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RESEARCH IN ECONOMICS AND RURAL SOCIOLOGY

Producer-retailer relationships, an economic and econometric analysis of inflationist mechanisms on retail prices

The French retail industry is the most regulated in Europe. However, the recent Dutreil law, which took effect on January 1st 2006, lightens the regulation reforming the previous 1996 Galland law. The purpose of this reform is to lower retail prices of products sold in supermarkets, especially the prices of national brands. The research work presented here help define better the mechanisms that facilitate the rise, or conversely the drop, in retail industry prices. The balance of power between suppliers and retailers and the regulations play a crucial part in the understanding of these mechanisms. The analyses associate theoretical and empirical contributions.

Introduction

Like most economic sectors, the retail industry is subject to the 1986 edict on free price setting. The aim of the edict is to maintain healthy competition, both at the horizontal level, that is to say, between retailers and at the vertical level between suppliers and retailers. As such, so-called “restrictive” pricing practices such as resale price maintenance, below-cost prices, or discriminatory pricing are prohibited.

Moreover, the retail industry is also restricted by the 1996 Galland law, which regulates relationships with suppliers. In particular, this law bans “the resale of a product at a price that is less than the net invoice price of the goods. Resale-below-cost laws existed in France since 1963, but the Galland law strengthened penalties and made clear the definition of the threshold as the “net invoice unit price” set by suppliers. Backroom margins which gather diverse fees such as slotting allowances, deferred price reductions or payment for commercial services obtained by retailers could not be included in the resale-below-cost threshold. Constantly criticized for its inflationary effects on retail prices, the Galland law was reformed in 2005 by the Dutreil law. The main reform is the authorization to reintegrate a proportion, which cannot exceed 20% of the unit price invoiced, of the backroom margins into the resale-below-cost threshold. This measure is intended to evolve towards a total integration of the backroom margins in the below-cost sales threshold corresponding to the *triple net price* level. Moreover, the new law legalizes tariff differentiation according to purchaser categories, in compliance with the non-discriminatory principle. Discriminatory practices consisting in offering different prices to purchasers who provide comparable services remain banned.

In practice, attributing an inflationary effect to such a law is a difficult exercise, because other factors (for instance the concentration or the Raffarin law which limit the opening of new stores...) can explain the rise in retail prices. However,

it seems that in the long term, the Galland law has brought about a rise in product prices, especially for national brands. Several panel surveys by Nielsen and the French DGCCRF (general Directorate for Consumption, Competition and Repression of Fraud) have shown a rise in retail prices, particularly high for national brands after enforcement of the law. More recently, a survey by Libre-Service-Actualités reported an 11.5% price increase for the national brand products against a price increase of about 4% for first price products or store brands between 2000 and 2003.¹ Over a recent period, retail prices also appear to be higher in France than in the Euro zone.

In 2003, in relation to an index of 100 for the entire Western Europe, Spain was among the cheapest countries at 95.5 while France reached 101.4.² It is difficult to attribute this difference solely to the statutory framework because the concentration observed in the retail sector is greater in France than in Spain. Buyer power may benefit to consumers, but limited retail competition may also be the source of a rise in retail prices. However, it is clear that the Galland law offers producers a roundabout way of imposing price-floor on retailers.

We will first look in detail at the economic analysis of the price-floor mechanism which led to the Galland law reform. Next, we present economic elements about the inflationary effects of non-discriminatory rules. Third, we will suggest new methods which associate the structural model and econometrics in order to test and measure the inflationary effects. The methodology was implemented in the bottled-water sector.

¹Etude exclusive d’inflation “Entrants-Sortants”, LSA, International panel, October 2003.

²Canivet report -Restorer la concurrence par les prix - Les produits de grande consommation et les relations entre industrie et commerce, 2004. La Documentation française, 164 pages. Official report Collection.

Economic analysis of resale-below cost laws

Without calling into question the principle, the recent Dutreil law redefines the prohibition of resale-below-cost in order to reduce inflation, which mainly appears on national brands. The debate on the qualities and damaging effects of loss-leading practices, which could have questioned the very principle of its ban, is left aside here.³ In fact, the Dutreil law is the logical conclusion of another economic analysis showing the anticompetitive effects of the very definition of the resale-below-cost threshold set by the Galland law. In fact, resale-below-cost laws was a roundabout mean for producers to set price-floor to their retailers. Furthermore, combined with the respect of the non-discriminatory principle, this rule allowed producers to impose a “uniform” price-floor on their retailers.

This phenomenon can be illustrated simply by taking the example of a monopoly producer offering products to two competing retailers. First, in his general terms of sale, the producer publicly announces his unit wholesale price, which constitutes the legal below-cost threshold. Because of the non-discriminatory principle, that price must be identical for both retailers. Then, negotiations on backroom margins secretly take place between the producer and the retailers. These backroom margins set the unit price actually paid by each retailer to the producer, without modifying the calculation of the threshold. In other words, the producer first set a price-floor to his retailers, which when binding also defines the vertical chain profit, and then share this profit through a bargaining “in the backroom” with retailers on another contract, either a two-part tariff or a linear tariff.

