"Supermarket power: serving consumers or harming competition?"

Executive Summary

The goal of this study is to show that large supermarkets have evolved into platforms operating in two-sided markets. These platforms control access of independent brands to consumers, and the other way round, through listing decisions and in-store category management. Therefore, these platforms operate as "competitive bottlenecks", a market structure advanced by the economist Mark Armstrong and now widely accepted in competition economics. These competitive bottlenecks are able to exploit (abuse) independent brands up to a point where social welfare is undermined. Moreover, once supermarket brands have become established in the market, the exploitation of independent brands has evolved into foreclosure and exclusion from the market. The practices of large supermarkets thereby undermine the competitive process and consumer welfare in a dynamic setting, where innovation, quality and variety are as important as "static" prices. In light of these conclusions, the study suggests that the current competition law analysis of supermarkets' power is outdated and needs to be adapted to the market power and parallel abuses of these competitive bottlenecks: undue preference is given to their "buyer" status (akin to consumer from a competition policy standpoint) in the procurement market and any enforcement at the retail level is only considered if single-firm dominance is found based on very high market shares and a significant market share gap with competitors. Likewise, the study advances several reasons that could justify reinforcing competition law remedies with ex-ante regulatory remedies. These remedies would basically ensure that (1) independent brands can access supermarket networks and compete within then on the basis of the FRAND (Fair, Reasonable and Non-Discriminatory) principle; (2) there is a legal separation between supermarkets and their grocery brand activities; and (3) there is an independent authority in place to enforce these remedies.

Traditionally, supermarkets have been portrayed as neutral traders who simply channelled to suppliers consumers' demand for their products. However, in recent years supermarkets have emerged as powerful platforms/networks, whose listing and category management decisions influence and condition how suppliers and consumers interact with each other up to a point that marketing experts have expressed that "whoever owns the shelf, owns the market". Indeed, independent sources estimate that over 70% of consumers' purchase decisions of specific brands take place once they are in the store.

This study shows that supermarkets now provide services to both consumers and suppliers. In their dealings with suppliers, supermarkets have managed to transfer more and more of the risks of their retailing operations to them by means of remunerated service agreements, manifestly unbalanced product supply agreements and unilateral practices that disregard contractual terms and legal provisions. For example, supermarkets and their alliances may impose access fees for the right to enter or be part of the supermarkets' product listing or request distinct sizes/packages that prevent customers' price comparisons across retailers. On top of that, independent grocery brands may be contractually forced to bear the cost of: (1) delivery to the individual stores or the provision by the supermarket of centralised delivery & warehousing services; (2) in-store replenishment; (3) in-store promotions and marketing activities; (4) product shrinkage; (5) consumer complaints; (6) guaranteed margins or wrong margin forecasts; (6) return of unsold items; and (7) positive credit terms enjoyed by supermarkets. If, despite all the risk-transferring activities put in place contractually, supermarkets do not meet internal profit forecasts or want to exceed them, there is always scope for unilateral practices that extract rents from suppliers under threat of delisting. Basically, supermarkets have transformed themselves into service providers to independent grocery brands and they seek to maximise profits from access to and competition within their platforms.

The study finds that the source of supermarkets' power is four-fold and self-reinforcing: First, competition between these platforms tends to be oligopolistic (few players, high market shares, transparency and full acknowledgment of their mutual interdependence), reinforced by local strongholds. Second, consumers tend to develop strong links with individual supermarkets ("the power of habit" according to Nielsen) and the information asymmetries and switching costs ease the competitive pressure on the platforms. Third, the business model of independent brands relies on access to as many consumers as possible in order to sustain the virtuous R+D-innovation-sales growth model and this model places them at the mercy of supermarkets: as a rule, a supermarket can easily substitute a supplier, whereas the loss of a supermarket client may turn around the virtuous growth cycle into a decline and market-exit spiral. Fourth, supermarkets have vertically integrated into grocery brands and this is a strong incentive to exploit suppliers of independent brands and expel them from the market.

