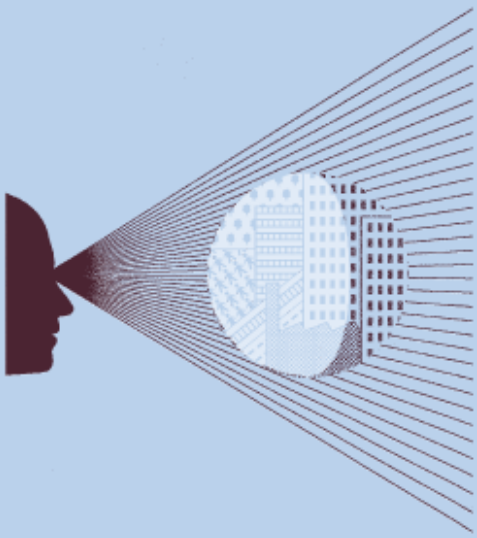
Oxera

Buyer power and its role in regulated transport sectors

Summary document

Prepared for
NMa

February 8th 2012

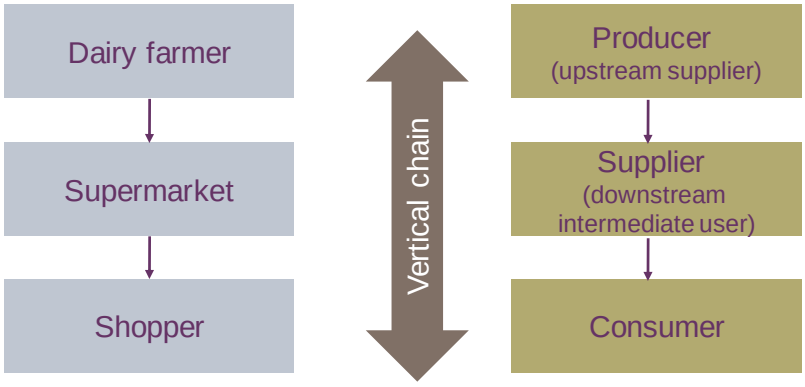


Executive summary

The NMa has commissioned Oxera to assess the concept of buyer power in the context of the regulation of the aviation and rail sectors in the Netherlands. The NMa wishes to consult with infrastructure and transportation providers to help it optimise regulation undertaken by the NMa. To support this consultation, this document summarises the concept buyer power, and explains why it might be relevant to the two sectors in question.

The relevance of buyer power to regulated sectors

Many industries can be described as having a 'vertical value chain'. Milk is produced by farmers, sold on to supermarkets, and bought by consumers. In this example, the farmers can be called 'upstream suppliers' (they are higher up the value chain than the supermarkets), while the supermarkets can be referred to as 'downstream intermediate users'.



Similarly, in a number of utility sectors, such as gas and electricity, and infrastructure sectors such as rail and aviation, an upstream provider supplies downstream intermediate users, which in turn supply consumers. A rail infrastructure provider sells access to train operators, which pay access charges to the provider; in turn, the train operators provide rail services to passengers. An airport provides aeronautical (and non-aeronautical) services to airlines, which pay landing charges to the airport; in turn, the airlines provide air travel to passengers.

However, in utility and infrastructure sectors, rather than being completely free to set prices and terms—where 'prices' could include the prices charged either to consumers or to intermediate users seeking to access the provider's infrastructure—companies are often constrained in some way by a regulator.[1]

The concept of buyer power is important because it can determine what form of economic regulation is required, and how involved the regulator needs to be. A key issue is whether the upstream firm has upstream market power—ie, it can profitably raise its prices to downstream intermediate users. If so, the regulator may need to formally regulate upstream charges. One of the constraints on the ability of the upstream firm to raise prices will be the buyer power of the downstream intermediate users. For example, in the case of a large airport, if the airlines have sufficient buyer power, they may be able to counteract to some extent an attempt by the airport to raise prices. In turn, this can mean that the regulator does not need to introduce formal price regulation of airport charges.

[1] In practice, economic regulation is a broad term, and can mean the regulator placing constraints on prices, service levels, access terms, and other aspects of an infrastructure provider's offering.

Importance in the Dutch context

The rail and aviation sectors in the Netherlands are regulated under a consult/negotiate regime. Specifically, legislation was introduced that requires upstream infrastructure providers (rail infrastructure managers; airports) to consult with their downstream intermediate users (railway undertakings; airlines). In rail, a (legal) requirement for negotiation of access terms was also introduced, with the parties required to reach agreement on these every year.

