Merger of Foodstuffs North Island ("FSNI") and Foodstuffs South Island ("FSSI")

Expert opinion on likely competitive effects with a focus on the upstream markets (i.e., grocery acquisition)

August 2024

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1. Background and the Objective of the Economic Opinion

1 The following sections first provide a brief overview of the context (see section 1.1), the relevant companies (see 1.2) and the structure of the economic opinion (see 1.3).

1.1 Context

2 Foodstuffs North Island Limited ("FSNI") and Foodstuffs South Island Limited ("FSSI") (together "Parties"), two independent grocery retailing co-operatives in New Zealand, are seeking approval to merge into a single entity ("Proposed Merger"). The Commerce Commission ("Commission") raised several issues in its Statement of Unresolved Issues ("SOUI") published on 16 July 2024.[1] In particular, the Commission raised the following points ("theory of harm"):

- The Proposed Merger would significantly reduce upstream competition by eliminating one of the major grocery acquirers in New Zealand, leaving suppliers with only two primary customers (the merged entity and Woolworths) instead of the current three. This consolidation would make the merged entity the largest grocery buyer in the country, limiting options for suppliers.[2]
- The Proposed Merger would substantially lessen competition in upstream grocery acquisition markets by increasing the merged entity's buyer power. This would enable the entity to secure lower prices and more favorable terms from some suppliers. As a result, some suppliers currently serving only FSNI or FSSI might exit the market if the merged entity chooses not to stock their products.[3]
- Finally, the Proposed Merger could impact the pace and development of new product innovation, resulting in reduced consumer choice and quality of grocery products.[4]

3 The objective of this economic opinion is to assess the potential for the Proposed Merger to lead to a lessening (or strengthening) of competition and innovation incentives in both the upstream (i.e., grocery acquisition) and downstream (i.e., grocery retail) markets.

Key assumptions to be considered include:

- The merging parties anticipate that, post-merger, they will be able to negotiate a small improvement in terms for the grocery products they currently acquire separately and will subsequently acquire jointly.

[1] https://comcom.govt.nz/__data/assets/pdf_file/0030/358734/FSNI-and-FSSI-Statement-of-Unresolved-Issues-16-July-2024.pdf
[2] SOUI, para. 10.3.
[3] SOUI, para. 10.4.
[4] SOUI, para. 10.5.

- The Parties do not compete within the geographic dimension of any grocery retail market and are not expected to do so absent the merger. Therefore, the proposed transaction is not expected to diminish rivalry within those retail markets.

4 The analysis will primarily be based on fundamental economic principles and established theoretical frameworks, rather than the specific circumstances of the Parties.

1.2 The Relevant Companies

5 FSNI is owned by 332 cooperative members based in the North Island, while FSSI is owned by 198 members in the South Island. The members of both FSNI and FSSI operate individual retail and wholesale grocery stores. Although each cooperative is ultimately controlled by its members—the retail store owner-operators—the two cooperatives jointly manage and share several retail grocery brands:[5]

1.3 Structure of the Economic Opinion

6 The remainder of this opinion is organized as follows: The next section provides a concise exploration of the relevant analytical frameworks, offering a theoretical foundation for understanding the potential effects of the proposed merger. This section highlights that these effects are most effectively conceptualized through the lenses of price differentiation and bargaining power within the market. Section 3 provides an analysis of the likely impacts on the downstream market. Section 4 shifts the focus to the expected effects in the upstream market. Finally, Section 5 offers a brief review of the competitive outcomes observed in European retail alliances that provide relevant insights for the likely effects of the Proposed Merger.

[5] SOUI, para. 18 and 19.

2. The Relevant Analytical Frameworks

7 The following chapter provides an overview of the relevant analytical frameworks, beginning with a general overview (see section 2.1), followed by discussions on monopsony models (see section 2.2), supplier pricing power and differential prices (see section 2.3), and bargaining models (see section 2.4), and concluding with a summary (see section 2.5).

