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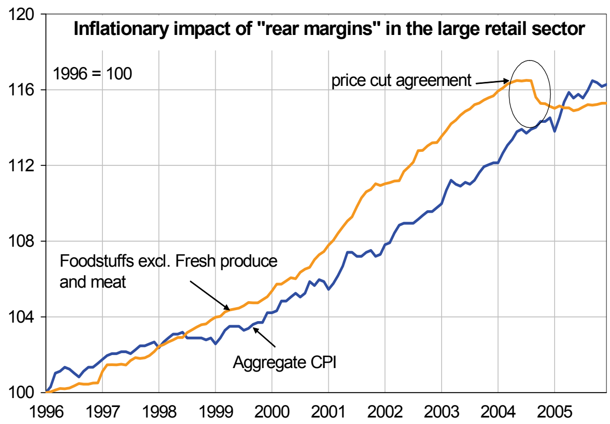
Business relationships between suppliers and retailers

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Industry.

- Relationships between retailers and suppliers are generally non-integrated and vertical, involving a complex blend of cooperation and competition. In the large retail sector, the balance of power has been tilted in the large retailers' favour over the last few years. This asymmetry is liable to breed market inefficiencies and anti-competitive effects. What is more, it is sometimes suspected by suppliers and small retail representatives of allowing large retailers to behave in a «predatory» fashion. This in turn sometimes feeds demands of some protective measures, in the name of the most vulnerable of these.

- The French authorities have long sought to regulate these relationships. They have notably done so by strengthening the ban on selling below cost, with the passage of the so-called «Galland» Act of 1 July 1996. However, this step also resulted in less competition among retailers and among suppliers of national branded products, while «rear margins» (off-invoice discounts paid by suppliers to retailers, theoretically in return for services provided by the latter) rose; eventually, prices paid by the consumer rose durably.

- The government responded to this by instigating an agreement between suppliers and retailers to reduce prices, signed in June 2004. Following that, the 2 August 2005 Act in aid of SMEs reformed the Galland Act in order to encourage suppliers and retailers to cut prices. The act gives more formal status to the annual negotiations between suppliers and retailers with a view to preventing abuse of «rear margins», and introducing a new method for calculating the threshold definition of selling below cost, thereby giving retailers greater latitude to cut their prices with effect from 2006. The impact of this policy is already perceptible, but it will take time to produce its full effects as resulting competition sharpens.



DGTPE
DIRECTION GÉNÉRALE DU TRÉSOR ET DE LA POLITIQUE ÉCONOMIQUE

1. The economic arguments in favour of adjusting the balance between suppliers and retailers

1.1 Typically, relationships in the retail sector are vertical relationships…

The prime function of a retailer is to provide consumers with a varied assortment of merchandises. As intermediaries, retailers also provide services, known as "commercial assistance" services, to manufacturers, and these are paid for via what are known as "rear margins" (*marges arrière*). As a result, retailers operate in a two-sided market, competing both among themselves in the upstream market in dealing with their suppliers, and in the downstream market in selling to consumers.

Relationships between retailers and suppliers are a complex blend of cooperation and competition within a vertical structure: although they share common interests, some of their aims are all the more likely to diverge since there are very few vertically integrated retail chains[1].

Consequently, to offset the inefficiency inherent in a non-integrated vertical structure, notably due to the phenomena known as "double marginalisation"[2] or "moral hazard"[3], manufacturer-retailer relationships are usually managed via contracts providing for vertical restrictions. These restrictions may concern the price at which the merchandise may be sold (via retail price maintenance or non-linear pricing[4]), or other trading variables (defining exclusive territories, exclusivity contracts, etc.). While these restrictions may in some cases be sufficient to restore efficiency to the vertical structure, some generate anti-competitive effects and as such are prohibited[5] or at least subject to scrutiny on a case-by-case basis[6].

1.2 …currently characterised by the predominance of the downstream sector

Over the course of the past century, there has been a gradual swing in the balance of power away from suppliers-manufacturers toward retailers. Faced with the growing power of manufacturing industry in the first half of the 20th century and the emergence of national brands, retailers joined forces, notably establishing central buying offices[7], and thereby boosting their purchasing power.

