



Buyer-Driven Vertical Restrictions

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Introduction

- Traditional emphasis on seller-led practices
 - upstream party places trading conditions on a downstream party
 - typically conceived in terms of a principal-agent relationship (upstream controls downstream)
 - focus on restraints like non-linear pricing, RPM, quantity forcing, exclusive dealing, exclusive distribution, selective distribution, and tying/bundling
 - producer-led emphasis evident from EC's *Guidelines on Vertical Restraints*

Introduction (cont.)

- In reality, VRs may be applied in either direction between trading parties
- In particular, powerful business customers may be able to negotiate or impose restrictions and conditions of trade on suppliers
 - *Buyer-driven* restraints include conditional purchase behaviour, additional payment requirements, most-favoured customer clauses, refusal to buy, and deliberate risk shifting, amongst others

Introduction (cont.)

- *Buyer-driven* restraints feature widely, e.g. in health care, professional sports, natural resource extraction, farming, ranching, and forestry
- Yet, it is retailing where much attention has been focused as buyer-driven VRs appear widespread and numerous in type and variety
- Powerful retailers may be able to exploit their gatekeeper role and place restraints on “economically dependent” suppliers

Introduction (cont.)

- *Buyer-driven* restraints may affect competition amongst suppliers and purchasers, thus potentially affecting both upstream (supply) and downstream (retail) markets
- Adverse effects for consumers may arise through impact on product/service prices, choice, quality, and/or innovation
- However, efficiency benefits associated with such practices suggest a *rule of reason* approach

Types of Buyer-Driven Restraints

- Purpose of Buyer-Driven Vertical Restraints
 - *direct financial benefits* (e.g. pay to play/stay lump sum payments)
 - *indirect financial benefits* (e.g. MFC guaranteeing no cost disadvantage; exclusive supply guaranteeing product differentiation; preferential supply shifting risk on to suppliers or rival purchasers)
- Control not a pre-requisite
 - Buyer driven restraints can also arise from mutual consent, “quid pro quo”, standard “custom and practice”, or due to a cartel of suppliers or buyers

Types of Buyer-Driven Restraints

- Classifying Buyer-Driven Vertical Restraints (by parties' behaviour and impact on competitors):
 1. *Conditional Purchase Requirements*
 2. *Additional Payment Requirements*
 3. *Non-Discrimination Clauses*
 4. *Refusal to Buy*
 5. *Deliberate Risk Shifting*
 6. *Service or Input Requirements*

Types of Buyer-Driven Restraints

1. Conditional Purchase Requirements

Supplier required to provide significant concessions in respect of whom else it may trade or what it (uniquely) provides the buyer as a condition of purchase

Examples:

- Insistence on exclusive supply
- Minimum supply obligations
- Exclusive distribution
- Reciprocal buying
- Tying purchases

Types of Buyer-Driven Restraints

2. Additional Payment Requirements

Supplier required to provide lump-sum payments or special discounts for gaining/retaining access to a key distribution system or to ensure that the buyer is rewarded for its efforts and compensated for any failings on the part of the supplier

Examples:

- Listing fees
- Slotting allowances
- Retroactive (overriding) discounts
- Joint marketing contributions
- Special payments (e.g. buyer merger “wedding gift”)

Types of Buyer-Driven Restraints

3. Non-Discrimination Clauses

Requirements placed on a supplier either to ensure that it does not offer (significantly) better terms or products to other purchasers or to assist in helping the purchaser compete on effective terms against other purchasers

Examples:

- Most favoured customer (MFC) clause
- Requirement to provide best or matching product/service quality
- Margin support guarantee
- Open book accounting requirement

Types of Buyer-Driven Restraints

4. Refusal to Buy

Purchaser boycotts a supplier or limits its purchases in such a way as to weaken its competitive position or put it out of business (potentially distorting supplier competition and perhaps raising other purchasers' costs)

Examples:

- Refusal to initiate trading
- Terminating long-standing trading relationship at short notice
- Delisting certain products

Types of Buyer-Driven Restraints

5. Deliberate Risk Shifting

Purchaser pushes on to its supplier the financial risk that it faces from uncertainty over its own performance and realised demand in its downstream markets