The ever-increasing power of large supermarkets has transformed them into competitive bottlenecks, as described in economic theory. Indeed, Mark Armstrong, the economist who developed the theory of competitive bottlenecks, had supermarkets in mind, as well as other sectors that have seen proactive competition/regulatory intervention (e.g., credit-card networks, computer reservation systems and mobile telephony). This theory shows that the exploitation of suppliers by supermarkets will always outweigh any potential benefit transferred to consumers from a social (producer + consumer) welfare perspective. Moreover, if consumer welfare is not only measured in terms of price but as a complex bundle of innovation, quality, variety and price, the unavoidable conclusion is that supermarkets' abuses against suppliers of independent brands undermine both social as well consumer welfare.

Once the theoretical foundations of supermarkets' power and abuses are laid down, the study examines supermarkets' commercial practices that distort the competitive process and economic efficiency. These practices undermine competition between supermarket brands and independent brands, as well as between supermarkets. Likewise, they undermine consumer welfare by reducing innovation, quality and variety and increasing naked prices as well as quality-adjusted prices.

These practices distort access of independent brands to supermarket platforms as well as competition within these platforms. The study portrays these practices in a horizontal dimension, as they not only unfairly exploit a business partner but, more importantly, foreclose a competitor from the market.

Access foreclosure takes place through the following practices: (a) the misuse of the business secrets provided by independent brands to supermarkets in favour of the supermarket brands; (b) access fees that prevent distribution of independent brands; (c) an abrupt termination of access that undermines the economic viability of the operations of independent brands; and (d) an upfront access refusal of the independent brands' products and innovations that compete with supermarket brands.

Market foreclosure may also take place through (A) pricing and (B) non-pricing practices that distort in-store competition between supermarket brands and independent brands. Even though supermarkets are able to transfer most, if not all, retail risks to suppliers and often operate *de facto* as providers of remunerated services to them, they have not formally foregone their "retailer" or "merchant" role (i.e., purchase for resale to consumers bearing all the associated risks), as far as it affords them competitive advantages such as the control of the retail price of independent grocery brands. (A) Pricing power may undermine an independent brand's value proposition to consumers through (1) an artificial price gap between the targeted independent brand and the supermarket brand; (2) a loss-leading price of the independent brand that undermines its quality perception; (3) a refusal to pass-through promotional wholesale prices of independent brands to their retail prices; and (4) a prohibition of the on-package promotions carried out by the independent brands. (B) Non-pricing practices may also be used to distort the

consumer's in-store choice through (1) degradation of the in-store services provided to independent brands; (2) switch marketing techniques in favour of supermarket brands; (3) better shelf-positioning of the supermarket brands or disproportionate space allocation; and (4) copycat packaging by supermarket brands of targeted competitors.

In order to address these unfair and exclusionary commercial practices, the study suggests that competition law and regulatory remedies may be necessary.

Competition Law remedies

The study suggests that current competition law analysis under Articles 101 and 102 TFEU has failed to understand supermarkets' competitive bottleneck role. Commission's Guidelines on vertical agreements (Vertical Guidelines) have dealt with access fees, category captains and foreclosure of independent brands without advancing any practical solution and yet consider that supermarkets are not competitors of independent brands when they source their own brands. Intervention under Article 102 TFEU has also failed since intervention is only considered if single-firm dominance is found, based on very high market shares and a significant market share gap with competitors.

In light of the specific features of the grocery retailing and its economic and social importance, the study calls for a holistic supervision of the supermarket practices governing access to the store and in-store competition. This may be accomplished by a sector-specific block exemption regulation and/or Guidelines. This solution would offer flexibility to establish hard-core practices between manufacturers and retailers that are normally anti-competitive irrespective of the market share of the companies involved (e.g., misuse of sensitive commercial information) and offer guidelines regarding the competitive analysis of the most common practices.