Following this rise to power of the major supermarket chains and the subsequent wave of mergers in the 1990s, the grocery-based retail business is now dominated by five central purchasing organisations, namely Auchan, Casino, Carrefour, Lucie, and Intermarché, which accounted for more than 86% of the market in 2004[8]. One consequence of this concentration is the demise of a large number of smaller signs, most of which have been swallowed up by the major retailers.

The structure of the downstream market, where retailers compete among themselves to satisfy consumer demand, has thus become oligopolistic[9]. In the upstream market, dealing with suppliers, this situation gives the retailers an oligopsonistic power which is amplified by the fact that the manufacturers supplying the major retailers are themselves fragmented: 96% of suppliers of mass consumer articles (excluding store or own brand goods) are SMEs whose products account for only 19% of the major retailers' revenue.

Moreover, many retailers have taken over the task of product design, developing their own house or store brands[10]. These brands directly compete with the manufacturers' national brands, representing a means of vertical differentiation and winning customer loyalty. The proliferation of store brands,

(1) Some examples of vertical integration are found in the luxury and apparel sectors.

(2) In a non-integrated structure, each entity levies its own margin regardless of the externalities this creates at the expense of the other party. By comparison with a situation where the two firms are vertically integrated, the resulting dual margin diminishes the total profit of the two firms and generates higher prices for the consumer.

(3) In a trading relationship, moral hazard exists when one of the parties is in possession of private information and its actions, which cannot be observed by the other party, affect the trading relationship to the detriment of the latter. In this particular instance, the problem of moral hazard can affect the supply of promotional services performed by the retailer with a view to boosting sales of an item of merchandise. In a non-integrated vertical structure, the retailer takes no account of the impact on the supplier's profits of an increase in services performed and will tend to provide a level of the said services that is too low relative to the level provided by an integrated structure, thereby reducing demand.

(4) The most common form of non-linear pricing consists in dual prices comprising a fixed and a variable portion, depending on quantity.

(5) In particular, resale price maintenance practices are prohibited in Europe and the United States, notably because they are liable to foster collusion among manufacturers and even among retailers (see Rey and Vergé (2002): "Resale Price Maintenance and Horizontal Cartel", mimeo).

(6) Tirole (1988) : «The theory of industrial organization», *MIT Press.*

(7) A central buying office centralizes a retailer's purchasing functions and supplies its stores.

(8) Expert group's report on relations between manufacturing and retailing, 2004.

(9) An oligopolistic market is characterized by the presence of a small number of suppliers able to influence prices thanks to their strategic interdependence. Symmetrically, an oligopsony is characterized by a small number of buyers.

(10) Store brands are brands created by retailers sold at a price below the price of equivalent products from national brands. Store brand suppliers are very few in number (1% of the total number of suppliers to the large retail chains); 90% of them are SMEs and they account for around 22% of the total revenues of the large retail chains.

which accounted for 30.8% of the market in 2004[11], and the rationing of shelf space as a result of legislation on store size and location[12], tends to bolster still further the retailers' bargaining power *vis-à-vis* suppliers of competing products.

1.3 Unequal relations between suppliers and retailers can breed inefficiencies and anti-competitive effects justifying government intervention

The economic effects of concentration are ambiguous. In the simple framework of competition *à la Cournot*[13] between identical firms, a merger reduces the number of competing firms and mechanically increases the bargaining power of each player, thereby pushing up prices, to the detriment of consumers. Consequently, a merger between retailers may reduce the number of competing store brands and lead to a rise in retail prices.

However, a merger can also lead to efficiency gains by giving the firms concerned the critical mass needed to achieve economies of scale. Thus, by promoting efficiency gains and boosting retailers' purchasing power and their bargaining power vis-à-vis suppliers, it can help to push down consumer prices. However, insofar as it leads to calls for price cuts, this increased retailers' bargaining power is sometimes suspected of sending the weakest suppliers to the wall and discouraging new suppliers from entering the market, and hence reducing the range of articles available, to the detriment of the consumer.