There is a presumption in the legislation that this consult/negotiate regime (which does not include consumer or other stakeholder groups) creates and enhances the buyer power of the downstream intermediate users, which then limits the incentive for upstream providers to exploit their market power. The regulatory framework that has followed from this could be described as 'light touch'. It requires limited resources from the NMa, with the sector stakeholders instead implementing the regime. This can be contrasted with more traditional 'CPI–X' (or 'price cap') regulation, in which the NMa would set prices and service levels up front (in the case of the aviation and rail sectors, the prices are airport landing and rail access charges).

Going forward, it is important that the above presumption of buyer power—and assumptions about the intended effects of this power—are tested at a practical level to ensure that the NMa's regulatory activities remain fit for purpose.

Factors influencing the degree of buyer power

The most appealing economic framework to apply to the regulated aviation and rail sectors in the Netherlands is *bargaining theory*. This recognises that a downstream intermediate user may be able to negotiate lower input prices through the threat that it will purchase less from the upstream supplier.[2] In this framework, the 'outside options' of upstream and downstream players drive the bargaining outcomes. These are what the parties would do if they are unable to reach agreement (for example, over prices). If, for example, a party to the negotiation can credibly threaten to supply to (or purchase from) alternative firms, it is likely to be able to achieve a better deal. Therefore, 'market structure' (the nature of demand, cost structure, and choices available) is the key determinant of buyer power in a bargaining framework.

The main determinants of *buyers' outside options* are their size, their ability to substitute quickly to alternative suppliers, and the nature of their consumers' substitutability patterns. The main determinants of *sellers' outside options* are the presence of alternative buyers to contract with, how specific the investment by the seller is to particular buyers, the structure of the sellers' costs, the presence or absence of buyer groups, and the short-run, cash-flow dependency of the seller on its current buyers.

Other factors can influence *bargaining effectiveness* more generally, some of which also relate to market structure. If the costs of the input sold to the buyer are a high proportion of the buyer's overall costs of supply, and the transaction costs of negotiating are low, the buyer will have more incentive to enter negotiations and is also likely to be more effective at bargaining.

Taken together, the buyers' outside options, sellers' outside options, and factors influencing bargaining effectiveness determine the degree to which buyer power is present.

For clarity, some specific terminology is used in this summary document to describe the strength of buyer power present. We refer to buyer power itself as a matter of degree—it may be strong or weak in opposing any upstream market power that is present. However, competition policy practitioners and regulatory authorities are often interested in whether an

[2] An alternative framework is *monopsony theory*. This is less applicable to the current context.

upstream firm enjoys a position of *dominance* or *significant market power* (SMP). We refer to *effective countervailing buyer power* (or *effective CBP*) as being present when the buyer power of downstream firms is strong enough to eliminate any market dominance or SMP that might otherwise be present in the upstream market.

Buyer power: a means to an end

It is worth bearing in mind that, from a regulator's perspective, buyer power is a means to an end, rather than an end in itself.

First, buyer power in a bargaining setting (or the more extreme effective CBP) is generally assumed to be welfare-improving, but this is not always the case. For example:

– waterbed/uneven bargaining effects may be present—ie, better terms for powerful buyers may mean worse terms for other buyers. In particular, if large intermediate users benefit from negotiating discounts, but at the expense of higher input prices for smaller downstream competitors, this can harm competition in the downstream market;

– firms may hold market power in the downstream market—this could prevent any cost reductions that have been secured through negotiations being passed through fully in the form of reduced consumer prices. In this case, the full benefits of buyer power would not be enjoyed by consumers;

– 'time inconsistency' effects might be present—ie, what is optimal in the longer term may not be optimal in the shorter term. For example, intermediate users may not be willing to pay for additional upstream capacity if this means that other intermediate users will be able to enter the downstream market, increasing downstream competition in the longer term.

Second, while regulators can play an important role in designing the consult/negotiate regime, this may not be concerned only with creating or enhancing buyer power; it could be about involving a *wide range of stakeholders* (not just intermediate users) in the overall process. It may also simply be a means of providing the regulator with *information* on appropriate investment and service levels.

In light of the above features, the impact and role of buyer power on the effectiveness of economic regulation need to be considered carefully.