Examples:

- Delayed payments
- Enforced sale-or-return
- Payments to cover product wastage on unused/unsold items
- No written contracts

Types of Buyer-Driven Restraints

6. Service or Input Requirements

As part of the terms and conditions of supply, the purchaser requires a supplier to provide particular services or to use particular inputs (beyond those normally offered) to suit its own specific needs

Examples:

- Tailored delivery terms
- Customized product presentation
- Obligations to use third-party contractors
- Category management services



Welfare Effects

- Three possibilities:
 - Neutral
 - Straightforward transfer of surplus (essentially different division of the same profit pie)
 - Harmful
 - capacity to generate or extend market power and distort/restrict/prevent competition amongst suppliers and/or amongst buyers
 - Beneficial
 - may serve to enhance efficiency, improve quality, and allow for innovation



The Pros

- EC Guidelines classification of beneficial effects:
 - i. solving a free-rider (under-investment) problem
 - ii. encouraging new investment (avoiding “hold-up”)
 - iii. facilitating new entry into markets
 - iv. allowing for a different promotional strategy in different markets
 - v. achieving economies of scale in distribution/production
 - vi. alleviating capital market imperfections
 - vii. allowing for uniformity and quality standardization

- Buyer-driven VRs may also facilitate scale, scope and span economies in purchasing



The Pros (cont.)

- Some examples:
 - i. Exclusive supply to prevent rival buyers free riding and encourage relation-specific investment by the supplier
 - ii. Reciprocal buying or tying purchases as a means to access a new market
 - iii. Customised product presentation to facilitate a promotional strategy in downstream markets
 - iv. Obligations to use third-party contractors to aid uniformity of the buyer's brand image or allow economies of scale in distribution

The Pros (cont.)

- Reducing transaction/exchange costs and aligning trading parties' incentives
- Directly derived benefits:
 - Imposed service requirements to improve service quality
 - Limiting the supply base to reduce transaction costs associated with negotiating, handling, invoicing, and monitoring performance
- Altering incentives:
 - Over-riding discounts to reward increased selling effort
 - Sale-or-return contracts to encourage new goods trials
 - Joint marketing contributions to encourage promotion effort

The Cons

- Anticompetitive effects of VRs commonly expressed (e.g. EC Guidelines) as:
 - foreclosure of other suppliers or other buyers
 - reduction of inter-brand competition (including facilitation of collusion amongst suppliers or buyers)
 - reduction of intra-brand competition between distributors of the same brand
- But, makes better sense to relate and express effects directly to the precise level of the supply chain affected
- Need to consider *inter-type* and *intra-type* competition; not just *inter-brand* and *intra-brand* competition

The Cons (cont.)

- Competition can be affected in a very direct manner – e.g. foreclosing markets through naked exclusion by a dominant buyer or used as a means to facilitate collusion
- Often, though, effects are more subtle - through distorting competition rather than blatant foreclosure
- When the buyer uses a combination of restraints or the restraints occur in a network of buyers, then there may be cumulative effects (with one distorting effect reinforcing or building on another)
- Buyer-led restraints may reinforce the purchaser's buyer power and also its seller power (in downstream markets)

Weighing Up Pros and Cons

- ***The Case of UK Grocery Markets***
- Supermarkets control over terms and conditions of trade:
 - Offering direct or indirect financial benefits to retailers, shifting business risk and/or restricting supplier behaviour
- UK Competition Commission *Supermarkets Inquiry* (2000)
 - 52 buyer power practices identified, with 42 found to be operating, 30 deemed anti-competitive, and 27 against public interest
 - Supermarkets Code of Practice (SCOP) established in 2002 to *regulate* not *prohibit* practices of top 5 retailers (mkt share > 8%)

Assessment of UK Supermarket Supplier Practices (CC 2000)

