IMPLICATIONS OF NEUTRALITY RULE:

AN APPLICATION TO OTHER SECTORS

Supermarket chains

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INDEX

1. NEUTRALITY RULE IN SUPERMARKET CHAINS

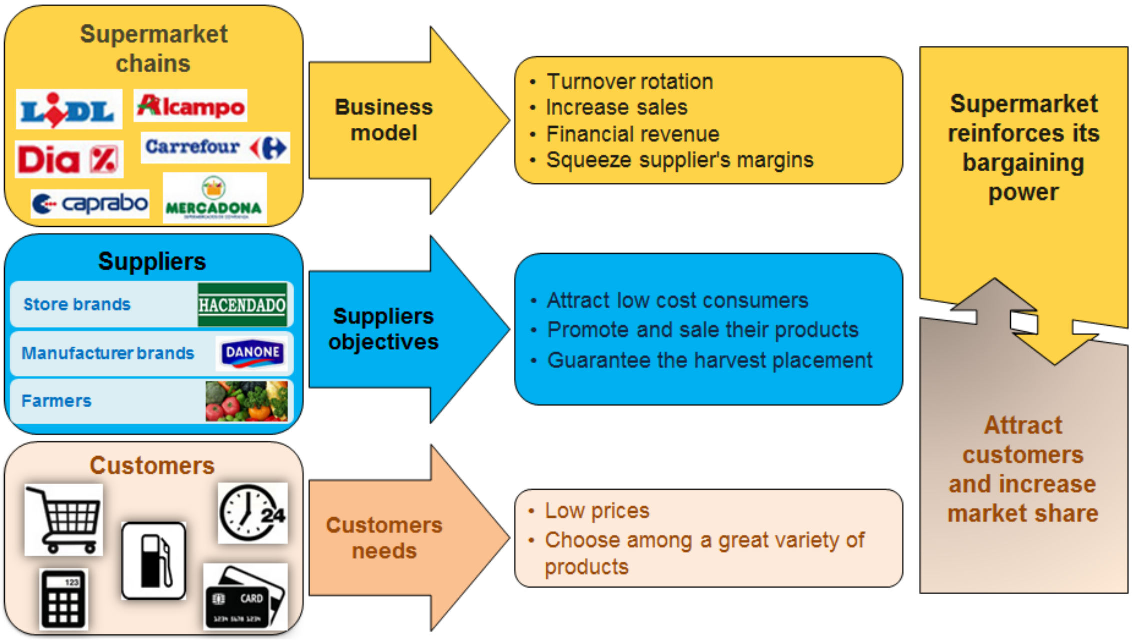
Supermarket chains business model entails a wide range of commercial strategies that imply different treatments towards both consumers and producers or suppliers. The application of these practices would be jeopardized in the case of imposed net neutrality regulation.

The supermarket chains' main source of profitability arises from high inventory turnover, financial incomes and margin reduction of suppliers, which allows them to operate with very competitive commercial margins.

A core aspect of the supermarket business model is their bargaining power. As a result they achieve favorable/different buying terms from producers and suppliers and make producers bear the promotions' costs, when, for example, brands need to launch new products in the market. Supermarket chains use their bargaining power to delay supplier's payments up to 60 or even up to 90 days. As customers pay in shorter periods, supermarket chains enjoy negative working capital balances which reduce their net debt requirements and lower their financial expenses.

Following their business strategy, supermarket chains attempt to increase sales and gain market share. Bargaining power allows supermarkets to improve conditions for consumers. In turn, supermarkets' buying power arises from their successful position as retailer, if they are able to provide good locations and facilities to consumers. Increasing market share strengthens buying power and feeds back the economic success of this business model.

Figure 1: The supermarket chains business model diagram



Source: Created in-house.

Supermarket chains' commercial strategies for customers

Supermarket chains use different strategies to attract customers in order to increase sales and rotation, such as a broad selection of goods, new and more appealing products at relatively low prices, convenient shopping hours, ease of parking or cheaper motor fuels. As they increase rotation they increase financial revenue from cash management.