Furthermore, the retailers' considerable bargaining power can be a source of inefficiencies if suppliers are required to make specific investments in order to satisfy specifications imposed on them by the retailers they supply. This is notably the case with manufacturers-suppliers of store brand goods, who are thus liable to depend increasingly on a single retailer. To escape from this dependent position, suppliers may find it expedient to limit this type of investment specifically geared to one retailer, thereby reducing the vertical structure's aggregate profit. This behaviour, which runs against the common interests of the vertical structure, produces what are known as "hold-up" inefficiencies[14].

In general, while low prices benefit a priori the consumer, and boost economic efficiency, in particular cases they can curtail the diversity of forms of trade. And indeed small and specialised shopkeepers have denounced the "predatory" behaviour of certain large retailers resulting from their "selling-below-cost strategy". This is because a large store can compensate for losses borne on certain products via the profits earned on others, thanks to the diversity of its product mix. Traditional shopkeepers, with their narrower product range, cannot match that strategy[15].

To protect suppliers and small shopkeepers from the growing power of large retailers and restore some "balance" between the two parties, the French government introduced specific legislation on top of the normal competition law. These new measures notably included a ban on selling below cost, introduced in 1963, and formalisation of the framework for supplier-retailer negotiations[16]. Subsequently, ascribing the apparent ineffectiveness of the ban on selling below cost to the imprecision of the concept's definition, the 1 July 1996 Galland Act ("on fairness and balance in business relationships") bolstered the existing legislation by defining modalities for calculating the threshold of selling below cost.

2. Limits to regulations aimed at balancing business relationships between suppliers and retailers

2.1 The ban on selling below cost and price discrimination between buyers, together with the obligation to disclose standard terms and conditions have debatable economic effects

Despite the risk of predation raised by some retailers, selling below cost can be economically justified on a variety of grounds:

– it can corresponds to a strategy of sending signals to imperfectly informed consumers[17];

– a firm may find it expedient to charge low prices, or even to sell at a loss, in order to initiate a learning curve[18];

– selling below cost may simply reflect the optimal pricing of complementary products, in accordance with the Ramsay pricing rule (1927)[19].

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(11) Source : FCD (*Fédération des entreprises du Commerce et de la Distribution*).

(12) The 27 December 1973 «Royer» Act on trade and crafts, reinforced by the 5 July 1996 «Raffarin» (development and promotion of trade and crafts) Act, makes the opening of new stores and the extension of existing ones subject to administrative authorization. By erecting institutional barriers to entry to the retail market, these laws have reduced the amount of retail floorspace, thereby increasing competition among suppliers for access to it and increasing their dependence on the retailers.

(13) In a *Cournot* competition model, firms simultaneously choose the quantities that maximize their profit, having regard to their capacity constraints and taking as given the quantities supplied by their competitors.

(14) Tirole (1988) : «The theory of industrial organization», *MIT Press.*

(15) Even so, this argument is valid only insofar as these different forms of trade compete with each other on identical or very similar ranges of products and services.

(16) Preventing selling below cost was supposed to protect the supplier, as retailers may ask "excessive" price cuts in order to remain competitive.

To be sure, selling below cost can also constitute a predatory behaviour on the part of the retailer, aimed at diminishing existing or potential competitors' expected profitability (to encourage existing competitors to exit the market, or at least to limit their activities in it, or to discourage potential ones from entering it). In practice, however, this argument is of limited application in the case of competition between the major retailers, which is nationwide in scope. In general, the benefit to the collective welfare of a ban on selling below cost varies, depending on the reasons behind the practice. However, it is not necessarily detrimental to the social welfare and its prohibition may reduce it.

Similarly, price transparency, resulting from the rule forbidding suppliers to discriminate among buyers within a single category, and from the obligation on them to disclose their standard terms and conditions[20] to all retailers on request, can bolster the national brand suppliers' market power and lead to higher prices. This is because, when a supplier grants a discount to a client, the non-discrimination rule obliges this supplier to grant the same discount to all their other clients. Conversely, they can raise their prices without upsetting their retailers since the latter know that their competitors will be treated likewise[21].

2.2 The strengthening of the ban on selling below cost has shifted the focus of negotiations between suppliers and retailers, and pushed up «rear margins»

The 1 July 1996 Galland Act strengthened the ban on selling below cost. This ban had been introduced in 1963 in response to complaints by small and specialised shopkeepers that certain large retailers were engaged in predatory behaviour, and by certain suppliers claiming that their industry was at risk of disorganisation and damage to their products' brand image[22].

