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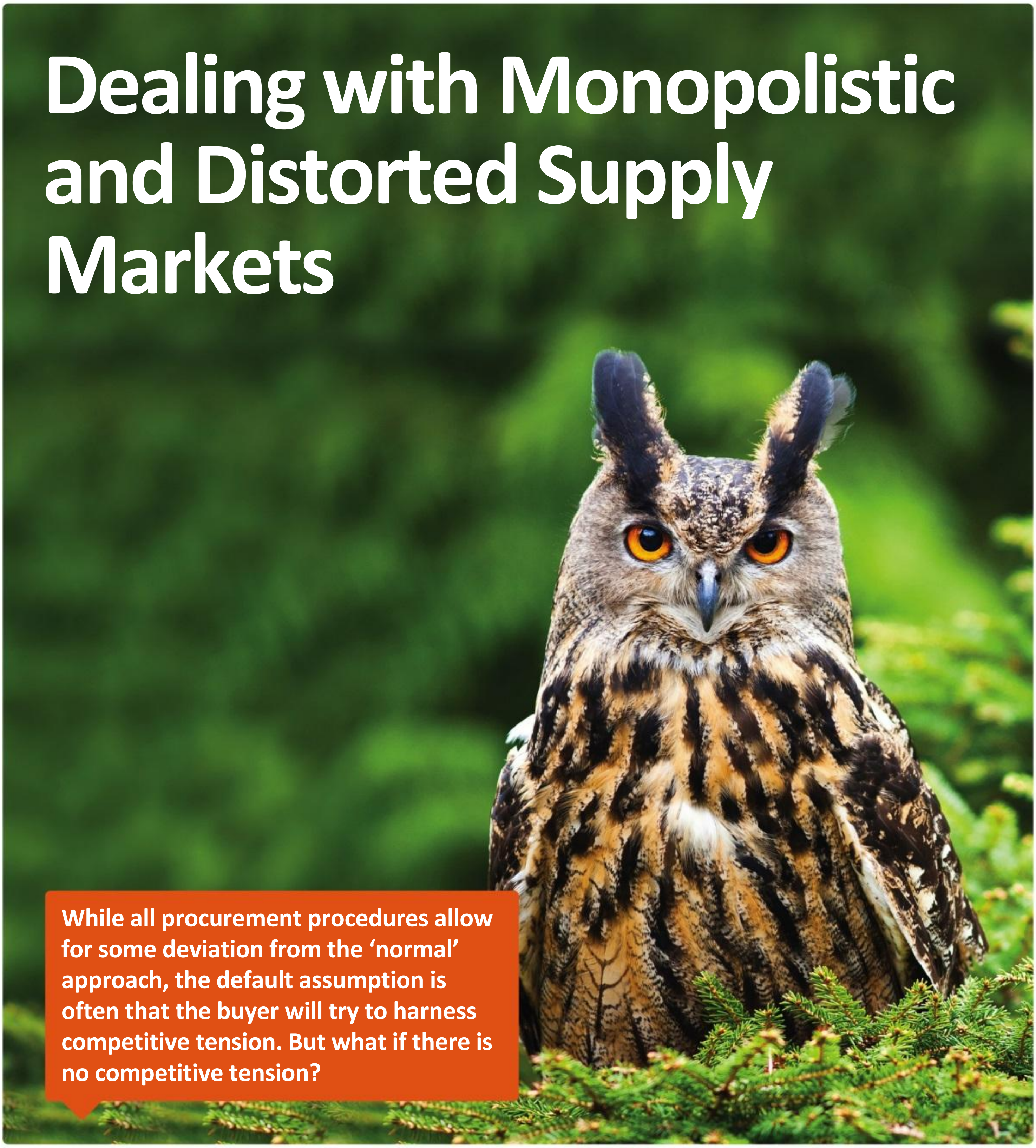
Dealing with Monopolistic and Distorted Supply Markets



While all procurement procedures allow for some deviation from the 'normal' approach, the default assumption is often that the buyer will try to harness competitive tension. But what if there is no competitive tension?

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Introduction

This paper is aimed at procurement practitioners who face markets which are complex and/or distorted. The objective is to help diagnose whether the market we face is distorted, and then suggest a variety of approaches – some tactical and some strategic – which may help get better value from that market.

What is a 'distorted market'?