Contents

List of figures

1 Introduction

The NMa has commissioned Oxera to assess the theoretical relevance of the concept of buyer power to the regulation of the aviation and rail sectors in the Netherlands. In these sectors, an upstream provider supplies services to downstream intermediate users (which in turn provide services to consumers):

– **Amsterdam Airport Schiphol**—the majority government-owned airport (upstream) provides runway capacity and terminal facilities to a number of airlines (downstream intermediate users), including KLM;

– **in rail, ProRail and its subsidiary Keyrail**—two government-owned upstream rail infrastructure managers—provide track access to several downstream railway undertakings, including NS Rail, DB Schenker NL, and some smaller passenger and freight operators.

This summary document is intended to support an NMa consultation with participants in the above regulated transport sectors on the applicability of buyer power to their sectors.

The rail and aviation sectors in the Netherlands are regulated under a consult/negotiate regime. Specifically, legislation was introduced that requires upstream infrastructure providers (rail infrastructure managers; airports) to consult with their downstream intermediate users (railway undertakings; airlines). In rail, a (legal) requirement for negotiation of access terms was also introduced, with the parties required to reach agreement on these every year.

There is a *presumption* in the legislation that this consult/negotiate regime (which does not include consumers or other stakeholder groups) creates and enhances the buyer power of the downstream intermediate users, which then limits the incentive for upstream providers to exploit their market power.

The regulatory framework that has *followed* from this could be described as 'light touch'. It requires limited resources from the NMa, with the sector stakeholders instead implementing the regime. This can be contrasted with more traditional 'CPI–X' (or 'price cap') regulation, in which the NMa would set prices and service levels (in the case of the aviation and rail sectors, the prices are airport landing and rail access charges).

Going forward, it is important that the above presumption of buyer power—and assumptions about the intended effects of this buyer power—are tested at a practical level to ensure that the NMa's regulatory activities remain fit for purpose. The consultation to be undertaken by the NMa with participants in the rail and aviation sectors should help the regulator develop a solid position on the impact that its regulatory activities have on buyer power.

This summary document is structured to explain the concept of buyer power; its significance in the context of economic regulation in general, and specifically in the regulated airport and rail sectors in the Netherlands; and the factors affecting the degree of buyer power, its causes and consequences.

2 The concept of buyer power

Buyer power in the value chain

Many goods pass through several stages before they reach consumers, a process commonly referred to as a 'vertical value chain'. In the case of milk, for example, farmers are 'upstream' providers, who sell to supermarkets, which are 'downstream' of the farmers. As the

supermarkets do not consume the milk (instead they might package it and apply their own branding), they might be described as 'intermediate users'.

Imagine that a farmer is a 'dominant' producer of milk in such a market. In economic terms this means that the farmer can set their prices (or other terms of purchase) independently of what their competitors or consumers do. The farmer faces little competition in supplying supermarkets because the supermarkets have few alternatives. The farmer may seek to raise prices and reduce the quantity supplied in order to increase profits. This can harm the supermarkets that rely on the input. They, in turn, need to pass on these increased costs to the consumers who buy the milk.

However, it may be that the buyers (the supermarkets in this example) are able to negotiate effectively with the upstream provider (the farmer). The term *buyer power* is used to describe a range of situations in which a (downstream) firm is able to exert pressure on an upstream supplier in order to secure better terms than it would otherwise achieve. In this case, the supermarkets would be able to negotiate reduced prices and increased output from the farmer, reducing monopoly profits (and the associated welfare losses) in the system. Assuming that there is a competitive market at the level of the supermarkets, these benefits would be passed on to consumers; so, under these conditions, downstream buyer power has the potential to be welfare-enhancing.

Economic framework

The most appealing economic framework to apply to the context of this study is *bargaining theory*, which assumes that a downstream company can achieve lower input prices through the threat of purchasing less. Here, upstream firms are not 'powerless'; rather, the bargaining power of the downstream firms may act to reduce or eliminate the dominance or significant market power (SMP) that the upstream firms might otherwise have. This framework matches the sector characteristics quite closely. It enables the interaction of (potentially) powerful buyers and powerful sellers to be investigated, which is the focus of this document.[3]

Insights from competition policy

Current practice in competition law permits a defence against a finding of market power (in the case of the market position of a particular company), or a detrimental reduction in competition (in the case of a merger between two or more parties), if it can be shown that the customers of an entity have sufficient bargaining strength. This bargaining strength is often known as 'countervailing buyer power' (or CBP).