To that end, the Galland Act introduced a more precise definition of the threshold at which a product was deemed to be sold below cost : it corresponds to the net price billedby the supplier to the retailer, i.e. before the "rear margin" has be given back to the retailer. This definition thus thus erects a barrier between retailers' "front margin" and "rear margin", with the result that retailers used their bargaining power to focus their negotiating efforts on their "rear margins" (through sales assistance services and non-billed rebates), rather than on the sale prices billed by their suppliers.

There are two main reasons for this development: first, there is no obligation of transparency regarding sales assistance, which has the advantage of having a measure of opacity for the retailer[23] ; second, since the price cuts granted by suppliers in return for sales assistance cannot be passed on to consumers, they offer retailers a guaranteed margin.

According to a study by Ilec[24], «rear margins» rose by more than 80% between 1998 and 2004, while their average rate (ratio of «rear margin» to net invoice price) rose from 21.9% to 33.5%. During the same period, retailers' aggregate margins rose by almost 50%, with «rear margins» alone accounting for 30 percentage points of that rise. According to the *Direction générale de la concurrence, de la consommation et de la répression des fraudes* (DGCCRF-French Competition Policy, Consumer Affairs and Fraud Control Directorate), «rear margins» accounted for between 25% and 45% of a product's sale price in 2004.

2.3 The non-discrimination rule and the method of setting the threshold for selling below cost have weakened competition between retailers and supliers of national brands, leading to an upward convergence of prices charged to the consumer.

By barring retailers from passing on the price rebates obtained for «sales assistance» (i.e. «rear margins») in the prices charged to consumers, in practice the Galland Act brought about an upward convergence of retail sale prices in the major retail chains.

(17) A firm may initially pitch a product's launch price low, to draw attention to the quality of its product and attract new, imperfectly informed clients, in the hopes that they will later make further purchases of the same product because of its quality, even though the firm has since raised its price.

(18) By charging a deliberately low price, the manufacturer increases its initial sales and so learns more rapidly to produce the article more efficiently and more cheaply.

(19) Optimal Ramsay pricing applies low margins to products with high price elasticity and high margins to products with low price elasticity. In addition, when the article in consideration is complementary with another article, the mark-up practiced is less than the inverse of the specific price-elasticity of demand. Consequently, the article may be sold at a loss, i.e. at less than its marginal cost.

(20) The standard terms and conditions define the unit price of each product and the amount of discounts conditional on quantities purchased.

(21) Rey and Tirole (2000): "Régulation des relations entre fournisseurs et distributeurs" (regulating relations between suppliers and retailers), *Report by the Conseil d'analyse économique (CAE).*

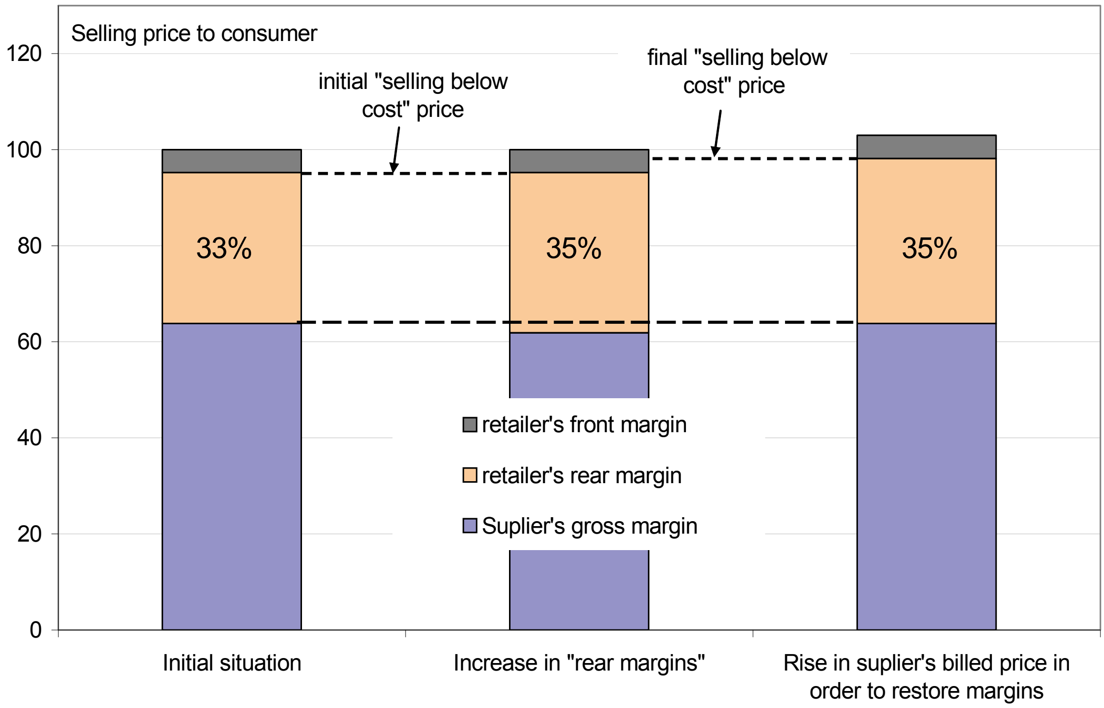
(22) However, where large retailers charge a zero or negative margin on their suppliers' products, this may serve to promote sales of the products and signal their quality to the general public (see 2.1).