Unfortunately some procurement procedures used to state that "normally, at least three competitive offers should be invited." The assumption was that there were a variety of suppliers with comparable solutions. More enlightened procedures now recommend varying the process to match the category goals and market[1] environment. While all procurement procedures allow for some deviation from the 'normal' approach, the default assumption is often that the buyer will try to harness competitive tension. But what if there is no competitive tension?

One reason why that the market may lack competitive tension is that the number of suppliers may not be sufficient to generate 'free and open competition', for example as in the case of a monopoly. Thus a distorted market is one where there is not free and open competition. "Free competition[2]" implies that the market participants are actually competing with each other, rather than co-operating with each other, as in a cartel. "Open competition" implies that the barriers to entry in the market are low enough that if the players were able to command premium profits, new entrants would be attracted into the market and would depress profitability to the benefit of the customers. The following causes of market distortion are explored:

- Market structure, i.e. how many suppliers are there in the market?
- Market concentration, i.e. are there a small number of dominant suppliers?
- Competitive rivalry, i.e. are the suppliers competing with each other?

Market structure

How many suppliers do we need to have 'fair and open competition'? Three is the magic number in most procurement policies, but three suppliers do not guarantee competition! We are all familiar with the term monopoly to describe the situation when there is a single supplier in the market, but other reasons why the buyer may face a de-facto monopoly, or at least less than three acceptable sources, include:

- There may be patent or intellectual property limitations which restrict the ability of other suppliers to offer the same or similar solutions;
- The source[s] may be specified by the end-user, leaving limited discretion as to which sources of supply are acceptable;

[1] Defining what is 'the market' is not always straightforward. The two key dimensions are the technical scope and the geographical scope. The technical scope is usually defined in terms of solutions that address substantially the same need. So if we are buying diesel fuel, should we also consider the market for petrol? And is that market a local, regional, national or global market? There are no hard and fast rules, but opportunities may present themselves by broadening your definition of what is 'the market'.

[2] "Free and open competition' implies that the suppliers in the market are genuinely competing with each other so that the basis of competition is 'free' to the buyer, and that there are two or more suppliers in a market with low barriers to entry and limited differentiation of solutions.

- Other solutions available on the market may be technically unacceptable to the business;
- Our switching costs may be so high that we are effectively 'locked in' to one supplier, and any potential benefit from resourcing is exceeded by the switching costs;
- Company policy may prevent sourcing from certain countries or direct buyers to buy from internal business units within the organisation or to buy from nominated suppliers as part of a reciprocal trade arrangement.

Market concentration

Even if there are more than three acceptable suppliers in the market, any markets in Australia and New Zealand have a small number of suppliers who dominate the market[3]. The fact that there are three suppliers in total may mask the fact that two suppliers have a combined market share of more than 90% of the total market by sales. These two suppliers may exert so much market power that they are price makers; they can 'set' the market price with limited risk that they will lose market share. So the number of suppliers in a market is not always a good proxy for the degree of competition between the participants. We need to understand the 'market structure', perhaps by estimating the combined market share of the top four market players[4].

Level of competition

In addition to the number of suppliers in the market and the market structure, we need to consider the extent to which the suppliers are competing with each other. That is a more difficult assessment than the simple assessment of the number of players in the market or the market structure. For example, the players may participate in competitive exercises initiated by the buyer, but compete within frameworks that the suppliers have agreed between themselves, and which act in the suppliers' interest.

Such 'distorted' markets may only become public after discovery by the market regulator, for example the ACCC in Australia. The fact that such anti-competitive behaviour is illegal in many jurisdictions does not mean that cartels do not exist! Given that fines for breaching competition legislation can run into tens [and sometime hundreds of millions] of dollars, this suggests that the rewards for collusion must be so attractive that companies are prepared to run the risk on the grounds that detection is hard, proving collusion is harder still, and the rewards can be substantial.

Symptoms of cartel behaviour

There are three broad types of cartel;

- Price fixing cartel
- Market sharing cartel
- Collusive bidding cartel

A price fixing cartel is one in which the prices bid by the suppliers are the consequence of some agreement between the players, rather than 'fair and open competition'. The fact that

[3] When a small number of firms dominate a market this is known as oligopoly.

[4] One measure of oligopoly is the four-firm concentration ratio. This expresses the market share of the four largest firms in an industry as a percentage; if the four-firm concentration ratio is above 40%, the market is oligopolistic.

bid prices are very similar may be the consequence of intense competition, rather than a cartel, so detecting and proving collusion requires evidence that the pricing behaviour was driven by prior agreement between the players.

