really the answer you want to have? Logical
33 consistency? I guess, maybe not. You want to know how
34 strong (!) it is.

35 Potentially what is more important is then to look
36 more into dynamic stories. Dynamic stories where, if the
37 purchase volume of, let us say, the independent stores

1 together, or their wholesaler, etc., if this falls below a
2 certain point, then suddenly non-continuous tipping point
3 stories kick in, or not, both with respect to wholesale
4 industries. If the small independent retailers purchase
5 through a wholesaler, then maybe because the wholesaler has
6 now lower volume this is going to change the whole
7 wholesale market potentially. You can think about it is
8 just not being effective or efficient to operate for the
9 wholesaler for basically the wholesale market crumbles. I
10 do not believe this is realistic. But potentially you
11 could argue that where there are fixed costs which now have
12 to be rolled over ... over fewer items or volume - I do not
13 know much about the wholesale structure here - then you
14 could argue that instead of like supporting three
15 wholesalers you only now have two or one. So there is more
16 concentration, less competition and therefore if you
17 believe in linear pricing, higher unit prices to retailers.
18 This is the wholesale story.

19 On the other hand, if you want to create this dynamic
20 story of a waterbed effect, which then could really account
21 for a large side effect, it is suppliers we also have to
22 look into.

23 The simple story could be the following. Just staying
24 with the large big retailers, say they extract more profit
25 from the suppliers. Therefore, the supplier market would
26 be more concentrated because of exit or because of more
27 concentration. This is documented. There are very nice
28 studies in the States and it (inaudible). I documented
29 them in what I have written together with Nicola.

30 Relating it to concentration, to exit of suppliers, is
31 one way. But maybe it is not the most important way. I am
32 really lacking here the facts and the details and you must
33 have it.

34 Maybe again we should talk about private labels. We
35 can talk to them in two senses.

36 First, suppose that we have a fixed number of
37 suppliers and the big retailers manage to tie some of those

1 particular second-tier brand manufacturers to them. Then
2 this, more directly, not by exit, takes away some of the
3 potential supply to independent retailers.

4 The second channel where private labels is also
5 important is potentially the following.

6 Leave aside the top-tier supplier, focusing on second-
7 tier. Suppose buyer power is very much like private label
8 power. So it is not really a size issue at the moment. If
9 we have these private labels, which basically, you could
10 say, replaced some second-tier manufacturers on the shelves
11 of the big retailers, that could mean, in the end, that
12 those manufacturers which remain independent or maybe still
13 supply to some extent to the big retailers, their
14 incentives to innovate, to keep up, might drop a lot.

15 In the end, the story just boils down to the following
16 point. Maybe by the exercise of buyer power, particularly
17 with private labels and also with volume, it is not only
18 the number of suppliers in total which could decrease, but
19 the number of free suppliers which are not tied up by
20 private label, and, what is maybe more, the quality of the
21 goods these second-tier suppliers may offer to the
22 independent retailers.

23 This is, of course, just hypothetically. It has not
24 been formalised. It has not been worked out. When I
25 talked before about "do I believe in the waterbed effect",
26 then logically consistent it is, yes. Do I believe how
27 strong it is? Maybe then this dynamic effect is quite
28 important. It could work very well through the wholesale
29 market. I do not have the details there. It could very
30 well work through the supplier side. Your upstream market
31 really. There, I think, we should not be too shortsighted
32 or too focused on the number of suppliers, etc., but cast
33 our net wider and look into variety issues, tying them to
34 particular retailer issues and in the end not only looking
35 at volume and market size but once again the private
36 labels.

37 John Davies: Thank you very much, particularly given the

1 amount of time you had for preparation.

2 I have got a very quick question and then I will hand
3 over to Miguel. That is something you might not be
4 terribly comfortable commenting on, but you said that you
5 found the wholesale tipping argument 'implausible'.

6 A. (PROF ROMAN INDERST) Did I say this? Maybe I'll delete it
7 from the record. The point is, I do not know anything of
8 the facts. I do not know anything about the facts, but a
9 wholesale tipping model where you would say that the whole
10 sector crunches and crumbles, maybe that is not really very
11 realistic.

12 John Davies: Do you know why you have that feeling?

13 A. (PROF ROMAN INDERST) Well I guess at some price there is
14 always going to be one wholesaler who steps in in order to
15 bundle the functions. If you have independent retailers
16 left in the market, they will, of course, almost general
17 economic logic, challenge their purchases through a
18 wholesaler. There is always going to be one. The question
19 is only one about at what prices and at what overall
20 quality this function can still be performed if the level
21 is lower. The second one how big the level of competition
22 at the wholesale level is, given the reduced volume.

23 John Davies: I understood that.

24 A. (PROF ROMAN INDERST) Sorry if I have not made that clear.

25 John Davies: Miguel.

26 A. (MR MIGUEL de la MANO) Thank you, John.

27 As a way of introduction, I would take on a question that you
28 asked before, which is how can we come up with an ideal
29 measure of buyer power such that we can predict significant
30 welfare effects. Size presents itself as an option, but I
31 think you might want to look also at whether or not the
32 buyer has or has not very significant seller power
33 downstream, I think that is ultimately the key question.

34 It relates to a very good paper by Nicola, which I
35 found very stimulating where he suggests that you might be
36 a small buyer but if you have significant selling power the
37 pie in that market is going to be big and that of course is

1 going to encourage upstream suppliers to deal with you, the
2 threat point being also the lack of options to get into
3 that market where there are significant profits to be made.

4 I think whether or not the buyer has significant
5 downstream powers is key in establishing whether or not it
6 will have significant bargaining power vis-a-vis its
7 upstream suppliers.

8 I will take this point from Nicola's paper more
9 generally. There is a single profit in the market to be
10 made and ultimately it is how it is split between the
11 upstream suppliers and the downstream buyers there.

12 John Davies: Can I ask you to comment on, or consider, how
13 that

14 thought would be affected if the market definition were
15 different at the two levels. In particular it might be
16 posited that there is a national market on the buyer side
17 and there are local markets - within which there might well
18 be quite high concentrations in some areas - on the seller
19 side.

20 A. (MR MIGUEL de la MANO) That complicates the assessment
21 significantly. One way of dealing with that possibly is to
22 look into the ultimate balance of both effects. Clearly if
23 you take the small buyer that has significant selling power
24 but it competes with a large number of other buyers in the
25 national market, then buyer power is limited and unlikely
26 to reinforce this firms downstream seller power. It is
27 when you have both seller and buyer power that I think you
28 might want to be looking into the combined effects more
29 seriously.

30 That leads me to my general comments which relate to
31 the competitive effects of buyer power in a downstream
32 market, which may be what you are most interested in.

33 Buyer power can lead to anti-competitive exclusion,
34 for example through predatory over-buying. Another
35 exclusion mechanisms is raising rivals' costs again through
36 over-buying. Then there are standard customer for closure
37 arguments and of course there are vertical restraints,

1 which we will talk later about.

2 But there are also potential benefits from the
3 exercise of upstream buyer power in a downstream market
4 clearly, such as efficiencies and most importantly the
5 possibility of countervailing buyer power in the context of
6 bilateral monopoly or bilateral oligopoly.

7 It is interesting that at the Commission we developed
8 this story, which I will get into briefly later, which I
9 would label as a countervailing buyer power offence. If
10 you have a countervailing buyer power, that is going to
11 allow you to extract better prices and better deals from
12 your suppliers and so you are going to grow, and if you are
13 going to grow in the downstream market, you are going to
14 exclude some of your downstream rivals and increase
15 downstream market share and that is going to allow you to
16 even more carry on extracting better deals from suppliers
17 and ultimately the fact that you have countervailing buyer
18 power leads to exclusion in the downstream market and
19 monopolisation of the downstream market. That could be a
20 problem. That I think is related to the waterbed effects I
21 do not think this story is very plausible.