Commercial strategies addressed to appeal customers have usually the form of discounts. A list with the most usual strategies follows:

i. **Temporary price discounts on specific products:** They are commonly used for promotions of new products or to get rid of seasonal stocks. It results very convenient for efficiently managing inventories.

ii. **Temporary price discounts in low season:** These are limited time discounts for several products. Such discounts are often used to attract customers during low seasons. As a result, large supermarkets are more efficient in managing fixed costs, in increasing sales and rotation and in absorbing revenue fluctuations.

iii. **Volume discounts:** The most extended volume discounts are the 3x2 promotions or discounts in the second unit bought. They are often used for launching new products or new versions of the same item and they are usually bore by the brand's producers.

iv. **Discounts according to customer's profiles**: Some supermarket chains have created special conditions in order to distinguish their customers' features. For example, Carrefour launched a discount card for young people or special discounts for unemployed people or large families. Their objective is to increase sales and promote clients’ loyalty.

v. **Discounts at low cost gas station**: Most supermarket chains have low cost petrol stations. They offer fuel at lower prices than conventional petrol stations and also offer discounts on bills for large purchases.

This strategy has great advantages for consumer’s welfare and motor fuel competition[1]. Indeed, supermarkets chains use motor fuel price discounts as an advertising ploy to attract customers to big malls. Supermarket fuel brands have transformed gas stations competition, and have forced traditional petrol companies to improve efficiency and align motor fuel prices as well.

vi. **Exclusive white label products:** Some supermarket chains have introduced own branded and exclusive products at lower prices to secure consumer loyalty and increase market share and rotation. Such discounts provide better price conditions and access to new products for customers.

Supermarket chains’ commercial strategies for providers or suppliers

On the supply side, supermarket chains try to leverage their position in the retail market, as explained before. This allows them to achieve more favorable buying terms than would otherwise be possible. They also obtain other revenues from advertising campaigns of their supplier’s new products[2]. Through these strategies they can reduce prices and increase the range of products. This, in turn, improves consumer’s welfare, attracts new customers and, at the end, boosts sales and the rotation of inventories.

This group of commercial strategies rests on product or supplier discriminations:

- For branded products, the most common practices consist on prioritizing positioning in the sales area or on shelves, supporting marketing campaigns or enforcing brand strategies.
- For unbranded producers, such as agricultural cooperatives, strategies are addressed to reduce margins as they have less bargaining power[3].
- More recently, supermarkets have launched white label products, at lower costs, by stablishing exclusive agreements with suppliers.

[1] As pointed out by the EC and the Spanish Antitrust Agency. See “Informe de seguimiento del mercado de distribución de carburantes de automoción en España”.
[2] Suppliers pay supermarkets for launching new products’ commercial campaigns.
[3] Supermarket chains use retail power with farmers. These have been organizing themselves as bigger cooperatives to reinforce their power against supermarkets and improve their margins.

Most common practices are:

i. **Listing canons**: Payments charged to supermarkets' suppliers for the access to the sales area.

ii. **Payments per use, location preference and location in the sales area**: Payments for locating suppliers' products in a specific area.

iii. **Payments for promotions**: Producers finance the commercial campaigns in the sales area, such as volume discounts and distributing leaflets.

iv. **Promotion of the retailer's own brands**: They give better conditions to producers of the supermarket private brands.

v. **Exclusive agreements**: Contracts that forbid to distribute a specific product to other supermarket chains or, to charge a higher final price to other competitors.

vi. **Most-Favored-Customer Clause**: Supplier is forced to offer the supermarket chain the same commercial conditions contracted with other customers.

i. **Risk coverage clauses**: They force producers to assume any unexpected costs or failures of demand forecasts.

Neutrality rule on supermarket chain strategies

The "neutrality rule" on supermarket chains would restrict the above mentioned strategies, as "When neutrality occurs, all market participants should be treated equally in terms of prices, preferences, quality, quantity or priority". More specifically, discounts and product and supplier discrimination strategies in the sales area would be restricted. As a result of "neutrality rule", supermarkets' optimal performance, producers' behavior and, in definitive, consumer's welfare would suffer important distortions:

a) **Impacts on supermarkets: Neutrality rule would modify the business model of supermarkets with direct implications** on:
   - Higher costs as a result of a bargaining power loss
   - Less investments in new shopping centers
   - Less incentives to innovate through white label brands products
   - Less incentives to introduce new brands and new products in their sales area

   All of these would reduce consumer welfare, due to higher goods' prices, less variety of goods, and less locations and facilities to shop.

