

# Differential Buyer Power and the Waterbed Effect: Do Strong Buyers Benefit or Harm Consumers?

Paul W. Dobson<sup>1</sup>

Roman Inderst<sup>2</sup>

## 1. Introduction

It is easy to cast seller power as the villain and buyer power as the hero in respect of how the market power of firms affects consumers. After all, the exercise of seller power is fundamentally about raising prices while buyer power is about reducing prices. Indeed, it is not unusual for powerful buyers serving consumers to portray themselves exactly in these terms – emphasising their role as the “consumer’s champion” in using their buying muscle to negotiate discounts from suppliers which they then pass on to consumers in the form of lower prices.

While there may well be cases of buyer power acting as a genuinely benign force operating on behalf of consumers, this is unlikely to be universally applicable. On its own, the buyer power of a *monopsonist* is the mirror image of the seller power held by a *monopolist*. Both can be detrimental to economic welfare – the former restricting quantity supplied by lowering prices (to suppliers), the latter restricting quantity demanded by raising prices (to customers).<sup>3</sup> Yet buyer power can also be exercised without restricting quantity, when it involves the firm bargaining for discounts from its suppliers. If the intention of the firm is then not to reduce quantity but in fact to buy and sell more, can there be detriment to consumers?

In considering this, we should bear in mind that a firm’s ability to negotiate discounts depends on its relative bargaining power – relative to its suppliers (i.e. in a vertical sense) and relative to its rival buyers (i.e. in a horizontal sense). It is this consideration of vertical and horizontal competition that is fundamental to determining the ultimate effects on consumers. Specifically, the ability of one buyer to negotiate

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<sup>1</sup> Professor of Competition Economics, Loughborough University Business School.

<sup>2</sup> Professor of Economics, University of Frankfurt and London School of Economics.

<sup>3</sup> This applies respectively when the monopsonist can exploit an upward sloping supply function (e.g. arising from a competitive supply industry operating under diminishing returns) and the monopolist can exploit a downward sloping demand function. For illustrations of these cases see R. Clarke, S. Davies, P. Dobson, and M. Waterson, 2002, *Buyer Power and Competition in European Food Retailing* (Edward Elgar, Cheltenham); and P.W. Dobson, R. Clarke, S. Davies, and M. Waterson, 2001, *Buyer Power and its Impact on Competition in the Food Distribution Sector of the European Union*, *Journal of Industry, Competition and Trade* 1 (No.3), 247-281.

discounts from suppliers will likely have ramifications for other buyers. If this helps them also to negotiate discounts then consumers may indeed benefit from generally lower prices when competition allows these discounts to be passed on in the form of lower consumer prices – i.e. buyer power acting as socially beneficial countervailing power.

However, this is only one possibility. If, in contrast, the discounts to one or a few buyers put other buyers in a worse bargaining position to the extent of them paying even higher prices (i.e. premiums rather than discounts) then the knock-on consequence can be higher retail prices and dampened competition amongst these buyers (due to their skewed competitive positions). This latter case is an instance of a “waterbed effect” – where differential buyer power means that some buyers gain at both the relative and absolute expense of other buyers.

The circumstances and likelihood of this waterbed effect arising and its implications for consumer welfare are the central concerns of this article. We draw on recent advances in economic theory to provide guidance in assessing cases of buyer power where waterbed effects may potentially arise.

