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THE POWER OF RETAILERS

Can buyer power of large retailers cause grocery prices in Germany to rise?

German consumers are known for spending relatively little money on food as compared to other continental European consumers. Over the years, fierce competition among retailers has been an important factor in keeping food prices down. At the same time, however, concentration in the retailing sector has noticeably increased. As research by DIW econ shows, this has gone hand in hand with rising buyer power of retailers on their respective procurement markets. Suppliers, on the other hand, are increasingly loosing negotiating clout in the face of more aggressive demands from retailers. Will the resulting stronger position of retailers eventually lead to higher prices for German consumers?

The level of concentration in grocery retailing in Germany has increased strongly over the past ten years. While in 1999 eight retailers jointly accounted for a market share of 70% in the crucial segment of "Fast Moving Consumer Goods", the four largest retailers now account for a share of even 85%. Although some of this concentration process may have been driven by an increasing consumer attachment to big retail brands, it is largely resulting from a string of high profile mergers and take-overs. The purchase of "Plus", a discounter chain, by the up-market "Edeka" Group in 2008 constitutes a prominent example and contributes to Edeka's position as market leader in Germany. This wave of consolidation has renewed interest in the market power of large retailing conglomerates on their procurement markets. Earlier this year, the German competition authority launched a sector investigation into the state of competition on procurement markets of grocery retailers.

Buyer power is bargaining power

The increased interest in buyer power goes hand in hand with a better understanding of the factors that determine it. Traditionally, buyer power has simply been defined as the ability of economic agents to strategically restrict their demand in order to lower prices, an ability commonly referred to as monopsony power. Nowadays, buyer power is increasingly seen as evolving from bilateral bargaining processes between buyers and sellers, which requires a closer look at the nature of the bargaining process.

Intuitively, it is clear that each side of a bargaining process will only enter into an agreement if the resulting gain is higher than that of available alternatives. These alternatives are called outside options. For example, outside options of retailers include swapping suppliers or replacing the good in question by an own brand. Likewise, the most important outside option of a supplier is switching to another retailer. Obviously, the availability and attractiveness of these outside options determines the credibility of the threat to abort negotiations and thus, to prevent a deal. It follows that if one side has more attractive outside options it possesses greater bargaining power and hence, will be less willing to accept a lower pay-off. Conclusively, better outside options for retailers as well as worse outside options for suppliers will increase the bargaining power and therefore the buyer power of retailers.

Consolidation strengthens buyer power

Overall, this bargaining perspective gives good reasons to expect that the wave of consolidation has led to increased buyer power of the remaining, large retailers in Germany.
Effectively, retailers serve as gatekeepers who give suppliers access to final consumer markets. With a lower number of independent retailers, the supplier's threat of switching to an alternative retailer becomes less credible.
Furthermore, large retailing companies can be expected to account for a considerable share of each of their suppliers' total revenue. Once the revenue from sales to a particular retailer exceeds a crucial level, the supplier simply cannot afford loosing this key customer. With the number of retailers declining, the remaining ones are also likely to account for even larger shares of their supplier's revenue, which further increases their bargaining power.
Finally, bargaining power of retailers' also increases with their absolute size because larger retailers can distribute the fixed costs of searching for an alternative supplier over a greater range of output, therefore reducing the cost of switching to another supplier. They can also more credibly threaten to produce own branded foods and thereby reinforce their outside options.