b) **Impacts on supermarkets' efficiency and innovation:** The imposition of neutrality in the supermarket chain industry would imply the end of price and placement discrimination measures. That would mean that supermarket chains should treat equally all providers and establish the same conditions and access to the sales area to similar products regardless of their brand. As a consequence, the market's efficiency and innovation would be definitely harmed, resulting in a decrease both in the products' variety and quality. There would be fewer incentives for suppliers to innovate and create differentiated products, as it would be compulsory to equally treat, prioritize and locate products on shelves.

c) **Customers' welfare loss:** Discounts on customers profile attract more customers and therefore increase sales and market share. As a result, they improve customers access to markets, in particular lower income ones. In addition to that, the negative impact on the supermarkets' innovation would result in less products' variety for the customers.

d) **Impacts on gas station competition:** Incentives to deploy and compete in the motor fuel sector would be distorted and the industry of distribution of motor fuel would be less competitive. Fuel prices would eventually increase and gas pump station options would be reduced.

Specific effects on each commercial strategy on customers and suppliers are shown in the following tables.

Table 1: Summary of retail commercial practices that would be forbidden in a "net neutrality rule" scenario and impact on consumers of supermarket chains

<table>
<tr><th>Commercial Strategy</th><th>Neutrality Rule restrictions</th><th>Impact on customers</th></tr>
<tr><td>Price discounts on specific products:
Ending stocks promotions
Free samples</td><td>Enforces uniformity in product prices:
No discounts among the same range of products are allowed</td><td rowspan="3">· Less appealing prices
· No special offers, promotions
· No free samples in supermarkets
· Less availability of cheap white label brand products
· No differentiation on products other than in qualities</td></tr>
<tr><td>Price discounts in low seasons:
Seasonal sales
Weekly promotions</td><td rowspan="2">Enforces uniform conditions for a range of similar products:
No different commercial strategies among a range of products can be applied</td></tr>
<tr><td>Volume discounts:
3x2 promotions
% additional volume</td></tr>
<tr><td>Discounts according to customer's profiles
Loyalty cards</td><td>All market participants should be treated equally
No differentiating practices depending on the customers willingness to pay or needs</td><td>· No appealing prices and promotions for the most loyal customers
· Foreclosure of market for some customers</td></tr>
<tr><td>Discounts on low cost gas station
% discounts related to purchases</td><td>All market participants should be treated equally
Same prices regardless shopping requirements</td><td>· No appealing deals for target drivers
· Higher motor fuel prices</td></tr>
<tr><td>Exclusive white label products:
Appeling low price products of supermarkets own brand</td><td>Enforces uniform conditions for a range of similar products:
No prioritization possibilities between own products and brand products</td><td>· Less availability of cheap white label brand products
· More expensive shopping basket
· Less diversity of products</td></tr>
</table>

Table 2: Summary of commercial practices towards suppliers that would be forbidden in a "net neutrality rule" scenario and impact of its application on consumers of supermarket chains

<table>
<tr><th>Commercial Strategy</th><th>Neutrality Rule restrictions</th><th>Impact on customers</th></tr>
<tr><td>Listing canons
Payments for using sales area</td><td>Enforces equal access to sales area
No restrictions on sales area to producers are allowed</td><td rowspan="3">· No special offers, promotions
· Higher final prices as supermarket revenues would be lower and supermarkets' costs would be higher
· Less freedom of choice for customers</td></tr>
<tr><td>Payments per preferential location
Payments for using a specific location on the sales area</td><td>Enforces equal treatment and trade conditions to all suppliers
Restrictions to practice differentiation depending on the suppliers willingness to pay or needs</td></tr>
<tr><td>Payments for promotions:
3x2 promotions
Publicity campaigning of new products</td><td>Enforces equal treatment to same products
No different commercial strategies among a range of products can be applied</td></tr>
<tr><td>Promotion of the retailer own brands
Prioritize supermarket own brand using preferential positioning</td><td>All market participants should be treated equally
No advantageous condition for own products</td><td>· Less availability of cheap white label brand products
· Less freedom of choice for customers</td></tr>
<tr><td>Exclusive agreements
No supply a product to other supermarket brands</td><td>Enforces equal access to sales area
No different contract conditions can be applied among supplier to restrict access to the sales area</td><td>· Less white label products</td></tr>
<tr><td>Most-Favored-Customer Clause:
Obligation for suppliers to equal any other commercial condition applied to competitors.</td><td rowspan="2">Enforces equal access to sales area
No prior conditions can be applied on suppliers to access the sales area</td><td>· Higher final prices as supermarkets cannot obtain from suppliers these advantageous conditions</td></tr>
<tr><td>Risk coverage clauses
Suppliers cover demand risks</td><td>· Less innovative products for customers, as suppliers have less incentives to launch new products and supermarkets cannot charge risk of demand to suppliers</td></tr>
</table>

