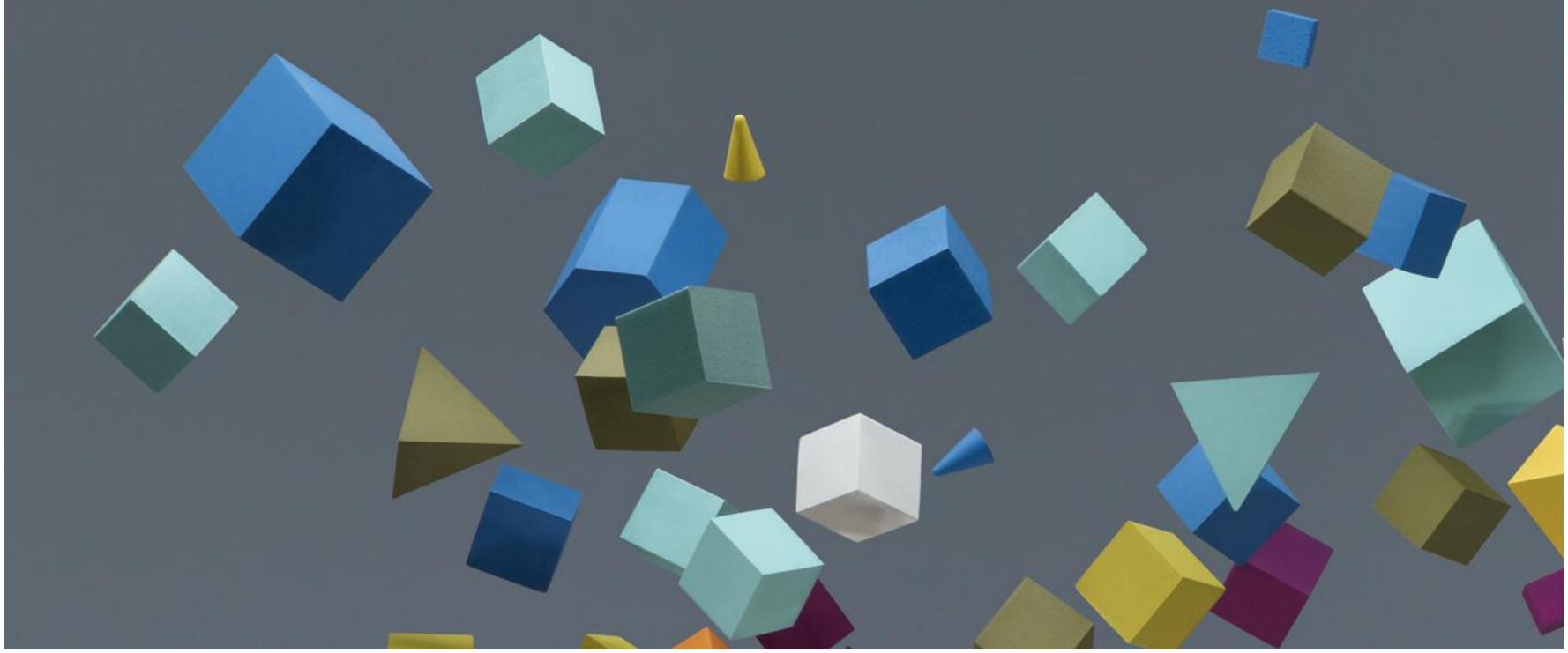
Buyer Power and Upstream Mergers:
Benchmarks for Assessment

Buyer Power: Benchmarks for Assessment
Diana Jackson
Oxford, May 15th 2012

CRA Charles River Associates

Some background: key aspects of bargaining for merger assessment



Buyer Power: Benchmarks for Assessment
Diana Jackson
Oxford, May 15th 2012

CRA Charles River Associates

Buyer power and bargaining

To what extent can the buyer power of customers lessen the price rise that might otherwise arise from an upstream merger?