(23) Since opacity is conducive to price differentiation, the most powerful retailers may be able to buy on more advantageous terms unobserved by their competitors.

(24) Institut de liaisons et d'études des industries de consommation (Ilec) (2004): «*Observatoire des prix des PGC, de la structure tarifaire, des marges dans la chaîne industrie-commerce au cours de l'année 2004*» (Observatory of staple consumer goods prices, price structure and margins in the manufacturing-retailing chain in 2004).

This was because those suppliers of national brands enjoying considerable bargaining power, especially manufacturers of major national brands, were able to control the resale price of their products by treating the threshold for selling below cost their «floor» price. This practice enabled suppliers to limit intra-brand competition[25] *de facto*, and resulted in an upward alignment of the prices charged by retailers for their products. By curbing competition in the downstream market, suppliers have been able to restore the efficiency of the vertical structure[26] for their benefit, but to the detriment of consumers. And indeed the prices of major branded products were raised in such a way as to generate a surplus via the «rear margins», which was shared with the retailers. Moreover, the existence of a floor price clarified the structure of wholesale prices and so fostered collusion between competing brands, thus also curbing inter-brand competition insofar as a unilateral departure from the price-fixing strategy via a price cut would be liable to trigger reprisals in the form of a price war[27].

Chart 1: how higher "rear margins" translate into a higher "selling below cost" threshold ?



In addition, the spread of «rear margins» has led to a long-term rise in the level of retail prices since suppliers have passed on the increased cost of sales assistance services – some of them fictitious – in their sale prices. For example, when a retailer demanded higher «rear margins» from its suppliers of national branded products, the latter subsequently raised their own prices in order to compensate for the resulting loss of revenue. However, in virtue of the principle of non-discrimination, this increase in supplier prices in the wake of a rise in «rear margins» (demanded by a specific retailer) was then applied across the board to all retailers. As a result this pushed up the threshold for selling below cost (i.e. the net price invoiced by the supplier to the retailer) and, *ipso facto*, the sale price of these national branded products to consumers, for all retailers[28].

Nevertheless, to make these now more expensive products more saleable, retailers began emphasizing new services, such as new promotional instruments (NIP)[29], or presenting the products at the end of the aisle, for example.

(25) Competition among retailers in selling a product of a given brand to consumers.

(26) Hart and Tirole (1990) show how the monopoly power of a dominant manufacturer can be blunted by competition among its downstream retailers. In this context, O'Brien and Shaffer (1992) point out that the imposition of a floor price can allow this manufacturer to regain its monopoly power in full.

(27) See Telser (1960) and Posner (1977).

(28) Thus, in the absence of price discrimination, a retailer raising its rear margins ran no risk of harm to its sales from a unilateral price rise.