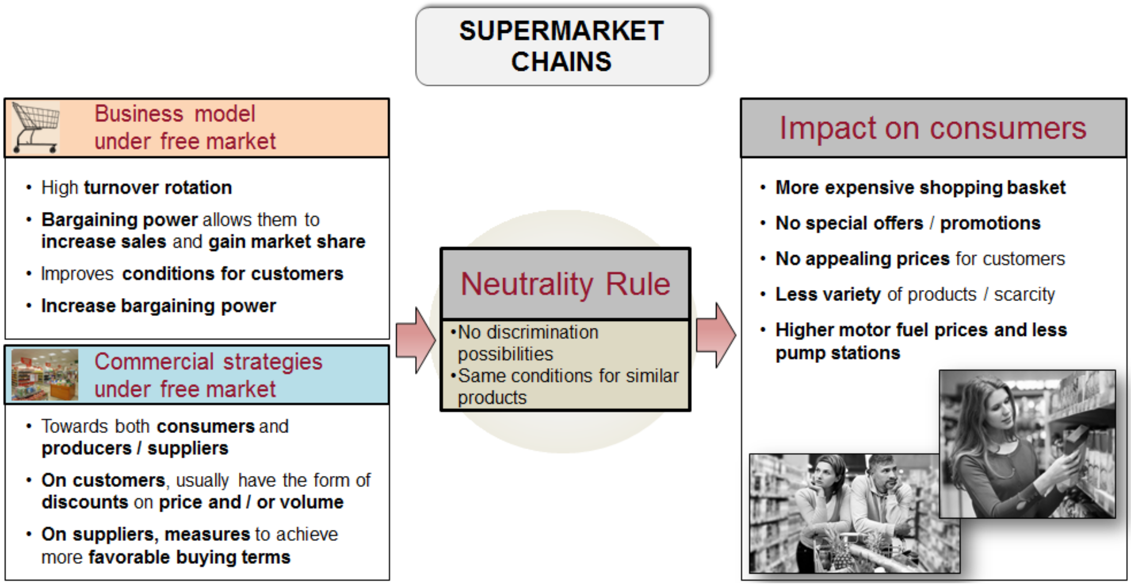
Main findings and conclusions

If a "neutrality rule" was imposed in the supermarket chains industry, supermarkets would lose substantial bargaining power over providers / suppliers.

This could ultimately hamper supermarket chains ability to improve conditions on consumers addressed to reduce prices (through special offers, discounts or promotions) or increase the variety of products (by prioritizing preferential positioning in shelves and payments for promotions).

As a result, it clearly seems that any attempt for homogenizing practices and commercial strategies in the supermarket chains would harm innovation, increase prices, reduce access to the market to low-income customers and drive to an effective loss of consumers' welfare.

Figure 2: Summary of "neutrality rule" application on supermarket chains industry



2. ANNEX I: DESCRIPTION OF THE SUPERMARKET CHAINS' BUSINESS MODEL

A supermarket is a large form of traditional grocery store. It generally offers a wide range of food and household products, organized into corridors. Larger establishments are called hypermarkets.

In 2013, the 18 Spanish biggest retailers accounted a gross value added of 7,181 M€, around 0.7% of Spanish GDP, had 3.2 million of customers every day (the 17.5% of the Spanish households), a turnover of 37,260 M€, an average level of investment of 1,143 M€, and employed 215.148 people.

Supermarket chains entail a wide range of commercial strategies in order to increase their benefits, most of them related to price differentiation towards both consumers and producers or suppliers.

i) Business model description, drawing out the relevant market, and customers and suppliers profiles

Supermarket chains are retailers and are included in the commercial distribution industry, the group of activities that connect producers and customers. The participants are producers, suppliers, intermediaries, wholesalers, retailers and customers. Retailers generally purchase large quantities of goods to manufacturers –directly or through wholesalers- and sale small quantities of them to final customers.

