PURCHASING AGREEMENTS: COMMISSION DRAFT GUIDELINES

Subject: Purchasing agreements

Industry: All industries

Source: Commission paper entitled Draft Guidelines on the Applicability of Article 81 to horizontal cooperation

(Note. In the July and August issues, there were extracts from the Commission's draft Guidelines on horizontal agreements dealing respectively with Production Agreements and Marketing Agreements. The extract which follows deals with Purchasing Agreements. As a broad generalization, the Commission seems to be willing to exempt purchasing agreements provided, first, that they result in economies of scale, second, that they benefit the consumer and, third, that they do not result in a dominant position. On this last point, the Guidelines are ambiguous. In the text, they say roundly that "a dominant position on either the buying or the selling market excludes exemption"; but, in the example illustrating the point, the more qualified view is taken that "even if efficiencies are caused by the [parties'] cooperation, it is not likely to be exempted due to the high degree of market power". The real test is whether competition is eliminated. The Guidelines point out, by the way, that horizontal agreements aimed at increasing purchasing power may be accompanied by vertical agreements between the purchasing body and the suppliers; and that, in these cases, the arrangements have to be looked at additionally in the light of the Commission's policy and regulation on vertical restraints.)

4. PURCHASING AGREEMENTS

4.1. Definition

106. This chapter focuses on agreements concerning the joint buying of products. Joint buying can be carried out by a jointly controlled company or by a company in which many firms hold a small stake or by a contractual arrangement or even looser form of co-operation.

107. Purchasing agreements are often concluded by small and medium sized enterprises to achieve similar volumes and discounts as their bigger competitors. These agreements between small and medium sized enterprises are therefore normally pro-competitive. Even if a moderate degree of market power is created, this may be outweighed by economies of scale provided the parties really bundle volume. Joint buying occurs in many sectors; most frequently it seems to occur in the retail sector.

108. Joint purchasing may involve both horizontal and vertical agreements. These agreements have first to be assessed according to the principles described in

the present guidelines. If this assessment leads to the conclusion that a co-operation between competitors in the area of purchasing would in principle be acceptable, a further assessment will be necessary to examine the vertical restraints included agreements concluded with suppliers or retailing members. This assessment should be based on the principles set out in the Guidelines on Vertical Restraints, for instance as regards the list of hardcore restrictions which are unlikely to be exempted in vertical agreements.

109. An example would be an association formed by a group of retailers for the joint purchasing of products. The agreement to set up the association and the conditions under which it engages in joint purchasing would be examined under the present guidelines. The resulting vertical agreements, between the association and an individual member, or between the association and an outside supplier, are covered - up to a certain limit - by the block exemption for vertical restraints: Article 2(2), Regulation EC/2790/1999. Those agreements falling outside the vertical block exemption will not be presumed to be illegal but may need individual examination.

4.2. Relevant markets

110. There are two markets which may be affected by joint buying: first, the market(s) directly concerned by the co-operation, that is, the relevant purchasing market(s); and, secondly, the selling market(s), that is, the market(s) downstream where the participants of the joint purchasing arrangement are active as sellers.

111. The definition of relevant purchasing markets follows the principles described in the Commission notice on market definition and is based on the concept of substitutability to identify competitive constraints. The only difference to the definition of "selling markets" is that substitutability has to be defined from the viewpoint of supply and not from the viewpoint of demand. In other words: the suppliers' alternatives are decisive in identifying the competitive constraints on purchasers. These could be analysed for instance by examining the suppliers' reaction to a small but lasting price *decrease*. If the market is defined, the market share can he calculated as the percentage which the purchases for the parties concerned account for out of the total sales of the purchased product or service in the relevant market.

112. Example 1. A group of car manufacturers agree to buy product X jointly. Their combined purchases of X account for 270 units. All the sales of X to car manufacturers account for 900 units. However, X is also sold to manufacturers of other products than cars. All sales of X account for 1800 units. Then the (purchasing) market share of the group is 15%.

113. If the parties are in addition competitors on one or more selling markets, these markets are also relevant for the assessment. Restrictions of competition on these markets are more likely if the parties will achieve market power by co-ordinating their behaviour and if the parties have a significant proportion of their total costs in common. This is, for instance, the case if retailers which are active in the same relevant retail market(s) jointly purchase a significant amount of the

products they offer for resale. It may also be the case if competing manufacturers and sellers of a final product jointly purchase a high proportion of their input together. The selling markets have to be defined by applying the methodology laid down in the Commission Notice on market definition.