2.1 General Overview

8 The effects of the Proposed Merger can be examined through various analytical frameworks, each offering a distinct perspective based on differing assumptions and methodologies. It is essential to briefly outline these key frameworks, highlighting their main differences and the conclusions they yield. The relevant analytical frameworks are the following:

i. **Monopsony models:** Monopsony occurs when there is only one buyer in a market. This single buyer can exercise significant power over numerous smaller sellers, similar to how a monopoly seller can set terms to buyers.[6] The monopsonist can reduce the price it pays for goods or services below what would prevail in an effectively competitive market, potentially leading to a reduction in the quantity supplied.

In an oligopsony, a few buyers dominate the market. These buyers may independently or collectively exert buyer power, pushing prices down. The oligopsony model highlights how the concentration of buying power among a few firms can affect market prices and reduce suppliers' profits, leading to less favorable conditions for the numerous smaller, less powerful sellers. However, oligopsony models are more complex and provide less clear and often ambiguous predictions compared to the simpler monopsony model, making them less suitable for the analysis in this particular case.

> Within this analytical framework, the potential theoretical effects of the Proposed Merger would result from a reduction in the number of buyers who determine market prices for the numerous smaller sellers.

ii. **Price differentiation:** Price differentiation is a common strategy used by firms with pricing power to optimize profits by charging different prices for the same product or service to different customers. In the business-to-business (B2B) sector, one of the most common forms of price differentiation is volume-based pricing, where the per-unit price decreases as the quantity purchased increases. Additionally, B2B suppliers often adjust prices based on the geographical location of the customer. This geographic price differentiation primarily reflects variations in competitive conditions—where customers in more competitive regions may benefit from lower

[6] This is why the monopsony model is also called the mirror image of the monopoly model.

prices—and differences in demand sensitivity, with more price-sensitive customers receiving more favorable prices.[7]

> In this analytical framework, the potential theoretical effects of the Proposed Merger would arise from the newly formed entity's reduced exposure to price differentiation that was previously imposed by suppliers with pricing power over individual firms. Post-merger, the entity is likely to benefit from more uniform pricing.

iii. **Bargaining models:**[8] The bargaining perspective is fundamental to understanding markets where contracts or terms of trade are negotiated rather than determined solely by impersonal market forces (as in the monopsony model). The relative bargaining power of buyers and sellers is critical in these negotiations, influencing the final terms of trade and the distribution of the resulting economic surplus. This framework highlights the strategic interactions between buyers and sellers.

> Within this analytical framework, the potential theoretical effects of the Proposed Merger would primarily result from a reduction in the number of potential retailers available to each supplier. With fewer retailers to engage with, suppliers could theoretically experience diminished bargaining power, as the newly merged entity would command a larger share of the market. This consolidation could shift the balance of power, enabling the merged retailer to negotiate more favorable terms.

2.2 Monopsony Models

9 The monopsony model is a simple framework found in most introductory microeconomics textbooks.[9] This model operates under three key assumptions:

i. There is a single buyer that dominates the procurement market and can increase profits by reducing volumes, thus forcing prices below competitive levels. If this buyer also wields power in the final consumer market, it could lead to higher prices for consumers, causing overall harm.

ii. There is a highly competitive supply side, that is, with numerous small suppliers acting as price takers.

iii. The aggregate supply curve is upward sloping, meaning that larger purchase quantities result in higher prices. This is based on the idea that increased production volumes lead to higher marginal and average costs, necessitating higher prices. While this assumption might be accurate in some

[7] See Dertwinkel-Kalt and Wey (2023) and the literature cited there.
[8] Successive monopoly models are a special case where one party in a vertical chain makes a take-it-or-leave-it offer to the other party regarding the price of an input.
[9] See, e.g., Pindyck and Rubinfeld (2013), pp. 385-389.

markets, its relevance to food production is less certain, that is, marginal and average costs might be constant.[10]

10 In processed food production, the assumption that increasing output leads to higher average costs implies that economies of scale have been fully exploited and that further growth results in higher costs. However, this is contradicted by the reality of the market, where large manufacturers are often very relevant, benefiting from economies of scale. If higher average costs were the norm, we would expect to see more small, efficient producers instead of a few large ones.

