The Economics of Buyer Power

Roman Inderst

University of Frankfurt (IMFS)

Introduction

Thank you very much for giving me the opportunity to present here my views on buyer power.

Only rarely do manufacturers sell directly to final consumers, notwithstanding the growth of trade that is conducted via the internet. Instead, goods typically reach final consumers after involving often several levels of distribution. At each level in the distribution channel, competitive forces are at play, which jointly determine the price, the quality and the variety of products that are ultimately available to final consumers.

Economic theory, as presented in most textbooks, tends to ignore distribution and retailing activities. Firms are typically treated as competing directly for final consumers, or as selling through a retailing industry that is no more than a “transparent window” to the market place.

Such a picture is increasingly misguided in markets where retailers have grown into internationally active giants. Recent merger cases and sector inquiries in various countries testify to this development.

My own academic work on buyer power started several years ago, when I was Professor for Economic and Finance at the London School of Economics. Even though agencies around the world had commissioned independent reports on this topic, arguably academic research had broadly neglected this issue at this time. This has changed.

Over the last years, I have personally produced a number of academic papers on this issue, jointly with, in particular, Greg Shaffer from Rochester, Paul Dobson from the UK and Christian Wey from the DIW in Germany. Their local experience has broadened my own knowledge. In addition, to consolidate this work, I have published on this topic extensively in practitioners’ journals and provided overviews, for instance in the new handbooks of the American Bar Association.

My subsequent comments draw on this work. I would also refer participants to this work for a more detailed exposition.

In my talk, I first want to provide some preliminary remarks on buyer power. The main purpose of this is to clarify the meaning of buyer power, at least within the confines of this talk. But I will also discuss various theories of the sources of buyer power.

I will then talk about the consequences of buyer power, in particular about various theories of harm. The insights on the sources and consequences of buyer power will then help to derive implications for the adequate metrics of buyer power.

I will also spend some time on issues relating to buyer power as a "defence" in merger cases, both as an efficiency defence and as countervailing power in the case of supplier mergers.

I will conclude with some final remarks.

1. Preliminary Remarks and the Sources of Buyer Power

In what follows, I will generally speak of suppliers and retailers. This shall, however, not indicate that the insights are restricted to a particular industry.

I furthermore want to broadly distinguish between two different paradigms of buyer power. In the paradigm or framework of "monopsonistic power", buyer power is exercised through withholding demand and, thereby, reducing the price for the respective input. This is simply a mirror image of the exercise of seller power.

Importantly, the exercise of buyer power through withholding demand benefits also other buyers, who may be rivals on the downstream market. Implications for welfare and consumer surplus broadly mirror those that arise when seller power is exercised.

The second paradigm is that of bargaining power, which is exercised in bilateral negotiations. It aims at extracting preferable terms of trade. Without further specifying the economic circumstances, we can not immediately conclude how this affects the volume of trade or, likewise, the terms and conditions of other buyers. I will return to these issues later in detail.

Unfortunately, to my knowledge, there does not yet exist a modeling framework that is flexible enough to bridge these two paradigms. Consequently, for the time being, we often have to make an "either-or" decision between the two paradigms.

In what follows, I will talk exclusively about buyer power as bargaining power. This framework seems indeed more suitable when there are relatively few firms on either side of the market, when products are differentiated, when we observe bilateral negotiations, and when we observe potentially big differences in individual contracts.

Each bilateral negotiation takes place in a network of other negotiations, as well as competitive relationships. To provide a brief description of the bilateral bargaining relationship, however, I will abstract from this.

The respective supplier and retailer negotiate on how to share the jointly realized profits, or surplus. What is on the bargaining table is the "net surplus". This is obtained by subtracting the value of each party's "outside option" from the jointly realized profits, the "gross surplus".

For instance, for the supplier the outside option could be to sell more of his fixed capacity to other retailers. For the retailer, if negotiations with the particular supplier fail, the option could be to stock instead a rival supplier's product. If the outside option of, say, the retailer becomes more attractive, then the retailer will obtain a larger share of the jointly realized profits.

Outside options thus constitute the first and most intuitive lever of bargaining power. Most theories of the sources of buyer power, consequently, focus on outside options.

Here, a buyer's size plays a key role. There are various reasons for why it should increase the buyer's bargaining power. For a larger buyer it may be more credible and also, per unit, cheaper to turn to an alternative source of supply, once negotiations with a particular supplier fail.

Also other measures of size are of relevance, such as a buyer's fraction of a supplier's total sales or a buyer's fraction of the whole potential market for a given supplier. Size may here reduce the value of a supplier's outside option.

In short, size should matter. I am, however, aware of several theories, to which I have also contributed, that show that size can sometimes be of a disadvantage. These theories may well apply in certain circumstances, which is why I would not suggest presuming a hard-wired relationship between size and bargaining power. However, when size risks becoming a disadvantage, then the respective buyer may have alternative strategies at his disposal, such as strategic second-sourcing.