## 2. Buyer Power, Discrimination and the Waterbed Effect

In this article we use the term buyer power to refer to the ability of buyers to obtain advantageous terms of trade from their suppliers. While some of these advantages may be justified by cost differences, reflecting in particular the economies of scale in handling one large order instead of many small ones, here we are concerned instead with non-cost related discounts. We further limit ourselves by abstracting from (first line) injury that could arise if a discriminatory practice has the objective or the effect of putting a supplier’s *own competitors* at a disadvantage. Instead, we will be concerned with (second line) injury arising from the fact that some of the firm’s *customers* are put at a disadvantage.<sup>4</sup>

Such a disadvantage arises as the obtained discounts make a larger or otherwise more powerful buyer more competitive vis-à-vis rivals. While eroding the margins of weaker competitors, for consumers this could, however, be good news on two accounts. First, the more powerful buyer may pass on some of the discount into lower retail prices. Second, rivals may respond by lowering their own retail prices so as to recapture some of the otherwise lost market share.<sup>5</sup> Consumers should then only be harmed if weaker rivals exit or cut back the depth or breadth of their offering.

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<sup>4</sup> Article 82(c) of the EU’s Treaty forbids practices by which a dominant firm would place trading parties at a competitive disadvantage. In the EU, price discrimination among *non-competing firms* has typically only been sanctioned if it involved geographic segmentation along the boundaries of the member states. (In particular, to prohibit restrictions on parallel trade, which is often a prerequisite to sustain price discrimination, Community courts have here relied also on Article 81.) A detailed discussion of European cases is contained in Damien Gerardin and Nicholas Petit, 2005, Price Discrimination under EC Competition Law: The Need for a Case-by-Case Approach, GCLC Working Paper 07/05, College of Europe, Bruges. It should finally be noted that we fully abstract from price discrimination by a vertically integrated firm.

<sup>5</sup> In standard terminology, this presumes that firms compete in strategic complements, which is typically the case under price competition.

A key implication of the concept of the waterbed effect is that consumers may be harmed even if there is no such adjustment in the downstream industry. Moreover, such an adjustment, including the exit of weaker rivals, would be amplified or hastened in the presence of a waterbed effect.<sup>6</sup>

In the presence of a waterbed effect, an additional discount to one buyer leads to higher wholesale prices for other buyers. By exercising buyer power a firm obtains now a two-fold advantage, namely through more advantageous terms for itself and through higher purchasing costs for its rivals. The mirror image of this virtuous circle for a strong buyer is then a vicious circle for its weaker competitors.<sup>7</sup>

Until very recently, the waterbed effect did not have a formal underpinning, which may explain why antitrust authorities have frequently at best been sceptical about the merits of this notion, though typically without dismissing it altogether. For instance, the UK's Office of Fair Trading recently noted "*there are theoretical questions that would need to be resolved before concluding that the price differentials observed are evidence of a waterbed effect.*"<sup>8</sup>

This article draws on recent research to examine the concept and relevance of the waterbed effect. An essential first step is to clarify when and to what extent we should expect large or otherwise powerful buyers to obtain non-cost related discounts in the first place. We then discuss several theories that can support the existence of a waterbed effect. This allows us to delineate the conditions under which it is more likely that a waterbed effect can arise and ultimately cause harm to consumers.

Our focus is restricted to examining the competition effects of differential buyer power on resulting competition and the ultimate prices facing consumers. In doing so we leave aside other aspects of buyer power that may be relevant to particular cases. For instance, we do not cover the role that buyer power can play as an efficiency defence in merger cases (e.g. where buyers' countervailing power can ensure that purchasing conditions would not deteriorate after an upstream merger).<sup>9</sup> Also, as our concern is exclusively on price negotiations and resulting buying terms, we do not cover the role of

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<sup>6</sup> It is from this background that Albert A. Foer, president of the American Antitrust Institute, can claim "[t]he key to competition analysis of buyer power may be what is becoming known as 'the waterbed effect'." Albert A. Foer, 2006, Mr. Magoo Visits Wal-Mart: Finding the Right Lens for Antitrust, AAI Working Paper 06-07 (p. 16). More generally, the topicality of buyer power is evidenced by a number of recent papers by both economic and legal scholars. For some of these papers as well as further references, see the symposium on that topic in the Antitrust Law Journal (2005) volume 72.

<sup>7</sup> See also Paul W. Dobson, Exploiting Buyer Power: Lessons from the British Grocery Trade, Antitrust Law Journal 72, p. 561.