For clarity, the terminology used in this summary document is that, while buyer power (ie, bargaining power) is a matter of *degree*, *effective CBP* is present if the buyer power of downstream operators is of sufficient strength to prevent an upstream business (even one with a high market share) from acting to an appreciable extent independently of its customers. In other words, the terminology adopted here is that, for effective CBP to be present, the downstream purchasers of the input must have sufficiently strong buyer power to *eliminate* the 'dominance' or SMP that the upstream supplier would otherwise have.[4] The question of whether effective CBP is present has been of relevance to both competition authorities and sector regulators. The presence of effective CBP can be used as a successful defence to demonstrate that upstream dominance is not present, in abuse of

[3] Strictly speaking, there are two theoretical economic frameworks in which buyer power might be understood. For the purposes of this summary, the *bargaining* framework (where the upstream and downstream parties negotiate to determine an outcome) is more relevant than the *monopsony* framework (where there is a single downstream user, and many powerless upstream providers).

[4] The term 'dominance' is used in competition policy cases to explore whether an abuse of dominance has occurred. The term 'SMP' is equivalent to dominance, but is used more specifically in the telecoms sector to examine whether (some form of) economic regulation should be introduced in a particular situation. Note that competition policymakers often refer to the *degree* of buyer power as being 'CBP' or a 'degree of CBP'. Nonetheless, the important question considered is then whether the level of CBP observed is 'effective' or 'sufficient' in eliminating upstream dominance or SMP. For clarity, the current paper adopts a terminology that distinguishes between buyer power as a matter of degree, and effective CBP as a level of buyer power that eliminates upstream dominance or SMP.

dominance cases brought before competition authorities. The presence of effective CBP can also be used to argue that SMP does not exist in infrastructure sectors and that upfront or 'ex ante' sector regulation is not required (particularly in the telecoms sector).

It is also of note that, in the case of a proposed merger between two or more upstream entities, if before the merger the downstream buyers are deemed to have effective CBP, the conclusion that the upstream merger would give rise to a substantial lessening of competition (SLC) in the upstream market is much less likely, at least in cases where effective CBP among downstream firms is likely to be maintained after the merger.

In 2006, for example, the NMa examined the sale of savoury snack manufacturer, Duyvis, to soft drink and snack manufacturer, PepsiCo. However, in this case the merger was not blocked, primarily because of the downstream buyer power of large supermarkets on which the merging companies were dependent for a large portion of their total snack product sales.[5] Here, the relevant bargaining power was defined as that of a customer in commercial negotiations with a supplier, due to its size and the commercial significance to the supplier, and its ability to switch to other suppliers. The retail purchasers of the snack products concerned were highly concentrated (over 90% of the parties' snack products were sold to five large and sophisticated supermarkets or grocery-buying groups).

The supermarkets were much less dependent on the snack products supplied by the merging parties (the products represented only up to 1% of the supermarkets' sales) than the merging parties were on the supermarkets. The supermarkets also used multiple sourcing strategies, to avoid dependence on any one supplier, and had launched own-label products in competition with those of the merging parties. Furthermore, they could credibly threaten suppliers that they would alter promotional activity, assign less attractive shelf space, or even de-list products. Given the size and importance of the supermarkets, their sophistication, the multiple sourcing strategies adopted, and the opportunities for threatening suppliers, the NMa concluded that a 'significant degree' of CBP existed.

The hurdle for achieving effective CBP, as defined above, can be quite high. Nonetheless, this summary document examines buyer power as a matter of degree—that is, a range of situations in which a downstream firm is able to exert some form of pressure on an upstream supplier—rather than solely effective CBP in a competition policy sense.

3 Application to regulated sectors

There are a number of industries that tend to be subject to some form of 'economic regulation'. Rather than being completely free to set prices and terms— where 'prices' could include the prices charged either to consumers or to intermediate users seeking to access the provider's infrastructure—companies are constrained in some way by regulator.[6] This tends to be in utility and network sectors such as gas and electricity, where there may be only one infrastructure provider within any given locality.[7] Other sectors that have been regulated include rail infrastructure and larger airports.

In a number of these industries there is an upstream provider with market power that supplies downstream intermediate users, which in turn supply consumers. For example, a large airport provides aeronautical (and non-aeronautical) services to airlines, which pay landing charges to the airport; in turn, the airlines provide air travel to passengers.

[5] NMa (2006), 'Besluit van de Raad van Bestuur van de Nederlandse Mededingingsautoriteit als bedoeld in artikel 37, eerste lid, van de Mededingingswet, Nummer 5476, Betreft zaak: PepsiCo – Duyvis', April 24th.

[6] In practice, economic regulation is a broad term, and can mean the regulator placing constraints on prices, service levels, access terms, and other aspects of an infrastructure provider's offering.