Unclear impact on consumers

For consumers, stronger buyer power of retailers may, at least in the short term, be good news. Grocery stores can pass their lower procurement costs on to consumers in form of lower food prices. This, however, will only happen as long as grocery stores have an incentive to do so, which in turn depends on the degree of competition among retailers. Yet in the long run, economic theory gives rise to concerns that competition may not always be so fierce. Since larger retailers enjoy a competitive edge over their smaller competitors on procurement markets, they are able to negotiate lower input prices. In turn, this enables large retailers to offer lower prices to consumers in order to expand their market shares at the expense of smaller competitors. Because higher market shares further strengthen a retailers' buyer power, this eventually results in a "spiral effect" in which stronger buyer power drives further concentration in the retailing sector which again enhances the buyer power of the remaining retailers. Ultimately, this reduces competition among the remaining retailers and eventually, can lead to higher prices for consumers.
On the other hand, a retailers' buyer power is also not unlimited. Indeed, some suppliers possess market power of their own as they sell highly known brands such as "Coca-Cola". These constitute so called "must-have" products, which retailers need to procure in order to attract customers. To some degree buyer power therefore, may simply countervail existing power asymmetries on the suppliers' side.
More fundamentally, it is generally difficult to distinguish anti-competitive practices resulting from high buyer power from tough bargaining. The latter is an essential part of the functioning of business negotiations, which are integral to core free-market principles such as freedom of contract.
A further concern relates to the fear that suppliers who see their margins reduced by powerful retailers will loose the incentive and opportunity to innovate and consequently fail to invest in new products. Here too, economic theory shows that the causality may just as well run in the opposite direction. In fact, since larger retailers profit relatively more from their suppliers' inventions than smaller ones, they might have an incentive to even encourage such innovations. Likewise, innovations allow suppliers to differentiate their products and to increase their specificity so that substituting them becomes more difficult. Hence, suppliers can also use innovation to reinforce their bargaining position, provided that consumers show a strong taste for the new products. Overall, the impact of retailers' buyer power on innovations and final consumers is therefore ambiguous.

Retailer and supplier imbalances

To examine the current level of bargaining position and thus, buyer power of German retailers, DIW econ conducted a survey of German manufacturers of branded consumer goods from different segments of the grocery market. The sample predominantly consisted of large suppliers with an annual turnover exceeding 50 Million Euro.

Results show that many suppliers are indeed economically dependent upon a few key customers. About 60% of interviewed firms state that their volume of business with their biggest customer exceeds the level of 22%, a threshold that the EU Commission suggests as critical level beyond which a supplier is economically dependent on an individual buyer.

Overall, the survey results clearly reveal a bargaining advantage for larger retailers. A total of 90% of respondents earned their lowest margins with one of their three biggest customers. Furthermore, these larger customers also engage in more aggressive negotiation behaviour. Of the suppliers polled, 87% indicate that at least one of their three biggest customers has threatened with delisting over the past five years. A further 74% of suppliers state to have been "frequently" faced with demands for rebates for past time periods following retail mergers.

What is more, these forms of assertive behaviour by retailers seem to be rising in frequency. More than two-thirds of respondents found that business relations with their three largest customers over the last five years were marked by an increasing use of threats and sanctions by retailers. Generally speaking, available evidence points towards a bargaining power that is progressively tilted in favour of large retailing chains.

Finally, when planning price increases, survey evidence indicates that manufacturers consider expected levels of rebates to retailers to be of similar importance than increased costs of production. At the same time, price increases can be better imposed on smaller than on larger retailers, implying that larger retailers indeed benefit from better conditions than smaller ones. In fact, this observation can initiate a spiral effect which, as described above, might lead to higher consumer prices.

Conclusion

We analyse the impact of consolidation in the retailing sector on competition on procurement markets. Based on a modern definition of buyer power as being determined by bargaining power we argue that stronger concentration in the retail industry is likely to strengthen the buyer power of the remaining firms on procurement markets. While this is to the disadvantage of suppliers, the resulting impact on consumers is ambiguous. On the one hand, buyer power could countervail the market power of suppliers and thus, benefit consumers through lower prices. On the other hand, increased buyer power might just as well initiate a spiral effect that ultimately results in higher consumer prices.

Our evidence for Germany supports this assessment. The results from a survey of manufacturers of branded food products clearly indicate that the already considerable buyer power of retailers has been increasing over the past five years. This raises concerns about detrimental effects on competition and consumer welfare. However, we also caution against rash conclusions. In fact, the line between anti-competitive practices and hard bargaining is difficult to draw, and even harder to prove in practice. Nevertheless, the theoretical and empirical evidence clearly stresses that retailers' buyer power does not automatically benefit consumers. Hence, more in-depth research and empirical evidence is needed to assess the complex welfare implications of buyer power.

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