11 In practice, the monopsony model is viewed as inadequate for analyzing the grocery retail sector. The assumption of a highly competitive supply side does not align with the realities of food procurement, where product differentiation and manufacturer concentration are significant factors. Moreover, the relationships between retailers and suppliers are characterized by bilateral contracting. These contracts differ significantly from the simple, anonymous exchanges assumed by the monopsony model.

12 As mentioned above, the model can be extended to address situations involving a few dominant buyers interacting with numerous suppliers, as seen in oligopsony scenarios. However, these models typically rely on very strong assumptions about the market-clearing process and the strategic behavior of buyers. Consequently, other frameworks may be more suitable for analyzing the effects of the Proposed Merger.

2.3 Supplier Pricing Power and Differential Prices

13 Setting aside local suppliers that supply one or a small number of individual stores, at present, FSNI and FSSI share the vast majority of their suppliers. Some of these suppliers possess a degree of pricing power, because their products are differentiated from those of competing suppliers and – for one reason or another – the bargaining circumstances applying to FSNI and FSSI are not the same. It might be expected that the entity operating in the larger of the two retail markets, being FSNI, typically secures better prices than FSSI on average. However, the extent of any price differential between FSNI and FSSI is also likely to be limited, since FSSI must remain competitive against Woolworths, which has already centralized procurement with optimized input prices for the entire New Zealand market.

14 Nevertheless, the Proposed Merger is expected to allow the Parties to secure the better of any differences in prices and associated terms currently faced by FSNI and FSSI. Assuming this expectation is realized, this will result in a small reduction in the prices paid by the Parties to some suppliers. This follows from the fact that, at present, some of the prices paid to suppliers are understood to differ as between FSNI and FSSI. The Proposed Merger would encourage suppliers to set a uniform price for their goods, rather than offering different prices as they currently do when FSNI and FSSI purchase separately and independently. That uniform price must be close to the lower price, which is likely typically to be charged to FSNI because of FSNI's larger volume and the no less intense competition in the geographical market in which FSNI operates.[11]

[10] Note that in a perfectly competitive market, the long-run supply curve must be horizontal, implying constant marginal and average costs.
[11] This follows from the literature of third-degree price discrimination (see Schmalensee, 1981, for the monopoly supplier case and Holmes 1989 and Dertwinkel-Kalt and Wey, 2023, for the oligopoly supplier case).

15 In summary, the primary effect of the Proposed Merger would be a reduction in supplier-induced price differentiation among the Parties. By negotiating purchasing terms collectively rather than individually, the newly formed entity would curtail suppliers' ability to offer different wholesale prices to each retailer, thereby uniform pricing across the board—a "non-discrimination effect." This harmonization of pricing would likely result in slightly improved input costs for the merged entity. The lower prices, in turn, should lead to a commensurate increase in procurement volumes, producing a positive "total quantity effect" in the downstream market.

2.4 Bargaining Models

16 Bargaining models provide an additional lens through which to analyze the potential effects of the Proposed Merger. These models highlight that the bargaining power and the outcomes of negotiations are influenced by a range of factors, including the negotiating skills of the parties involved, the availability of alternative options, the relative patience of each party, and their tolerance for risk.

17 More specifically, these models recognize that procurement prices and terms can vary based on the bargaining power of the parties involved. In particular, these models allow for the consideration of more complex contracts, which can help mitigate or eliminate efficiency losses due to double marginalization, monopsonistic quantity rationing, and incentive and coordination problems that typically occur in vertical relations.[12]

18 The foundational model in modern bargaining theory is the Nash Bargaining Solution.[13] It separates the problem of maximizing the total profit/surplus (especially the quantity to be exchanged between the seller and buyer) from the issue of dividing that profit/surplus between the parties. This assumes that the contracting parties draw up a contract that—regardless of the distribution of profits—initially maximizes the joint profit.[14] Through transfer payments (which are independent of quantities traded), the joint profit can theoretically be divided between the contractual partners at will without any loss of efficiency (i.e., without inducing a double mark-up inefficiency as it is the case when only a linear wholesale price can be used to transfer money from the retailer to the supplier).