Category of Practices	Number of practices	No. practices distorting supplier competition	No. practices distorting retailer competition	No. practices against the public interest
Payments for access to shelf space	8	6	0	4
Imposing conditions on suppliers' trade with other retailers	2	0	0	0
Applying different standards to different suppliers	1	1	1	1
Imposing an unfair imbalance of risk	12	10	10	10
Imposing retrospective changes to contractual terms	8	6	6	6
Restricting suppliers' access to the market	1	0	0	0
Imposing charges and transferring costs to suppliers	8	6	1	5
Requiring suppliers to use third party suppliers nominated by the retailer	2	1	0	1

Assessment of UK Supermarket Supplier Practices (CC 2008)

➤ 2008 UK Grocery Markets Investigation

- Continued presence of most practices
- Focus on 26 practices concerned with the transfer of excessive risk or unexpected costs to suppliers – source of uncertainty, disincentive to investment and innovation, barrier to entry for small suppliers
- Recommendation to replace SCOP with GSCOP and introduce ombudsman scheme



Insights from UK Grocery Markets

➤ **Three Key Insights:**

1. Market shares of individual purchasers do not need to be high for the possibility of significant anticompetitive effects to arise (e.g. 8% shares in CC 2000)
2. Buyer-driven practices may be numerous and arise in parallel, so cumulative effects need to be considered
3. Powerful buyers can often adapt and modify their practices to manoeuvre around specific restrictions or prohibitions (so regulation may be more effective)



Specific Examples

➤ **Three Examples:**

1. Slotting Allowances and Off-Invoice Fees
2. Category Management
3. Exclusive Supply Arrangements

Slotting Allowances and Off-Invoice Fees

- **Pros** - slotting fees levied in the context of a highly competitive, risky environment serving the following roles:
 1. Efficient signal of those products most likely to be successful
 2. Screening device by retailers
 3. Mechanism to equilibrate the number of new products brought to market with number consumers demand
 4. Allocating shelf space among competing uses
 5. Sharing the risks of failed products between supplier and retailer
 6. Covering the costs of removing failed products

Slotting Allowances and Off-Invoice Fees

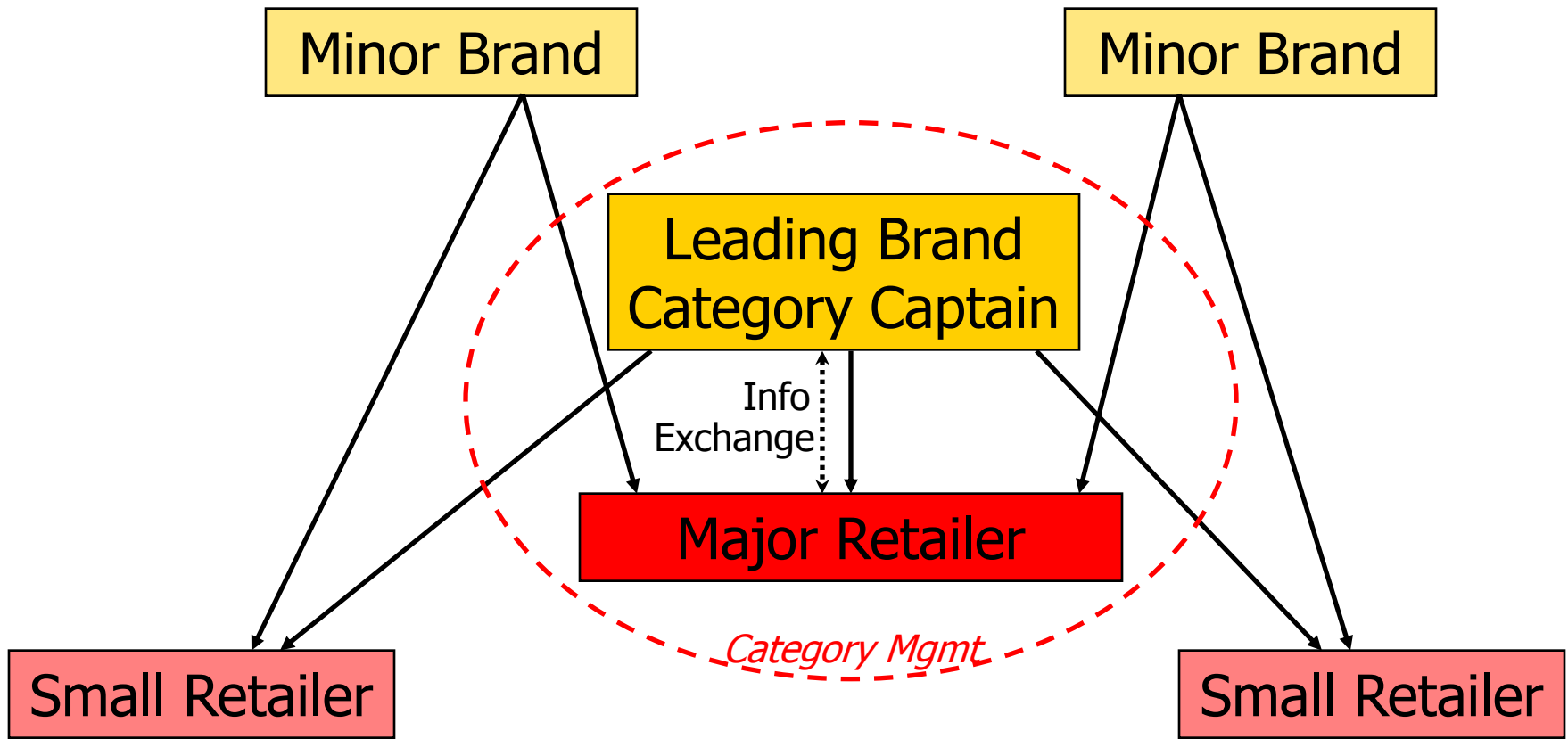
- **Cons** - anticompetitive effects arising from slotting fees:
1. Dampening retail competition (by taking profits upfront with higher supply prices leading to higher retail prices)
 2. Barrier to entry for small, independent suppliers (serving to sustain market power of larger suppliers)
 3. Creative way of implementing two-part, discriminatory pricing schemes among cartels of retail buyers
 4. Raising rival suppliers' costs (impeding their ability and/or willingness to compete aggressively on prices)
 5. Raising total cost of bringing new products to market and thus reducing the rate of innovation