22 Going back to the sources of anti-competitive
23 exclusion in the downstream market, Salop has a very
24 interesting paper where he distinguishes between "predatory
25 over-buying" and the "raising rivals' costs over-buying".
26 On the face of it, it probably sounds like the same thing,
27 but the mechanics are slightly different.

28 In the context of predatory over-buying the simple
29 idea is that a downstream buyer would engage in excess
30 purchases of inputs or of supplies more than it would in
31 the normal working of competition in order to ensure that
32 its downstream rivals will have to pay excessively for such
33 input and therefore will exit the market, so there is a
34 period of sacrifice and there is a period of recoupment.
35 Once the downstream rivals have exited the market, then you
36 can of course bring down input prices and consequently also
37 raise downstream prices.

1 I think that strategy in the context of the grocery
2 markets in particular is very hard to sustain over time.
3 First of all, not only are you paying more for your inputs
4 but you are buying more of them because your rivals that
5 you are trying to exclude will exit the market so you have
6 a lot of input, a lot of goods running around, yet you have
7 to figure out what you are going to do with that additional
8 input. You may not be able to sell it in the downstream
9 market or if you do it is going to be at a much lower
10 price, further squeezing your margin and therefore it is
11 going to be very costly ultimately to sustain this
12 predatory over-buying.

13 The most important thing, I think, is that in a way
14 the downstream rivals will simply switch to other cheaper
15 sources of input. In any case the impact on consumers is
16 going to be very limited because there is going to be a
17 period of time where they are going to benefit from much
18 lower prices.

19 I would not think that predatory overbuying is very
20 plausible in the groceries sector.

21 In the alternative version of this, which is raising
22 the rival's costs through over-buying, the only difference
23 is that essentially there is no sacrifice for the buyer,
24 because in a way what it is doing is over-buying inputs to
25 raise rival's input costs in doing so. Rivals pay more for
26 inputs so they have the incentive to reduce their input
27 purchases and the production of output and in this way
28 maybe they will be obliged to charge a higher output price
29 downstream. This allows the dominant buyer to also charge
30 a higher output price in the downstream market and
31 therefore recouping simultaneously the cost of higher input
32 prices without a profit sacrifice.

33 This story does not necessarily require the exit of
34 the rivals downstream, it is just that their input prices
35 have to go up and they are less competitive and that puts
36 less competitive strain downstream on the dominant buyer.

37 But in the contexts of supermarkets how plausible this

1 might be? Well consider there is a one to one input/output
2 relationship between the input and the output, which is
3 generally the case. As input prices increase due to
4 overbuying input purchases also expand and thus downstream
5 sales. Then it is very hard to see how the buyer can
6 prevent prices downstream from staying where they are, or
7 even from going down.

8 It could work, and this is a theme that I will pick up
9 on also later, in the context where the power buyer has
10 private labels of its own, because it has less reliance on
11 input and even though it imposes a cost on itself by paying
12 more for the input, it poses less of a cost to itself than
13 it does on other buyers who might not have private labels.

14 In that situation it can potentially lead to anti-
15 competitive exclusion.

16 One possible test in thinking about how can you detect
17 the existence of raising rival's costs overbuying, is if
18 you look into the situations where private labels have been
19 recently introduced. You would think that if private
20 labels have been recently introduced it would lead to
21 increased buyer power and this should induce lower
22 wholesale prices for branded goods as a result. If, on the
23 other hand, you look into the effects of private labels and
24 you realise that it actually has led to higher wholesale
25 prices for branded goods, this might be evidence of raising
26 rival costs over-buying. There is a new test there. If
27 the introduction of the private label leads to lower
28 branded-good prices - then this is pro-competitive.
29 Otherwise the private label may just help the dominant
30 buyer to over-buy branded goods, pushing up their wholesale
31 price, and thus raising rivals cost.

32 John Davies: I think it is probably fair to say that over-
33 buying has not featured very heavily as a theory of harm
34 and effect that has been put to us. Except possibly land,
35 but I think that is rather different because it does not
36 feature in your marginal costs.

37 A. (MR MIGUEL de la MANO) No.

1 Those are, from a theoretical point of view, at least
2 in my opinion, the most solid stories. Yet in the context
3 of this Inquiry they may not be particularly applicable.
4 That is something you will need to ponder about.

5 Finally I have some comments on countervailing buyer
6 power, which is of course potentially a source of good in a
7 bargaining context if upstream suppliers have a strong
8 selling power.

9 The key question here that I find most interesting is,
10 if a dominant firm is in a position to exercise
11 countervailing buyer power, be it because it is a large
12 buyer, it has lower switching costs, it can exercise a
13 threat of backwards integration or a sponsoring of entry or
14 simply, as was mentioned before, it has an ability to
15 stabilise collusion, in those cases if this leads to lower
16 prices for that particular firm, would these lower prices
17 be extended to other smaller firms who do not have that
18 countervailing buyer power? I think that is the most
19 fascinating question for two reasons.

20 One is because you would expect that for non-myopic
21 suppliers it would be in their own interest to extend such
22 lower prices to other rivals, even if they do not have
23 buyer power because, on the one hand, if you help the
24 dominant buyer all the time you are going to face an
25 increasingly more powerful dominant buyer, so it is a way
26 to sustain a little bit of competition for the input in the
27 upstream market.

28 On the other hand, if that does not happen then you
29 enter into this bizarre world of the spiral effect, which I
30 encountered for the first time in an EU case where it was
31 laid out. The idea is very simple. It is that the greater
32 size of the dominant firm leads to larger volume related
33 discounts. This enables it to offer lower prices than those
34 offered by smaller rivals. This in turn increases the
35 dominant buyer's market share which in turn raises the
36 volume of its purchases and this enhances the buyer power
37 again through a higher volume related discount, and so on,

1 which leads to this spiral effect.

2 What is the evidence of spiral effects taking place in
3 grocery markets? This EU case in particular was one on
4 supermarkets.

5 The first point to make is that I think large buyers
6 do not necessarily obtain lower input prices. Although it
7 could be a good proxy, you cannot take it granted for at
8 least three reasons. One is that small buyers might get
9 better terms than large buyers because contracts may remain
10 secret and in that way a supplier can get a secret contract
11 with a small buyer and does not need to extend the terms of
12 that deal to others, whereas with large buyers those
13 contracts tend to be public and therefore discounts to
14 large buyers reduces the bargaining power of the supplier
15 vis-à-vis other buyers. Also small buyers, as in the
16 example given by Nicola, which I mentioned before, might
17 have significant buyer power if they enjoy a monopoly
18 position downstream.

19 Finally there is an interesting paper by Raskovitch
20 and a few follow ups where he talks about pivotal buyers
21 having less bargaining power, the reason being that in a
22 situation where you are a pivotal buyer that means that
23 unless you buy from the supplier, the supplier will go out
24 of business because it will be unable to cover its fixed
25 costs. Unless you buy from the supplier, there is going to
26 be no ability to enter into a relationship which could make
27 profits for you. Then in a way you have very little
28 bargaining power, and of course the larger you are the more
29 likely you will be a pivotal buyer. So smaller buyers can
30 have buyer power, which of course removes all concerns with
31 a spiral effect.

32 But also, and I think it is a very interesting
33 insight, which Roman mentioned, small buyers can compete in
34 other dimensions other than price. They can have a
35 different image, store location, range of products and so
36 on as a way to survive. Again that would eliminate the
37 risk of spiral effects.

1 Then last but not least, and this is an empirical
2 anomaly, I would say, why don't all markets with buyer
3 power degenerate in such a spiral? We do not really
4 observe that happening very often, so there might be good
5 reasons why not.

6 I had a few comments on the waterbed effects, but I
7 think I have spoken too much, so I will maybe finish here.

8 John Davies: Well we will maybe come back to those.

9 PROFESSOR BRUCE LYONS: Can I just ask about that, to pick up
10 on the spiral effect, which as I understand it, is a
11 European Commission theory which has been beautifully
12 picked apart by Miguel here, ironically?

