United Kingdom – Decision ME/4638/10 of the Office of Fair Trading

The OFT's Approach to Attributing Merging Parties' Private Labels to Retailers for its Competitive Assessment: An Economic Comment Based on Bargaining Theory

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I. Introduction

The *Symington/Cockburn* merger decision[1] sets out the conditions under which the Office of Fair Trading (OFT) is prepared to allocate private label (PL) sales of the merging parties to their retailer customers for the purposes of the competitive assessment. This case note comments on these conditions from the perspective of an economic framework based on bargaining theory. Thus, we will first provide some background on PLs. Second, we will summarise the *Symington/Cockburn* decision, focusing on the conditions that the OFT deemed relevant to justify allocating PLs to retailers. Third, we will present a relevant economic framework based on bargaining theory. Finally, we will comment on the conditions set out in *Symington/Cockburn* from the perspective of that economic framework. In summary, we find that the OFT's reasons for allocating PLs to retailers for the competitive assessment in *Symington/Cockburn* were mostly in line with bargaining theory.

II. Background on PLs

A PL, which is also known as an 'own brand', 'store brand' or 'retailer brand', is a product sold exclusively at a particular retailer. A PL normally carries the retailer's name or a brand name that is owned by the retailer. PLs are usually manufactured

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[1] *ME/4638/10 – Symington/Cockburn*.

by an upstream producer on behalf of the retailer who is in control of virtually all aspects of the product, from product design and quality to marketing and pricing. This is in contrast with branded products, which are introduced by the manufacturer, carry the manufacturer's brand and are sold across many different retailers. PLs are now estimated to account for 25% of total supermarket sales globally, with certain countries, such as the United Kingdom (UK), experiencing a penetration of almost 50 %.[2]

PLs are either produced by specialised independent small and medium-sized enterprises (SMEs) or large manufacturers of branded products. For example, Coca Cola produces ASDA's PL cola in the UK.[3] However, the latter arrangement of a producer producing both branded and PL products is less common.[4] Indeed, such a PL-branded 'dual production' may at first seem like a counterproductive strategy. This is because, by supplying PLs to retailers, branded manufacturers are in essence supplying products that may directly compete with and threaten the sales of their own branded products which normally earn them a higher margin than PLs. However, the economic literature suggests a number of plausible explanations for this behaviour, including wanting to utilise spare capacity for economies of scale, to improve bargaining position vis-à-vis the retailer, or simply to earn revenues on a product that would be supplied anyway.

There have been a number of cases involving mergers between such 'dual producers'. In some of these cases, the merging parties argued that their PL sales should be attributed to the retailers for the purposes of the competitive analysis.[5] One such case is the OFT's *Symington/Cockburn* merger, which is the focus of this case note.

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[2] Claire Chambolle, Clémence Christin, and Guy Meunier, 'Who produces private labels?' (2012) preliminary draft <http://crem.univ-rennes1.fr/Documents/Docs_sem_eco_appliquee/ 2012-2013/12-10-11_Christin.pdf> accessed 20 October 2012.

[3] Fabian Bergès-Sennou, 'Store loyalty, bargaining power and the private label production issue' (2006) 33 European Review of Agricultural Economics 315.

[4] Fabian Bergès-Sennou and Zohra Bouamra-Mechemache, 'Is producing a private label counterproductive for a branded manufacturer?' (2012) 39 European Review of Agricultural Economics 213.

[5] For example, *IV/M.623 – Kimberly-Clark/Scott*, *ME/4960/11 – Princes/Premier*, *COMP/M.4344 – Lactalis / Nestle / JV (II)*, and *COMP/M.6321 – Buitenfood / Ad van Geloven Holding / JV*.