<sup>8</sup> See OFT, The Grocery Market: The OFT's Reasons For Making a Reference to the Competition Commission, London, May 2006 (par. 6.13).

<sup>9</sup> For a detailed discussion of this matter, see Roman Inderst and Greg Shaffer, 2007, The Role of Buyer Power in Merger Control, chapter prepared for the ABA Antitrust Section Handbook, Issues in Competition Law and Policy (W.D. Collins, ed., in preparation).

buyer power in vertical restraints (e.g. buyer-led demands for exclusive supply, most-favoured-customer treatment, or supplier payments).<sup>10</sup>

Finally, we should note that the term “waterbed effect” has also been used in other areas to describe different types of “re-balancing” effects that we do not cover in this article. Most notably, the term has been used to describe the effect that a regulated reduction in mobile termination rates may have on the (un-regulated) rates charged for other retail mobile services.

### **3. Differential Buyer Power**

#### **3.1 Negotiations, Size and Discounts**

We refer to buyer power in a very broad way as the *bargaining power* that a buyer has with respect to the suppliers with whom he trades. This is, however, not the only possible way to frame buyer power. A possibly more standard, “textbook” view of buyer power is in terms of monopsony where upstream and downstream firms interact through a “market interface” instead of through bilateral negotiations. In its simplest manifestation, and as noted in the Introduction, buyer power then represents the mirror image of seller power and is thus exercised through withholding demand with the purpose of thereby reducing the prevailing (uniform) market price for an input. In this framework there is no scope for a buyer to exert power by obtaining an *individual* discount. As a result, the only way to achieve a lower price, namely by withholding demand, also benefits all other buyers, while reducing consumer surplus and welfare compared to the competitive benchmark.<sup>11</sup>

While this “textbook” view may be appropriate under certain circumstances, say for markets where standardized goods (such as certain commodities) are traded under equally standardized contracts, it may be less fitting in case relatively few up- and downstream firms, such as large retailers and the producers of branded goods, interact bilaterally. In such an environment, there could be substantial variations in the average prices paid by different buyers. Buyer power may then manifest itself precisely through the size of individually negotiated discounts.

Bargaining theory provides us with the tools to conceptualise the interaction of trading firms, respectively upstream and downstream to each other in a supply chain, where terms are determined through bilateral negotiations. Admittedly, the fact that negotiations between several vertically connected upstream and downstream firms typically proceed simultaneously and that the latter are typically rivals in the downstream market requires careful consideration of a number of modelling issues. Yet, despite these complications even the most basic setting, which we briefly explore next, offers some simple but important insights and helps to clarify which factors should influence the outcome of negotiations and should therefore be potential levers of buyer power.

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<sup>10</sup> See, Paul W. Dobson, 2007, Buyer-Led Vertical Restraints, chapter prepared for the ABA Antitrust Section Handbook, Issues in Competition Law and Policy (W.D. Collins, ed., in preparation).

<sup>11</sup> Instead, to harm rivals a firm would have to engage in (predatory) “overbuying”. See S. Salop, 2005, Anticompetitive Overbuying by Power Buyers, *Antitrust Law Journal* 72.

Suppose thus that two parties, A and B, can realize a joint profit of  $z$ . How this will be shared should depend, amongst other things, on what the two sides could realize outside of their negotiations. For instance, if A is a retailer then he could instead start negotiations with another supplier. Likewise, the supplier could start searching for different distribution channels for its good. The profits from these alternatives, which we denote by  $v_A$  and  $v_B$ , are typically referred to as the respective “breakdown” or “outside-option” payoffs. The net surplus that A and B can thus jointly achieve if negotiations are successful is then  $z - v_A - v_B$ . If this is split equally, then party A obtains the sum of  $v_A$  plus one half of  $z - v_A - v_B$ , while B obtains the sum of  $v_B$  plus one half of  $z - v_A - v_B$ .<sup>12</sup> In the following Section, we will mainly capture buyer power by its impact on these outside options. Clearly, if A represents the buyer in question, then any change that would result in an increase of  $v_A$  or in a reduction of  $v_B$  will allow the buyer to extract a larger share of  $z$ .