19 Formally, the Nash Bargaining Solution is found by maximizing the product of the parties' net benefits of trade (”utilities”), which are measured as the difference between what each party gains from the agreement and what they would receive if no agreement were reached (their respective "threat points" or “outside options”). This approach ensures that both parties' relative bargaining positions are considered, leading to an outcome that reflects the “balance of power” and the potential “fallback” (or “disagreement”) positions of each party. The result is an allocation that is Pareto optimal, meaning that

[12] Double marginalization is a problem that arises in vertical relations, such as those involving a supplier and a retailer, where each entity independently sets its prices or engages in bargaining under incomplete contracts. The issue occurs when both the supplier and the retailer add their own markup to the product, leading to a higher final price for consumers than what would be optimal for the supply chain as a whole. Additionally, incentive and coordination problems, such as those arising from moral hazard and externalities, are common in vertical relationships.

[13] See, e.g., Osborne and Rubinstein (1990), pp. 7-26, for a textbook presentation, and Binmore et al. (1986) for a discussion of its relevance in economic modelling.

[14] In cases of asymmetric information, where the retailer lacks full knowledge of the goods' quality and production costs, the traded quantity often ends up being too small. However, the expertise of large retailers in purchasing helps reduce this information gap, bringing the traded quantity closer to an efficient level.

no other agreement could make one party better off without making the other party worse off. Regardless of how profits are shared, both parties will seek to maximize their combined profit. This means that changes in buyer power may not influence the quantities supplied. Unlike in the monopsony model with reduced order quantities, both parties here are incentivized to agree on the quantity that creates the greatest overall surplus. As a result, there are no negative effects of the Proposed Merger on the quantities supplied.[15] Notably, this observation is particularly robust in the Proposed Merger, because here the Parties operate in geographically separated markets, which erases any possible concern that intrabrand competition could be hurt by the Proposed Merger.

20 The stronger a negotiating party's outside option, the easier it is to replace its counterpart with an alternative partner. In other words, the smaller the potential profit loss from failed negotiations, the stronger that party's negotiating position.

21 A retailer’s bargaining position is significantly strengthened when they can easily pit multiple suppliers against each other, particularly if a supplier heavily relies on the retailer's demand. Additionally, if the retailer can readily substitute a product with an alternative or replace it with a private label, their negotiating power is further enhanced. These factors create leverage, allowing the retailer to extract more favorable terms from suppliers. Conversely, a supplier's power in negotiations increases if they can operate effectively without being overly dependent on any single retailer. If the supplier can easily replace one retailer with another, they can play retailers off against each other to secure better deals.

22 The supplier's negotiating strength is also bolstered if they have flexibility in their production processes or offer products that are essential to the retailer, such as those with strong "must-stock" brands. These brands are indispensable to retailers because they drive customer traffic and sales, giving the supplier more influence in negotiations. It is important to note that the strength of a brand does not necessarily correlate with the size of the company; local brands in certain product categories can hold significant sway in their specific markets, despite the company’s overall size. Thus, the value of outside options in bargaining is influenced by a variety of complex factors, including market dynamics, brand strength, and product substitutability. This complexity means that bargaining power cannot be simply reduced to a linear relationship to firm size.

23 A key principle in bargaining theory is the Outside Option Principle (OOP), which states that a player's outside option will enhance their bargaining power only if that option is sufficiently attractive. If the outside option is not compelling enough, it will have little to no impact on the bargaining outcome. The OOP highlights that simply having an outside option—such as an alternative retailer or supplier—does not automatically strengthen one's bargaining position. For a retailer to effectively leverage this option and negotiate a lower price from their current supplier, the alternative offer must present a price that is clearly more favorable than what the current supplier provides. Without such a distinct advantage in the outside option, the bargaining outcome is unlikely to change, leaving the retailer with limited influence over the negotiations. This principle underscores the importance of the quality, not just the existence, of outside alternatives in shaping bargaining outcomes.[16]

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[15] There could be some quantity effects due to double marginalization in situations involving incomplete contracting due to moral hazard problems by both parties (see Romano, 1994). Notably, all our findings remain valid under these circumstances. The only difference is that the increased buyer power of the new entity tends to reduce the double mark-up inefficiency.

