

## Article

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# Competition Law and the Regulation of Buyer Power and Buyer Cartels in China and Hong Kong

**Abstract:** The paper focuses on the application of competition law in HK and China to buying alliances and buyer cartels in intermediate markets. The discussion set to clarify the legality, under the competition provisions, of purchase price fixing agreements between buyers.

**Keywords:** buyer power, competition law, buyer cartel, purchase price fixing, buying alliance

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## I. INTRODUCTION

Buyer power enables a single buyer, or a group of buyers, to influence or dictate the terms of trade with upstream suppliers. This power may stem from strategic advantages enjoyed by the purchaser. Alternatively, it may derive from the attainment of a dominant or collective dominant position on the input market.

The treatment of buyer power in competition law is challenging. At times buyer power may deliver efficiencies and benefit consumers. In other instances, buyer power may have anti-competitive effects and harm both the competitive process and the consumer. Interestingly, it is not always easy to determine the effects of buyer power in a given case, thus making the enforcement decision a complex one.

An inquiry into the treatment of buyer power in competition law requires the consideration of the legal regime and the availability of instruments which may enable appraisal of buyer power. In addition, it requires consideration of the enforcement approach and the type of actions which should be deemed anti-competitive.

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In this paper we set to explore this complexity in the context of the competition laws of China and Hong Kong. Our analysis sets to outline the availability of legal provisions which may be used to address buyer power and consider the appropriate use of such provisions. Our focus on these two jurisdictions is not incidental and reflects the size and significance of these markets internationally, the relative novelty of their modern competition regimes, and the fact that each market (though very different in size and ownership structure) exhibits significant concentrations of market buyer power.

In China, state-owned enterprises dominate many sectors of the economy and exert significant buyer power, often as the sole purchaser of inputs or by controlling distribution channels. In Hong Kong, family controlled conglomerates that exercise considerable buyer power in many product markets, dominate the domestic market. As both China and Hong Kong have adopted competition regimes primarily based on substantive European Union (E.U.) competition law concepts, we make reference to E.U. doctrine and case law by way of comparison as both the Chinese and the Hong Kong competition regimes have yet to tackle collusive buyer power in their respective jurisdictions.

Our analysis focuses on downward pressure on price and considers two distinct manifestations of buyer power. First, we consider the use of *unilateral buyer power* as a means to decrease the purchase price of goods. We consider the behaviour of a single large company in its relations with upstream supplier and its effect on consumers and other companies operating on the market. Second, we explore the application of competition law to instances of *collusive buyer power*. Here we review the legal approach to agreements between competitors that join forces in their negotiations with upstream suppliers. In that context, we consider both the legality and the welfare effects of agreements to fix the purchase price of goods (also known as purchase cartels).

While both the *unilateral* and *collusive* strategies make use of buyer power to affect the conditions of trade with upstream providers, their analyses are distinct. In unilateral cases the competition provision predominantly focuses on whether there has been an abuse of a dominant buying position. That analysis requires consideration of the likely harmful effects stemming from the exercise of buyer power. In cases of collusive purchase cartels, the analysis centres on the illicit price fixing of the input price and the distortion of competition. The consideration of the welfare effects, stemming from the exercise of buyer power, plays a secondary role in this case.

We begin our analysis with a review of the two common models used to assess the welfare effects of buyer power – the monopsony and bargaining models. Having established the bargaining model is the preferable theoretical framework for the review of buyer power, we turn to explore the legal treatment

of unilateral and collusive buyer power. We first focus on unilateral buyer power and explore the legal framework applicable to possible abuse of buyer power in China and Hong Kong. Following this, we explore the treatment, in both jurisdictions, of collusive buyer power and in particular, purchase cartels.

## II. THE WELFARE EFFECTS OF BUYER POWER

Buyer power considerations have attracted media attention and legal scrutiny in many competition law regimes worldwide.<sup>1</sup> For example in the U.S., collusive practices on the buyer side have been scrutinised in a large number of different market settings ranging from blueberries to tobacco leaves and from college basketball coaches to prescription drugs.<sup>2</sup> In the E.U., both the E.U. Commission and the Court have scrutinised buying alliances and buying cartels.<sup>3</sup> Further, recent trends in the retail and food sector have attracted heated policy debates in both the E.U. and U.S.<sup>4</sup>

The extent to which competition law may be used to address buyer power, depends predominantly on the economic theory of harm. Two main models are commonly employed to ascertain the effects of buyer power. These are the monopsony model and bargaining model.

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<sup>1</sup> See, for example, Alex Renton, “British Farmers Forced to Pay the Cost of Supermarket Price Wars”, *The Guardian* (2 July 2011), online: The Guardian <<http://www.theguardian.com/environment/2011/jul/02/british-farmers-supermarket-price-wars>> (last accessed 30 September 2013); “Q&A: milk prices row and how the system works”, *BBC News* (23 July 2012) online: BBC News <<http://www.bbc.co.uk/news/business-18951422>> (last accessed 30 September 2013); ICN, *Special Program for Kyoto Annual Conference: Report on Abuse of Superior Bargaining Position* (2008); See also Paul Nihoul & Thomas Luebbig, “The Next Big Question in Competition Law: How Do We Treat Buyer Power?” (2011) 2 J. Eur. C. L. & P. 107.

<sup>2</sup> See OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 19–20.

<sup>3</sup> Case COMP/C.38.238/B.2, *Raw Tobacco Italy*; Case 123/83, *Bureau national interprofessionnel du cognac v Guy Clair* [1985] ECR 391. On these cases see below text to n. 52.

<sup>4</sup> See, for example, ECN, *Activities in the Food Sector* (May 2012), (Report on Competition Law Enforcement and Market Monitoring Activities by European Competition Authorities in the Food Sector); Commission (EC), “A Better Functioning Food Supply Chain in Europe” COM(2009) 591. For the situation in the U.S., see M. Stucke, “Looking at Monopsony in the Mirror” (2013) 62 *Emory L.J.* 1509 (forthcoming). See also <<http://www.justice.gov/atr/public/division-update/2011/ag-workshops.html>> (last accessed 30 September 2013); For the situation in the U.K. and Australia see Competition Commission, *Market investigation into the supply of groceries in the UK* (2008); Australian Competition & Consumer Commission, *Report of the ACCC Inquiry into the Competitiveness of Retail Prices for Standard Groceries* (2008).