Why and when can a buyer’s size lead to increased bargaining power? A buyer’s total (or “raw”) size may matter as this makes it more credible to switch suppliers. Also, it should only be large buyers who may sponsor the entry of a new supplier, e.g., through pre-committing their future business. In these cases, size increases the value of the *buyer’s* outside option. Moreover, if a large buyer acts as a “gatekeeper” to a substantial fraction of a supplier’s potential market and can thus not be easily side-stepped, then by withdrawing its business the large buyer can inflict a large loss on the supplier. In this case, the more of the supplier’s market a buyer controls the lower the value of the *supplier’s* outside option. Finally, a buyer’s size may also be defined in relation to a particular supplier’s total business.<sup>13</sup> In *Aetna/Prudential* it was argued that the cost to a physician of replacing one half of his patients is likely to be twice that of replacing only one quarter.<sup>14</sup> Likewise, in *Carrefour/Promodès* a supplier was deemed to be “economically dependent” on one buyer if the latter accounted for more than 22% of the supplier’s total revenues.<sup>15</sup>

### 3.2 Implications of Discounts

If we hold both the market structure and other buyers’ wholesale prices constant, then any additional discount to one buyer should lead to a reduction of all retail prices. Yet, the extent to which this is the case depends on the prevailing competition in the downstream market. While often a more competitive downstream market may give rise to

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<sup>12</sup> The two parties’ respective shares of  $z$  are then  $s_A = 1/2 + (v_A - v_B)/(2 \cdot z)$  and  $s_B = 1/2 + (v_B - v_A)/(2 \cdot z)$ .

<sup>13</sup> Overall, buyer power can, however, not be too mechanically equated with size. For a more detailed perspective on what defines buyer power see Chris Doyle and Roman Inderst, 2007, Some Economics on the Treatment of Buyer Power in Antitrust, *European Competition Law Review* 28, 210-219. (A much more detailed account of buyer power is given in Roman Inderst and Nicola Mazzarotto, 2006, Buyer Power in Distribution, chapter prepared for the ABA Antitrust Section Handbook, *Issues in Competition Law and Policy* (W.D. Collins, ed., in preparation)).

<sup>14</sup> *United States, et al. v. Aetna, Inc., et al.*, No. 3-99CV1398-H.

<sup>15</sup> Case No COMP/M.1684, *Carrefour/Promodès* Art. 6 & Art. 9 Decisions (Jan. 2000). The threshold was chosen as survey evidence indicated that this was the most suppliers could afford to lose without risking bankruptcy.

a higher pass-through (i.e. proportionately more of the discount being passed on to final consumers), in case of perfectly elastic demand, say where the relevant market is the “world market”, the pass-through would be zero (since the individual firm would take the market price as given and therefore retain the benefits entirely for himself). Moreover, the level of pass-through also depends on the nature of bilateral supply contracts, to which we turn next.<sup>16</sup>

Large and powerful retailers have often been pictured as “agents” of final consumers. In a supply chain that is characterized by successive mark-ups on prices received, by reducing the mark-up that can be commanded by the next higher level up the chain the exercise of buyer power will also tend to reduce also final prices (i.e. paid by consumers). However, at least in the short run, such pass-through is only likely to arise if discounts affect the *marginal* purchasing price. If, instead, a more powerful retailer only demands a larger slotting fee (for shelf-space allocation), since this does not affect the marginal wholesale price this would leave the retailer’s own pricing policy unchanged in the short run. Having said this, such discounts at the “front margin” must, however, be given a sufficiently wide interpretation. For instance, despite their lump-sum nature, the anticipation of year-end rebates or other retrospective performance-based discounts should clearly affect a retailer’s optimal pricing policy.