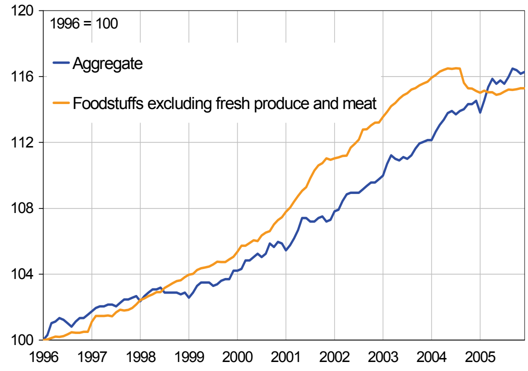
(29) Retailers have developed these new promotional instruments in order to boost customer loyalty, thereby reintroducing an element of intra and inter-brand competition. These instruments (e.g. loyalty points convertible into vouchers) allowed them to lower the effective sale price of certain branded goods. This was an indirect way of using part of their rear margins to cut the prices charged to the consumer.

In return, these measures enabled them to raise their «rear margins» still further, again squeezing the suppliers' revenue. That was then offset by another rise in supplier prices and hence in retail prices.

An atypical price trend has thus been observed since 1996. As a result, the price of foodstuffs excluding fresh produce and meat[30], for which "rear margins" are high, rose faster than the French consumer price index, whereas the reverse was the case earlier in the beginning of the decade. They also rose faster than in the other European Union countries, even though the harmonised index of consumer prices (HICP) rose faster in the rest of the euro area than in France (see charts 1 and 2).

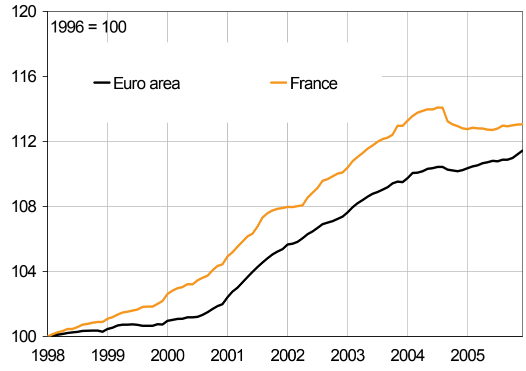
Further, in 2003 and 2004, prices of national branded staple products rose faster than the average rate of increase for all staple products, where prices of entry-level and of store brand products fell[31]. On the other hand, there was a tendency for prices in «hypermarkets» (large supermarkets of over 2,500 m^2), «supermarkets» (mid-sized supermarkets of between 400 and 2,500 m^2) and mini-markets (under 400 m^2) to converge. Conversely, price differentials widened between these forms of «traditional» retailing and the hard discounters[32], which have spread very vigorously since 1996. These trends reflect an attenuation of intra-brand competition between retail formats.

Chart 2: price indices



Source : INSEE.

Chart 3: ... in France et in the euro area



Source : Eurostat..

3. Recent reforms have boosted competition and helped attenuate these inflationary effects

3.1 The need to correct these effects

The foregoing observation convinced the French government of the need to act. After having instigated an agreement between manufacturers and suppliers, on 17 June 2004, aimed at creating a framework for reducing prices of national branded products in large and mid-sized supermarkets, the 2 August 2005 Act in aid of SMEs, Chapter IV of which was designed to modernise business relationships, modified the ground rules.

The new Act redefined the threshold for selling below cost as the net unit invoice price less the portion of «rear margin» exceeding 20% of the said price with effect from January 1, 2006, and exceeding 15% with effect from January 1, 2007. An assessment of whether or not to lower the threshold for selling below cost still further – by including the fraction of «rear margins» exceeding 10%, or even the totality of the «rear margin» – will be made at the end of 2007. Moreover, the contractual framework for annual negotiations between suppliers and retailers was further formalised. In particular the services performed by a retailer and included in the «rear margin», notably under the heading of sales assistance, must now be spelled out in a contract whose form and content are defined by law, subject to criminal prosecution.