III. Summary of the Symington / Cockburn Merger

1. The Parties and the Transaction

Symington Family Estates (Symington) is a wine company and port house in Portugal. Symington operates several vineyards and wineries. It owns the port brands Dow's, Graham's and Warre's, and produces and supplies PL port to multiple retailers in the UK. *Cockburn's* was a port brand owned by *Beam Global Spirits & Wine Inc.* (Beam). Beam did not own any vineyards or wineries and purchased all of its port from Symington through a long-term supply agreement. Beam did not supply PL port. On 6 October 2010, Symington agreed to acquire the Cockburn's brand and associated goodwill.[6]

2. The Merger Decision

The parties overlapped in the supply of port in the UK. The OFT determined that the merged entity would control over 25% of the supply of port in the UK and therefore, it would result in the creation of a relevant merger situation. After having reviewed the merger on 7 December 2011, the OFT decided not to refer the merger to the UK Competition Commission (CC) under section 22(1) of the Enterprise Act 2002, thus clearing the merger.

3. Product Market Definition

Regarding the product market definition, the parties made two submissions: 1) that port is distinct from wine; and 2) that no distinction should be drawn between (a) different types of port; (b) the retail channel where the port is sold (i.e. on- or off-trade); and (c) branded, PL, and high/low brand port.[7]

Based on the evidence the OFT agreed with all of the above points, except 2b, where it held that the on- and off-trade channels should be treated separately. Given this market definition, the OFT found that the parties' combined share of port branded, PL and high/low brand in the UK retail channel would be around 39% in volume terms and 52% in value terms.[8]

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[6] The long-term supply agreement was consequently internalised and ceased.

[7] High-low brands are a hybrid between branded and private label port. They carry the brand of the manufacturer, but are created specifically for a particular retailer. For example, 'Cockburn's Acclaimed' is a high-low brand supplied by Cockburn's exclusively to Morrison's.

[8] *ME/4638/10*, para 49.

4. The OFT's Approach to PL Attribution

Under the assumption that the relevant product market included branded, PL and high/low brand port, the parties submitted that for the purposes of the competitive assessment, the sales of PL and high/low brand port should be attributed to the retailers and not to the producer of the PLs, *i.e.* Symington. In particular, the parties submitted the following arguments in support of their assertion:[9] first, that for the purposes of allocating market shares the question is not whose name is on the product but 'which company controls the sales in seeking to exercise market power', and, in this case, it is the retailers who control the PL and high/low brand port. Second, the relevant test is 'whether retailers would be able to seek alternative suppliers for post-merger'[10] and in this case the retailer could readily switch supplier given significant spare capacity. Finally, the PL and high/low brands are created specifically for a given retailer such that if the retailer de-lists the PL or high/low brand then the product disappears. Therefore and in light of the above assertions, the parties submitted that allocating PLs and high/low brands to retailers would reduce the parties' combined share to 34%.[11]

The OFT agreed with the parties' contention that PLs are 'correctly attributable to its customer [the retailer]' and set out the following additional reasons:[12] first, that contracts for supply of PL port 'rarely exist'; second, that all promotional activity is done by the retailer; third, that the retailer generates business and sets terms of trade; and forth, that if the retailer were to reduce the output of the particular PL, the producer would not be able to sell the same volume elsewhere. However, on a cautious basis, the OFT did not accept that high/low brands should be attributed to the retailers, because, among other reasons, 'there is a greater tendency towards longer- term (one- to two-year) supply arrangements'.[13]

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[9] ibid, para 50.

[10] The parties cited the European Commission in *Kimberley-Clark/Scott*, which stated that the 'essential question' for attribution is whether retailers would have sufficient scope for switching their PL needs to alternative suppliers post-merger (*IV/M.623*, para 123).

[11] *ME/4638/10*, footnote 26. It is not clear from the decision whether this figure is in volume or in value terms.

[12] ibid, para 51.

[13] ibid, paras 52-56.

IV. Economic Framework Based on Bargaining Theory

In assessing demand-side substitution in *Symington/Cockburn*, the OFT found it more appropriate to focus on substitution at the *upstream level* where the merging parties were active, as opposed to the *downstream level*.[14]

At the upstream level, competition takes place with respect to shelf space and prices are negotiated bilaterally between the producer and the retailer. The relevant economic framework for assessing pricing constraints at the upstream level is the one based on bargaining theory, which takes into account the outside options of both the retailer and the producer. The simplest bargaining model describes bilateral negotiations between one manufacturer and one retailer.[15] The manufacturer's outside option is to sell its product elsewhere. The manufacturer will not agree to a price that results in a lower margin than it can obtain from its outside option. Thus, the manufacturer's outside option determines its lower-bound price. On the other hand, the retailer's outside option is to purchase an alternative product to sell downstream. The retailer will not agree to a price that results in a lower margin than this alternative product. Thus, the retailer's outside option determines the upper-bound price. Provided that the manufacturer's lower-bound price is lower than the retailer's upper-bound price, there is space within which they can negotiate and achieve a price that they will both be willing to accept.