In practice, casual evidence suggests that bilateral supply contracts take on widely different forms. Moreover, even in a given industry casual evidence suggests broad variations across different European countries. A careful consideration of how contracts are negotiated and of how this is likely to affect retail prices is thus a necessary step in any case.

Summing up, *absent* a waterbed effect consumers should at least in the short run benefit from the exercise of buyer power resulting in lower final prices, though the extent may depend on various factors including, in particular, the nature of bilateral contracts (given that these can influence the extent to which buyer benefits are passed on to consumers).<sup>17</sup> As noted above, though, if weaker rivals are forced to exit then in the longer run there could be a substantial lessening of competition, albeit only if this is not compensated for by new entry or other sources of competition such as new retail formats.

As we show next, the presence of a waterbed effect could give rise to consumer harm even without exit, though a waterbed effect also makes further concentration in the downstream industry more likely.

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<sup>16</sup> With perfectly elastic demand an antitrust authority with a pure remit to defend the interests of final consumers would find it hard to raise objections. For an example, in Cargill-Continental, which concerned the merger of two major grain traders, the US Department of Justice did not allege harm on the selling side, since grain prices to national processors are determined in world markets. (*States v. Cargill Inc. and Continental Grain Co. Final Judgment (06/30/2000)*) However, action was nevertheless taken due to alleged harm to farmers or other grain suppliers.

<sup>17</sup> This also presupposes that buyer power is not used in other ways to prevent, restrict or distort competition, such as through buyer-led vertical restraints – see Dobson, 2007, *supra* note 10.

## **4. The Waterbed Effect**

### **4.1 Preliminary Remarks**

It seems useful to start by stating a common criticism of what is possibly a too naive view of the waterbed effect. According to this view, as one buyer obtains a discount and thereby reduces a supplier's profitability, other buyers will have to make good for this as otherwise the supplier will no longer be able to break even. This mechanical view of the waterbed effect does not make precise why the supplier should *now* be able to command a higher wholesale price from other buyers. Most likely, one could argue, if this were possible then the supplier should have already (i.e. previously) tried to raise the price.

The mechanical "rebalancing" argument seems to rest also on the assumption that suppliers have no ultimate market power and can thus at most cover their costs (including the required return on their employed capital). If suppliers lack market power, say because they are only marginally differentiated and there is free capacity in the industry, then *all* buyers should obtain wholesale prices close to costs and there should consequently be only marginal scope for individual buyers to obtain further discounts.

We can apply a somewhat similar logic also to the downstream market. Clearly, in order to obtain a discount a buyer must have some market power at the downstream market as, otherwise, any given supplier could simply channel his goods through another buyer with at most only a negligible loss of revenues. The same applies to those buyers that are supposedly affected by the waterbed effect. Without market power and thus also bargaining power, there would be only very limited scope for their wholesale price to increase further due to the working of a waterbed effect.

The different theories of the waterbed effect that we turn to next help to narrow down further the circumstances under which a waterbed effect is more likely to arise and to be also substantial. Yet, even then this clearly need not imply consumer harm. Consequently, we then turn to considering the still narrower conditions under which we could expect consumer harm to arise.

### **4.2 Theories of the Waterbed Effect**

In light of the fact that, as we noted above, the concept of a waterbed effect working through differential discounts is still contentious, it is paramount to work through the economics of the argument. In what follows, we expose in detail various channels through which a waterbed effect could work. By clearly laying out the economics of the respective channel, we accomplish several things at one time. First, it is made sure that the argument is not conceptually flawed. Second, the conditions under which a waterbed effect can arise are clearly spelt out. They can then be checked against the specifics of the particular case. Finally, this allows us to link the argument to more formal economic work, from which one can then distil quantitative predictions on when we should expect the waterbed effect to be stronger and when it can also amount to consumer harm.