4.3. Assessment under Article 81(1)

4.3.1. Nature of the agreement

4.3.1.1. Agreements that do not come under Article 81(1)

114. By their very nature joint buying agreements will be concluded between companies that are at least competitors on the purchasing markets. If, however, competing purchasers cooperate who are not active on the same relevant market further downstream (for example, retailers which are active in different geographic markets and can not be regarded as realistic potential competitors), Article 81(1) will rarely apply unless the parties have a very strong position in the buying markets, which could be used to harm the competitive position of other players in their respective selling markets.

115. In most cases, joint buying will be agreed between companies that are competitors on both the purchase and the selling market (see below 4.3.1.3).

4.3.1.2. Agreements that almost always fall under Article 81(1)

116. Purchasing agreements only come under Article 8 1(1) by their nature if the cooperation does not truly concern joint buying, but serves as a tool to engage in a disguised cartel, i.e. otherwise prohibited price fixing, output limitation or market allocation.

4.3.1.3. Agreements that may fall under Article 81(1)

117. Most purchasing agreements must be analysed in their legal and economic context. The analysis has to cover both the purchasing and the selling markets.

4.3.2. Market power and market structures

118. The starting point for the analysis is the examination of the parties' buying power. Buying power can be assumed if a purchasing agreement accounts for a sufficiently large proportion of the total volume of a purchasing market so that prices can be driven down below the competitive level or access to the market can be foreclosed to competing buyers. A high degree of buying power over the suppliers of a market may bring about inefficiencies such as quality reductions, lessening of innovation efforts, or ultimately sub-optimal supply. However, the primary concerns in the context of buying power are that lower prices may not be passed on to customers further downstream and that it may cause cost increases for the purchasers' competitors on the selling markets because either suppliers will try to recover price reductions for one group of customers by increasing prices for other customers or competitors have less access to efficient suppliers.

Consequently, purchasing markets and selling markets are characterised by interdependencies as set out below.

Interdependencies between purchasing and selling market(s)

119. The co-operation of competing purchasers can appreciably restrict competition by means of creating buying power. Whilst the creation of buying power can lead to lower prices for consumers, buying power is not always pro-competitive and may, under certain circumstances, even cause severe negative effects on competition.

120. First, lower purchasing costs resulting from the exercise of buying power cannot be seen as pro-competitive, if the purchasers together have power on the selling markets. In this case, the cost savings are probably not passed on to consumers. The more combined power the parties have on their selling markets, the higher is the incentive for the parties to coordinate their behaviour as sellers. This may be facilitated if the parties achieve a high degree of commonality of costs through joint purchasing. For instance, if a group of large retailers buys a high proportion of their products together, they will have a high proportion of their total cost in common. The negative effects of joint buying can therefore be rather similar to joint production.

121. Secondly, power on the selling markets may be created or increased through buying power which is used to foreclose competitors or to raise rivals' costs. Significant buying power by one group of customers may lead to foreclosure of competing buyers by limiting their access to efficient suppliers. It can also cause cost increases for its competitors because suppliers will try to recover price reductions for one group of customers by increasing prices for other customers (e.g. rebate discrimination by suppliers of retailers). This is only possible if the suppliers of the purchasing markets also have a certain degree of market power. In both cases, competition in the selling markets can be further restricted by buying power.

122. There is no absolute threshold which indicates that a buying co-operation creates some degree of market power and thus falls under Article 81(1). However, in most cases, it is unlikely that market power exists if the parties to the agreement have a combined market share of below 15% on both the purchasing market(s) and also the selling market(s). In any event, at that level of market share it is likely that the conditions of Article 81(3) explained below are fulfilled by the agreement in question.

123. A market share above this threshold does not automatically indicate that a negative market effect is caused by the co-operation but requires a more detailed assessment of the impact of a joint buying agreement on the market involving factors such as the market concentration and possible countervailing power of strong suppliers. Joint buying that involves parties with a combined market share significantly above 15% in a concentrated market is lik~y to come under Article 81(1), and efficiencies that may outweigh the restrictive effect have to be shown by the parties.

4.4. Assessment under Article 81(3)

4.4.1. Economic benefits

124. Purchasing agreements can bring about economic benefits such as economies of scale in ordering or transporting which may outweigh restrictive effects. If the parties together have significant buying or selling power, the issue of efficiencies has to be examined carefully. Cost savings which are caused by the mere exercise of power and do not benefit the consumers cannot be taken into account.