Therefore, the resulting price will fall between the manufacturer's lower-bound price and the retailer's upper-bound price. Where exactly will depend on two things: (a) the relative outside options and (b) the relative negotiating power of the retailer and the manufacturer. [16] The retailer's outside option depends on the extent to which consumers view the alternative product as a substitute for the manufacturer's product. If consumers view the two products as close substitutes, then, the retailer's outside option is more valuable. This is because wholesale demand is 'derived demand', which means that retailers only demand products that are in turn demanded by consumers. Regarding the retailer's outside option, this also depends on the ease with which it can switch to alternative products. If there is

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[14] ibid, footnote 18. The upstream level is where producers sell products to their customers (the retailers), whereas the downstream level is where retailers sell to end-consumers.

[15] This is described in Roman Inderst and Greg Shaffer, 'Buyer Power in Merger Control' in Wayne D. Collins (ed), *Antitrust Section Handbook, Issues in Competition Law and Policy* (ABA 2008).

[16] Economic theory does not explain the source of this negotiating power well, although it has been suggested that it depends on 'patience' (i.e. the cost of continuing negotiations) and the balance of information that negotiating parties have about one another (in particular, information about the other side's outside option). See Inderst and Shaffer (n 15).

sufficient spare capacity of the alternative product, then the retailer will find it easier to switch and its outside option would thus be strengthened.[17]

With this in mind, it is worth noting that the manufacturer's outside option is related to how 'economically dependent' the manufacturer is on the retailer for selling its product. If the retailer is large or acts as a 'gatekeeper' to important segments of the downstream market, then the manufacturer's outside option is reduced, because it will find it difficult to sell its volumes elsewhere. If the manufacturer can only achieve limited volumes and or margins in alternative channels, then its outside option would be weakened. Moreover, an additional factor that is relevant to outside options is the length of any existing contract between the manufacturer and the retailer.[18] If the retailer and the manufacturer are locked into a long-term agreement, then both parties' outside options are reduced.

V. Applying the Bargaining Framework to the OFT's PL Allocation

In *Symington/Cockburn*, for the purposes of the competitive assessment, the OFT treated PL sales as sales by the retailers rather than sales by the merging parties in order to better reflect the balance of power in the upstream market. In the bargaining framework, the balance of power would be captured by the relative outside options of the merged entity and the retailer. Thus, within this framework, the OFT would be justified to reflect the merged entity's reduced market power (*i.e.*, allocate PLs to retailers) if the outside option of the merged entity was weaker than the outside option of the retailers. The OFT finally allocated PLs to retailers on the following basis: first, alternative suppliers and sufficient spare PL capacity would exist post-merger such that retailers can readily switch. Second, contracts 'rarely exist' and/or are shorter than one to two years. Third, the retailer does all the promotional activity and generates business for the PL, and if it were to reduce output of or de-list the PL, the PL would 'disappear' and the producer 'would not be able to sell the same volume elsewhere'.

In what follows, we will comment on the extent to which the above three conditions are consistent with the merged entity having a weaker outside option relative to the retailers. As a preliminary point, however, we can recall that the strength of the retailer's outside option depends on the extent to which consumers view the 'alternative product' – that is the product the retailer would threaten to

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[17] Paul Dobson and Roman Inderst, 'The Waterbed Effect: Where buying and selling power come together' (American Antitrust Institute 8th Annual Conference, Washington, DC, 1 January 2007) <http://hosted.law.wisc.edu/lawreview/issues/2008-2/dobson_inderst_-_final.pdf> accessed 19 December 2012.