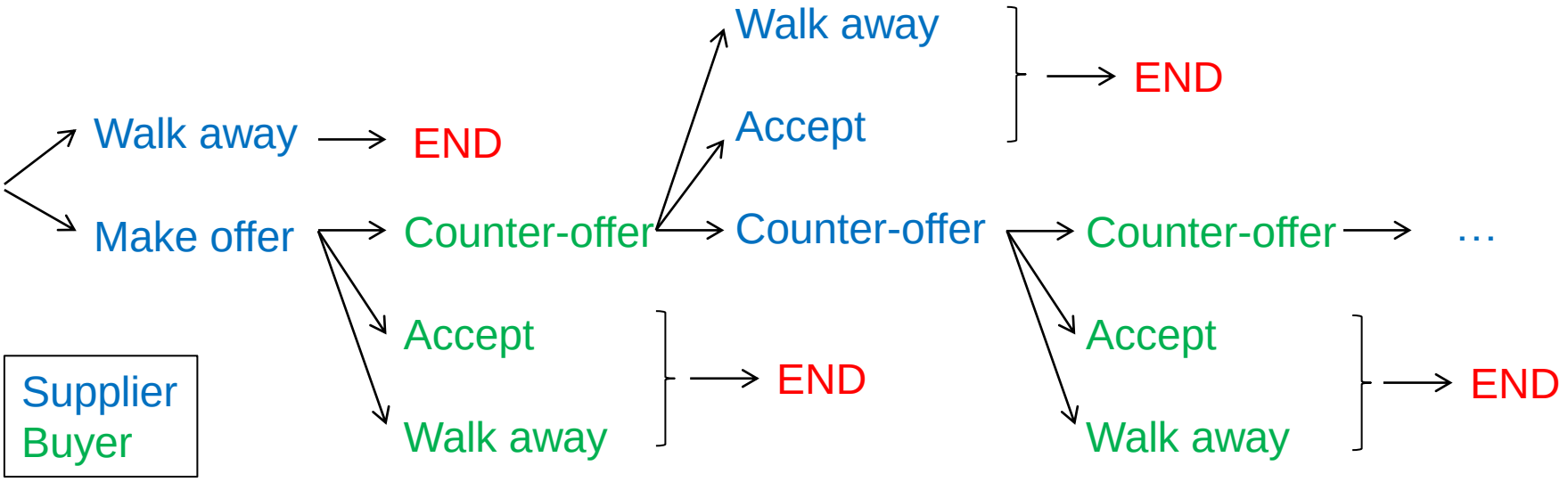
"Even firms with very high market shares may not be in a position, post-merger, to significantly impede effective competition, in particular by acting to an appreciable extent independently of their customers, if the latter possess countervailing buyer power. Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller, and its ability to switch to alternative suppliers."
(HMG paragraph 64, emphasis added)

But how do we assess whether such countervailing bargaining power exists and – if it does – to what extent it softens merger effects that could arise?

Inside versus outside options

Bargaining takes place over a number of rounds – need to consider:

- **Outside option:** payoff to walking away from the negotiation – lose gains from that particular trade
- **Inside option:** payoff to failing to agree – retain option to agree (and benefit from gains to that trade) later



Nash bargaining solution

The outcome of the bargain solves the following equation:

$$\text{Max}_{z} \; [A_1(z)-D_1(z)]^{a} \; [A_2(z)-D_2(z)]^{1-a}$$

st

Payoff A1 ≥ Outside Option 1

Payoff A2 ≥ Outside Option 2

Ai(z) = Payoff if the parties agree

$D_i(z)$ = Payoff if the parties disagree

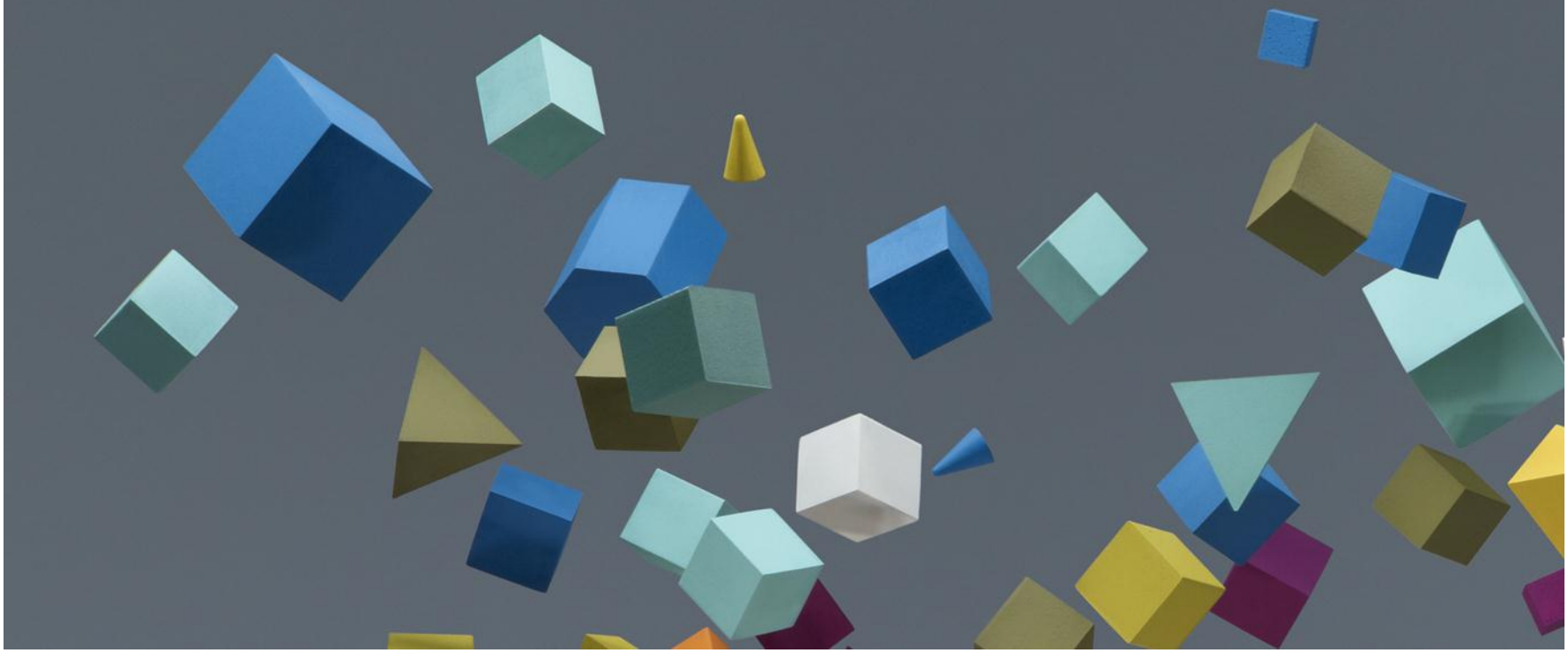
a is the relative strength of party 1's "exogenous bargaining power"