13 Is there anybody round here who believes the spiral
14 effect, the long-term dynamic?

15 A. (PROF ROMAN INDERST) What does it mean? Belief that
16 there is going to be exit of other retailers or only that
17 there is complementarity between organic growth and, let us
18 say, non-organic growth, that maybe there is some convexity
19 in the growth pattern, or something like this?

20 A. (PROF MICHAEL WATERSON) No. Give me a version that you
21 believe in.

22 A. (PROF ROMAN INDERST) With the spiral effect in a way I do
23 believe it is as follows. Maybe this is not exactly to the
24 point, but (inaudible). For instance, retailers can grow by
25 being very efficient. Let us say, they have been very
26 efficient. So he grows just because of this volume and he
27 is getting, let us say, a discount based on this volume.

28 This discount and particularly the lower wholesale
29 price he is getting may make it more likely for him for
30 instance to acquire, let us say, one of the weaker rivals
31 than if this rival could already be snapped up by someone
32 else, so I believe in a spiral-kind of effect if you only
33 look at the retail market. There is a tendency for a
34 creeping concentration of the downstream market because
35 buyer power begets buyer power. Buyer power from organic
36 growth is complementary to buyer power from acquisition.
37 It is formalised in a paper.

1 I do not know how much this is to the point here, but
2 in this sense, yes, in the sense that it is going to lead
3 to a long run monopolisation of the market. This could
4 be the case in a sense when keeping all parameters constant.
5 But that is, of course, nonsense, because there is going
6 to be new retail formats. And if there is going to be
7 monopolisation and higher prices, it invites entry of new
8 retail performers.

9 But if you keep these dynamics out of the market, I
10 think there is a big tendency formally to watch this
11 creeping process; more concentration, buyer power begetting
12 buyer power, organic growth being, complementary to growth
13 as acquisition. So if this is what the spiral effect is
14 logically going to capture I can somewhat underwrite it.
15 If it is about monopolisation of the market as being
16 inevitable, then, of course, I would not support it because
17 we are keeping so much constant.

18 John Davies: Does anyone else want to comment on this question
19 about whether they find the spiral effect possible? It is
20 important, because this spiral effect is something that has
21 been put to us quite vigorously already in this Inquiry.
22 The contention is that it is happening in the UK.

23 PROF DR CHRISTIAN WEY: When we talk about downstream market
24 structure then of course we also have to look at the entry
25 conditions, the costs of entry, and then we come into the
26 zoning and planning restrictions. This has structured
27 European retailing very much, so in many countries
28 basically the retail structure was a direct result of
29 planning and zoning restrictions.

30 In a sense when you analyse the effects on downstream
31 competition, you have to look at how easy it is to enter
32 the downstream market. Where can you locate is also very
33 important. For example, as a large multiple do you have to
34 locate far outside of the city? This will have different
35 effects than when you are allowed to locate this multiple
36 more in the downtown area. This will have strong effects on
37 consumer welfare, of course.

1 John Davies: Would it be right to say that almost any theories
2 of harm affecting downstream consumers depend upon barriers
3 to entry of the retailer?

4 PROF DR CHRISTIAN WEY: Yes.

5 A. (PROF MICHAEL WATERSON) Can I raise a different point? If
6 you want to look at the effect of upstream buyer power on
7 the downstream market, then one way to do that is to look
8 at markets where, compared to the UK, there is significant
9 upstream buyer power but not as much downstream power.
10 Those markets would be markets where important players are
11 buying groups who are not themselves sellers. I do not
12 know whether it is still true, but it certainly used to be
13 true that Germany was a market of this sort where there
14 were several important buying groups who did not themselves
15 carry out retailing. By making comparisons with those
16 markets, you would have some chance of isolating the effect
17 of upstream buyer power separately from downstream seller
18 power.

19 DR NICOLA MAZZAROTTO: Can I perhaps try and expand on Bruce's
20 previous question about the spiral effect, because I think
21 it may be useful to split the question in two, in a sense.

22 There is one issue, it seems to me, that has been
23 discussed concerning whether the existence of this buyer
24 power were mainly due to increasing discount and whether
25 this in turn may lead the powerful buyer to further
26 increase its buyer power. But there is another issue about
27 whether these types of discount that he may enjoy, which
28 are perhaps higher than his competitors, will be relevant
29 for the relative competitiveness of the powerful buyer.
30 Yes, if I am a powerful buyer, I may get big discounts, but
31 does that make me a very strong force in the downstream
32 market? One may be able to observe some degree of
33 increasing concentration because of this effect downstream
34 because a category of buyer may, for example, enjoy further
35 volume discounts but that individual buyer discount may not
36 be so big as to guarantee monopolisation of the final
37 market.

1 Is it useful to distinguish these two? I was
2 wondering whether anybody had a feel for whether they
3 thought that buying discounts arising from buyer power were
4 decisive or not in competing with other retailers?

5 A. (DR THIBAUD VERGE) I think what we are looking at is a
6 market which, first, is already highly concentrated and the
7 three or four big players already are pretty big. The only
8 way I could believe it is seeing small chains being
9 acquired by some of these big players, but I guess it is
10 unlikely that we will observe concentration between these
11 big four players unless the Competition Commission is
12 willing to allow that.

13 PROFESSOR BRUCE LYONS: We are interested in the entire grocery
14 market. It is not just a supermarket inquiry.

15 A. (DR THIBAUD VERGE) No, I agree, but if we look at your
16 numbers, if we look at the top five chains, they are all
17 vertically integrated. They all look to be vertically
18 integrated and they represent about 85 per cent of the
19 market.

20 The convenience market is probably the only place
21 where we could see this monopolisation and that looks to be
22 a small part of 15 to 20 per cent of the total grocery
23 market. It is already starting to look pretty concentrated
24 with the entry of these new big players.

25 DR NICOLA MAZZAROTTO: You mentioned the possibility of
26 monopolisation occurring through acquisition. Do you think
27 there is any risk of further monopolisation of the
28 downstream market occurring through organic growth, or one
29 player becoming so competitive that it may drive its
30 competitors out of the market, even one of the main four or
31 five players, and that this could arise from buyer power?

32 A. (DR THIBAUD VERGE) Well there are a few things. One is if
33 one of these players was becoming too weak, then maybe some
34 of the other big players from other countries would be
35 willing to get in, so it is not clear that the barriers to
36 entry are so high. They are probably important because the
37 only way you can get in the market currently is by

1 acquiring some of the small firms and that would never give
2 you more than 5 per cent of the market. But if one of the
3 big ones was in danger of getting bankrupt, then we could
4 probably see one of the big foreign chains coming in and
5 that would just limit this monopolisation anyway.

6 To go back a bit on the waterbed effect and whether I
7 believe that there is a chance that this growth could come
8 in, I do not believe too much in that story, and I guess
9 Roman does not believe it either, for the large
10 manufacturers. I think that is what you mentioned. If we
11 look at top tier manufacturers they have enough power and
12 that is probably why it is less likely to appear.

13 If we look at the low quality segment, or low value
14 item manufacturers, that is probably already looking at a
15 quite fragmented upstream market, so you probably can't get
16 strong effects. Even if one retailer gets a huge discount
17 from one of these suppliers, there are probably lots of
18 other suppliers who would be willing to give big discounts
19 to the other ones, so I do not believe the waterbed effect,
20 at least in the short term, would be very likely on that
21 type of product either, because the big players could still
22 get the big discounts from some of the suppliers.

23 Again where it is most likely to occur is in the
24 convenience market, if we look at the independent retailers
25 who have to go through this wholesale market and cannot
26 probably get the same volume discounts than the Tesco
27 Express or Sainsbury Local.

28 John Davies: That indeed is where it is principally being put
29 to us. Presumably the adverse effects on final consumers
30 of any such waterbed effect that only affects the small
31 independents will depend upon the degree to which those
32 independents are imposing a constraint upon the multiples
33 rather than the multiples upon each other?