[16] See Binmore et al. (1989).

24 In summary, the bargaining perspective in the context of the Proposed Merger focuses on the strategic options for securing better procurement terms (e.g., some individual discounts). It is not about exerting pressure on the overall supply or manipulating the broader market dynamics within the supply chain. When evaluating the effects of the Proposed Merger, it is crucial to analyze changes in the outside options of the relevant players. If these outside options remain (largely) unchanged, the resulting bargaining outcomes are also unlikely to shift. This highlights the importance of understanding whether the relevant options of the involved parties are truly impacted, rather than *assuming* the Proposed Merger alone will change the bargaining outcome and lessen competition in the upstream market.

2.5 Summary

25 The Proposed Merger can be analyzed through three distinct frameworks. The monopsony framework, however, seems inadequate for capturing the relevant effects in this specific case. The other two frameworks—supplier price differentiation and bargaining—offer more valuable insights into the potential effects of the merger. Both frameworks require a nuanced analysis that goes beyond simplistic explanations and requires a focus on incentives and relevant outside options available to the parties involved.

26 A deeper examination often reveals that the underlying dynamics are far more complex than they initially appear. Factors such as the relative dependency between the parties, the availability of alternative partners, and the strategic incentives of each player can significantly influence the outcome. A thorough and economically sound analysis is essential for accurately assessing the merger's potential effects, particularly for mergers between non-competing entities in the downstream market, as discussed in the following sections.

3. Positive Effects in the Downstream Market

27 This section demonstrates that the Proposed Merger leads to positive effects in the downstream market, specifically by showing that there are no effects on the downstream market structure (see section 3.1) and lower prices for final customers (see section 3.2).

3.1 No Effects on the Downstream Market Structure (i.e., Grocery Retail)

28 The Proposed Merger is unlikely to have any significant impact on the downstream market structure for two primary reasons:

i. **Geographical separation:** The Parties operate in entirely separate territories, each on different islands, with no overlap in their areas of operation. Consequently, the Proposed Merger will not, on its own, result in any changes to the number or location of stores within any given territory. Each market will continue to function as before the Proposed Merger, maintaining the same level of competition. This geographical separation ensures that the merger will not have any significant impact on the downstream market.

ii. **Alignment in brands and overall business strategies:** The Parties are already closely aligned in terms of their brand portfolio and overall business strategies. This alignment suggests that the merger will not result in any major shifts or changes in how the companies operate or present themselves in the market. Essentially, the way they conduct business, market their products, and interact with customers will remain consistent with their current practices. This stability ensures that the Proposed Merger will not generate any significant changes in the downstream competitive landscape.

3.2 Lower Prices for Final Customers

29 The primary impact of the Proposed Merger is a modest reduction in some input prices and thus higher volumes for the newly formed entity. This reduction in costs has two significant strategic effects:

i. **Direct effect:** Lower input costs will result in decreased downstream prices for the merged entity. This outcome is consistent with general optimization principles that apply to any kind of economic model, which suggests that when a company (even a monopolist) secures more favorable procurement terms, a portion of the resulting cost savings is passed on to consumers in the form of lower prices, resulting in higher purchase volumes, all else being equal.[17]

ii. **Indirect effect:** The price reduction by the newly merged entity will likely prompt its competitors, particularly Woolworths, to lower their prices as well. This reaction is driven by the fact that prices in the market are usually strategic complements, meaning that a decrease in the price of one firm

[17] The extent of such price reductions depended notably on the degree of competition existing in the relevant downstream market.

tends to encourage other firms to follow suit to maintain their competitive position.[18] As a result, the overall market may experience downward pressure on prices, leading to increased competition and benefiting consumers across the board. As a consequence of this positive volume effect downstream firms' incentive to keep costs of retailing (e.g., warehousing and transportation costs) low are strengthened.