## A. The Monopsony Model

The monopsony model provides a mirror image of monopoly, and serves to analyse the behaviour of a single dominant purchaser which faces a competitive input market. According to the model, the monopsonist is by definition a powerful buyer, and so can artificially withhold demand and as a result, procure input at a price below competitive levels.

The pure monopsony model serves as the standard instrument to examine buyer power. It shows that under its restrictive underpinning assumptions, monopsonist power and demand withholding will result in welfare loss and detriment to consumers.<sup>5</sup> According to the model, the lower prices extracted from suppliers do not entail lower costs and subsequent benefit to consumers. The distortion which stems from monopsony power is assumed to lead to higher production costs and possible wasteful expenditure.<sup>6</sup> As a result, the monopsonist will not pass on the lower input cost, since it is marginal cost that determines its level of output, and its marginal cost will be higher than the marginal cost of a firm with no monopsony power.<sup>7</sup> The resulting allocative inefficiencies lead to welfare loss. When the market for the output is competitive, the presence of a monopsony upstream is not likely to affect the price, since the monopsony is a “price taker”. However, when the monopsony enjoys market power downstream, the reduced output would lead to an increase in output price, to the detriment of consumers.

*Collusive monopsony or oligopsony*,<sup>8</sup> can trigger similar welfare outcomes.<sup>9</sup> When the conditions necessary for collusion and attainment of joint market

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<sup>5</sup> Roger D. Blair & Jeffrey L. Harrison, *Monopsony in Law and Economics* (Cambridge: Cambridge University Press, 2010) at 45; Alan Manning, “The Real Thin Theory: Monopsony in Modern Labour Markets” (2003) 10/2 Lab. Econ. 105–131; Also see: Alan Manning, *Monopsony in Motion* (Princeton University Press, 2003).

<sup>6</sup> Jean Tirole, *The Theory of Industrial Organisation* (MIT Press, 1988) at 65, 66–92.

<sup>7</sup> Output levels will reduce below “non-monopsony levels”. Roger D. Blair & Jeffrey L. Harrison, *Monopsony in Law and Economics* (Cambridge, 2010) at 46; Jonathan M. Jacobson & Gary J. Dorman, “Joint Purchasing, Monopsony and Antitrust” (1991) 36 Antitrust Bull 1.

<sup>8</sup> Oligopsony represents another form of distorted competition and a demand-side mirror image of an oligopolistic market. Each purchaser is powerful enough to influence the market, but cannot act independently to the extent that it can ignore the reaction of other competitors to its actions. Coordination between buyers would maximise collective buyer profit. On the condition for successful coordination between oligopsonists, see: James Murphy Dowd, “Oligopsony Power: Antitrust Injury and Collusive Buyer Practices in Input Markets” (1996) 76 B.U.L. Rev. 1075; OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 31.

<sup>9</sup> Absent price discrimination, monopsony and oligopsony will result in quantity distortion and loss of efficiencies. This is aggravated when the monopsonist benefits from market power downstream. See: OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, Background Note.

buyer are present, buyers may be able to cooperate to decrease purchase levels below the competitive equilibrium quantity, and achieve a lower procurement price. This conduct may trigger similar distortion on the market, leading to higher production costs, wasteful expenditure, limited output and possible higher prices, all to the detriment of consumers. The welfare reducing result of collusive monopsony will be similar to that of a monopsony.<sup>10</sup>

It is important to highlight the main assumptions at the heart of the model. It assumes that the buyer faces a competitive upstream market and that each additional unit purchased by the monopsonist will *increase* the unit cost that will apply to all of the procured units. While valuable as a proxy to some markets, the model's assumptions preclude its applicability to most markets. This is so as in the majority of markets one expects to see *bilateral negotiation* between the parties, which lead to a *reduction* in price for any additional unit of input.<sup>11</sup> "Bargaining theory" provides an alternative, and more subtle, approach to analysing buyer power.

## B. Bargaining Theory

In a bargaining scenario, a buyer faces an identifiable decision-maker with whom it engages in bilateral negotiation. Its actions may therefore trigger a range of responses from the other player as the two parties engage in dynamic bargaining. The outcome will lead to specific and unique contract which need not reflect agreements with other players on the market.

A bargaining process differs from the monopsony model described above at several fundamental points. First, in a bargaining situation the buyer faces another identifiable decision maker with whom it engages in bilateral negotiation and does not engage in anonymous deals.<sup>12</sup> Second, bargaining model assumes that lower prices are obtained by the threat of shifting demand, rather than the actual withholding of demand.<sup>13</sup> Third, the bilateral negotiation between the parties is likely to lead to a *reduction* in price for any additional unit of input.<sup>14</sup>

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**10** V. Bhaskar, A. Manning & T. To, "Oligopsony and Monopsonistic Competition in Labor Markets" (2002) 16 J. Econ. Perspectives 155–174; Roger G. Noll, "Buyer Power and Economic Policy" (2005) 72 Antitrust L.J. 589.

**11** On this point, see Office of Fair Trading, *The Competitive Effects of Buyer Groups, Economic Discussion Paper, A Report prepared for the OFT by RBB Economics* (OFT 863, 2007).

**12** Alan Coddington, *Theories of the Bargaining Process* (Chicago: Aldine Pub Co, 1968) at 4.

**13** The overall goal of the negotiation is to lower the input price and increase the quantities purchased.

**14** Office of Fair Trading, *The Competitive Effects of Buyer Groups, Economic Discussion Paper, A Report Prepared for the OFT by RBB Economics* (OFT 863, 2007) at 5–6; OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 22–24.