34 That was sort of a question!

35 A. (MR MIGUEL de la MANO) Maybe I could state the obvious for
36 the record, but when we are talking about the waterbed
37 effects, I suppose the risk is that you are going to

1 stigmatise volume discounts. The idea here is that if you
2 are a large buyer who gets a volume discount, the upstream
3 supplier is going to increase the prices from the level
4 previous to the volume discount to downstream competitors,
5 the smaller convenience stores, and so on. This might
6 happen because smaller buyers reduce purchases as the large
7 buyer uses the volume discounts to expand output. But this
8 should not be a concern as the consumer benefits from lower
9 downstream prices.

10 I think we should be very careful in stigmatising
11 volume discounts in this way because even though there
12 might theoretically be instances where some sort of
13 waterbed effect where final consumers are worse off is
14 possible the required assumptions in my view, are very
15 idiosyncratic.

16 Also, the impact of the waterbed effect will always be
17 marginal because I think that in a general setting, if the
18 upstream supplier had the ability to raise input prices to
19 convenience stores in the first place, they would have done
20 it already, so it is not because of a volume discount to
21 the large buyer that all of a sudden they decide to raise
22 the price.

23 John Davies: It will need something more sophisticated to get
24 to that?

25 A. (MR MIGUEL de la MANO) It has to be.

26 John Davies: To clarify, you have talked about not
27 stigmatising volume discounts. I think this is a point of
28 yours, Roman.

29 Coming back to the spiral effect, the spiral effect
30 could presumably occur without any buyer power, just by
31 cost-related volume discounts, and without any waterbed
32 effects. I think this is what you said, Roman, that if I
33 get a lower price just because I am big, then that should
34 lead to a spiral effect, if I can translate that into a
35 downstream competitive advantage. We are not necessarily
36 depending upon anti-competitive buyer power to observe
37 potentially effects which are detrimental to competition

1 downstream. Is that right?

2 A. (PROF ROMAN INDERST) Anti-competitive in the sense of say:
3 that one buyer gets a discount, let us suppose because the
4 linear pricing is passed on; that it has got a large market
5 share etc.; then this is going to lead to increased
6 concentration. And we do not have to go through the
7 waterbed effect?

8 John Davies: Yes.

9 A. (PROF ROMAN INDERST) I guess that that was the point. But
10 the waterbed effect I think, would be like a story which
11 enhances this. But the waterbed story: Maybe I am a
12 little bit mistaken but for me it is a bit like, maybe, we
13 are asking almost the wrong question, or maybe I asked the
14 wrong question and everybody else asked the right question.
15 (laughter)

16 Maybe we ask the question what has happened if one
17 buyer gets a discount. Why should he get a discount all of
18 a sudden? No. We have to go one step back. What happens
19 if he gets supposedly more efficient, let us suppose
20 organically, or he acquires another retailer, or whatever:
21 He just gets bigger.

22 Let's get some figures right. A 70 per cent share of
23 the market. Not a 60 per cent share of the market. You
24 only have to look at it now: What does this do? Oh, yes,
25 maybe he gets another discount. But that would mean,
26 (inaudible), that the other retailer has a lower share of
27 the market. And then it is not just a formal, hypothetical
28 theoretical exercise but it is a logical consequence that
29 we are going to see the waterbed effect.

30 The question is not what happens if all of a sudden a
31 retailer does get a discount. Of course, then all these
32 arguments apply: 'If I am now able to charge a higher
33 price to the other retailer, why wouldn't I have been able
34 to do it beforehand'. The right question is to go one step
35 behind this. Something drives a change in the retail
36 structure so that one buyer gets a larger chunk of the
37 retail market which then may lead to a discount. But by

1 this, leaving market expansion effects on one side, we
2 would lose the market share of the other party. And this
3 may, if you believe in the discount story, reduce this
4 guy's buyer power and therefore lead to a premium. So
5 basically, this is logically completely consistent if we
6 ask the right question, starting from the primitives and
7 not just thinking the discount comes from heaven.

8 PROFESSOR BRUCE LYONS: Well, wait a minute. You said earlier
9 that the buyer power does not depend just crudely on the
10 quantity.

11 A. (PROF ROMAN INDERST) If there is just one, potential
12 primitive that could drive the buyer power. But it could
13 be also like, you could say, private label goods. This is
14 exactly the point we could also make here as well.

15 It is depending very much on what is the source of the
16 buyer power. If the source of the buyer power is
17 potentially private labels, and this has no effect, let us
18 say, on the market share of the other buyers, then it may
19 be, in the model I have in mind, that there is not going to
20 be this extra premium they would have to pay. We have to
21 be very clear. This is one point I want to repeat about
22 distinguishing between the different sources of buyer
23 power.

24 John Davies: We shall break for coffee before it gets cold.
25 When we come back in ten minutes time, can we spend ten
26 minutes talking about product variety still within this
27 topic area and then we will go on to a rather shorter
28 discussion perhaps of the final topic, vertical agreements.
29

30 (A short break)

31
32 John Davies: We are going to stop in 45 minutes time. I would
33 like to raise the question, for completeness perhaps, of
34 product variety within the area of buyer power potentially
35 affecting consumers. Does anyone want to comment on
36 whether buyer power or conceivably even the 'efficiency
37 offence' spiral effect could have an effect on product

1 variety. (I sense no great enthusiasm)

2 A. (MR MIGUEL de la MANO) Certainly one story which rings
3 possible to me is when the dominant buyer engages in
4 customer foreclosure, so essentially engages in a strategy
5 where he refuses to buy from upstream suppliers who would
6 benefit from economies of scale but also economies of scope
7 and, as a result of that, the upstream supplier decides it
8 is not interesting any more to manufacture a particular
9 product. Where there are economies of scope they would
10 probably reduce the product range accordingly. When that
11 happens smaller downstream rivals will have no access to
12 these upstream suppliers. Of course, that would lead to a
13 reduction in variety and possibly higher prices downstream.

14 John Davies: Is there a link there to this argument against
15 the spiral effect - that smaller retailers can diversify?
16 In other words there is suddenly a gap in the market once
17 that has happened.

18 A. (MR MIGUEL de la MANO) I think you would need to find out
19 some story of why there are also significant entry barriers
20 in the upstream market and upstream users do not come in
21 and exploit that opportunity together with the downstream
22 retailer. It is a double entry phenomenon.

23 John Davies: It has got to be a one-way door.

24 A. (MR MIGUEL de la MANO) It has to be a situation where the
25 retailer finds a supplier and vice-versa, and that is what
26 customer foreclosure makes more difficult. That can be a
27 problem.

28 John Davies: Thank you. Roman?

29 A. (PROF ROMAN INDERST) I am very short on the issue of
30 variety. And maybe different points complete a better
31 picture. I have only five sentences of wisdom here.

32 I would distinguish a little bit between - if you want
33 to analyse or understand the impact of buyer power on
34 variety - between like stories we tell, keeping the set of
35 existing products already at the store constant and stories
36 basically where buyer power has an effect on what is the
37 set of these products.

1 Keeping the set of existing products in the factories
2 constant, you could ask whether the formation let us say of
3 a bigger buyer through mergers, through organic growth,
4 where this has an impact on the number of items that are
5 stocked in a particular category at one retailer. Of
6 course, it is an empirical question and I would not know
7 the answer to it, but definitely you will know the answer
8 to it. But in theory, of course, you can construct a
9 scenario where to exercise buyer power you basically de-
10 list on the equilibrium. (Inaudible). Basically, you
11 commit to only one source, let us say, after a merger, even
12 though you know it is going to lose consumers. Or you
13 reduce basically some customers' willingness to pay because
14 it is not their preferred product. This is because by
15 bundling you effectively make suppliers compete more
16 vigorously for this particular slot on your shelf space.
17 However, will you do it or not? I would argue that it is
18 particularly less powerful buyers who would do this,
19 because this additional strategy of basically creating
20 buyer power destroys industry profits; it destroys surplus.