[18] See Bulow et al. (1985).

4. No Negative Effects in the Upstream Market

30 This section demonstrates that the Proposed Merger leads to no negative effects in the upstream market, specifically by showing that there are no direct effects on the upstream market (see section 4.1) and that supplier incentives are strengthened (see section 4.2).

4.1 No Direct Effects on the Upstream Market (i.e., Grocery Acquisition)

31 The Commission has expressed concerns that the Proposed Merger could negatively impact suppliers by concentrating procurement, potentially reducing the number of suppliers to secure more favorable procurement terms.

32 It is crucial to consider that any analysis of upstream market effects must consider that the Parties' main brands are "full-service" supermarkets, distinguished by a very broad and diverse range of suppliers.[19] This market positioning will be maintained, which ensures that the Parties have a strong and ongoing incentive to preserve a diverse ecosystem of suppliers. Consequently, they will be motivated to avoid any actions that could harm their suppliers.

33 From a price differentiation standpoint, the Proposed Merger is unlikely to have negative effects on upstream competition. By integrating previously separate markets, it would lead to more "uniform pricing" by suppliers engaged in price differentiation. The resulting modest average price reduction would then increase procurement volumes.

34 From a bargaining perspective, the Proposed Merger could potentially improve the position of the new entity in two ways:

- **By improving the own outside option:** The merger could potentially strengthen the new entity's position by broadening its access to alternative suppliers. For instance, if the new entity can attract new suppliers that were previously out of reach for the individual companies, this would enhance its outside option, thereby increasing its leverage in negotiations.[20] However, this scenario seems unlikely in this particular case. The Proposed Merger, by itself, is not expected to significantly impact the existing outside options of the new entity. If it does, however, it would be pro-competitive, leading to increased competition in the upstream market following from the merged entity's ability to open up new supply sources. Notably, those new supply sources could come from foreign suppliers in the short run and induced investments of those supplies in new production facilities in NZ in the longer run.

[19] A full-service supermarket is a retail grocery store that offers a wide range of products and services to meet the diverse needs of customers. Unlike discount or specialty stores that may focus on specific categories or limited product ranges, full-service supermarkets provide a comprehensive selection of goods.

[20] The new entity could actively support the entry of new suppliers by, for instance, sharing some of the entrant's set-up costs or by contractually committing to allocate a fixed share of purchases to the newcomer. Additionally, the presence of large buyers could indirectly enhance the economic viability of new entrants, as securing just a few contracts with these major players might be sufficient to establish a sustainable business.

- **By weakening the suppliers' outside options:** The merger could also enhance buyer power by diminishing the alternatives available to suppliers. If the merger results in suppliers having fewer potential buyers, their negotiating position could weaken, thereby increasing the buyer's leverage. In this scenario, the new, larger entity would have more influence compared to when the involved companies operated separately. This could lead to more favorable terms for the buyer, as suppliers may have fewer opportunities to turn to other customers.

35 To evaluate the latter point, one has to answer the key question whether the Proposed Merger indeed deprives suppliers of their best alternative outside option—that is, whether the merger changes a supplier's most favorable alternative in the circumstance where a supplier is unable to reach agreement with one of the Parties. This would only occur if the Proposed Merger eliminated the best available alternative outside option for a given supplier. However, this scenario seems highly unlikely in the current context.

36 The rationale is that if negotiations with one of the merging Parties were not to result in a supply agreement, then it is unlikely to be the best outside option for the supplier to shift any lost volume to the other company involved in the Proposed Merger. This is primarily because it is likely that the supplier has already optimized its channels to market for retail grocery sales in the geographic area covered by the other Foodstuffs cooperative (whether this involves serving that geographic market by means of the other Foodstuffs entity or somehow else). Redirecting the lost volume to the other geographic market cannot therefore be optimal.[21] Instead, the supplier would most likely find it optimal to find ways to serve the consumers it lost following the absence of agreement with one of the merging Parties. This can never be achieved via re-negotiating terms with the other company involved in the merger simply because that company serves a completely different geographical market.