The outcome of the negotiation may depend on several variables which include, among other things, the firms' outside options.<sup>15</sup> The value of the buyer's outside option depends primarily on its market power, absolute and relative size,<sup>16</sup> and the level of competition on the upstream market. The seller's outside option mainly depends on the ability to reach consumers through alternative channels. As such it is influenced by the buyer's relative market power. The lower the value of an outside option is, the less credible is a threat of shifting demand or supply. Other main variants which affect the negotiation outcome include the firms' access to inside option,<sup>17</sup> the risk of the negotiations breaking down,<sup>18</sup> cost and time sensitivity, and access to information.

By contrast to the assumption of welfare loss in a monopsony model, bargaining scenario represents a more complex reality in which the welfare consequences vary depending on market realities.

The exercise of bargaining power (*i.e.*, buyer power which does not amount to monopsony power) will often enhance efficiency and welfare. The ability to reduce the price for input through successful bargaining often implies that the prevailing price is above marginal levels and the supplier benefits from some market power. In other words, absent market power, *i.e.*, in a competitive environment, there would be no margin for discount as sellers will not discount below marginal costs. Accordingly, the exercise of bargaining power is efficiency enhancing.<sup>19</sup> One would expect it to bring the input price and quantity closer to competitive levels. Subject to the firm not benefiting from market power downstream, the lower wholesale price which was attained via bargaining power is likely to be welfare enhancing, as saving upstream will be transferred to consumers in the form of lower prices.<sup>20</sup>

Yet, at times, bargaining power may give rise to negative welfare effects. These include waterbed effects, spiral effects, dynamic effects and quality erosion. "Waterbed effects" stem from a buyer's favourable bargaining position

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**15** This represents the ability of one of the parties to the negotiation to find another trading partner. On the role of outside options in negotiations, see Abhinay Muthoo, *Bargaining Theory with Application* (Cambridge: Cambridge University Press, 1999), c. 5.

**16** The larger the buyer, the greater its outside options. OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 40, referring to Katz, "The Welfare Effects of Third Degree Price Discrimination in Intermediate Goods Markets" (1987) 77 *Am. Econ. Rev.* 154.

**17** Contrast with outside option which would lead to terminating the negotiations.

**18** Abhinay Muthoo, *Bargaining Theory with Application* (Cambridge, 1999), c. 4.

**19** OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 43.

**20** For a detailed account on the consequences of the exercise of buyer power, see OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 42–53.

which may increase input costs for other buyers.<sup>21</sup> Accordingly, the increase in the buyer's volumes and size will have a negative impact on its competitors.<sup>22</sup> "Spiral effects" may enhance the buyer's market position as a result of other competing buyers being pushed out of the market.<sup>23</sup> As smaller buyers are pushed out of the market, concentration levels will increase. "Dynamic effects" concern the negative effects buyer power may have on investment in new products or product improvements, to the detriment of consumer.<sup>24</sup> "Quality erosion" concerns instances in which increase pressure on input price will lead the seller to undermine quality in an attempt to retain profitability.<sup>25</sup>

The crucial distinction to bear in mind is that in a non-monopsony scenario, welfare loss cannot be assumed. It is necessary to consider and balance the effects of the execution of buyer power. Given that the bargaining power scenario is the more readily applicable model, this can make the question of enforcement challenging as it is not always clear whether buyer power and bargaining process results in harm to consumer or merely affects the distribution of profit along the supply chain.

Having established the economic foundations for the analysis of buyer power, we turn to explore the ways in which unilateral and collusive buyer

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**21** The lower price negotiated by the buyer group and the supplier results in higher price to non-members. For a detailed analysis of these points see: OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38; Office of Fair Trading, *The Competitive Effects of Buyer Groups, Economic Discussion Paper, A report prepared for the OFT by RBB Economics* (OFT 863, 2007), at 17–18; also see Bundeskartellamt, *Buyer Power in Competition Law – Status and Perspectives* (2008), submission by Germany to the OECD, online: <[http://www.bundeskartellamt.de/wEnglisch/download/pdf/2008\\_ProfTagung\\_E.pdf](http://www.bundeskartellamt.de/wEnglisch/download/pdf/2008_ProfTagung_E.pdf)> (last accessed 30 September 2013). The U.K. Competition Commission has addressed waterbed effects as part of its 2008 grocery sector inquiry. See OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 69, 236–237.

**22** Waterbed effects may be the result of changes in the supply market (e.g. reduction in number of suppliers) which were triggered by the buyer power, increase in barriers to entry, or market share shifting. For a detailed review of these three theories, see OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, at 50–54.

**23** Note that intervention in this case is problematic, as it requires foregoing welfare gains to consumers who benefit from lower prices due to a speculative fear of future exit by competitors from the market and increased concentration. See OECD, "Monopsony and Buyer Power" [2008] DAF/COMP(2008)38, Background Note.

**24** When competition upstream is high, suppliers' margins will be limited. When faced with concentrated downstream market and buyer power, both incentive and capacity to invest upstream would be limited.

**25** On the limited instances in which quality erosion may take place – see: Ariel Ezrachi & Koen de Jong, "Buyer Power, Private Labels and the Welfare Consequences of Quality Erosion" (2012) 5 ECLR 257.

power could be manifested and the application of the competition provisions in China and Hong Kong.

### III. UNILATERAL BUYER POWER AND DOWNWARD PRESSURE ON PRICE

The exercise of buyer power often results in downward pressure on price. The buyer, benefiting from a superior bargaining position, may be in a position to extract a lower input price. As illustrated above, the effects of such practices depend on market characteristics. Indeed, the presence of a powerful bargaining position, from which the buyer benefits, and its ability to negotiate lower purchase prices, does not necessarily represent a competitive problem. This may merely reflect the reality of commercial contracting in which bargaining power determines the distribution of profit along the supply chain. At times, however, the exercise of such bargaining power may generate welfare harm and may justify intervention. Distinguishing between harmful buyer power and legitimate bargaining is not always easy.