21 The cake is getting smaller but you are getting a large
22 share of it. But if you are getting a large share of the
23 cake anyway, you have less incentive to employ these
24 additional strategies of de-listing some of the players in
25 order to make them compete more aggressively.
26 Basically this should bring us to the following point: that
27 large powerful buyers may actually, maybe, have less of an
28 incentive to employ this. They are interested in
29 maximising total, you could say - you would not say
30 consumer surplus, but the total pie, the total industry
31 profits, because they are getting such a big share of it.

32 Maybe from this perspective we shouldn't care, even
33 though I have written a model of it to say otherwise. But
34 I do not differentiate there between different forms of
35 buyer power. Basically, it takes just one particular
36 sharing rule. However, in another paper I have written,
37 when you change the sharing basically this effect is more

1 or less likely. (Inaudible) strong buyers get a large
2 chunk of the profits. They have less incentive to do
3 something which is inefficient, because it destroys the
4 surplus from which they are getting a large chunk.

5 However, the second theory or hypothesis relate to what is
6 happening, if buyer power is exercised, to the set of
7 products that is available. This brings us back to right
8 at the beginning of our discussion about innovation. And
9 without repeating what we said there, there is maybe just
10 one point we should make here. Again, the issue may be
11 that of private labels.

12 (Inaudible) If you look at a big retailer and you say:
13 'well, the top-tier brand is basically racing against a
14 retailer to become very innovative, to come up with the
15 newest product; and on the second level there we have got
16 very good private label goods'. What is happening to the
17 independent retailers? So looking at the set of products
18 that is available once buyer power is exercised, an
19 interesting question could be to whom this set of products
20 available. This could change by the exercise of buyer
21 power, in particular through private labels.

22 John Davies: That does sound to me as if it is an empirical
23 question for which one could almost find a theoretical
24 justification, whichever way the empirical findings went.
25 Perhaps that is a little unfair. I won't ask you to
26 comment.

27 A. (PROF ROMAN INDERST) Basically theory should guide you on
28 which theoretical questions to ask, or theories.

29 John Davies: Unless anyone has got anything to say on product
30 variety, I suggest we move on to our final topic, which is
31 vertical agreements.

32 PROF DR CHRISTIAN WEY: One final comment, perhaps, also for
33 investigation. A lot of your story of course is high up-
34 front payment. I mean a slotting allowance, or something
35 like this. This will indicate that there is only a limited
36 amount of shelf space available, so when you observe a lot
37 of up-front payments, a lot of slotting allowances, then

1 this may be an indication that somehow the variety is
2 reduced. For example, (inaudible), as I know, they do not
3 ask for slotting allowances. Then you come into the story
4 very basically that there is no loss of variety, so perhaps
5 this is an indication.

6 A. (PROF MICHAEL WATERSON) I think the point about the size
7 of the cake is very important really because, if you think
8 about it, supermarkets would naturally be in a shrinking
9 market, because the income elasticity of demand for food is
10 less than one.

11 John Davies: Relatively shrinking.

12 A. (PROF MICHAEL WATERSON) Yes. Not absolutely shrinking but
13 relatively shrinking. In order to increase their take of
14 consumer income, they have to move into increasingly more
15 areas rather than shrinking areas.

16 John Davies: Let us move on to our final topic and then I will
17 call upon Thibaud to speak first and then I think it is
18 Miguel again responding. All of you fairly briefly please,
19 to allow time for discussion.

20 MS KIRSTEN EDWARDS: Our final topic for discussion is
21 vertical agreements. There are a number of practices that
22 we have been told, or have previously found to be present
23 in the UK groceries markets, such as slotting allowances,
24 pay to stay fees, category management, exclusivity
25 agreements and resale price maintenance.

26 The CC will be considering the extent to which these,
27 and other, practices occur and the resulting impact on
28 consumer welfare. The main concerns are exclusion of
29 competitors, collusion, and reduction in innovation.
30 However, it is possible that certain practices are
31 efficiency enhancing. The CC will need to identify if and
32 when certain types of agreement or practice reduce consumer
33 welfare.

34 There is a table in the discussion paper which sets
35 out the possible pro-competitive, neutral or anti-
36 competitive effects which might arise from the different
37 practices mentioned. The panel may wish to discuss the

1 circumstances under which these practices might be anti-
2 competitive in effect and the evidence which might be used
3 to test for this.

4 A. (DR THIBAUD VERGE) I guess first I would like to come back
5 on a point that Mike made earlier.

6 One of the big problems we have, so that it will be
7 clear here, with vertical restraints is to identify whether
8 effects are likely to be good for consumer welfare or not,
9 and that really depends on what the modelling assumptions
10 are and again the big question is on the type of the
11 bargaining. What do they bargain upon? Do we have linear
12 prices? Do we have non-linear tariffs? I have tried to
13 defend my case and I think Mike has already said before
14 that we believe strongly that we observe non-linear
15 pricing.

16 A. (PROF MICHAEL WATERSON) The "we" is Thibaud as well.
17 (laughter)

18 A. (DR THIBAUD VERGE) I believe so. We believe. Sorry.
19 That is exactly the opposite strategy to Mike.
20 There are few arguments to believe on non-linear tariffs
21 based on some very good empirical papers. Some might be
22 biased because they also come from Toulouse that might just
23 be used to sustain our theories. There is some recent
24 empirical work by Céline Bonnet and Pierre Dubois in
25 Toulouse, some with Michel Simioni as well, on structural
26 estimation of vertical relationships. They try to recover
27 the type of contract. They look at different modelling
28 assumptions and try to look at which is the model that fits
29 best with data. The data they are using come from the
30 French bottled water markets in the late 1990s and the
31 evidence suggested that the most consistent model is one
32 with non-linear tariffs and possibly resale price
33 maintenance. I will come again on that, because it links
34 to some of the work that we have done with Patrick.

35 One of the points I would like to mention here is that
36 it is not clearly linked to buyer power or at least for
37 sure it is not linked to buyer power alone because these

1 are situations where we are probably talking at bargaining
2 between large retailers, a few chains and a very small
3 number of multi-product retailers, so various brands of
4 mineral water and spring water are usually owned by only
5 two or three big producers. There is also some evidence in
6 the US from Sofia Berto Villas-Boas, who has a paper
7 forthcoming in the Review of Economic Studies, where she
8 mentions that there seems to be some evidence of non-linear
9 pricing in yoghurt market in California. We believe
10 strongly in non-linear pricing.

11 Some debate has taken place in France about changing
12 the laws about banning below cost pricing. That took place
13 about last year. There seems to be strong evidence that
14 they are bargaining on some tariff, maybe some quantity
15 discounts, but there are also lots of negotiations on fixed
16 fees that sometimes are not really conditional on any
17 proper activities, such as advertising rebates where the
18 price that these retailers charge to manufacturers is not
19 really related in any way to the cost they have to pay.

20 From the theory side I will focus on two of the types
21 of restraints that are mentioned in the paper. I will talk
22 briefly about resale price maintenance.

23 One of the views is that purely bilateral contracts
24 can be used to sustain collusion to facilitate collusion
25 not only between the retailers but also globally between
26 the retailers and the manufacturers. That is one view we
27 want to defend. There are two theories here. One is that
28 resale price maintenance can be used to make deviation from
29 the tacit collusion more observable by the retailers, so if
30 I observe that you lower your price, then if we have these
31 RPM contracts then I will know now that that is because you
32 have got a better deal rather than because you had a shock
33 on your local demands or your costs so I will be able to
34 punish you more easily now that I observe more easily the
35 deviation.

36 That is one of the theories that RPM will make
37 deviation more likely to be observed and that tacit

1 collusion is easier to sustain.

2 Welfare effects are ambiguous because also we maintain
3 on average higher prices. The trouble is we cannot change
4 the prices when the shocks really occur because we would be
5 scared that our competitors would start believing that this
6 is not a cost shock, but is simply a deviation.