[18] Roman Inderst and Nicola Mazzarotto, 'Buyer power in distribution' in Wayne D. Collins (ed), *Antitrust Section Handbook, Issues in Competition Law and Policy* (ABA 2008).

switch to – as a substitute for the manufacturer's product. If consumers view the two as close substitutes, then the retailer's outside option is strengthened. In this case, the 'alternative product' would most likely be PL port produced by an alternative supplier.[19] As explained above, the retailer is in control of all aspects of a PL including product taste, quality, design, pricing and so on. Thus, in switching to an alternative PL supplier, all aspects of the PL product would remain the same with the only difference being the producer of the PL. Thus, we would expect consumers to view the new PL port as virtually indistinguishable from the PL port that was produced by the merging parties. Therefore, the retailer's outside option should be strengthened. We now turn to the OFT's three conditions.

1. The OFT's First Condition: Sufficient Alternative PL Suppliers and Spare Capacity

The OFT held that PLs should be allocated to retailers, because of the existence of sufficient alternative PL suppliers and of spare capacity allowing retailers to readily switch their PL requirements.[20] According to the bargaining framework, spare capacity on the market strengthens the retailer's outside option relative to the merged entity. Thus, in this respect, the OFT is justified to use sufficient spare capacity as a relevant condition for allocating PLs to retailers. However, we should add here that, although *existing* spare capacity is important, *potential* post-merger capacity may also be relevant, whether via new entry or expansion. This is particularly the case for PLs, because an entrant into PL supply would not need to invest in a brand. Indeed, post-merger entry in PL was an important factor for the CC's *Kerry/Headland* clearance.[21]

2. The OFT's Second Condition: Contracts 'Rarely Exist' and/or Are Short-term

The OFT held that the parties' PLs should be allocated to retailers, because contracts for PLs 'rarely exist'. The OFT also considered that high/low brands

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[19] In principle, the retailer has other outside options, such as purchasing more branded port, high/low brands, wine, spirits, or some other FMCG.

[20] This is consistent with the precedent. See *Kimberly-Clark/Scott* (n 5), para 123; Case *COMP/M.2779 – Imperial Tobacco Group plc/Reemtsma Cigarettenfabriken GmbH*, para 30; and *Case 7313/318 - NPM Capital - Lion Capital - Buitenfood - Ad van Geloven*, paras 109, 114.

[21] This merger involved the UK's two largest producers of PL frozen ready meals. Pre-merger imports were small and customers were not familiar with overseas suppliers, but post-merger price rises had 'created the incentive for customers actively to research their import options and for potential importers actively to make themselves known to UK customers'. *UK Competition Commission – Kerry Foods Ltd / Headland Foods Ltd merger inquiry*, para 7.41 <http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/kerry-foods-headland-foods> accessed 19 December 2012.

should not be allocated to retailers, because contracts for high/low brands exist and tend to last one to two years. Thus, the OFT appears to consider that, if contracts do not exist or tend to be short, then it is justified to shift PLs from the merged entity for the purposes of the competitive assessment. However, according to the bargaining framework, short-term contracts improve the outside option of *both* the retailer and the manufacturer, because under short-term contracts both players would be free to switch to their alternatives. Thus, in this respect, the OFT should be careful when using the length or existence of contracts as conditions for allocating PLs to retailers.

3. The OFT's Third Condition: Retailers Promote and Generate Business for the PL, and Can Terminate the Parties' PL Volumes

The OFT agreed with the parties that their PLs should be allocated to the retailers, because the retailers promote and generate business for the PL product, and if the retailer were to reduce output of or de-list the PL, the PL would 'disappear' and the producer 'would not be able to sell the same volume elsewhere'. It could be argued that these conditions are consistent with the merging parties being 'economically dependent' on the retailers. According to the bargaining framework, the manufacturer's outside option is reduced when it is 'economically dependent' on the retailer to sell its volumes. Thus, in this respect, the OFT was right to use the above conditions to justify allocating PLs to retailers.

VI. Conclusion

In conclusion, we find that the OFT's conditions for allocating PLs to retailers for the competitive assessment in *Symington/Cockburn* were mostly in line with bargaining theory, because the conditions were consistent with the retailer's outside options being stronger than the merged entity's outside options.