Still, there may be many other sources of buyer power, other than pure size. A buyer may control as a "gatekeeper" the access to specific, local markets. Some buyers may be more "sophisticated", still others may have a captive clientele that allows them to switch more easily between different suppliers, without substantial losses in own sales.

At this point, I would like to draw attention to the following issue. Typically, what should matter for bargaining power is the total value of the loss that is incurred or that is inflicted on the other party, when negotiations fail. A retailer is thus not necessarily powerful simply because each supplier's business only accounts for a small fraction of total sales. For instance, if a supplier's product has a captive clientele, then even a small supplier should have substantial bargaining power.

My remarks have focused on sources of buyer power that derive from outside options. This clearly neglects other channels of buyer power, including the use of particular mechanisms such as auctions, exclusive dealing or multiple sourcing.

2. Consequences of Buyer Power

When a powerful buyer negotiates better terms of supply and passes them on to consumers, the latter benefit: The buyer becomes a "consumer champion". However, the extent of such a pass-through may vary widely and should depend, in particular, on the prevailing degree of competition.

In the short run, the extent of such a pass-through should depend also on the way these preferential terms were granted. At one extreme, a retailer negotiates a higher lump-sum payment. At the other extreme, a retailer negotiates a lower unit price—or he can force the supplier to fund another promotional campaign.

Antitrust practitioners should not be mislead by academic arguments that a particular form of contracting should simply be assumed to prevail, say as it is more efficient. There is simply not sufficient research that would preclude one or the other form of discounts, say lump-sum payments or lower wholesale prices. In fact, a cross-country comparison

on how and how often suppliers and retailers negotiate shows that there are profound differences.

Still, when discounts are passed on to consumers, regardless of the extent to which this happens, this increases consumer welfare. Harm to competition and consumers may, however, follow once we factor in the effect on other, rival retailers.

In the long run, provided that preferential terms of trade are passed on, less powerful or otherwise disadvantaged retailers may no longer operate profitably. It is argued that their subsequent exit will allow the powerful buyer to raise prices. It is needless to say that such a theory of harm is based on many, and often too many, “ifs” and “whens”. For instance, less competitive retailers could be replaced by newcomers.

However, if regulation and government intervention, such as local planning restrictions for new stores, prevent future entry, then such a theory of harm could indeed have a more profound underpinning.

Consumer detriment may also occur without a change in downstream market structure, provided the preferential treatment of one retailer leads to a deterioration of the terms of trade of other retailers: A waterbed effect.

Recent research has provided a thorough and logically consistent economic underpinning for the waterbed effect. It shows, in particular, that a waterbed effect is stronger and more likely to lead to consumer harm if the affected retailers are already sufficiently “squeezed”, in terms of low market share and margins. However, if other retailers are equally strong and powerful, then a discount given to one retailer may, instead, lead to a “me too” effect: Also other retailers’ wholesale price decreases.

To stress this again: While it is possible that either a waterbed effect or an anti-waterbed effect arises, economic research allows to provide guidance on when one or the other effect is more likely.

A waterbed effect can also arise if the exercise of buyer power leads to a consolidation among suppliers. While the strong retailer may be shielded from the subsequent exercise of supplier market power, this may not be the case for smaller retailers. There is some empirical evidence that the creation of more powerful buyers indeed has repercussions on the upstream market.

The exercise of buyer power may also affect dynamic efficiency through affecting incentives to invest and innovate. This concerns both retailers’ and suppliers’ incentives.

Regarding suppliers, the often prevailing view is that the exercise of buyer power undermines their incentives. It is argued that a stronger buyer is more likely to “hold up” the supplier, extracting a larger fraction of the additional profits that the suppliers’ up-front investment generates. I do not fully share this view.

First of all, the presence of fewer and stronger buyers may make such a hold-up problem less likely. For instance, larger buyers may find it in their own interest to engage with the supplier early on and to co-finance some of the required investment.

Moreover, powerful buyers may indeed be necessary to keep suppliers sufficiently on their toes. I want to give two examples for this. First, a large buyer may be more willing to substitute away from a given supplier, in case the supplier's product falls short of expectations. Second, a large or otherwise powerful buyer may more readily engage in "vertical competition" over functions performed in the supply chain. Such a function could be branding or it could relate to customer service.

If bargaining power is related to size, then it can create powerful incentives to invest and innovate for the retailer. This follows as growth pays a "double dividend": First, holding all else constant, it creates additional profits. Second, these gains are amplified from winning an additional discount.

Admittedly, formal research shows that the effect on weaker rivals could be to stifle their incentives. Any immediate "spiral effect" from discounts to powerful buyers would then, in the long term, be amplified, even without the exit of rivals. Formally, the existence of such a negative effect depends, however, strongly on the assumed form of the strategic relationship.