#### A. Illustrative Examples

One noticeable sector in which allegations of excessive downward pressure on price have been common is the retail market, characterised by the presence of large supermarket chains. These markets are often characterised by high levels of concentration. Very large supermarket chains and outlets often dominate the distribution channels and create a bottleneck through which producers have to operate in order to reach a large segment of final consumers. To appreciate the dependency of producers on the retailer as distribution channel, one can simply reflect on the prohibitively high costs to suppliers of switching distribution channels. It is generally accepted that switching between distribution channels is difficult, costly and usually impossible in the short term.<sup>26</sup> When these channels capture a significant part of the market, switching may not be possible at all. In an attempt to quantify this, it has been suggested, on this point, that a loss of 22 percent of turnover is the figure “above which a customer can be replaced only at the cost of very heavy financial losses, if at all.”<sup>27</sup>

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<sup>26</sup> *Ibid.*, at paras. 97, 102.

<sup>27</sup> *Ibid.*, at para. 101.



Concentration at the retail level has attracted much media attention in both China and Hong Kong, raising suggestions as to possible illicit use of buyer power in these sectors. In the context of downward pressure on price, the following examples are illustrative.

In China, a much-publicised case that demonstrates the relative market power of major retailers in city-level markets is that of Carrefour and the Shanghai Seed and Nut Roasters Association (SSNRA). In 2003, a dispute arose in respect of “slotting fees” demanded of the SSNRA by Carrefour.<sup>28</sup> Carrefour was the single largest grocery retailer in the city with substantial market power which it brought to bear in its dealings with the SSNRA. It was able to secure significant discounts and high slotting fees from the SSNRA. Members of the SSNRA, which itself benefited from market power upstream, threatened to refuse to supply Carrefour on these price terms. But when the matter eventually resolved, the SSNRA had been forced to accept Carrefour’s terms. The outcome of the dispute reflects Carrefour’s buyer power in the relevant market segment. Other upmarket grocery chains also demand similar discounts and slotting fees in the higher-end grocery markets in the most developed Chinese cities, which tend towards oligopoly.<sup>29</sup>

More recently, there have been wide spread press allegations that major retailers’ slotting fee policies are driving down manufacturers margins but that these input cost reductions have not been passed on to consumers. Carrefour was again specifically mentioned with an anonymous supplier quoted as saying: “We have to cooperate with Carrefour even though we cannot earn anything because many manufacturers demand that their products are sold in Carrefour stores. Carrefour has taken advantage of our weak position and forced on us all kinds of fees and charges.”<sup>30</sup> Another example again the retail sector is market power exercised by the two largest electronic/electrical goods chains – Gome and Sunning. These chain stores dominate the Chinese electrical goods retail market and have been accused on numerous occasions of imposing lower purchase prices on manufacturers, especially small and medium-sized suppliers as well as demanding high slotting and other fees to allow goods access to their

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**28** The top six members of the SSNRA occupied around 75% market share in the Shanghai city region, that had at the time a population of over 20 million consumers, due to the high quality and good reputation of the products.

**29** Hao Wang, “Slotting Allowances and Retail Market Power”, China Center for Economic Research, Peking University.

**30** Chen Yali, “Slotting fees push commodity prices higher” *Shanghai* (19 October 2011), online: Shanghai <http://www.shanghaibao.net.cn> (last accessed 29 February 2012).

stores. This problem is not new and has been a hot topic of discussion in the Chinese business press at least since the middle of the last decade.<sup>31</sup>

The phenomenon of high slotting fees in China has been attributed to a weak national distribution system that means that local manufacturers have little choice but to sell to local distributors. Another posited cause is the inability of small manufacturers to develop brand awareness in anything more than a very localised market, again ensuring that they can only sell via local retailers.<sup>32</sup> Further, it is a structural feature of the Chinese distribution system that there are a number of intermediate agents and wholesalers that stand between the producer and the ultimate retailer, and that has also been blamed for facilitating high slotting fees.<sup>33</sup> In practice, it is likely to be a combination of all of these factors, combined with concentrated downstream markets and the buyer power that goes with it. The Government has tried to intervene; regulations were enacted in 2006 to attempt to regulate commercial relationships between retailers and suppliers, but these rules have been widely ignored and have proved to be largely ineffective.<sup>34</sup>

The story is similar in Hong Kong, where the retail grocery market is dominated by a supermarket duopoly. Similar allegations of the use of buyer power to squeeze suppliers have been made in relation to the imposition of slotting fees and other charges, as well as other commercial practices that operate to the detriment of suppliers. The concessions extracted from suppliers would be unlikely to occur but for the degree of control exercised by the duopoly.<sup>35</sup>

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**31** Wu Xiong Guang & Li Ling, “Financial Survival in the Electrical Retail Market” *Xin Cai Fu* (September 2005), at 43–59.

**32** Lisa Hui, “Poor Logistics Prop Up Slotting Fees” (19 October 2011), online: <<http://cib.shangbao.net.cn/c/59664.html>> (last accessed 30 September 2013).

**33** Lisa Hui, “To Collect or Not?” *Shanghai Bao* (14 December 2011), online: Shanghai Bao <<http://www.shanghobao.net.cn>> (last accessed 29 February 2012).

**34** Measurers for the Administration of Fair Dealing Between Retailers and Suppliers, Order no. 17 of 2006, Ministry of Commerce, National Reform and Development Commission, Ministry of Public Security, State Administration of Taxation and State Administration of Industry and Commerce.

**35** See David Web, “Hong Kong Needs a Competition Law” (13 July 2001), online: <<http://www.webb-site.com/articles/noncompete.asp>> (last accessed 30 March 2012). See also “Disposal of Hong Kong Stores” *Carrefour Press Release* (18 December 2000), online: Carrefour Press Release <<http://www.carrefour.com/cdc/press/press-release/financial-news-releases/disposal-hong-kong.html>> (last accessed 30 March 2012). See also “Small Store Causes Stir by Selling Cheaper Noodles” *The Standard* (3 November 2011).