For instance, the producer may set a price floor equal to the monopoly price. If backroom contracts take the form of a two-part tariff, the price floor is always binding and retailers then systematically set a retail price equal to that monopoly price. If backroom margins take the form of a linear contract, retailers with weak bargaining power on backroom margins may be encouraged to make a positive margin by setting a final price higher than the monopoly price. This double marginalisation effect makes the price-floor mechanism useless. However, as soon as the retailers’ bargaining power is sufficient, they are constrained by the price-floor and set the monopoly price. Finally, in most cases the resale below-cost law is diverted into a price-floor restraint, which entirely relaxes competition between retailers and leads to higher prices (Allain and Chambolle, 2005a, [1]).

Introducing upstream rivalry, when competition among producers is fierce, they have an incentive to lower the price-floor which may explain why the observed inflation was particularly high for national brand products where producer’s competition is weak. But, when the price-floor mechanism works, it not only relaxes entirely the competition between retailers but also softens competition between producers. In particular, when retailers’ buyer power is high, producers will capture a low share of the chain profit and they thus have an incentive to set a higher price-floor in order to increase the total industry profit, and this incentive prevails over the incentive to compete with each other (Allain and Chambolle, 2005b, [2]).

The 05-D-70 decision by the French Competition Authorities (19th of December 2005) illustrates the vertical-agreement mechanism facilitated by the resale below-cost laws. In this case, the French Competition Authorities fined Buena Vista Home Entertainment (BVHE), the videotape editor, Carrefour and Casino, the retailers, and a big audio and video-wholesaler, SDO, for their vertical agreement on a videotape’s resale price to consumers between 1995 and 1999. BVHE strongly encouraged the above-named customers to respect the “recommended” retail price, namely the invoiced unit price, which constituted the resale-below-cost threshold defined by the Galland law. Moreover, BVHE systematically granted his customers a set of so-called “conditional” rebates at the highest level. As remuneration for fictitious services, the purpose of these rebates was to offer retailers compensation for their alignment on the resale-below-cost threshold.

To avoid these anticompetitive effects, the Dutreil law reform authorizes a partial integration of backroom margins into the resale-below-cost threshold. On the one hand, this reform brings the resale-below-cost threshold closer to the unit price really paid by retailer and on the other hand, it no longer guarantees any threshold uniformity. The levels of negotiated backroom margins may differ from one retailer to the next since they notably depend on commercial services and bargaining power: The resale-below-cost threshold may be different from one retailer to the next.

Debate on the inflationary effects of the ban on price discrimination

Even though recent reforms have brought in the possibilities of tariff differentiation and thus lead to a relaxing of non-discriminatory rules, there is a strong consensus about that rule among public decision-makers. However, there are pros and cons that should give rise to discussion. Moreover, the ban on price discrimination may lead to contradictory effects on retail prices.

First, non-discrimination may be seen as a measure aiming at protecting small retailers from the tariff advantages obtained by the retail industry. Non-discrimination may make a retail price rise in a short term, but provide the perspective of a possible deflationary effect in the long term. However, maintaining small shops does not offer any low-price guarantee in the long term, and the debate is more concerned with an idea of public service. Furthermore, as the neighbourhood offer is largely controlled by major retail stores, its maintenance and development are more and more independent from the implementation of a non-discriminatory rule. Discrimination may also result from a simple multi-market tariff, the object of which is to facilitate the penetration of certain markets through attractive pricing. A supplier may find it optimal to offer a reduction in prices to develop relationships with a new retailer. In this case, prevented from discriminating, a supplier will not be able to grant a reduction in prices because it will also be compelled to offer it to other clients. Therefore, banning discrimination will not be of any benefit to consumers.

³ This debate is raised by Claire Chambolle, 2005, [6], and the economic results appeared to be mixed.

Lastly, banning discrimination may strengthen a big wholesaler's power by giving it a way to guarantee a client that its competitors will be in the same situation when it offers a high wholesale price. In this case, non-discrimination facilitates the maintenance of high wholesale prices and, when all is said and done, of high retail prices. The theory developed with non-linear tariffs specifies that the mechanism applies when suppliers are in a situation of a monopoly (Rey and Tirole, 2005⁴). When there is upstream competition, the situation becomes more complex, because a problem of rent sharing is to be added to the previous mechanism. When competing, a producer is encouraged to set a low wholesale price to increase the chain profit-share it will capture, even if, for this reason, chain profit is lower. By providing a guarantee on contracts, a non-discrimination rule may help a producer implement such a price policy. It is then possible to see a retail-price reduction when upstream competition intensifies (Caprice, 2006, [5]) and the non-discriminatory rule may benefit consumers. In practice, when upstream competition is weak, the theoretical mechanism previously explained instead favours the withdrawal of anti-discrimination rules. On this matter, the experience of Spain, which has not adopted any system relating to discriminatory tariff practices, is consistent with this analysis. In Spain, trade negotiations may be more flexible and retail prices lower, as confirmed by the figures presented in the introduction. The lack of a system relating to discrimination may be an area worth looking at in order to guarantee lower retail prices.