Efficient versus inefficient bargaining

Bargaining can be efficient or inefficient:

- **Efficient bargaining:**
  - Maximises the joint surplus of the parties to the agreement
  - Relies on the parties having sufficient instruments over which to negotiate (e.g. non-linear pricing with fixed and variable elements)
  - Relies on lack of significant information asymmetry between the parties
  - ➢ Retail prices are set to maximise joint surplus, which is then divided through the bargain: upstream mergers have no impact on retail prices
- **Inefficient bargaining:**
  - E.g. if a buyer and seller can only bargain over a single unit wholesale price), bargaining outcomes may not be efficient (trade off between maximising surplus and the split of that surplus between the parties)
  - ➢ This raises the possibility of downstream merger effects, but they may still be softened by the presence of downstream bargaining power

An example: Unilever and Sara Lee



CRA Charles River Associates

The Commission's concerns

- Merging of two significant product portfolios in deodorants, soaps and shower gels → traditional concerns about raising retail prices.
- However the parties do not set retail prices, so the impact on consumers needs to take account of both:
  - The extent of any increase in wholesale prices due to an increase in market power
  - The extent of pass-through of such increases to final consumers (to the extent that the merger simply shifts the split of the cake between manufacturer and retailer, should competition authorities care?)

Commission concern: Merger leads to higher wholesale prices, which are at least in part passed on to consumers: retailer power limited by parties' control of "must have" products

Key question on buyer power: Are wholesale price increases mitigated at the retail level by the bargaining power of large supermarket chains?

Merger impact

Outside options available to each are arguably unattractive, and unlikely to be binding either pre- or post-merger (and therefore unlikely to determine the outcome of the bargain)

Supermarkets: Supply rival brands only and/or vertically integrate into supply

Suppliers: Lose important distribution channel

Inside options are arguably more relevant: but change due to merger unclear (both sides potentially benefit from the wider portfolio)

Supermarkets: Can delist certain brands or remove marketing opportunities

Suppliers: Can withhold certain lines/brands or refuse to participate

There is no reason to assume that mergers will increase **exogenous bargaining strength** (may increase expertise resources? But also creates integration issues/complexity, at least in the short term)

Bargaining power: “must have” brands

What do we mean by “must have”?

- In an extreme case, retailer cannot operate without these products: negotiate over “must have” surplus and retailer profit on other products

What would this imply for merger effects? Three possible scenarios:

Both have “must have” brands:	• No increase in upstream bargaining power: both brands needed • Indeed the merger *increases efficiency* ↔ pricing of complements
Only one has “must have” brands:	• The firm with the must have brand already gets a share of the whole surplus • The merged entity gets the same share as the “must have firm”
Only “must have” in combination:	• The merged entity can now appropriate part of the retailer surplus on other products, while neither supplier could pre-merger • The supplier share of the pie increases post-merger

“Must have” brands and merger effects

How does a merger affect relative bargaining strength?