Moving away from the retail sector, another illustrative example of buyer power concerns the situation in the Chinese pharmaceutical products market. In China, the supply of pharmaceutical drugs is dominated by dispensaries at hospitals. China does not have an equivalent of a family doctor service and patients usually see doctors at out-patient departments attached to a hospital. The vast majority of hospitals are public institutions controlled by local government entities throughout the country and are subject to various price control mechanisms regulating inpatient and outpatient care. However, hospitals supply of medicines is not price regulated. As such they can and do use a high drug charging structure to cross-subsidise the low regulated price they are required to charge for direct medical care. However, given the power hospitals have in the market for supplying medicines, they individually and collectively have market power over upstream suppliers and are able to exert a downward price pressure on suppliers. In Guangzhou, the largest city in southern China, hospitals have also been accused of using their market power to require suppliers not to supply goods to discount retailers to ensure the continuance of their dominant position.<sup>36</sup>

A more general illustration of the exercise of buyer power may be found in the existence of many state enterprises that occupy a monopoly (or oligopoly) position in many Chinese domestic markets who have undoubted market power to impose a downward pressure on input markets.

## B. Competition Law Intervention – Establishing Dominance

Having established that buyer power is an issue in both China and Hong Kong, we will now examine how the law of each territory treats it. It is first key to note that whilst The People's Republic of China incorporates Hong Kong, Hong Kong retains a high degree of legislative autonomy and mainland laws do not generally apply in Hong Kong.<sup>37</sup>

As with many other regimes, the application of competition law in both China and Hong Kong to instances involving unilateral use of buyer power is first conditioned on establishing that the powerful buyer benefits from a specified degree of market power.

Under Chinese law, one distinct badge of a “dominant position” is that a business operator is “able to control prices”. Article 19 of the *Anti-Monopoly*

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<sup>36</sup> Lin Wen Qiao, “Why Do Cheap Drug Stores Fail?” *Southern Metropolis Daily* (21 May 2004).

<sup>37</sup> See *The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China* (1990), specially Arts. 12, 17, 18 and 19.

*Law* (“*AML*”)<sup>38</sup> provides an evidentiary presumption of single firm dominance where it enjoys a market share of not less than 50 percent of the relevant market or where two operators hold, in aggregate, 66 percent of the market or three operators have 75 percent. Article 18(2) notes that one of the factors to be taken into account in determining whether a business operator has a dominant market position is whether “control” is exercised over procurement markets. Article 10 (2) of the State Administration of Industry and Commerce (SAIC) Rules stipulates that “control” of procurement markets will be determined by (1) the ability to control procurement channels or (2) the ability to influence or determine prices, quantities, or the duration of supply contracts or (3) the ability to obtain priority access to raw materials, semi-finished products, parts and components necessary for the firm’s production or business operations.<sup>39</sup>

The approach in Hong Kong is similar. Under the *Second Conduct Rule of the Hong Kong Competition Ordinance* (the “*Ordinance*”),<sup>40</sup> undertakings are prohibited from abusing a “substantial degree of market power”. The “substantial degree of market power” test was chosen in preference to a “dominance test” (the standard used in the E.U. and other established national competition law regimes, like the U.K.) precisely because many Hong Kong markets are oligopolies and the Government sought to lower the evidentiary burden to establish market power. The *Ordinance* does not make any further specific reference to buyer power per se. However, it is anticipated that as the substantive prohibitions and legislative schema are modelled on the *U.K. Competition Act*, and so the Hong Kong provisions derive ultimately from E.U. competition law, reference in forthcoming implementation guidance to be written by the Hong Kong Competition Commission will at the very least, make reference to British and E.U. jurisprudence on this issue, notwithstanding that the substantive standard for assessing market power is different.

As with many other advanced competition law regimes like, for example the E.U. or the U.K., when dominance or substantial degree of market power is established, the analysis turns to whether that position of power has been abused.

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**38** The *Anti-Monopoly Law* of the People’s Republic of China was enacted on 30 August 2007 and entered force on 1 August 2008.

**39** State Administration of Industry and Commerce “Rules on the Prohibition of Monopoly Agreement Behavior”, Order No. 53 of 2010 dated 31 December 2010 effective 1 February 2011.

**40** The *Competition Ordinance* was gazetted on 22 June 2012 (Ordinance No. 14 of 2012). Whilst it is being gazetted, it will be put into force in stages of over one to two years due to the appointment and setting up of a Commission.

### C. Competition Law Intervention – Establishing Abuse

The question of abuse is most challenging when evaluating downward pressure on price. Lower prices are usually a positive sign of a competitive market which would benefit consumers. How does one determine the price level below which prices suggest abusive pressure? Recall that, in the more realistic bargaining model, harm to consumers cannot be assumed simply because there is “buyer power”. In order to make the tough decision as to whether to intervene, policy ideas as to the aims of the competition regime may be involved. The question the competition agency must ask itself is whether to intervene only when harm to consumers has been established, or should it seek to protect the market structure as such, and intervene to protect the interests of the upstream producers and sellers.

Under Chinese law, the most relevant provision is Article 17 *AML* which prohibits “business operators who hold a dominant position” from “abusing” such a position. Exercise of buyer power is expressly dealt with. Article 17(1) enumerates *inter alia* that “purchasing commodities at an unfairly low price” constitutes an abuse. Article 11 of the National Reform and Development Commission (NRDC) Provisions gives guidance as to determining what constitutes an “unfairly low price”. It provides that the following factors must be taken into account: (1) whether the purchase price is markedly higher or lower than the price at which other business operators purchase the same type of goods; (2) where costs are essentially stable, whether the purchase price has been lowered beyond the normal range; (3) whether the range of the price reduction for the purchased goods is markedly greater than the transaction counterparty’s cost reduction range; and (4) any other related factors that need to be taken into consideration.<sup>41</sup>

Under the Second Conduct Rule of the *Hong Kong Competition Ordinance*, undertakings would be prohibited from abusing a “substantial degree of market power” by engaging in conduct that has the object or effect of preventing, restricting, or distorting competition in Hong Kong. A non-exclusive list of prohibited conduct is provided. While unfair pricing conduct is not specifically mentioned, it might be included in forthcoming guidance to be issued by the Commission, once established. Consequently, it is uncertain whether “abusive conduct” by an undertaking exercising market power in a monopsony market will be caught or not.