7 The second theory we have is one looking at more
8 complex situations. There are lots of theories on why
9 vertical restraints cannot have a negative impact when you
10 have competition between vertical chains simply because if
11 one vertical chain tried to introduce some anti-competitive
12 measure, then the others would be able to get the market.

13 One of the big problems with these theories, is that
14 when we observe the retail market, we see that the big
15 multi-product manufacturers, if I go back to Danone or
16 Nestle for the bottled water, usually sell all their
17 products to all the retailers, so we have this kind of
18 complicated relationship where all manufacturers have their
19 products on the shelves of all the retailers. We have a
20 paper on that where the results are a bit different from
21 what Mike finds, simply because we look at different types
22 of contracts. Again which one is the more realistic is
23 really I think an issue for you. It is an empirical issue
24 and again you have better data than we have. But our view
25 is that if you have non-linear pricing, then resale price
26 maintenance can be used to maintain high prices and the
27 impact on consumer surplus will really depend on what we
28 are looking at.

29 If we are looking at situations where you have
30 competing suppliers, so maybe this second tier of suppliers
31 that want to access these different shelves, then we
32 believe clearly there is an unambiguous effect here and
33 that this will lead to monopoly pricing by the retailers.
34 It will help the collusion at both levels and will be bad
35 for the consumers.

36 If we go to situations where we look at this
37 relationship between the top tier manufacturers and

1 retailers, then the situation is a bit more complicated
2 because what we could observe again that resale price
3 maintenance will allow to maintain high prices. But it can
4 also allow for more competition in the sense that all
5 products would be sold on all retailers shelves, whereas
6 there could be some exclusion if we do not have these
7 complicated contracts. Here we have these two conflicting
8 effects that maybe we have high prices but with a larger
9 set of products.

10 Two remarks on this resale price maintenance issue.
11 First it is inconsistent with some recent anti-trust cases
12 in France. It was the case for grocery products that are
13 also sold in France through some of these big retail
14 chains, there was a case on brown goods and some of the big
15 manufacturers at this time. Some of the big manufacturers
16 were fined by the Conseil de la Concurrence last December.

17 There was a case in the perfume industry. There was a
18 case also in the video industry for sale through
19 supermarkets, so there seem to be some evidence that these
20 kind of restraints are used in the industry, so we do not
21 really see why that would be unrealistic for grocery
22 markets when we look at these big chains.

23 The second point answers the second issue for
24 discussion you had in your papers. In this type of model
25 the result does not depend on who initiates the contracts.

26 So whether resale price maintenance is imposed by the
27 manufacturers or it is asked for by the retailers or
28 whether we have a kind of bargaining model is unlikely to
29 change. The result is that that will affect the way the
30 pie is shared. But again that really depends on the
31 modelling assumption and on what type of contracts you are
32 using. If it is just really issues on the way we share
33 this pie, then these are the results we get. If you use
34 only linear tariffs then Mike has reserves. That will
35 really depend on what the bargaining power is.

36 The second point, briefly, is on slotting allowances
37 and here again there are conflicting results. Here I do

1 not want to talk about listing fees for new products but
2 rather pay to stay fees for existing products. For new
3 products there are all these pro-competitive theories that
4 slotting allowances can be used to efficiently select the
5 products, or simply to auction the shelf spaces to these
6 manufacturers.

7 Here I want to talk about pay to stay fees for
8 products that have already been tested, that have been
9 there for a few years and we know them, and probably
10 products where we are talking about again top tier
11 manufacturers.

12 Again there are conflicting theories and here again it
13 really depends on the type of contracts we are looking at.

14 Marx and Shaffer are looking at a situation where these
15 slotting allowances will always lead to the exclusion of
16 some of the retailers. These big top tier manufacturers
17 would be present only on some of the retailers shelves but
18 not in all retail chains. We believe it is not really
19 consistent with what we observe in practice, since these
20 big manufacturers seem to be selling to all the retailers.

21 So we look at a slightly different framework. It is just
22 again pure theory, so whether we believe it, some might not
23 believe our stories.

24 If we have these sufficiently complicated contracts
25 and that is where slotting fees can be used, then these
26 slotting fees can be used again to facilitate collusion
27 between the retailers. Again there are conflicting effects
28 on consumer surplus because we maintain high prices but now
29 these products are sold everywhere so that might be better
30 for consumers because you do not need to change store if
31 you want to find your favourite product, or you do not need
32 to change product if you do not find it in your favourite
33 store.

34 From the simulations we get, we suggest that these are
35 more likely to be welfare decreasing because these high
36 prices, or exclusion, would be more likely to occur when
37 the second retailer does not bring much to the consumer,

1 does not add much value to the consumer, so missing that
2 product could not be a big cost. So allowing slotting fees
3 might just allow for these products to be sold everywhere
4 but anyway it is not very important that it is sold
5 everywhere.

6 John Davies: And that arises from an asymmetric market
7 structure when you have a large player and a smaller one?

8 A. (DR THIBAUD VERGE) Well the big difference is we do not
9 even need big players and small players here. It always
10 occurs. If there is bigger symmetry then exclusion would
11 be more likely to occur without slotting fees, but then the
12 effect would be that if you have a pretty small retailer
13 then missing that product of that pretty small retailer
14 would not harm very much consumers.

15 To try to conclude briefly, we believe vertical
16 restraints can harm consumers in these frameworks where you
17 have this kind of complicated structure, where multiple
18 manufacturers sell their products to all retailers. That
19 seems to be consistent with the grocery markets, so we
20 should see this is consistent again for these top tier
21 manufacturers, so where we observe these big manufacturers
22 - we talked at the break about Coca Cola and Pepsi so we
23 rather observed them sold in all the chains - so this
24 interlocking relationships are something that might have an
25 impact on the role played by vertical restraints and in
26 most of the cases the impact on the consumer does not
27 really seem to depend on who initiates or who instigates
28 this type of vertical restraint, so who is really behind
29 it.

30 John Davies: That is interesting.

31 A. (DR THIBAUD VERGE) We believe that in this kind of
32 framework it is mostly used to sustain the collusion
33 between all the players, so it is just a tool to facilitate
34 the collusion between the players, so whether it is really
35 done by the manufacturer or the retailer does not really
36 matter. The bargaining power will be used to share this
37 extra profit between the different players so it does not

1 really matter whether it is retailers forcing these
2 restraints or manufacturers setting them in their general
3 conditions for sale.

4 John Davies: Thank you very much. Now Miguel fairly quickly
5 and then Christian.

6 A. (MR MIGUEL de la MANO) I will try to be brief. Stop me if
7 I am not.

8 John Davies: Five minutes.

9 A. (MR MIGUEL de la MANO) There is scarce literature on the
10 role of retailers as promoters of vertical restraints.
11 Maybe that simply reflects, as Thibaud was saying, that it
12 does not make much of a difference who encourages the
13 restraint, although I will mention an example where I think
14 it does.

15 I would strongly agree with Thibaud that by and large
16 in the context of buyer power one might want to worry about
17 vertical restraints when they encourage collusion at the
18 level of buyers or at the level of the sellers and this
19 certainly can happen through resale price maintenance or
20 even in extreme circumstances category management.

21 I think the point is that buyer collusion in itself is
22 more easy to sustain than seller collusion. That is
23 something you might want to worry about. The reason is
24 fairly simple. First, it is a lot easier to allocate
25 suppliers geographically or by category than it is to
26 allocate customers.

27 Second the profits from deviating in the context of
28 buyer collusion are much less in the sense that when you
29 deviate you pay a higher price for the input but at the
30 same time that harms your prospects in the downstream
31 market because that would lead to higher output prices
32 downstream for your products as a retailer, so small buyers
33 have really much less of an incentive to deviate by bidding
34 up input prices and rather would want to live under the
35 umbrella of the buyer collusion. Of course, it is also
36 pretty easy to detect deviations because suppliers are
37 pretty good informants about what is going on.