Over the last years, supermarket chains have acquired an increasing share of the grocery market and have enlarged their influence over producers and suppliers of fresh goods thanks to buyer power and vertical integration with wholesale activities.

The most important supermarket chains in Spain are: Mercadona, El Corte Inglés, Carrefour, Auchan, Eroski and Lidl. In 2009, the 5 greatest supermarket chains concentrated 70% of the total of grocery sales. They are usually vertically integrated with transportation services, warehouse facilities and do wholesaling activities. For instance, to reinforce vertical integration, Mercadona has also signed long-term exclusive agreements with some suppliers.

According to the antitrust Agency, the most important supermarket chains enjoy market power in the retail sector, an aspect that they can use to gain buying power.

Supermarket chains sell a wide range of products: fresh products, manufactured products, appliances and electronics, textile and bazaar. The variety of products sold depends on the size of the retailer's sales area and its product portfolio policies. Other services offered at the supermarkets areas may include petrol stations and mechanic workshops. Their geographic market has a local dimension. The Spanish competition authorities have established a limitation based on isochronous[4]: 15 minutes (city center stores) or 30 minutes (rural stores).

The demand of supermarket chains is attributed to the final customers. Supermarket chains use different strategies to attract customers in order to increase turnover and rotation, such as different kinds of discounts, the availability of a broad selection of goods and new and more appealing products at relatively low prices, convenience shopping hours, ease parking or providing cheap gas.

The most important and sometimes controversial commercial strategies of supermarket chains' are related to their buyer power. They achieve more favorable buying terms than in a fully-competitive market and obtain additional revenues from advertising campaigns of their supplier's new products. Supermarkets buyer power arises from their position as retailer.

ii) Revenue and cost function and profit maximization description

The supermarkets chain industry's main source of income is the sale of goods. As it has been mentioned above, they can also obtain additional revenues from producer's publicity campaigns when introducing new products. Supermarket chains are very competitive in terms of costs, as they generally obtain good conditions for resealing supplier's products.

Supermarkets' buyer power reinforces their retail power. As their market share increases, they are able to reach better agreements and product deals from their suppliers. Hence, as buying prices fall, retail prices fall too and can offer a more appealing variety of products, giving them further market share.

In economic terms, the profit maximization of supermarkets leads to the transference of a fraction of suppliers' surplus to customers and creates the appropriate incentives for product innovation and development.

iii) Description of differentiation mechanisms and effects on quantity, quality, efficiency, equity and incentives of the industry

Supermarket chains use different strategies to attract customers in order to increase sales and rotation. Most of them are related to price differentiation practices. The most extended are:

i. Temporary price discounts on specific products.

ii. Volume discounts.

iii. Discounts according to customer's profiles.

iv. Discounts on low cost gas station.

On the supply side, supermarkets also use several commercial strategies addressed to capture the producer's surplus. Most common practices are:

[4] Isochronous are used to establish the territorial boundaries as a function of the traveling time.

i. Listing canons.

ii. Payments per use, location preference and location in the sales area.

iii. Payments for promotions.

iv. Promotion of the retailer own brands.

v. Exclusive agreements.

vi. Most-Favored-Customer clause.

vii. Risk coverage clauses.

On the demand side, price differentiation practices may benefit customers. They may contribute to reduce prices and encourage product diversity. Suppliers are encouraged to improve quality and introduce more appealing products to increase bargaining power with supermarkets. Discount strategies guarantee the maximum efficiency of the sales management area, inventory optimization and avoid the waste of resources.

For suppliers, the results are controversial. Producers claim that supermarkets exercise abuse of buyer power. The Antitrust Agency has published several reports dealing with this issue, but there are not concluding results. In most cases, the aggressive commercial practices on the supply side allow supermarkets to capture a very big share of the producer surplus, obtaining great business margins in the intermediation process. In some cases, supermarket chains transfer a high portion of the producer's surplus to customers, especially in very competitive retailing markets, and customers are better off.

3. ANNEX II: MAIN BIBLIOGRAPHICAL REFERENCES

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