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# Purchasing Agreements

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# Outline

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- Background
- Benefits and potential harm
- Guidelines and case

# Background

# Purchasing Agreements



- **What are they?**
  - An agreement for the joint purchasing of products
  - Range from loosely structured cooperatives of atomistic buyers to joint ventures amongst buyers

- **Structure**
  - Can have open or closed membership
  - Can have symmetric or asymmetric terms for members
  - Can be ‘passive’ or ‘active’

# Intermediate market



**Suppliers**

Upstream: Suppliers
sell input to ‘buyers’

**Buyer Group**

**Rival buyers**

Downstream: Input sold
on to end consumer
(either directly or as
part of a new product)

**End Consumers**

# Benefits and potential harm

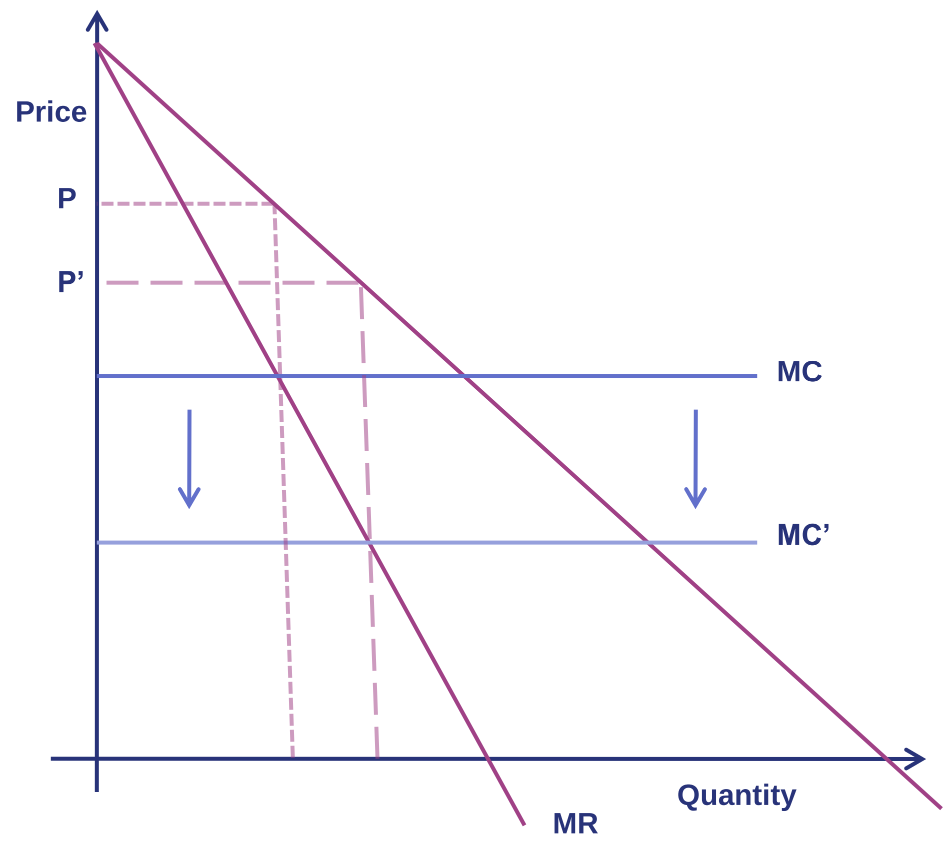
# Benefits?



- **Why is there a general presumption of benefits?**

- **Purchasing agreements used to increase bargaining power or obtain economies of scale in purchasing.**

- **Lower input costs result in lower prices to consumers downstream – provided agreement doesn't change downstream competition.**



# Benefits

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- **Buyer groups established to obtain <u>better terms of supply</u>**
  - Improved supply chain efficiencies
  - Intensify competition between suppliers
  - Intensify competition between downstream competitors
  - Potential to increase innovation/investment

- **But benefit must <u>pass through</u> to final consumers. If purchasing agreement leads to:**
  - lowers input price (↓MC) expect lower consumer prices
  - efficiencies which expand output or improve quality expect increased output or higher quality downstream, but
  - lower fixed costs benefits less likely to be passed on – especially in short term

# Degree of power



- **"Substantial buyer power" → <u>ability</u> of the group to materially influence competition between suppliers**

**Requires:**

- **Firms in purchasing agreement must by able to <u>credibly</u> resist attempts by suppliers to increase price**
  - Switching
  - Sponsor new entry
  - Self-supply

- **Firms in purchasing agreement must be a <u>'gateway'</u>**
  - Firms control access to a downstream market or a key sales channel
  - Supplier would forgo substantial economies of scale

# Direct harm



- **Façade to hide explicit collusion**
  - E.g. Spanish Tobacco case – Used purchasing agreements to fix relative downstream quantities and segment the market.