Furthermore, the interpretation of Article 102 TFEU should take into account the specificities of competitive bottlenecks, which have prompted competition authorities to (a) protect business customers of the bottlenecks as much as the end-consumers (e.g., advertisers in media platforms; merchants in card payment networks ; content providers in network neutrality issues); and (b) apply narrower market definitions (e.g., call termination on each operator's network in mobile communication networks or aftermarkets in the motor-vehicle sector); and/or (c) show greater readiness to find market power/dominance. The study proposes different options, including narrower market-definitions of dominance; lower dominance thresholds (e.g., 20%, as in the Rewe/Meinl Decision) and the application of remedies (e.g., FRAND terms) in local/regional markets where dominance is found.

Regulatory remedies

Several factors point towards the need to supplement competition policy enforcement with the regulation of unfair/exclusionary in the grocery retailing: supermarkets' anticompetitive practices are widespread, simultaneous and multifaceted, evidencing a structural market failure; the retail market concentration is ever growing; supermarkets' vertical integration and foreclosure practices place the old vertical relationships between grocery brands and supermarkets in a new horizontal dimension: a non-reciprocal commercialisation agreement with a competitor, whose brand competes head-on with independent brands in the store; authorities have acknowledged that buyer power and competition bottlenecks are better dealt with under an *ex ante* regulatory regime; competition policy enforcement has been biased against manufacturers (sellers) and in favour of retailers (e.g., prohibition of resale price maintenance); and economic regulation may also take into account other public policies worth of protection such as the Common Agricultural Policy.

A regulatory remedy should (1) prohibit unfair/exclusionary practices regarding access to supermarkets and in-store competition with supermarket brands; (2) order the separation of supermarket and supermarket brand activities; and (3) be enforced by an independent authority with sufficient investigatory and fining powers. The EU regulatory experience with other competitive bottlenecks such as CRSs could serve as an inspirational source. Regulation 2299/89 put in place regulatory remedies regarding (1) access to CRSs; (2) competition within each CRS; (3) legal and functional separation between CRSs and their parent airline carriers; and (4) effective guidance and enforcement by the Commission with the aid of independent auditors.

(1) Access and in-store competition

Access to the supermarkets should be granted on fair, reasonable, and non-discriminatory (FRAND) terms.

The principle of ***fairness*** requires that the supply agreements (1) are written; (2) cover at least the most important elements of the contractual relationship; and (3) provide for balanced rights and obligations on both sides. Furthermore, the terms of delivery should be regulated (e.g., a fair dispute resolution mechanism and proportionate penalties). Finally, supermarkets must not transfer to independent brands the risks of activities falling within their retailer function. For example, supermarkets should bear the cost of shrinkage, wastage and customer complaints (unless the supermarket is legally entitled to a compensatory action before the supplier).

Public authorities should also evaluate whether access fees should be regulated, i.e., subject to a test of proportionality and due consideration, or prohibited altogether. Several arguments militate in favour of an upfront prohibition or limitation of access fees in the retail business model (experts have referred to supermarkets' shelf space as "the most expensive real state in the world"). Experience shows that the prohibition of unjustified/disproportionate fees for services rendered is useless.

The principle of ***non-discriminatory*** access might come to play once the supermarket has decided its assortment strategy ("light non-discrimination") or it may be extended to the listing criteria used to select the listed grocery brand(s) ("pure non-discrimination). The light non-discrimination obligation would simply ensure that the listed independent brands are not discriminated in terms of access (e.g., access fees levied only on independent brands). Public authorities might impose the light non-discrimination obligation or the pure non-discrimination one according to the market-size of the supermarket concerned (e.g., leading supermarkets would be subject to the pure non-discrimination obligation). In certain sectors such as CRSs, regulations have even mandated open access to a facility, subject to capacity/technical constraints. Certainly, an unrestricted access obligation would be more difficult to enforce in the grocery retail business, in light of the ever-changing features of the grocery categories and segments. However, this difficulty may be overcome by fixing a minimum number of competing brands in specified categories (the Commission has accepted this kind of remedy in the Microsoft case and seems inclined to accept it in the Google case).