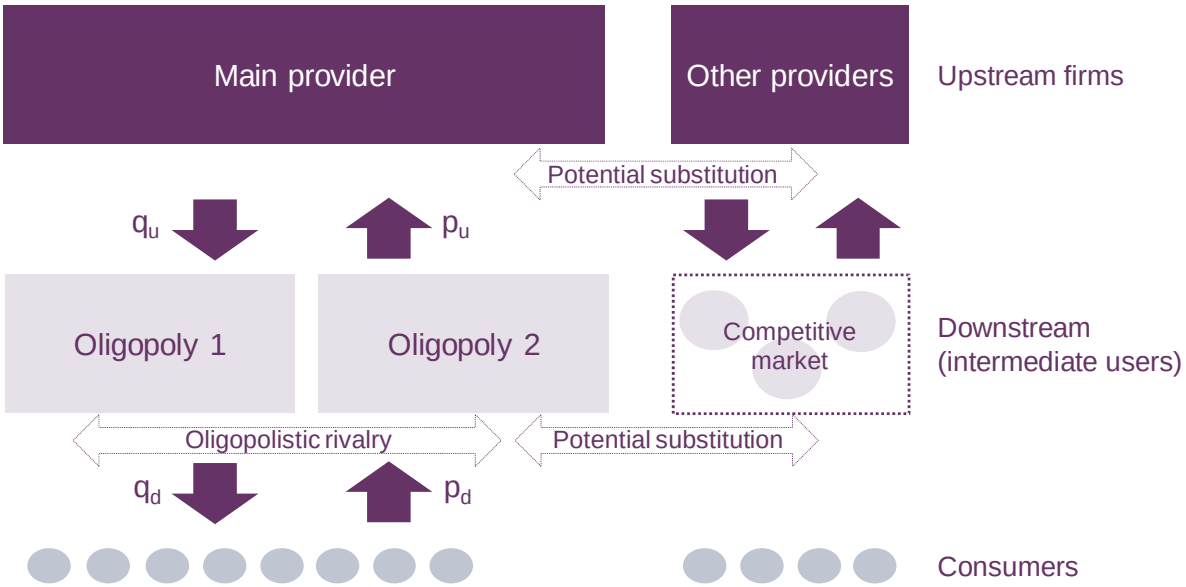
[7] Without some form of economic regulation, providers of 'natural monopoly' or 'bottleneck' infrastructure might seek to raise prices to make excessive profits, as a result of their position as a provider of an essential service with market power.

The concept of buyer power is important because it can determine what form of economic regulation is required and how involved the regulator needs to be. For example, in the case of a large airport, if sufficient buyer power is present, the airline (s) concerned may be able to counteract to some extent an attempt by the airport to raise prices. In turn, this can mean that the regulator does not need to introduce formal price regulation of airport charges.

To illustrate the theory, consider the case where a main upstream provider of an input sells to just a few firms. If the upstream firm has market power in the input market, it can charge a price significantly above the costs of producing the input when selling it to the firms downstream. However, if the upstream provider has little choice but to sell to the selection of buyers in question, this limits its 'outside options'. In addition, if, in the event that the upstream firm raised prices, the buyers can credibly threaten to switch to other upstream firms to source their input, this will improve their own 'outside options'. This situation may create some degree of buyer power. The strength of this will determine the extent to which it prevents the upstream firm from potentially raising its input price significantly above the costs of production (for example, whether effective CBP is present).

This market structure—often seen in network industries—is illustrated in Figure 3.1, in which a selection of buyers downstream purchase from an upstream main provider (on the left of the figure), but have the potential to substitute to other providers of the input. This may enable the downstream buyers to bargain on the price for the upstream input (p_u). In addition, the downstream firms face immediate competitors, and other competitors that purchase from other upstream firms. If competition overall is sufficiently intense, the benefits of buyer power among intermediate users in securing better input price terms should also be reflected in lower prices to consumers.

Figure 3.1 Buyer power with downstream competition



Source: Oxera.

An example of this may be an airline located at a particular airport (the main provider), which is capable of switching a number of its services to another airport (other providers) at short notice. At the same time, the downstream airlines within the airport concerned compete for consumers (passengers) with one another and with airlines at other airports.

In such a situation, it is important for regulation to be designed such that the potentially welfare-enhancing properties of buyer power can be realised.