- **Increased risk of tacit coordination**
  - Increased contact
  - Information exchanges
  - Symmetry of terms of supply
  - Symmetry of costs
  - Standardisation

# Direct harm



- **Reduction in rivalry:**

  - Obtaining lower costs via a purchasing agreement is the ‘easy option’, pursuit of efficiencies through organic growth would have been better

  - Purchasing agreements ‘rigidify’ the market – e.g. damaging innovation in buying practices

# Indirect harm

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- **Indirect harm by adversely affecting rivals terms of supply, e.g.**

  - **Input foreclosure:** striking a (near) exclusive supply deal with a supplier of a key input

  - **Raising rivals costs:** bid up the price of an input which is more important to the rivals than the buyer group

  - **Reduce rivals benefits:** induce a supplier to adopt a technology, quality level or means of delivery which is more favourable to the group

# Indirect harm



- **Strategies weaken downstream rivals and may result in exit**

- **But:**
  - **Incentive:**
    - Buyer groups generally do not want to harm upstream competition
  - **Ability:**
    - Does the group have substantial buyer power?
    - Groups may face problems coordinating divergent demands of members.

# Indirect harm

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- **Increased bargaining power for the buyer group may lead to higher prices for rival retailers – <u>Waterbed effect</u>**

- **Difficult to argue:**
  - If suppliers could charge a higher price to the rival buyers why are they not already be doing so?

- **But could be credible where:**
  - Rival buyers offer suppliers less scope to benefit from scale economies
  - Better terms for group gives them a competitive advantage downstream → the fall in input demanded by rivals, weakens their ability to credibly threaten to switch supplier

- **Even if the waterbed is credible consumers could still benefit!**

# Indirect harm

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- **‘Rent sharing’ agreements**
  - Coordination on upstream purchases may spillover into anticompetitive vertical agreements
  - Powerful groups may induce suppliers to facilitate downstream collusion via RPM or exclusivity agreements
  - Usually suppliers would have no incentive to join a collusive agreement that restricts supplier but could be induced by non linear contracts enabling rent sharing

# Guidelines and OFT case

# EC Horizontal Guidance

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- **Agreements exempt if members have a combined market share of:**
  - <15% of the upstream purchasing (i.e. supplier’s) market, and
  - <15% of the downstream market
- **Hard to imagine buyer group as a ‘gatekeeper’ with only 15% market share**
- **Merger analogy – if merger would not be anti-competitive, why would a purchasing agreement**
  - Not a perfect analogy as purchasing agreement does not involve coordination downstream so likely to be less harmful, but also to produce less downstream efficiencies
- **Suggests a more tolerant view than the 15% block exemption**

# Makro and P&H Retail case

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- **Two food retailers/wholesalers**
  - Makro – business to business wholesaler
  - P&H – wholesale supplier to independents

- **Agreement to jointly purchase and negotiate discounts and promotional contributions**
  - Implemented through jointly owned service company (PalMak)
  - PalMak negotiates contributions to promotional activities on behalf of both parties, but they individually negotiate how they will be used
  - Each party free to negotiate outside the agreement, with outcomes of outside negotiations kept secret

# Makro and P&H Retail case

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## Market definition and market shares

- **Upstream market consists of purchases of daily consumer goods from producers**
  - Combined market share <15%

- **Downstream market (narrowest) comprises the wholesale supply by independent wholesalers to independent and convenience retailers**
  - Combined market share between 15-20% (above the block exemption)

- **In the absence of parallel networks of similar purchasing agreements, OFT indicated agreements are unlikely to cause harm when the parties have no downstream market power**

# Makro and P&H Retail case



**Exclusion of economically dependent suppliers from agreement:**

- Parties initially proposed to exclude any supplier who relied on parties for more than 22% turnover
- Heavy dependence need not raise competition concerns
- Use of specific threshold may in <u>fact chill parties incentives to expand</u> their business

**Information Exchanges**

- Parties only exchange <u>aggregated</u> information on promotional contributions, making coordination less likely
- Payments between parties calculated by independent auditor