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<sup>41</sup> The Anti-Price Monopoly Provisions promulgated by the National Development and Reform Commission on 29 December 2010 and effective on 1 February 2011.

China makes express provision for excessive downward pressure on price; Hong Kong's proposed rules seem able to deal with it. The difficulty, however relates to whether and when intervention in such cases would be triggered.

At the *policy level*, the question of intervention depends on aims and scope of each competition regime. A narrow view of the aim of competition law would favour intervention only when consumer harm is established,<sup>42</sup> most likely when monopsony conditions are present. As discussed, those conditions are rare. In all other instances, downward pressure on price would be treated as part of the bargaining process which determines the distribution of profit along the supply chain but does not trigger intervention. A wider view would call for intervention in additional instances, for example when market structure is undermined. That approach would safeguard not only consumer welfare but also the process of competition. In Europe, for example, in the context of the application of Article 101 TFEU, the Court of Justice held that Article 101 TFEU “aims to protect not only the interests of competitors or of consumers, but also the structure of the market and, in so doing, competition as such.”<sup>43</sup>

At the *practical level*, difficulty exists in determining which level of price is unfairly low and constitutes an abuse, and which level reflects the outcome of legitimate bargaining between the parties. This is a challenging question. On one hand, the ability to reduce the price for input through successful bargaining often implies that the prevailing price was above marginal levels and the supplier benefited from some market power.<sup>44</sup> On the other hand, it is possible that pressure from buyers led the seller to price below marginal costs – at a loss – in an attempt to retain the distribution channel.<sup>45</sup>

In Europe, these difficulties have led to some scepticism as to the merit in challenging downward purchase on price by a *single buyer*. Nonetheless, in some instances such pressure triggered investigation into possible abuse of dominant position. The difficulty in establishing such form of abuse may be illustrated using the U.K. Office of Fair Trading approach in the *BetterCare* case. There, the OFT has received complaints alleging the payment of excessively low purchasing prices but the complaints were dismissed in light of the lack of evidence. The OFT stated in its decision rejecting the complaint that “paying

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<sup>42</sup> See the *Weyerhaeuser* case in the U.S., where the U.S. Supreme Court requested the same standard in predatory bidding and predatory pricing cases. *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 127 S. Ct. 1069, 1077 (2007).

<sup>43</sup> Case C-501/06, “GlaxoSmithKline Services Unlimited v Commission” [2010] 4 CMLR 2 (ECJ), at para. 63.

<sup>44</sup> OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 43.

<sup>45</sup> Ariel Ezrachi & Koen de Jong, “Buyer Power, Private Labels and the Welfare Consequences of Quality Erosion” (2012) 5 ECLR 257.

excessively low purchase prices is likely to amount to an abuse ... only in exceptional circumstances.”<sup>46</sup> An uncommon instance in which unilateral downward purchase of price was found abusive concerned the Polish Competition Authority’s review of the Polish Health Fund (NFZ), which holds a monopoly position in the provision of health care and was found to abuse its buyer power by artificially underpaying for dental services for which it contracted.<sup>47</sup> As the larger buyer of such services the NFZ was accused of abusing its monopsony power by imposing unfairly low purchase prices while contracting dental services. In doing so it took no account of the reasonable costs nor did it guarantee fair profits, or at times any profits, for dental services providers. According to the Polish Competition Authority,

[t]he rationale for intervention in this case was that in the long run the imposition of the dental services contracting price that is too low to reimburse reasonable costs would tend to inhibit investment and decrease service standards provided by the NFZ’s suppliers. It might also force some of the contractors to leave the market – especially those that are public and do not have a possibility to provide private services simultaneously with those contracted by the NFZ – leaving the market underserved.<sup>48</sup>

## D. Other Forms of Abuse

While our paper concerns the effects and legality under the competition provision of downward pressure on price, it is worth noting, that at times the presence of buyer power may be used as a leverage not only to lower the input price, but also to force the seller to engage in activity which may harm competition. For example, a powerful buyer may force the seller to impose price discipline in its agreements with other buyers, thus using the vertical channel to dampen horizontal competition and indirectly fix the *selling* price. Alternatively, it may threaten to restrict or stop purchases from the supplier if the latter supplies other competitors or new entrants, thus foreclosing the market and

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<sup>46</sup> Case No CA98/09/2003, *BetterCare Group Ltd/North & West Belfast Health & Social Services Trust*, at para. 58. See OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 235.

<sup>47</sup> OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 213.

<sup>48</sup> OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 213. For similar examples from the health care sector in the Netherlands, see OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 209–211. For relevant cases on the abuse of a dominant bargaining position by large-scale retailers in Japan, see OECD, “Monopsony and Buyer Power” [2008] DAF/COMP(2008)38, at 197–199. For other reported cases of abuse of dominance by buyers, see ICN, *Special Program for Kyoto Annual Conference: Report on Abuse of Superior Bargaining Position* (2008), at 31–32.

excluding competitors. Such instances are outside the scope of this paper. Generally, these practices are more obvious infringements of the competition provisions through horizontal price fixing or foreclosure of markets and would more readily trigger intervention.<sup>49</sup>

## IV. COLLUSIVE BUYER POWER – THE CASE OF PURCHASE PRICE FIXING

In the section above we illustrated the difficulty of dealing with the *unilateral* use of buyer power as a mean to lower purchase price. A mixture of effects and policy goals makes the judgement call as to intervention a difficult one. We now turn to explore the treatment of collusive buyer power – instances where several smaller buyers join forces and use their combined market power to create downward pressure on price.