In separating out the arguments, it is helpful to distinguish between a “dynamic” theory, which works through adjustments in the upstream market structure, and a “static” theory, where such an adjustment is not a prerequisite. These channels through which a waterbed effect could work are, however, not mutually exclusive and can, instead, mutually reinforce each other.

#### *A “dynamic” theory of the waterbed effect*

To take a specific example, consider a large retailer that grows further through acquisitions. Suppose also that the increase in size allows the retailer subsequently to extract better terms from suppliers (cf. Section 3.1). In anticipation of a further squeeze in their margins, some suppliers may no longer find it profitable to stay in this market. As these suppliers drop out (or, likewise, as their operations are merged with those of competitors), the upstream market becomes more concentrated. This raises the profits of the remaining suppliers by two channels. First, each supplier can now take a larger share of the total business. Absent any scale effects, this should have no direct implications on the wholesale price of buyers. Second, as there are fewer remaining suppliers in the market this should reduce competition or, to stay in the bargaining framework, it should reduce the outside option of buyers as they have fewer opportunities to substitute away from a given supplier. It can be through this mechanism that other buyers will be adversely affected, including buyers that are not competing directly with the large buyer. On the other hand, for the large buyer the initial increase in bargaining power would still be sufficient to ensure that his own wholesale price remains lower even after the adjustment in the upstream market.

Instead of through exit, the upstream market can become more concentrated if there is less entry than there would have otherwise been in the absence of buyer power. If entry is possible but costly, suppliers make *ex-ante* zero profits irrespective of the extent of buyer power, while the profits that they make *ex-post* (i.e. after entry) depend both on prevailing competition and buyer power.<sup>18</sup> Holding all else constant, as buyer power increases competition among suppliers will be lower (this time through less entry).

#### *“Static” theories of the waterbed effect*

A distinct implication of the previous “dynamic” theory of the waterbed effect is that it works through an adjustment of the upstream industry serving both strong and weak buyers. Empirically, whether this has happened or not should be observable, at least in retrospective. A key insight that we want to convey in this article is that such an adjustment is, however, *not* a necessary condition for a waterbed effect.

The growth of one retailer should come, at least partially, at the expense of some rivals. This is immediate if the more powerful retailer’s outlets take away business, but it also applies if a large chain acquires previously independent retailers that formed part of

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<sup>18</sup> Clearly, the concepts of competition and buyer power should not be seen as altogether distinct given that, as noted above, the same forces that are commonly thought to induce more competition, such as the presence of more sellers and a lower degree of differentiation, also shift bargaining power to buyers.

a buyer group. In the presence of economies of scale, including fixed costs of entering the industry, the remaining, now smaller volume that other retailers jointly purchase may make their business less attractive to other suppliers. Reduced competition and, more directly, the loss of economies of scale may then push up the wholesale price of these buyers.<sup>19</sup>

If retailers (or buyers more generally) are in (imperfect) competition with each other, then there also exists another, natural “static” channel through which a waterbed effect could work.<sup>20</sup> As one retailer becomes more competitive through additional discounts from suppliers, rivals’ market shares should decrease. If size is a key determinant of wholesale prices, given that it affects suppliers’ and retailers’ bargaining power, then as a consequence of this rivals’ wholesale prices should indeed increase. How strong the waterbed effect is depends here crucially on how tightly wholesale prices are linked to size over the relevant range. Another immediate implication is that the waterbed effect is stronger if the growth of more powerful retailers is more at the expense of smaller buyers rather than through expanding the size of the market as a whole.