3.2 This new reform is expected to revive intra- and inter-brand competition and curb the practice of «rear margins» ...

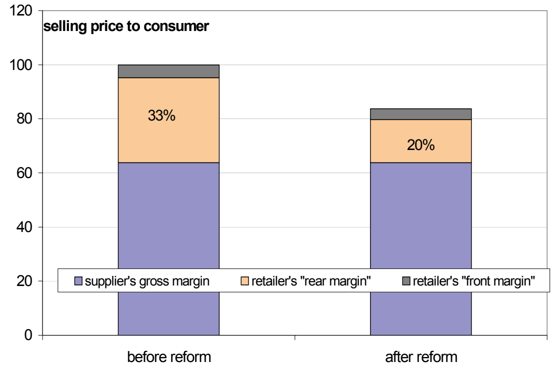
The reform of the Galland Act will allow retailers to retrocede a portion of their «rear margins» (the fraction exceeding 20% of the net invoice price) to the consumer in the form of price cuts. This makes it impossible for manufacturers to control the price at which their products are sold to consumers, and should thus revive intra-brand competition between retailers and inter-brand competition between suppliers.

(30) The food price index (excluding fresh produce and meat) attenuates the impact of climate or epidemiological factors-which can otherwise affect the food price index.

(31) Source : Panel International.

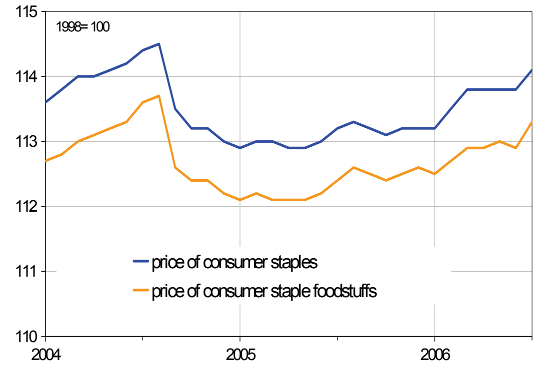
(32) In a hard discount, there is no national brand, no commercial service, no special presentation of products, and prices are lower as there is no «rear margin». By 2005, the hard discounters' share of sales of staple products and fresh products had grown to 13.3%, from 1.6% in 1992 (source: Fédération des entreprises du Commerce et de la Distribution).

Chart 4: impact of a cut in «rear margins» to 20%



Source : DGTPE.

Chart 5: prices of consumer staples in large retail chains since 2004



Source : INSEE.

Even so, the new definition of the threshold for selling below cost is unlikely to be sufficient in itself to end the upward trend in «rear margins». Two further factors could also help limit, or perhaps even roll back, the rise in «rear margins», namely the tougher requirements regarding the formalisation of sales assistance services[33], which are now defined in law[34], and the reversal of the burden of proof as to the reality and pricing of sales services to the supplier, this burden now being placed on the retailer.

3.3 ...leading to lower prices and increased economic activity

The maximum medium-to-long term impact of the reform of the Galland Act can be estimated by incorporating all «rear margins» into the calculation of the threshold for selling below cost, assuming «rear margins» revert to their 1996 level : this assumption is based on the idea that the reform enables price cuts which would compensate for prices increases since the Galland act was implemented. This would entail a progressive and maximum decline of 1.4 percentage point in the consumer price index, reflecting the gradual elimination of the rent accumulated by the major retailers and some of their suppliers. This decline would give a 0.3 percentage point stimulus to GDP and create 80,000 jobs over a 4-5 year time frame, thanks to the additional consumption resulting from the boost to household purchasing power, and from increased competitiveness and efficiency. For short-term effects, these estimates were made using the macroeconomic model MESANGE, and small model incorporating the long-term effects of MESANGE but modelling the structural consequences of this reform in finer detail.

Prices of staple products sold in large retailers were found to have fallen in the wake of signature of the 2004 agreement. Ultimately, the entry into force of the reform of the Galland Act in 2006 ought – other things being equal – to put a brake on price rises as retailers and suppliers shift the focus of their marketing strategies to their «front margins», under the stimulus of greater competition.

Claire BORSENBERGER, Nicolas DOISY

(33) Distinct sales assistance and services must now be covered by annual contracts that serve as a basis for calculating the threshold of selling below cost. Failure to show that such contracts have been signed carries a fine of up to 75,000 euros; corporate entities can be found criminally liable and incur a fine of up to 375,000 euros.

(34) - Article L441-7 of the French Commercial Code defines sales assistance services as services unconnected with purchase or sale obligations, performed on the occasion of the resale of products or services to consumers and intended to facilitate their marketing.

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