The distinction between unilateral and coordinated action impacts on the competition analysis and has far reaching consequences with respect to the finding of an infringement of competition law. Although both unilateral and coordinated use of buyer power may have similar effects upstream, the collusive nature of the agreement between buyers will trigger the application of the law dealing with agreements between companies, and as such invoke the considerations attached to those provisions. In other words, in the case of collusive buyer power the analysis of effects is preceded by consideration of the nature of agreement between the buyers.

In what follows we focus on agreements between buyers to fix the purchase price in their dealing with a given seller. The price fixing confronts the seller with buyers that are willing to purchase its output only at a reduced price. This practice enables the buyers to present a single front in their dealing with the seller and limit its “outside options” to trade with other buyers. They subsequently result in lower purchase price, to the benefit of the buyers.

From a competition law perspective, the main concern in such cases is not the effect of buyer power but rather the collusion between competitors and the act of purchase price fixing. Indeed, this is the approach under E.U. competition law.

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<sup>49</sup> An example of this type of conduct has been recently observed in the Hong Kong grocery market where one of the incumbent supermarket duopolists allegedly applied pressure to a manufacturer of a popular variety of noodles to enforce a standard resale price level when another grocer had discounted the resale price of the product. See Alice So, “Small Store Causes Stir by Selling Cheaper Noodles” *The Standard* (3 November 2011).



The wording used in both Chinese and Hong Kong competition regimes to address possible collusion resembles the European Competition Law regime. In as much as the former competition regimes are modelled upon the substantive E.U. competition law, it can be assumed that they will follow a similar approach. Accordingly, while to date no buyer cartels have been sanctioned either in the Hong Kong or China, the following discussion of E.U. competition law may provide valuable analytical framework for the assessment of purchase cartels.

## A. Outright Condemnation of Input Price Fixing

In several instances the European Commission and Court clearly condemned purchase price fixing activities. In the *Raw Tobacco Spain* decision, a cartel of tobacco processors which aimed, among other things, to reduce the price paid to producers for raw tobacco, was sanctioned.<sup>50</sup> Similarly in *Raw Tobacco Italy* the Commission noted that “purchase price is a fundamental aspect of the competitive conduct of any undertaking operating in a processing business and is also, by definition, capable of affecting the behaviour of the same companies in any other market in which they compete, including downstream markets.”<sup>51</sup> In *BNIC v Clair*<sup>52</sup> the European Court noted that “it is unnecessary to take account of the actual effects of an agreement where its object is to restrict, prevent or distort competition. By its very nature, an agreement fixing a minimum [purchase] price for a product ... is intended to distort competition on that market.”<sup>53</sup> Indeed it is generally accepted that “an agreement or decision on the part of buyers to fix the purchase price on a given market must be understood to have as its object to restrict competition, without the need, at that stage of the analysis, for any investigation of its competitive effects.”<sup>54</sup>

It is important to note that the strong condemnation of input price fixing is independent of the presence of buyer power. In other words, collusive input price fixing is condemned regardless of the joint entity occupying a significant market position. Accordingly, the presence of collusive monopsony or bargaining power, is not requisite to trigger the finding of anti-competitive agreement or

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<sup>50</sup> Case COMP/C.38.238/B.2, *Raw Tobacco Italy*.

<sup>51</sup> *Ibid.*, at para. 280.

<sup>52</sup> Case 123/83, *Bureau national interprofessionnel du cognac v Guy Clair* [1985] ECR 391.

<sup>53</sup> *Ibid.*, at para. 22.

<sup>54</sup> Opinion of Advocate General Jacobs in Joined Cases C-264/01, C-306/01, C-354/01 and C-355/01, *AOK Bundesverband and others v Ichthyol-Gesellschaft Cordes and others* [2004] ECR I-2493.

practice. It is the act of input price fixing which triggers the condemnation, regardless of the effect on the market.<sup>55</sup>

The focus on anti-competitive object with no regard as to downstream effects treats price fixing as anti-competitive irrespective of its effect on consumers. As such, it sets out to protect the structure of the market and prevent the distortion of competition.<sup>56</sup> As will be illustrated below, purchase price fixing activity is distinguished from open and public amalgamation of orders by a buying alliance.

## B. Price Setting as Part of Open and Public Activity of a Buying Alliance

It is accepted that at times, the creation of a buying alliance – that is an agreement between buyers to coordinate their purchasing strategies, may yield efficiencies. This may arise primarily from aggregating purchases by small undertakings and achieving economies of scale, which position the group on an equal footing with larger traders.<sup>57</sup> These benefits mitigate towards a more lenient approach when examining the activities of a buying alliance. For example, when dealing with transparent buying consortiums the European Commission has considered the effects of the agreement and refrained from outright condemnation of it, even if it included provisions which set the purchase price.<sup>58</sup> Often, in such instance the setting of purchase price is viewed as an ancillary function to the collaborative agreement. The effects based approach reflects the view that transparent buying alliances, which activities result in input price fixing, cannot be assumed to have the object of restricting competition and should be analysed in view of the effect they generate.

In such instances consumer harm is used as the threshold for intervention, rather than the mere existence of input price fixing. One would therefore expect the analysis in such instances to refocus on the presence of buyer power and

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<sup>55</sup> A. Ezrachi, “Buying Alliances and Input Price Fixing – In Search of a European Enforcement Standard” (2012) *J. Compet. L. Econ.* 8(1), 47.

<sup>56</sup> Case C-501/06, *GlaxoSmithKline Services Unlimited v Commission*, at para. 63 noted in A. Ezrachi, “Buying Alliances and Input Price Fixing – In Search of a European Enforcement Standard” (2012) *J. Compet. L. Econ.* 57.

<sup>57</sup> European Commission First Report on Competition Policy, para. 40.

<sup>58</sup> 80/917/EEC, Commission Decision of 9 July 1980 (IV/27.958 *National Sulphuric Acid Association*) [1980] O.J. (L 260) (paras. 31–36); Case 61/80, *Coöperatieve Stremmel – en Kleurselafabriek v Commission* [1984] ECR 0851 (para. 22).

consider whether the joint effort results in collusive monopsony or whether it should be analysed through the prism of bargaining theory.