### 4.3 Consumer Welfare Implications

As noted above, holding the wholesale price of other buyers fixed, as one buyer receives an additional discount this should lead to lower retail prices. However, if rivals own wholesale prices increase through a waterbed effect, then two competing forces are at work. On the one hand, rivals would want to pass on some of their higher costs to consumers. On the other hand, increased competition by the more powerful buyer provides incentives to lower prices as well. Which of these two forces dominates is *a priori* ambiguous. However, economic modelling allows us to delineate conditions for when either a reduction or an increase in retail prices is more likely.<sup>21</sup>

We explore to this end only the theory that we discussed at the end of the preceding Section. There, the working of a waterbed effect crucially relied on the reduction of rivals’ purchasing volume. Consequently, the effect should be stronger if the relationship between size and discounts is generally “steeper”. If the relationship is steeper, then the loss in size and market share of smaller buyers will push up more markedly their wholesale prices. For this, the existing relationship between size and discounts may provide some information. That is, a waterbed effect should be stronger, making thus an overall increase of the retail prices of adversely affected buyers more likely, if there is already substantial price discrimination among buyers of different size.

Next, under the considered channel the waterbed effect should also be stronger the more a buyer grows at the expense of its weaker rivals. For instance, in the case of

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<sup>19</sup> This argument has been formalized in Adrian Majumdar, 2005, Waterbed Effects and Buyer Mergers, mimeo.

<sup>20</sup> Roman Inderst and Tommaso Valletti, 2007, Buyer Power and the Waterbed Effect, mimeo..

<sup>21</sup> Note that we abstract from implications that would arise as the upstream industry adjusts to buyer power such as a reduction in variety or quality.

retailing the waterbed effect should thus be stronger the greater the overlap between the outlets controlled by the more powerful buyer and those of the adversely affected rivals.

Finally, the preceding discussion also suggests that when considering market shares (say, instead of differences in individual wholesale prices), then the waterbed effect would generally be stronger if large buyers have already acquired a large share of the market, partly on the back of their preferential wholesale prices. The exercise of buyer power may then gradually move large buyers' market share towards a threshold from which on the waterbed effect becomes sufficiently strong so as to ultimately induce an increase in rivals' retail price.<sup>22</sup>

#### 4.4 “Anti-Waterbed” Effects

We complete the picture by discussing instances when even the opposite of a waterbed effect may arise, namely that discounts to one buyer make further discounts to other buyers more likely. Importantly, far from leaving practitioners in the cold, we argue that an understanding of when such an “anti-waterbed” effect is more likely to arise may allow for insights that further clarify the conditions for when a waterbed effect is in turn more likely.

If it becomes known that one retailer has negotiated a discount, then this can undermine a supplier's bargaining position vis-à-vis other competing retailers. This is the case since a discount to one retailer then lowers the costs of additional concessions to rivals. Precisely, this follows since a part of the costs of additional concessions are made up of the now lower margins that the supplier earns from conducting business with the first retailer. This “me-too” effect should be stronger the more a rival negotiates with the supplier on equal terms, while the waterbed effect should otherwise dominate.<sup>23</sup> This reinforces our former insight that the waterbed effect should be stronger the smaller and more squeezed a buyer already is compared to his larger rivals.

If the relative advantage of large or otherwise powerful retailers becomes too large, for smaller and less powerful rivals it may no longer be profitable to stay in the market. In such a situation, instead of further turning the screws on smaller buyers, suppliers may jointly be better off by instead offering them deals that are sufficiently attractive to keep them in the market. Otherwise, the large buyer's market power and thus ultimately also his buyer power would in the long run undermine also suppliers' profits. However, unless the supply side is relatively concentrated, it may not be likely that any individual supplier would sacrifice short-term profits in order to provide a public good for all other suppliers, namely the preservation of a competitive downstream market.

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<sup>22</sup> An interesting aspect to be noted here is that there can be a significant complementarity between the growth of buyer and seller power. For instance, retailers who already enjoy substantially lower wholesale prices may have higher incentives to grow still further by, say, acquiring more outlets or developing new land (see for a formalization Roman Inderst, 2006, *Leveraging Buyer Power*, mimeo).