4.4.2. Indispensability

125. Purchasing agreements cannot be exempted if they impose restrictions that are not indispensable to the attainment of the above-mentioned benefits. An obligation to exclusively buy through the co-operation can in certain cases be indispensable to achieve the necessary volume for the realisation of economies of scale. However, such an obligation has to be assessed in the context of the individual case.

4.4.3. No elimination of competition

126. Joint buying agreements can never be exempted if they afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question. This assessment has to cover buying and selling markets. The combined market shares of the parties can be regarded as a starting point. It then needs to be evaluated whether these market shares are indicative of a dominant position, and whether there are any mitigating factors, such as countervailing power of suppliers on the purchasing markets or potential for market entry in the selling markets. A dominant position on either the buying or selling market excludes exemption under Article 81(3).

4.5. Examples

127. Example 2. Situation: Two manufacturers, A and B, decide to jointly buy component X. They are competitors on their selling market. Together their purchases represent 35% of the total sales of X in the EEA, which is assumed to be the relevant geographic market. There are 6 other manufacturers (competitors of A and B on their selling market) accounting for the remaining 65% of the purchasing market; one having 25%, the others account for significantly less. The supply side is rather concentrated with 6 suppliers of component X, two with 30% market share each, and the rest between 10 and 15% (HHI of 2300-2500). On their selling market, A and B achieve a combined market share of 35%. Analysis: Due to the parties' market power in their selling market, the benefits of possible cost savings may not be passed on to final consumers. Furthermore, the joint buying is likely to increase the costs of the parties' smaller competitors because the two powerful suppliers probably recover price reductions for the group by increasing smaller customers' prices. Increasing concentration in the downstream market may be the result. In addition, the cooperation may lead to further

concentration among suppliers because smaller ones, which may already work near or below minimum optimal scale, may be driven out of the business if they cannot reduce prices further. Such a case probably causes a significant restriction of competition which may not be outweighed by possible efficiency gains from bundling volume.

128 Example 3. Situation: 15 small retailers conclude an agreement to form a joint buying organisation. They are obliged to buy a minimum volume through the organisation which accounts for roughly 50% of each retailer's total costs. The retailers can buy more than the minimum volume through the organisation, but they may also buy outside the co-operation. They have a combined market share of 20% on each the purchasing and the selling market. A and B are their two large competitors, A has a 25% share on each of the markets concerned, B 35%. The remaining smaller competitors have also formed a buying group. The 15 retailers achieve economies by combining a significant amount of volume and buying tasks. Analysis: The retailers may achieve a high degree of commonality of costs if they finally buy more than the agreed minimum volume together. However, together they have only a moderate market position on the buying and the selling market. Furthermore, their co-operation brings about some economies of scale. This co-operation is likely to be exempted.

129 Example 4. Situation: Two supermarket chains conclude an agreement to jointly buy products which account for roughly 50% of their total costs. On the relevant buying markets for the different categories of products the parties have shares between *25%* and 40%, on the relevant selling market (assuming there is only one geographic market concerned) they achieve 40%. There are five other significant retailers with each 10-15% market share. Market entry is not likely. Analysis: It is likely that this joint buying arrangement would have an effect on the competitive behaviour of the parties because co-ordination would give them significant market power. This is particularly the case if entry is weak. The incentive to co-ordinate the behaviour is higher if the costs are similar. Similar margins of the parties would add an incentive to have the same prices. Even if efficiencies are caused by the co-operation, it is not likely to be exempted due to the high degree of market power.

105 Example 5. Situation: 5 small co-operatives conclude an agreement to form a joint buying organisation. They are obliged to buy a minimum volume through the organisation. The parties can buy more than the minimum volume through the organisation, but they may also buy outside the co-operation. Each of the parties has a total market share of 5% on each of the purchasing and selling markets, giving a combined market share of 25%. There are two other significant retailers each with 20-25% market share and a number of smaller retailers with market shares below 5%. Analysis: The setting up of the joint buying organisation is likely to give the parties a market position on both the purchasing and selling markets of a degree which enables them to compete with the two largest retailers. Moreover, the presence of these two other players with similar levels of market position are likely to result in the efficiencies of the agreement being passed on to consumers. In such a scenario the agreement is likely to be exempted. ■