### C. Input Price Fixing in China and Hong Kong

Having outlined the European Commission's approach to purchase price fixing and to buying alliances, we turn to examine their treatment in China and Hong Kong. Unsurprisingly, as in the E.U., the legal provisions outlined below set up a stringent approach to price fixing. That approach encompasses instances of both sale and purchase price fixing.

Under Chinese law, Article 13 *AML* provides that certain “monopoly agreements” between competing business operators are prohibited. These include, among others, agreements that: fix the prices of commodities; agree quantitative restrictions; divide downstream sales markets or upstream procurement markets; or agree joint boycotts. No distinction is made between the object or the effect of the agreement. These types of agreement may be exempted under Article 15 *AML*. Among other things, exemption may be granted if the parties can prove that the object of the agreement is to improve product quality, reduce production costs, improve efficiency, or increase the efficiency or competitiveness of small or medium-sized enterprises.

The SAIC Implementation Rules<sup>59</sup> identify agreements between competitors to allocate procurement markets between themselves based on quantities or geography as being unlawful. Other delegated legislation, issued by the NRDC deal with monopoly agreements that restrict price competition.<sup>60</sup> The NRDC Anti-Price Monopoly Provisions<sup>61</sup> specifically deal with collusive horizontal

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<sup>59</sup> Rule 5, State Administration of Industry and Commerce “Rules on the Prohibition of Monopoly Agreement Behavior”, Order No. 53 of 2010 dated 31 December 2010 effective 1 February 2011.

<sup>60</sup> It should be explained that under China's complex enforcement regime, three agencies have differing and, to some extent, overlapping enforcement responsibilities. NRDC is charged with dealing with “price monopoly” cases whether they involve unilateral conduct or collusion between competitors. Non-price monopoly cases are under the purview of the SAIC. The ability to distinguish in any meaningful way between cases where price is or is not a factor will be exceptionally difficult. This matter is an issue of bureaucratic jurisdiction, not of substance. But it explains why two bodies both issue implementing regulations on these issues. A co-operation mechanism is apparently in place to resolve turf wars and the higher level Anti-monopoly Commission of the State Council is charged with resolving any intractable disputes between the agencies.

<sup>61</sup> The Anti-Price Monopoly Provisions Promulgated by the National Development and Reform Commission on 29 December 2010 and effective on 1 February 2011.

price setting. The Provisions cover both selling and buying prices, with the proviso that the parties must be “competitors”; that is to say, they are at the same level in the supply chain. Article 5 of the Provisions defines price monopoly agreements as “any agreement or decision or other act of co-ordination that eliminates or restricts competition in pricing.” Article 7 prohibits various types of anti-competitive agreement. Of particular relevance to buyer cartels is Article 7(4)-(6) which prohibits agreements whereby the parties agree upon a price to be used as the basis to deal with a third party; or where they adopt a standard pricing formula for calculating price; or where they accept mutual obligations not to vary prices paid or charged without the consent of the other party to the monopoly agreement.

In Hong Kong, section 6 of the *Competition Ordinance* prohibits agreements or concerted practices where the object or effect is to prevent, restrict or distort competition in Hong Kong. The *Ordinance* provides a non-exclusive list of prohibited agreements and concerted practices which includes directly or indirectly fixing purchase or selling prices or trading conditions. Pursuant to section 9, undertakings can obtain individual exemption for offending agreements on the basis that (i) the agreement enhances overall economic efficiency by contributing to improving production, distribution, technical or economic progress and (ii) does not impose restrictions that are indispensable to the attainment of these objectives and (iii) will not eliminate competition in respect of a substantial part of the relevant market.

As illustrated above, the law in both China and Hong Kong provides for clear condemnation of purchase price fixing. To date, however, the two authorities are yet to pursue such cases; in the five years since the *AML* has been in operation in China no buyer cartels have yet been uncovered or sanctioned. It is important to note, however, that the Chinese regime has gradually intensified its enforcement. Indeed, very recently cartel enforcement in China has been intensified.<sup>62</sup> It may well encompass buyer cartels in the future. In Hong Kong, the *Competition Ordinance* was enacted in June 2012 and the Competition Commission was only appointed in May 2013. The two Conduct Rules prohibiting anti-competitive agreements and abuse of substantial market power are unlikely to be in force until the end of 2014 and so no buyer or seller cartels have, as yet, been investigated. The increase of enforcement activity is likely to lead to increase number of price fixing cases being sanctioned, some on the buyer side.

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<sup>62</sup> In August 2013, fines amounting to US\$110 million were imposed by the NRDC on five foreign milk power suppliers for price fixing and announcements were made that a number of other investigations were underway. See “Tough-Talking China Pricing Regulator Sought Confessions from Foreign Firms” *Reuters* (21 August 2013).

## V. CONCLUSION

In this paper we explored the economics of buyer power and the legal framework available, in China and Hong Kong, to address unfair and excessive downward pressure on input price. In our analysis we explored the distinction between the treatment of unilateral buyer power and that of collusive buyer power which forms the result of collaboration between several buyers.

The analysis of unilateral buyer power and the imposition of unfair purchase price is dealt with, in both China and Hong Kong, through the prism of dominance and abuse. We illustrated how at times, even when buyer power is established, the question of abuse is challenging at both policy and practical levels. While unfair purchase price may be held abusive, it is not always easy to demark the trigger for intervention.

By contrast, when dealing with coordinated action, the imposition of unfair purchase price is dealt with, in the two jurisdictions, through the prism of anti-competitive agreement. Here, the use of a different set of legal instruments, the provisions dealing with anti-competitive agreements, bypasses some of the difficulties associated with the finding of abuse. In the case of purchase cartels, it is the act of illicit purchase price fixing which is condemned, regardless of the effects it generates or the presence of buyer power. We note however, than when the fixing of purchase price is part of the activities of a legitimate and transparent buying consortium, its analysis will encompass consideration of effects. In such instance, the analysis of unfair purchase price resembles that of unilateral buyer power and focuses on the possible harmful effects generated from the unfair purchase price.