<sup>23</sup> More formally, the waterbed effect should become more important the more the buyer's terms of trade depend on his outside option alone. To further expose the economics of the argument, however, more space and, in particular, technical material would be necessary.

## 5. Policy and Legal Implications

Price discrimination, which is at the heart of the waterbed effect, can be pursued under European antitrust law under different aspects. Certain practices of price discrimination such as selective discounts to a competitor's key customers or market-share rebates may be alleged to distort competition between suppliers (a first line injury). A second line injury could result from the competitive disadvantage that some buyers suffer as rivals obtain preferential treatment. As we have seen, the presence of a waterbed effect may further accentuate such a disadvantage. However, for Article 82 to be applicable the supplier that practices price discrimination must enjoy substantial market power. While, as noted previously, the presence of non-negligible individually negotiated discounts clearly requires that both upstream and downstream firms possess market power, in many cases where potential harm from the exercise of buyer power is alleged the respective suppliers may be far from dominant. In fact, it is then typically individual buyers or a group of buyers collectively that are deemed to be in a dominant position, at least with respect to a particular subset of suppliers.

In *Carrefour/Promodès*<sup>24</sup>, discussed above, as well as in *Rewe/Meinl*<sup>25</sup> and *Kesko/Tuko*<sup>26</sup>, the Commission repeatedly made reference to the increasing dependency of suppliers when raising its objection. Moreover, in several European countries, notably France, Germany, Greece, Portugal and Spain, the abuse of buyer power may also be prosecuted under prevailing economic dependency laws.<sup>27</sup> While we cannot discuss in this article the benefits and drawbacks of possibly extending such dependency laws also to other countries<sup>28</sup>, it should be noted that a focus on suppliers' dependency would provide only limited scope for the consideration of a waterbed effect. In contrast, the consideration of a waterbed effect may be particularly important in cases where some powerful buyers also possess substantial seller power (or where such market power is created through a merger). Buyer power could then give rise to a dominant position at the retail market, as alleged, for instance, in *Kesko/Tuko*<sup>29</sup>, where the Commission argued that the unmatched discounts of the merged firm would make new entry into the market more difficult. In *Rewe/Meinl*<sup>30</sup>, as well as in *Carrefour/Promodès*<sup>31</sup>, the Commission

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<sup>24</sup> Supra note 20.

<sup>25</sup> Case No IV/M.1221, *Rewe/Meinl* Decision 99/674/EC, 1999 O.J. (L274).

<sup>26</sup> Case No IV/M.784, *Kesko/Tuko* Decision 97/277/EC, 1997 O.J. (L110).

<sup>27</sup> For instance, with a particular view on retailing the respective French Ordonnance prohibits in a situation of economic dependence explicitly both the threat of a sudden breaking-off of commercial relations in order to extract more advantageous terms (Article 36(4)) as well as the actual ending of established commercial relations without notice (Article 36(5)).

<sup>28</sup> For more details, see Paul W. Dobson, 2002, Retailer Buyer Power in European Markets: Lessons from Grocery Supply", Loughborough University Business School Research Series, No. 2002: 1; and L. Vogel, 1998, Competition Law and Buying Power: The Case for a New Approach in Europe, *European Competition Law Review* 19 (No. 1), 4-11.

<sup>29</sup> Cf. footnote 26.

<sup>30</sup> Cf. footnote 25.

<sup>31</sup> Cf. footnote 15.

went one step further and alleged that the exercise of buyer power would, via the associated discounts and the potential of predatory conduct, lead to further consolidation of market power at the retail level (“spiral effect”). The consideration of a waterbed effect in these cases, which to our knowledge was not the case, may have helped to clarify the likelihood of further consolidation and, thereby, the potential harm arising from greater buyer power. It remains to be seen how seriously the prospect of anti-competitive waterbed effects are considered in future cases, including the current groceries market inquiry by the UK’s Competition Commission (due to conclude in November 2007).