1 Certainly when you have a concern about buyer
2 collusion tied up with a vertical restraint of some kind,
3 that is something that requires quite some degree of
4 attention and, of course, buyer collusion would naturally
5 lead over time to mechanisms to collude also in the
6 downstream market and that could of course exacerbate the
7 effects quite significantly.

8 More specifically in terms of some of the vertical
9 restraints that you mention on your note, I find that
10 slotting fees should not be much of a concern. I
11 understand that the competitors' concern is that slotting
12 fees are viewed as a mechanism by which suppliers with
13 market power can over-buy shelf space to exclude rivals,
14 but I think it relies on the assumption that there are no
15 viable alternatives left for distribution. By and large I
16 think this is not true.

17 Last but not least there is a self-correction device
18 here. If slotting fees really are so profitable and lead
19 to situations where they are demanded again and again, this
20 would lead to an increase in shelf space. Naturally there
21 would be some kind of entry at the level of creating more
22 shelf space if it is so scarce. Of course slotting fees
23 also have a lot of pro-competitive effects. They allow the
24 supplier to signal which products are likely to be
25 successful and also allow the buyer to share the risks with
26 the seller of bringing a new product into the market.
27 These positive effects are very well detailed in the
28 literature.

29 Another interesting practice is category management.
30 I have a little to say on that but I will point to the
31 Proctor and Gamble/Gillette merger case which the EU
32 Commission dealt with last year. Third parties were
33 concerned with the increased scope for category management.

34 The EU Commission looked into it and concluded that by and
35 large category management would only bring efficiencies in
36 those situations because the contracts are relatively loose
37 and the buyer always has the ability to switch from one to

1 the other, so if there is a problem it would be only
2 because again it would increase the risk of collusion at
3 the level of supplier, not in itself.

4 I turn now to the main focus of my intervention. My
5 concern is with private labels and I would tie that to a
6 theoretical framework developed by Rey and Comanor Private
7 labels strengthen the retailers' position vis-a-vis their
8 suppliers. It reduces their dependence on individual
9 branded goods. It gives a retailer better flexibility to
10 reduce branded product shelf space. So there are clear
11 advantages in terms of exercising buyer power when
12 retailers integrate upstream and acquire private labels.

13 It also gives access to sensitive information which
14 could be exploited, although I do not think that in general
15 such information can be exploited in an anti-competitive
16 way, rather it is likely efficient in that the retailer
17 better understands the supplier side of the market.

18 In what setting can private labels raise a concern? I
19 think they might raise a concern in the context of
20 exclusive supply agreements. There is a very interesting
21 paper and some follow ups by Rey and Comanor where they
22 present the following framework.

23 They have an incumbent distributor in the downstream
24 market who faces entry by a more efficient distributor.
25 The entrant has only access to an upstream seller, which is
26 an established upstream seller, whereas the incumbent
27 distributor, i.e. the incumbent retailer, has also access
28 to a possibly less efficient upstream supplier or more
29 likely in the case of supermarkets, a private label. It is
30 not as good as a branded good but it has access to this
31 private label.

32 In the absence of any kind of exclusive supply
33 agreement between the incumbent distributor and the
34 incumbent branded good seller, entry would happen because
35 this distributor is coming in as more efficient, so the
36 supplier will be happy to deal with the entrant. But of
37 course the incumbent retailer would like to deter entry and

1 can try to bribe, as it were, the upstream supplier to
2 enter into an exclusive supply agreement.

3 The key question is why would the upstream supplier
4 agree to an exclusive supply agreement with the incumbent
5 distributor? One simple answer is that the incumbent
6 distributor can threaten to rely on the alternative
7 producer (that is on its private label), and therefore
8 create very intense competition in the downstream market,
9 so if the incumbent seller decides to supply the more
10 efficient new entrant, the incumbent reacts by saying 'I am
11 just going to rely on my private label. There is going to
12 be a lot of competition downstream; you are going to make
13 no profits'. So both the incumbent distributor and the
14 incumbent supplier might have an interest to sign an
15 exclusive supply agreement and try to share the gains from
16 monopolising the downstream market by keeping the more
17 efficient entrant out.

18 John Davies: Is that because of the private label or is it
19 because of their negotiating power? In this instance it
20 arises from the private label?

21 A. (MR MIGUEL de la MANO) Exactly. The framework is rather
22 abstract. There may be various reasons why the incumbent
23 distributor has access to this alternative source of
24 supply. In the context of supermarkets I think that is
25 because of private labels but there may be others. Of
26 course, the key there is that indeed the more efficient
27 entrant has no access to that alternative source of supply
28 for whatever reason. You need to identify why is that. If
29 the incumbents have some other source of supply why not the
30 more efficient entrant?

31 Here it seems to me at least that it matters who is
32 imposing the exclusive dealing, because the mirror image of
33 this story is that there is an upstream supplier entering
34 the market and the upstream incumbent wants an exclusive
35 supply agreement with an incumbent distributor to prevent
36 entry from a more efficient upstream supplier. In a way
37 whoever promotes the exclusive dealing gives you a signal

1 as to what is going on. When the distributor is promoting
2 the exclusive supply agreement it is likely that entry is
3 expected from a more efficient distributor, whereas if it
4 is the incumbent producer who is asking for the supply
5 agreement maybe it is because entry is expected at the
6 upstream level.

7 John Davies: Thank you very much. Now Bruce, I think.

8 PROFESSOR BRUCE LYONS: I do not know how much time we have
9 got?

10 John Davies: Not a lot.

11 PROFESSOR BRUCE LYONS: There is another broader issue that I
12 wanted to get on to because I know that some of my
13 colleagues are particularly interested in it and as long as
14 you promise that I can come back on that with five minutes,
15 if you just want to pick up on these things with someone
16 else then okay. But I do need to ask this question.

17 John Davies: Okay. You get two goes. Do you want to go to
18 Roman or do you want to ask your question now?

19 PROFESSOR BRUCE LYONS: The issue that I wanted to pick up on
20 was quite separate from what we have just been discussing,
21 so do you want me to go straight there?

22 John Davies: Yes, go straight there.

23 PROFESSOR BRUCE LYONS: Okay. It is to do with more
24 agricultural issues, because a lot of what we have been
25 talking about is about manufactured goods, branded
26 suppliers and the rest. That has a good airing.

27 What has not had a good airing is some very early
28 stuff on shapes of supply curves. Agricultural issues,
29 fresh fruit producers, meat producers and the rest.

30 There are certain characteristics. There is often a
31 long lead in to their supply decisions and then at any
32 moment in time supply can be quite inelastic. A typical
33 planting cycle is a year in advance or with animals it
34 takes longer to breed them, and the rest.

35 For certain agricultural products there are futures
36 markets for bulk grain, but for others these do not exist.

37 We have had information on a variety of relationships with

1 the supermarkets, but I just wondered if anyone had any
2 comment about how the issues that we have been discussing
3 change substantially when we are talking about the
4 suppliers being fragmented agricultural markets of fresh
5 produce with these sorts of characteristics that I have
6 been talking about as distinct from the manufactured
7 branded goods.

8 A. (PROF MICHAEL WATERSON) [✂]

9 DR NICOLA MAZZAROTTO: [✂]

10 A. (PROF MICHAEL WATERSON) [✂]

11 DR NICOLA MAZZAROTTO: [✂]

12 A. (PROF MICHAEL WATERSON) [✂].

13 I am not sure how helpful that is, Bruce.

14 PROFESSOR BRUCE LYONS: I am in demanding mode, so I am biting
15 my tongue at the moment.

16 John Davies: If you also want your other demand, if you want
17 to talk about non-linear pricing, then I think we will be
18 able to do it now.

19 A. (PROF MICHAEL WATERSON) Sorry, can I make another point
20 about an entirely different thing while I am here, as it
21 were.