4 Importance in the Dutch context

The NMa provided to Oxera oral and written descriptions of the nature of consultation and negotiation in the rail and airport sectors. On the basis of this information, Oxera notes the following.

– **Airports**: Amsterdam Airport Schiphol is subject to regulatory obligations in respect of its tariffs and conditions, which are enforced by the NMa. Schiphol has to demonstrate that its tariffs are cost-oriented (eg, revenues at or equal to costs), non-discriminatory and reasonable. It sets tariffs at least once per year, and is required to consult on them and associated service levels with airlines.

– **Rail**: each year, the infrastructure managers (IMs) in the Netherlands (ProRail and Keyrail) consult on a network statement, which contains information on access charges and the capability of their respective networks. This statement forms the basis on which access agreements[8] between the IMs and rail undertakings (RUs) can be negotiated and concluded. There is a requirement in the rail sector for annual agreement to be reached between each RU and the relevant IM on the price and terms of access.

Importantly, buyer power is relied on across both sectors to ensure that the upstream businesses have incentives to invest and operate efficiently, and provide a good standard of service. To create or provide a foundation for buyer power, the Dutch government imposed obligations in both sectors with respect to transparency, consultation, taking users' views into account, the ability of parties to file a complaint to the NMa, and, in the case of rail, to negotiate. With these obligations, the legislator expects or hopes to create and enhance buyer power for intermediate users.

Thus, the regulatory framework in the Netherlands, as designed by the legislator, relies on the *assumption* that the process of consultation (and negotiation, where permitted) between upstream providers and downstream intermediate users helps to create buyer power for the downstream firms. In this context, insofar as the upstream firms would otherwise enjoy market power upstream, it is assumed that the companies downstream from a regulated business have characteristics that enable them to improve outcomes from their relationship with their service provider, relative to monopoly outcomes. The consultation (and negotiation) process assists in realising these outcomes.

If buyer power can be brought to bear, the idea can be taken one step further: outcomes improve not only for the downstream provider, but also for its customers. For example, if an airline is able to negotiate better prices or an improved service from an airport, these benefits can be passed on to consumers.

An additional, important, benefit is that using a consult-and-negotiate regime assists in reducing the intrusiveness and cost of regulation, resulting in a lower regulatory burden. The approach in the Netherlands can be contrasted with the more traditional and involved model of CPI–X regulation, as applied in the energy sector in the Netherlands, under which regulators set prices and service levels for the regulated entities up front, which requires the regulator to be more heavily resourced and to play a much more significant role.

In theory, there are a number of factors that determine whether buyer power is likely to be present in any given situation. These are discussed in section 5. Buyer power is a means to an end, not an end in itself. In particular, there are factors that determine whether buyer power—if present—is likely to be beneficial to consumers, and there are questions more generally about the interaction between buyer power and economic regulation. These issues are discussed in section 6.

[8] Without an access agreement, an RU is not permitted to operate on the network.

5 Factors influencing the degree of buyer power

The main factors determining the outcome of negotiations between an upstream seller and a downstream buyer, and ultimately the degree of buyer power, are:

– the outside options of the buyer;
– the outside options of the seller; and
– bargaining effectiveness.

In essence, the outside options are what the parties would do if that they cannot reach agreement (eg, over prices).

Buyers have more bargaining power if they have more outside options. The main determinants of the buyers' outside options are their size, their ability to substitute quickly to alternative suppliers, and the nature of consumers' substitutability patterns (eg, if the product sold by the supplier is a 'must-have' for the consumer, ceasing to stock it is not a credible strategy for the buyer, thereby undermining buyer power).

Being 'big' can help buyer power, and individual companies might form buyer groups or trade associations in order to increase bargaining strength. However, being big is not sufficient to generate buyer power—at least power that is sufficiently strong to be considered effective CBP. Rather, for effective CBP to be present, the buyer must be able and prepared to credibly switch a significant proportion of its purchasing away from the supplier over a reasonably short timescale.

So, ideally, the buyer should be able to switch rapidly to competing suppliers—for example, an airline to a rival airport, or a train operator to a rival rail infrastructure provider. To be in a position to do so, buyers must be well-informed of alternative upstream providers; there must be other upstream providers with spare capacity willing to serve the buyer (eg, an alternative train route or airport); there should be few infrastructure investments dedicated to the buyer linked to its purchasing relationship with the upstream firm (eg, few airport facilities that are specific to a given airline[9]); and, importantly, consumers should be willing to switch 'with' the downstream firm (eg, airline passengers should be willing to travel to another airport). Alternatively, to generate increased buyer power, the buyer might promote new entry upstream, or set up or acquire its own upstream operations ('vertically integrate'). Strategies that may generate some buyer power, albeit short of effective CBP, include shifting some aspects of capacity.