37 Instead the best alternative outside option will most likely be for the supplier to redirect the lost volume to other retailers operating within the same geographical market as the retailer with which it has lost its supply agreement (i.e., either other retailers in the North Island when there is disagreement with FSNI or other retailers in the South Island if there is disagreement with FSSI).[22] Given the geographical separation of the Parties and the resulting lack of market overlap, the supplier's alternatives would thus be unchanged, implying no "buyer power effect" from the Proposed Merger. This is supported by the Commission's findings that the Parties do not typically compete in the upstream market.[23]

38 Therefore, the Proposed Merger does not reduce competition in the upstream market, as suppliers retain the best alternative outside options, implying no change in the resulting outcomes.

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[21] The only qualifier here is that the supplier's marginal costs are increasing in which case the loss of sales volume would reduce the supplier's marginal cost when bargaining with the other company of the Proposed merger. In that case, the supplier may want to increase the sales quantity with the other company of the Proposed merger. Taking away that option by the Proposed merger would then led to buyer power (see Inderst and Wey, 2003). However, by the same logic, if marginal costs are decreasing then the opposite would be true; i.e., the Proposed merger would increase seller power. As we do not know whether a supplier's marginal costs are increasing or decreasing we are left with the linear approximation of the supplier's marginal cost which implies that the supplier will not redirect the lost sales to the other company of the Proposed merger.

[22] Suppliers may also revert to online sales or other sale channels (e.g. vending machines) to reach those consumers they lost because of a disagreement with one of the merging parties.

[23] SOUI, para. 166.1.

39 Moreover, the Parties have a distinct commitment to offering a wide range of products due to their diversified brand portfolio, supported by a differentiated supplier network. This structure is integral to their well-established business model, making it improbable that they would further reduce supplier diversity or limit product variety in a significant way.[24]

40 Finally, the fact that the assortments of the Parties are very similar rules out exclusionary behavior by the merging parties (i.e., a commitment to single sourcing) which can only be expected to occur if the parties procure from different suppliers before the merger (see Inderst and Shaffer, 2007). Notably, such a hard-core discounter strategy (one brand per category) is also incompatible with the full range strategy employed by the Parties.

4.2 Strengthening of Supplier Incentives

41 The analysis of supplier incentives is primarily rooted in the Arrow Replacement Effect.[25] This means that suppliers are more likely to invest in innovation when the incremental net gains from such investments are anticipated to be positive–even if the total net gain might be small.

42 In markets dominated by smaller retailers, suppliers often have limited innovation incentives, as negotiations with these retailers tend to yield similar outcomes. In such a fragmented market, any innovation efforts by suppliers may not significantly improve their bargaining position with a specific retailer. The lack of variation among retailers means there is little to no meaningful change in their outside options.

43 However, as buyers become fewer but larger—the dynamics shift considerably. In this environment, suppliers face stronger incentives to invest in innovation. The reasoning behind this is that losing a large contract in such a market forces the supplier to seek alternative distribution channels for a substantial volume of goods, which can drastically reduce the price and, consequently, the profit they can achieve. Without an attractive, innovative product, it becomes difficult for suppliers to make up for lost sales elsewhere, making innovation crucial to staying competitive. Finally, by investing in innovation, a supplier can increase the potential loss a retailer would face if the business relationship were to end and the supplier chose to serve only rival retailers. This strategy effectively weakens the retailer's alternative options.[26]

44 The increasing size of buyers can thus prompt suppliers to seek out new ways to differentiate themselves, whether through product innovation, such as the development of new offerings, or process innovation, aimed at reducing costs and/or improving quality. These innovations help suppliers to strengthen their own negotiating position by strategically enhancing their outside options.