22 If you think about exclusive agreements of various
23 sorts, vertical agreements of various sorts, then one of
24 the main factors is whether the agreement in some way
25 reduces competition between the retailers and that is, in a
26 sense, the main thing that you would be concerned about.
27 It can do that in two ways (well, I suppose they boil down
28 the same way), by making supermarkets less comparable with
29 each other, so either I can stock one product and you can
30 stock another one and so we are less comparable, or we have
31 some other way in which we have come to an agreement with
32 our supplier, which means that people are less likely to
33 shop elsewhere.

34 John Davies: Or potentially by exclusion?

35 A. (PROF MICHAEL WATERSON) Yes.

36 John Davies: We are in the last few minutes, so I think one
37 question from Bruce in this area of non-linear pricing.

1 PROFESSOR BRUCE LYONS: On non-linear pricing, hopefully we
2 might get a little bit of blood between Mike and Thibaud on
3 this, but what we seem to be picking up is that there is
4 something to do with price and quantity going on. We have
5 not tied it down yet. My question is there are three
6 aspects of this that I would like to hear some comments on.

7 Firstly, the extent to which this is cost reflective
8 in the sense that it is cheaper to set up a distribution
9 system whereby large quantities are being delivered rather
10 than small. There are certain aspects, and that is only
11 one of them, whereby the costs are related to the quantity
12 demanded. To what extent are they affected by that cost
13 reflection versus some other pure buyer power lower price?

14 Secondly, this picks up a little bit on one of the
15 things that Thibaud was discussing in relation to
16 restrictive practices. Does it matter if there is a
17 credible *ex ante* supply schedule offered by a supplier?
18 Where there is not negotiation but there is an annual price
19 list, as it were, with quantity discounts in.

20 Thirdly, lump sum payments, that are sometimes known
21 as over riders, that if there are certain quantities that
22 are achieved in terms of sales, then the supplier would
23 give a lump sum payment back to the supermarket, the story
24 goes, in respect of having been so good at selling the
25 supplier's goods. Those are the three things.

26 John Davies: I wonder if I could suggest that I call upon a
27 couple of people to give instant responses to that and then
28 we can also perhaps take that up in written comments after
29 the session.

30 Roman, do you want to comment on those, or not?

31 A. (PROF ROMAN INDERST) Well I have other comments as well,
32 but maybe just very quickly.

33 It is basically about the focus on particular
34 contracts or practices, be them (inaudible), ordinary
35 discounts or lump sum payments, etc.

36 I would be very careful about drawing inferences from
37 this but you have been very careful about it as well. If I

1 need in a model a lump sum payment in order to get
2 exclusion because the only other contract I am having is a
3 linear tariff, it does not mean that in reality if I
4 exclude, let us say, this lump sum payment, this will have
5 the same effect. The parties will find different means to
6 transfer profits between them. Let us say by ordinary
7 discounts. You could say, for instance, by non-linear
8 pricing. You could say, for instance, maybe delaying
9 payments. So there are other channels. Basically I would
10 be very careful then to jump to the conclusion that for
11 policy measures if you very precisely rule out one
12 contractual practice you may have any positive effect about
13 reducing potential harm. Maybe it will have an effect,
14 that of reducing potential harm. Maybe it will have an
15 effect of reducing the efficiencies of the contractual
16 practice. This is the only point I am making here.

17 John Davies: I think that is an incredibly important point.

18 Thank you very much. Thibaud?

19 A. (DR THIBAUD VERGE) I do not know what you mean by how
20 credible these credible schedules are.

21 PROFESSOR BRUCE LYONS: Nor do I. A perfectly reasonable
22 answer might be that there can be no credibility in such
23 schedules despite what people say. But that is what I was
24 wondering.

25 A. (DR THIBAUD VERGE) I think the people from the Irish
26 Competition Commission Authority have the same idea.

27 There has been a lot of debate in France about these
28 below cost pricing rules recently, so what happens is that
29 the producers set these credible schedules and that is what
30 we see in the invoices that the retailers receive and that
31 sets the price below which the retailers are not allowed to
32 sell. Then after these credible payment schedules come
33 quantity discounts, so everything, non-discriminatory
34 schedule. Then it seems that there were lots of
35 negotiations on other things, so annual discounts because I
36 am doing special things for you or, as we said at the
37 break, we deliver the product in the right way so that you

1 can use it directly on your shelves. Sometimes also
2 payments, as I have already mentioned, for advertising
3 campaigns, where the sums which were paid by the producers
4 have nothing to do with the real cost of producing that
5 flyer that was sent to all the consumers. They were really
6 disguising all these end of year rebates or all the other
7 things in some other kinds of payments.

8 That is what Roman said, that there are lots of ways
9 you can distort the rules and as soon as that law was
10 introduced in 1996 making clear what the minimum price was,
11 it seemed that that is what we started to observe, that the
12 credible schedule started having very high wholesale prices
13 and you, as the retailer, could not sell below that price
14 because that is what you had on your invoice and then we
15 were negotiating privately lots of rebates because I was
16 putting your product in a better place on the shelves or I
17 was doing advertising campaigns or you were giving me
18 offers on these two for one offers so that I could have at
19 some point in the year lots of promotional campaigns on
20 your products. That was observed mostly again on these top
21 tier well-known producers, so all these prices went up
22 after 1996. There are international comparisons: it seems
23 that prices in France compared to Germany went up more than
24 10 to 15 per cent just after this introduction in 1996, so
25 as I say, I agree with Roman that saying we ban one thing
26 does not mean we will have the right effect on the market
27 because also we have banned that one, the manufacturers
28 will find another way to use another one and transform the
29 contracts.

30 John Davies: It pops up somewhere else.

31 I think we do have to close it down there. I mentioned
32 right at the start that we would be very keen indeed on
33 participants today - although of course you do not have to
34 - sending in any written comments they might have.

35 I am conscious that right at the end Bruce posed three
36 hugely broad questions and actually preceded them by an
37 even broader one on agriculture, so in a sense those

1 questions are still outstanding and it would be useful
2 perhaps if you remind yourself when you see the transcript,
3 if you have any thoughts on those, to address them.

4 More generally I think today has been very useful. I
5 think it has been very interesting. But also I think these
6 things are incredibly difficult and for me, at least, today
7 has raised more questions and more possibilities than it
8 has closed down. While that is still just about okay at
9 this stage in our inquiry, I think increasingly from now on
10 what we need to do as much as possible is close things down
11 - either on theoretical grounds or on obvious applicability
12 grounds. I think you have all been very good at saying
13 almost what your feelings are about some of these areas
14 without necessarily being too hung up on the details, which
15 has been most useful. But also in particular how we can
16 test these competing theories and emerge with, as it were,
17 a few candidates to potentially run with and test in great
18 detail.

19 If you are going to submit written comments - and as I
20 said, we very much hope that you will - things that would
21 help us focus down and things that would help us test are
22 particularly valuable. You might want to think about, for
23 example, if you had to pick one or two really important
24 things within the huge topic that we have covered today,
25 important things for us to investigate, what do you think
26 those should be? A couple of you have made indications
27 along those lines. Then empirically how can we tell the
28 difference? We have impressive data gathering powers. We
29 have the ability to do data analysis. But what we need to
30 know is what the right questions are. Thoughts about how
31 we could test these different competing IO models against
32 reality would be particularly helpful.

33 Most of all, thank you all very much for your
34 participation and I would like to invite you all to lunch.

35 THE CHAIRMAN: John, can I just add on behalf of us ordinary
36 folk thanks to everybody, the team for setting it up and
37 for the distinguished visitors for contributing both today

1 and yesterday. It has been very interesting listening to
2 this framework debate. Somebody said at the beginning that
3 sooner or later we do have to apply this to the facts of
4 the case and I am sure what you have said will be extremely
5 helpful in enabling us to do that. So thank you to
6 everybody.

7 (The hearing concluded)
8