Buyer power is also higher if sellers have few outside options. The main determinants of sellers' outside options are the presence of alternative buyers to contract with; how specific the investment by the seller is to particular buyers, the structure of the sellers' costs, the presence or absence of buyer groups, and the short-run, cash-flow dependency of the seller on its current buyers.

If there is limited new entry downstream, the supplier has little option but to deal with existing buyers. Where there is more entry (eg, if there is frequent new entry into the rail sector by rail transportation providers), this increases the outside options of the seller, undermining the buyer power of existing transportation providers. If there are significant economies of scale upstream—for example, where the upstream sector is particularly capital-intensive and/or has high fixed operating costs—losing a particularly large buyer would raise the seller's unit costs. This again reduces the seller's outside options. If the upstream supplier has invested in dedicated facilities to serve the existing downstream buyer(s), such as rail infrastructure, this also reduces the likelihood of the supplier trading with other buyers, thereby reducing the seller's outside options.

[9] Where there are specific investments with the existing upstream provider, being 'big' in essence reduces buyer power as it lessens the likelihood of the buyer switching to an alternative upstream provider.

Again, these issues are a matter of degree. It is necessary to compare in relative terms the outside options of the buyers and sellers to conclude whether buyer power exists, and to what extent.

Bargaining effectiveness is important in influencing the above respective outside options of the buyers and seller(s). Factors determining the effectiveness of bargaining as a process include the ability of the buyer to withhold payments from the seller, the transactional costs of bargaining, and the extent to which the sums paid to the upstream buyer are large in relation to the seller's total costs. For example, if the transaction costs of a rail transportation operator to engage in a consult-and-negotiate process are low, and the costs of track access in terms of rail operators' total costs are high, this helps rail operators come to the bargaining table. The degree to which parties can credibly commit to strategies aimed at boosting their bargaining power (by 'tying their hands'), the degree to which each party knows the outside options of the other trading party, and the ability to keep concessions secret also determine bargaining effectiveness.

In regulated sectors, regulators might seek to influence the bargaining effectiveness of the buyers and sellers by requiring sellers to disclose information to buyers. They might also seek to influence the order and timing of the consultation and negotiation process, to reduce transaction costs, and provide sufficient time for engagement in negotiations. The regulator may influence bargaining by specifying regulatory sanctions if agreement cannot be reached, in effect influencing the outside options of the buyer and seller. However, the degree to which these measures are possible will depend on the legal and regulatory framework in place.

In practice, the above discussion highlights the fact that, while regulators can influence buyer power, the main determinants of buyer power appear to be structural—ie, the nature of the upstream and downstream markets. Where these structural characteristics are not conducive to creating (countervailing) buyer power, even the best consult/negotiate regime is unlikely to lead to buyer power that eliminates upstream dominance or SMP (ie, buyer power that is sufficiently strong be considered effective CBP). So, while the regulatory approach can influence the bargaining process and outside options, and enhance buyer power, in itself it is unlikely to be sufficient to create effective CBP.

6 Buyer power: a means to an end

Creating or enhancing buyer power should be seen as a means to an end, not an end in itself. In this respect, there are some important further points to note about buyer power in terms of its effects further downstream, whether consumers' wishes are aligned with those of buyers, and the importance of buyer power in the regulatory framework.

Buyer power tends to be pro-competitive. Competition authorities tend to consider buyer power in a bargaining setting (in particular, effective CBP) to be desirable, provided that there is sufficient competition in the downstream market. However, the extent to which the benefits of effective CBP are passed on to consumers in the form of lower prices depends on the nature of the downstream competition faced by the buyers. If the buyers have market power in each of the downstream markets that they serve, they may simply keep the additional profits gained from their advantageous bargaining position. So, buyer power does not always mean that consumers benefit.

If the upstream firm is allowed to 'price-discriminate', reductions in prices to larger buyers downstream may be at the expense of higher prices to smaller buyers downstream. This 'waterbed effect' could harm competition downstream where rival buyers purchasing from the seller compete in the same downstream market, since it raises some retailers' costs and could lead to them leaving the market. For example, a large wholesaler may offer substantial discounts to a large retailer that has buyer power, while raising the prices charged to smaller independent retailers that operate on a competitive fringe in the downstream market. This could result in the smaller retailers being unable to compete and

exiting the market. However, the waterbed effect relies on the downstream buyers indeed competing in the same downstream market. Moreover, this effect is controversial—there may instead be 'uneven bargaining', whereby improvements in the terms offered to some buyers do not adversely affect the other buyers. In a regulated sector, an economic regulator might influence the extent to which consumers benefit from buyer power through careful design of the regulatory regime.