Category Management

- **What is it?** – a retailer/supplier process of managing in-store product categories as strategic business units, intended to enhance consumer value and profitability
- **Pros** – (i) cost savings through supply chain and distribution efficiencies; (ii) enhanced consumer value with carefully designed product choice and positioning
- **Cons** – (i) “category captains” disadvantaging/foreclosing rivals; (ii) information exchange facilitating collusion amongst suppliers and/or retailers; (iii) *coalescing power* “copper-fastening” big retailer and big producer positions

Category Management



Exclusive Supply Arrangements

- **Pros** – (i) protects trading-specific investments (e.g. in the production process or design of the product) to avoid free-riding and “hold up” problems; (ii) can allow for more efficient transfer pricing (to avoid double marginalization) and reduced transaction costs
- **Cons** – (i) prevents intra-brand competition; (ii) possible foreclosure at buyer level; (iii) dampening competition through partial exclusion effects
- **Theoretical Analysis** – (i) Comanor/Rey (2000) on foreclosure motives in the context of asymmetric positions; (ii) Dobson/Watson (1996) on dampening competition effects with symmetric positions



Conclusion

- Buyer-driven vertical restraints can offer both efficiency benefits and anticompetitive effects
- Concerns arise when one or both sides of the market are concentrated and/or dominated by one/few major players
- Such VRs can foreclose markets (by directly reducing consumers' choice of products and/or distribution services) and/or lessen competition (either by facilitating collusion or strategically dampening competition)
- Existing work in this field is still limited and further theoretical and empirical contributions are required



Conclusion (cont.)

- Competition authorities must be vigilant and courts aware of the danger posed by unchecked buyer power when it manifests itself in competition-reducing or competition-eliminating VRs
- Critical need to take greater account of buyer-driven VRs and move beyond present producer-led VR policy focus
- Policy challenge is to come up with workable rules and guidance that will protect competition and serve the consumer's interest while allowing practices that promote efficiency, choice and innovation