In-store competition between supermarket brands and independent brands should also be governed by the FRAND ("fair, reasonable and non-discriminatory") principles governing access to the supermarket platforms.

In the field of ***non-pricing competition***, the enforcement of these principles should be straightforward in respect of practices such as degradation of in-store services, switch marketing and allocation of preferential shelf-space. Furthrermore, it may be necessary to introduce a specific provision against copycats in this sector, in light of the dual role played by supermarkets.

In the field of ***pricing competition***, a fair dealing and non-discrimination obligation may apply to wholesale promotional prices and retail promotions (which should be reflected accordingly in the retail prices of the independent brands). Competition authorities have also identified artificial retail price gaps between leading independent brands and supermarket brands (i.e., higher retail margins on the former cross-subsidise the latter) in recent market investigations in Spain, France and Finland. A regulatory remedy against this practice could provide that supermarkets may not earn higher retail margins on independent grocery brands than they do on their own brands. Finally, even though brand-destruction through loss-leading retail prices has never been a concern for competition authorities, which were more focused on static intra-brand price competition than on dynamic inter-brand competition, it should now be treated as an exclusionary practice. Overall, the study argues that the issues raised by the supermarkets' pricing practices in respect of independent grocery brands, especially when they are vertically integrated and have an incentive to expel independent competitors from the market, should force public authorities to consider the authorisation, if not the mandatory obligation, of resale price maintenance by independent brands in the modern grocery wholesaling/retailing.

All in all, the study suggests that the enforcement of the FRAND principles regarding access to supermarkets and in-store competition might be better advanced if the regulation clarified the ***boundaries between the role of supermarkets as service providers (where they charge access fees and provide all sorts of remunerated services) and retailers (merchants) who purchase goods and control all aspects of their resale***. As explained before, currently, leading supermarkets contractually and/or unilaterally transfer all sorts of retail risks to suppliers (including guaranteed margins and retroactive payments/deductions to meet margin forecasts), essentially foregoing their role of retailers. In order to respond to this market reality, public authorities should consider whether it is more efficient to confine supermarkets to a service provider role (e.g., analogous to a market-place/shopping mall) where grocery brands pay upfront fees and/or variable fees on sales to gain access to the distribution/market-place services and then can interact with shoppers directly or through agency agreements with supermarkets. Under this role, supermarkets would auction their shelf-space and associated in-store services. If the public authorities do not consider appropriate to mandate the market-place model, at least they should regulate the respective boundaries (e.g., prohibition of access fees if supermarkets retain their retailer role) and make sure that in-store competition fully respects the FRAND principles.

(2) Separation of grocery brands and supermarket activities

This obligation may be necessary in order to guarantee and enforce the FRAND principles regarding access by independent brands to supermarkets and in-store competition with supermarket brands. The study argues that the goal of protecting the innovative efforts by independent grocery brands should be sufficient to justify a legal separation of the supermarket's distribution and grocery brand activities. Neither the obligation of fair and non-discriminatory dealing nor internal preventive measures (e.g., a Chinese wall) seem sufficient to guarantee that a supermarket will not misuse the confidential information received from an independent grocery brand.

(3) Independent enforcement authority

The regulation should be enforced by an independent authority with ex officio investigatory and fining powers. This mechanism could rely on a newly created public authority charged with the enforcement of the regulation or an existing authority such as the Competition Authority. If the enforcement power was vested on a newly created authority, it should be able to (1) issue interpretative guidelines; (2) settle/arbitrate bilateral disputes; (3) open infringement proceedings, *ex officio* or following complaints by affected parties or their representative associations, and impose remedies and economic fines; (4) publish reports and recommendations. The Adjudicator set up to enforce the UK GSCOP, as well as the new

Authority charged with the enforcement of the Spanish Food Chain Law provide useful benchmarks. Furthermore, since the vertical integration of supermarket and grocery brand activities and the supermarkets' control over in-store competition (under the retail business model) raises significant compliance problems, public authorities should consider the introduction of an audit mechanism such as the one put in place by Regulation 2299/89.

Javier Berasategi Torices