Non-price discrimination may also lead to 'quasi-waterbed effects'. If price discrimination is not permitted—for example, in the case where the same uniform price must be offered to all buyers within a given customer class and/or for the same level of service—an upstream firm might still offer services that are more geared to the business model of one particular downstream buyer than to another. In transportation this may arise if service offerings to different downstream buyers involve the use of shared *or* of separate upstream infrastructure. Priorities by the infrastructure provider regarding service levels and investment decisions may be given to larger buyers over smaller ones. Again, in a particular sector, a regulator might seek to examine the extent to which these effects are present, including in a consult/negotiate regime.

The interests of intermediate users and consumers may not be aligned. There can be a disjoint between the objectives of current downstream buyers and of both current and future consumers. There could be 'time inconsistency' issues, in that short-term decisions do not correspond to long-term optimal outcomes. For example, a downstream buyer (such as an airline or an RU) might not negotiate for the upstream firm to increase its current capacity if this means that more competitors (other airlines, other RUs) will be able to access the capacity (increasing the intensity of downstream competition going forward). A more benign version of this market failure arises when the long-term interests of the supplier (and conceivably those of the government and other stakeholders) conflict with the short-term cash needs of its buyers. A regulator might, however, seek to address such issues as part of the consult/negotiate regime, and through regulation more generally, to align the interests of intermediate and consumers more effectively.

Consultation and negotiation in regulated sectors is not just about creating or enhancing buyer power—rather, it may also be intended to address information asymmetries, in particular by providing information on service-level requirements and what investment is likely to be required, when, and at what cost. This is of benefit to the regulator in assessing service and investment requirements, but also more generally to sellers, buyers and stakeholders more widely. In addition, consultation and negotiation can involve a wide range of user types and stakeholders in the process in order to ensure that government policy or consumer welfare is reflected in agreed outcomes, for example. It is as much about involving a wide range of stakeholder groups in the regime as generating buyer power for actual buyers. The regimes of customer engagement currently being discussed in the UK regulated energy and water sectors are examples of this.

Regulators play an important role in designing the consult/negotiate regime. Even where lighter-touch regulation is used, as is the case in the Netherlands, the regulator has an important role in setting out the terms and process for consultation and negotiation, and the credible sanctions if parties cannot agree. For example, the regulator may require consultation and negotiation to focus on certain parameters (eg, willingness to pay for different levels of service quality), but not others (eg, the cost of capital). The timetable for this process might also be set out in a way that enables meaningful engagement. The regulator might wish to provide incentives to the suppliers to engage with their buyers (and other stakeholders) through financial and process incentives, such that the parties are better off seeking agreement than referring the issues to the regulator for a decision. There are examples of this from the process of negotiated settlements in the USA, as facilitated by the Federal Energy Regulatory Commission.

Enhanced consultation and negotiation may fit within various regulatory models. While light-touch regulation, if effective, is a substitute for more detailed ex ante price regulation,

enhanced user involvement and buyer power might be a complement to, rather than substitute for, various forms of regulation. Consultation and negotiation can be used alongside all manner of regimes, from the heavy-handed to light-touch. Even under a system of CPI–X regulation, consultation and negotiation can help provide information to the regulator on appropriate investment and service levels. Moreover, formal price controls might be used as a credible threat of intervention if consultation and negotiation are not successful.

Taken together, the above points illustrate two important concepts. First, while buyer power tends to be of benefit to consumers, this is not always the case. Second, regulators can play an important role in designing the consult/negotiate regime, but this may not be solely concerned with creating or enhancing buyer power.

Park Central
40/41 Park End Street
Oxford OX1 1JD
United Kingdom

Tel: +44 (0) 1865 253 000
Fax: +44 (0) 1865 251 172

Stephanie Square Centre
Avenue Louise 65, Box 11
1050 Brussels
Belgium

Tel: +32 (0) 2 535 7878
Fax: +32 (0) 2 535 7770

200 Aldersgate
14th Floor
London EC1A 4HD
United Kingdom

Tel: +44 (0) 20 7776 6600
Fax: +44 (0) 20 7776 6601

www.oxera.com