Methodology and inference on producer-retailer relationships

The resale-below-cost laws and non-discriminatory rules are restrictions that producers and retailers integrate and try to get round in their relationships, be it through horizontal competition, bargaining, backroom margins or even contracts with non-linear tariffs. Empirical methods are necessary to assess the effects of these practices on consumer well-being, in terms of competition as well as margin sharing. They are based on easily observable data such as supermarket retail prices and market shares of different goods.

Bonnet, Dubois and Simioni (2004), [3] present a methodology to model producers and retailers' price-fixing strategies; they consider the possibility of supplying contracts with non-linear tariffs in vertical relations, in particular two-part tariffs, with or without resale prices imposed by producers. The method determines margins from estimated supply parameters, both for double marginalisation models and for two-part tariff models. Different assumptions on producers and retailers' relationships may then be tested with this method.

Some results

Bonnet et al. [3] analysed the market of bottled still water in France from 1998 to 2000. Empirical results show that producers and retailers use two-part tariff contracts with resale price maintenance. This result is important because it shows that regulation through wholesale prices (such as the

Galland law ban on resale-below-cost) cannot be efficient if backroom margins are not taken into account, as they are partly in the Dutreil law today. Results show that over the 1998-2000 period when the Galland law was in force, retail prices behaved as if resale prices were imposed. Therefore, with the 1996 Galland law, contractual vertical relationships probably adapted and very likely favoured the possibility of resale price maintenance on retailers, a result which confirms theoretical predictions on the economic analysis of the rule. Moreover, thanks to the structural model assessment, Bonnet et al. [3] show that consumer surplus benefits from the presence of store brands on the market. Retail prices are lower in relation to a situation when those brands would be replaced by national brands not controlled by retailers. Finally, in a more recent work, Bonnet and Dubois (2006), [4] extend this analysis to the case where supermarket chains benefit from buying power. Retailers may thus use competition between producers to improve their bargaining power. They show that, on the bottled-water market, retailers' bargaining power with producers does not benefit from other producers' supply, because they cannot refuse to distribute the brands proposed by Nestlé, Danone and Castel, the three main producers. This result may also come from an agreement, at least partial, between these main producers of the upstream market, favoured by the non-discriminatory rule.

Conclusion

Introduced following the Canivet report of 2004, the Galland law reform came into force on January 1st 2006. It appears that the first deflationary effects were confirmed, since the rise in high-quality brand prices was 0.2% in May 2006 and -0.1% in June 2006 (International Panel Institute and LSA). However, consumer gains in purchasing power remain limited, which at the very least speaks in favour of continuing with the reform until complete reintegration of backroom margins into the resale-below-cost threshold. The debate challenging the very principle of resale-below-cost also remains topical. In 2006, Ireland abolished the "Groceries Order" which, since 1986, had forbidden retailers from reselling below cost in accordance with a definition very similar to that established by the Galland Law in France. Theoretical research work on discrimination also prompted a debate on the possible role of non-discrimination in the inflation noted. Similar talks have already been carried out by other European authorities responsible for competition. This is particularly the case of Sweden.⁵ The methodologies combining structural economy and econometrics developed here may help develop a diagnosis.

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⁴ Handbook of industrial organization: M. Armstrong and R.H. Porter, editors, North Holland.

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For further information

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Definitions

Linear tariff/ non-linear tariff: we traditionally make a distinction between these two forms of tariffs. The first is made up of a wholesale unit price identical to each unit of purchased goods. The second associates a differentiated wholesale price for each unit. The simpler form of non-linear tariff is the two-part tariff. The tariff includes a fixed part and a wholesale unit price. The unit price actually paid decreases with the quantity sold.

Backroom margins (or rebates): These margins concern all the off-invoice discounts, rebates and reductions for commercial services granted to a retailer by a supplier. Before the Dutreil II reform, they could not be included in the calculation of the resale-below-cost threshold.

Double marginalisation: Double marginalisation refers to a problem of externality specific to vertical relationships. When we consider a monopoly chain, supplier and retailer, setting their margin in a non-cooperative way, ignoring the externality that they, in fact, exert on each other's profit and this lack of coordination is damaging to consumers. The retail price is too high in relation to what would be invoiced by an integrated chain where both entities form one sole business. More or less complex contracts such as the imposition of a retail price or the implementation of a two-part tariff can solve this inefficiency.