- It cannot be *assumed* that an upstream merger will result in higher wholesale prices due to increased upstream bargaining strength
- A merger only creates upstream bargaining power through this mechanism if it *creates* a “must have” portfolio that didn’t previously exist

Even then, it is important to recognise that there is a certain **symmetry** to the “must have” concept:

- “Must have” brands for the retailers are also likely to be “must sell” (i.e. high value brands) for the seller: the cost to either of failure to agree is high

What is the net effect of the merger?

- Evidence on existing margins and history of delistings etc. may be helpful
- Evidence on existing retailer power (e.g. share of total chain margin)
- Evidence on consumer behaviour (willingness to switch retailer vs. brand)

Buyer power for small buyers

But what about small buyers (retailers)? If they don't have buyer power, can the final consumer ever be fully protected by buyer power?

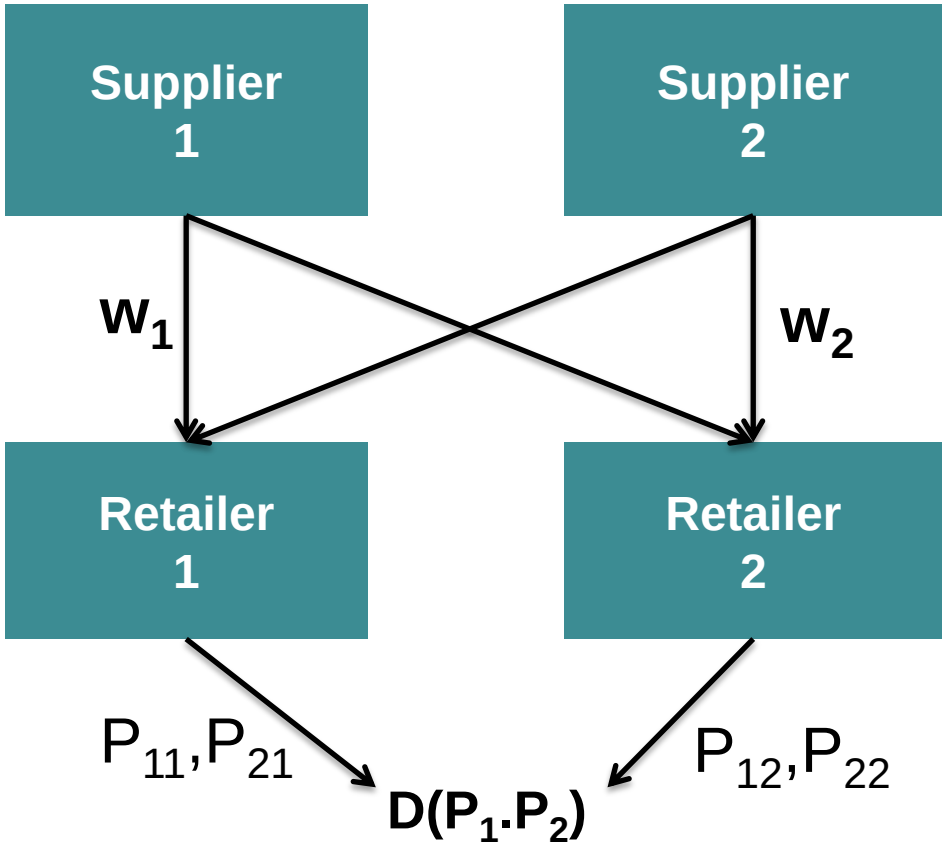
- It is not clear that small buyers will automatically have a worse bargaining position: either theoretically or empirically
- ➢ **But even if small buyers do have less bargaining strength, this ignores competition between retailers downstream:** a small buyer cannot charge consumers more simply because she is charged more at the wholesale level
- Indeed, this competition can support small buyers' bargaining strength (they have less to lose from walking away from a higher price if this would simply result in compressed margins).

This appears to be implicitly recognised by the Commission: otherwise there would be little practical role for countervailing buyer power in merger assessment (there is nearly always at least one small buyer).

Retailers as “common” agents

If retailers set retail prices, each retailer already takes the substitution between good 1 and good 2 into account when setting its own retail prices

The upstream merger therefore does not lead to a direct increase in the “coordination” of such prices: the traditional source of concern about horizontal mergers is therefore weaker



Some general lessons

In these frameworks the critical difference to the "standard model" is that competition takes place through bilateral negotiations, rather than the "take it or leave it" list prices assumed in standard models underpinning the link between size and market power

Within this bargaining framework the effect of increasing buyer or seller power depends on our understanding of what constitutes "power":

- Increased exogenous bargaining capability?
- Improved inside or outside options?

The link with upstream and downstream concentration levels is not simple and is not always clear

Strong buyer power should mean lower wholesale prices, and under many circumstances *can also mean* lower retail price increases resulting from an upstream merger than would be expected if buyer power were ignored

- Our challenge is to quantify these effects in a bargaining framework