In sum, with this background I would recommend that if buyer power is exercised in the form of bargaining power, then the first presumption should be that it is likely to benefit consumers, at least in the short run. Having said this, however, antitrust agencies are also well advised to bear in mind the possibility of harm, both in the short and in the long run. Theories of harm, such as that of a waterbed effect, would clearly need sufficient empirical support. The same applies to theories relating to reduced dynamic efficiency and consolidation on the upstream or downstream market.

I should also say that my remarks do by no means cover all possible consequences that the exercise of buyer power may have. For instance, I have not touched on theories of "raising rivals' costs", which are different to the waterbed effect. I have also not talked about the effect of buyer power in the presence of collusion. Buyer power can destabilize supplier collusion, if this aims to raise wholesale prices. But the presence of a strong and powerful buyer can also facilitate collusion, through facilitating the exchange of information or through orchestrating the exclusion of rival suppliers or rival retailers in the joint interest of the incumbents.

Unfortunately, there is also almost no research on how buyer power interacts with vertical restraints. One could argue that powerful buyers can more easily resist, but that they may also more easily impose vertical restraints, such as exclusive dealing relationships. Here, I would only like to draw attention to one issue. A powerful buyer, who extracts a larger share of joint profits, may simply have less to gain by imposing inefficient restraints, relating, for instance, to tying or exclusion.

3. Metrics of Buyer Power and the Role of Consumer Welfare

Where theories of the sources of buyer power and of the consequences of buyer must meet is in the determination of adequate metrics of buyer power. I have, though only briefly, touched on several theories of the sources of buyer power. Some, but not all of them, are related to different measures of size. Given any metric of buyer power, when shall we assume that buyer power is sufficiently large, so as to warrant further consideration?

At least when framed as bargaining power, there is no presumption that buyer power leads to inefficiencies or a loss of consumer welfare. This stands in stark contrast to the exercise of seller power and speaks in favor of applying higher thresholds, so as to avoid potentially costly type-I errors.

On the other hand, it is sometimes claimed that a buyer has already substantial bargaining power when he controls only a small fraction of a supplier's sales or of a supplier's potential market. Such an argument has been made with respect to a supplier's financial dependency or with respect to national mass-marketers, which rely on broad market coverage. Such an argument would speak in favor of lower thresholds.

What further complicates matters for antitrust practice is the question of what standard to apply. If we only care about the welfare of final consumers, then cases where the downstream market is highly or even perfectly competitive should not raise concerns. However, in such cases suppliers may sometimes face only few and powerful buyers, given high transportation costs for their product. Should policy not seek to prevent possible inefficiencies from the exercise of buyer power, provided such inefficiencies are to be expected?

In a similar vein, any standard that only concerns the welfare of the "next downstream level" has problems to adequately capture competitive harm from buyer power. Such a standard may have some theoretical justification, in case we can safely assume that the downstream level is always substantially more fragmented than the upstream level. But this not or no longer the case in many markets, such as grocery retailing or health care.

4. Buyer Power as Defence

Turning to buyer power as a defence, I will not talk about buyer power as an efficiency defence in the case of a buyer merger. It is my understanding that this rightly plays only a very small role in practice. Instead, buyer power as countervailing power in the case of a supplier merger plays a key role.

Powerful buyers may indeed resist price increases or the imposition of vertical restraints. But how broad is the shield of buyer power? Often, it may not include less powerful buyers. In addition, I would question that buyer power is generally an adequate substitute for upstream competition. Even if powerful buyers can resist higher prices, will not the merger among suppliers still affect their incentives to invest and innovate?

And how will the merger affect "vertical competition" between the two levels of the distribution chain? Unfortunately, to my knowledge, this issue has been largely ignored by academics, and potentially also by antitrust practitioners.

5. Concluding Remarks

Time does not permit to summarize the various observations that I made, spanning the sources and consequences of buyer power, as well as its treatment in academics and antitrust practice. I have also no time to distinguish between buyer power exercised by a single entity and buyer power exercised by a buyer group. More gravely, I have no time to talk about the pros and cons of various policies to tackle buyer power, such as a ban on price discrimination or remedies to protect dependent suppliers in merger cases.

I feel, however, that I should briefly comment on only one policy measure. Some agencies have implemented “codes of conduct” that, for instance, large grocery retailers have to follow. Other countries use economic dependency laws for the same purpose. This seeks to stamp out practices that are considered to be unfair and inefficient. For instance, retailers have been accused of paying excessively late, of unilaterally changing contractual terms, or of demanding conditions that excessively shift risk on suppliers.

Without attempting a full evaluation of such policies, I would still like to express two warnings. First, banning some practices does usually not shift bargaining power. The only consequence may then be that the retailer extracts profits through another, potentially less efficient channel.

Second, our first presumption should always be that observed contracts are efficient at least for the involved parties, though, in particular when used by dominant firms, they can be at the cost of third parties. Late payments and seemingly opportunistic adjustments of terms of supply by retailers may, for instance, help to ensure that smaller suppliers satisfy the expected quality standards. Contractual restrictions would then backfire by leading to less instead of more efficiency.