[24] The fact that the assortments of the merging parties are almost identical rules out exclusionary behavior by the merging parties (i.e., a commitment to single sourcing) which can only be expected to occur if the parties procure from different suppliers before the merger (see Inderst and Shaffer 2007). Notably, such a hard-core discounter strategy (one brand per category) is also incompatible with the full range strategy employed by the merging parties.

[25] See Arrow (1962).

[26] See the work of Inderst and Wey (2003, 2007, 2011), which consistently highlights the positive incentive effects of buyer power that is fed by size. See also Chen (2019).

45 With fewer but larger buyers, suppliers may become more motivated to engage in both product and process innovation. This drive for innovation allows suppliers to remain competitive and responsive, where the stakes are higher and the potential rewards for successful innovation are more substantial.

46 In the case of the Proposed Merger, the primary effect appears to be a small improvement in procurement terms. This can induce stronger incentives for suppliers to diversify their product offerings, reduce cost and enhance quality. In other words, the Proposed Merger might actually boost suppliers' incentives to innovate.

47 Overall, the Proposed Merger could lead to some positive innovation effects, as suppliers are incentivized to strategically adapt.

5. Review of European Retail Alliances

48 The experience with grocery retail alliances in Europe offers some valuable insights in the context of the Proposed Merger. The European grocery retail market is predominantly national in scope. While some discounter retail chains, like Aldi and Lidl, have expanded internationally, most retailers tend to focus on their domestic markets. Edeka, for instance, one of Europe's largest retailer, operates exclusively in Germany.

49 On the supply side, large international manufacturers distribute their products across Europe and even globally. This creates a fundamental imbalance in the grocery retail sector, with international manufacturers dominating the supply of branded goods, while retailers remain predominantly limited to their national markets.

50 In response, European retailers have established several retail alliances ("RAs"), such as AgeCore and Coopernic. The purpose of these horizontal alliances is primarily to achieve efficiency gains and strengthen their bargaining position with large manufacturers.[27] The activities of the RAs are primarily focused on the upstream market and do not directly impact the downstream consumer market.

51 A key point in this context is that the individual members of these alliances do not compete with each other in the retail market. Colen et al. (2020, p. 9) outlines this as follows:

> *"An important characteristic is that the alliances are usually composed of only one member active in each national market. Therefore, their members do not have overlapping markets and are not direct competitors on the consumer market."*

52 The Proposed Merger mirrors the structure and objectives of RAs by uniting non-competing entities to improve their procurement terms. This approach allows them to negotiate more effectively with suppliers, driving efficiencies that can create value across the supply chain without directly impacting competition in the downstream market.

53 The European Commission has long been studying the potential effects of RAs. Specifically, the European Commission investigated the activities of the two alliances, AgeCore and Coopernic, with concerns that the trading terms they negotiated with manufacturers might breach EU competition laws. The investigation aimed to determine whether these actions had restricted competition, potentially harming innovation and consumers by leading to reduced product variety and higher prices.[28]

54 The European Commission's analysis has now been completed, and it concludes that the actions of the mentioned RAs did not result in any anticompetitive effects. On the contrary, the analysis demonstrated the opposite. It was found that retailers enhanced their bargaining power with suppliers, which ultimately resulted in lower retail prices for consumers and intensified competition among retailers at the national

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[27] RAs may also benefit smaller suppliers. For example, RAs may offer smaller suppliers access to a larger (international) network, allowing them to expand their markets.

[28] See https://ec.europa.eu/commission/presscorner/detail/en/mex_23_3847, accessed on 19. August 2024.

level. Thus, RAs support the central objectives of European competition policy, namely ensuring competition among retailers.[29]

55 The European Commission's analysis of the economic impact of retail alliances suggests that the Proposed Merger is unlikely to have negative effects on the market. More specifically, The European Commission found that the analyzed RAs do not harm competition. On the contrary, these alliances often improve efficiency by securing better procurement terms and reducing costs, which lead to lower prices and better product offerings for consumers.

[29] See ibid.

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