As an alternative to a price-fixing cartel, firms can attempt to achieve the same effect by other means, e.g. they may divide up the country between them and agree not to sell in each other's designated area, thereby enabling each to set prices knowing that the others will not undercut them.

At its simplest, a market-sharing cartel may be no more than an agreement among companies not to approach each other's customers or not to sell to those in a particular area. This may involve secretly allocating specific territories to one another or agreeing lists of which customers are to be allocated to which company.

A market-sharing agreement can exist in a number of ways. Suppliers may decide on the share of the market that each player is to 'win'. For example, suppliers may agree that each will get 25% market share. Alternatively, suppliers may decide which firms will 'win' particular contracts. Rigging of bids ensures that suppliers bid for contracts, but the 'winner' is predetermined as the suppliers have planned between who will bid at what price for which contract.

Market sharing is more likely to occur where there are a few dominant suppliers, and buyers are fragmented or are not well co-ordinated. However, many buyers will have experienced suppliers who are more competitive in some territories than others, and proving that the behaviour is not the consequence of geography, logistics or other legitimate market characteristics isn't easy.

Collusive bidding is a form of market sharing agreement where bidders respond to bids, but based upon some collective agreement about 'basement' pricing, or discount levels, or relative pricing levels. The more predictable the buyer, the more likely the bidders can manipulate who will win the bid.

The most common examples of collusive tendering are as follows:

- Bid suppression; one or more bidders decline to bid or withdraw a previously submitted offer, so that a competitor's offer will win;
- Complementary bidding; suppliers submit token bids that are uncompetitive, or submit a deliberately non-compliant bid;
- Bid rotation; bidders submit offers, but the lowest bidder rotates between the players, depending upon whose 'turn' it is to win the contract.

Collusive bidding may be easiest to detect if parcels of work are regularly submitted to competitive offer to the same supplier community, and the buyer has good records on relative supplier competitiveness.

Example
A company had routinely invited offers from the same community of five technically approved bidders. The procurement process routinely accepted the lowest technically-acceptable bid, without post tender negotiation, and awarded a two year contract each time. This happened for four contract cycles, with the successful bidder changing on each occasion.

A review of the market prompted the technical experts to revisit why they had not approved two other potential bidders four contract cycles ago. The original reasons were found no longer to be valid, and when the two excluded bidders were invited to participate in the next bid exercise, their pricing was 15% lower than the originally-approved suppliers and more than 10% lower than the current contract price.

Was this a penetrative price to win the business, or evidence of market collusion?

Other sources of distortion

Reciprocity is an issue in the relatively self-contained markets faced in Australia and New Zealand. Entering into reciprocal deals is relatively simple; decoupling the deals and terminating one of the contracts is more difficult. Good practice is to separate the two relationships, though this can be hard to achieve in practice.

Some markets are subject to increasing consolidation, and so we may face a market with multiple sources which have the same ultimate owners. Venture capitalists are acquiring companies with potential to create superior returns, and the pattern has been that the new owners plan to lose unprofitable customers, and plan to 'harvest' profitable customers.

Harvesting means that we may have an incumbent supplier who is increasing the prices, and our switching costs may be such that we cannot easily change source. In that case, the supplier may exploit us as an account.

Symptoms of exploitative behaviour

The market may or may not be distorted, but suppliers may still behave in an exploitative way. We may not be able to change source for a variety of reasons, and the suppliers may seek to 'harvest' value from such accounts. Here is a checklist to give a 'reality check' on whether the supplier may be exploiting your account. If you answer "yes!" to four or more of these questions, then perhaps some of the tips may be relevant to you:

1. Is our annual spend on the category increasing disproportionately compared with the rate of change in demand or consumption?
2. Is the level of price increases requested by the supplier greater than the underlying rate of inflation for the key cost drivers?
3. Are any supplier performance improvements subject to bargaining for increased service fees, or other billable charges?
4. Are claims and/or additional billable activities greater than other suppliers in other sectors?
5. Is our Key Account Manager in the supplier measured on account profitability?
6. Is there evidence of continual and patent conditioning[5] about cost drivers?
7. Is there evidence of relationship building by the supplier's staff with our technical personnel to try to influence sourcing decisions?
8. Is the supplier's published strategy [e.g. annual accounts] focusing upon margin protection/growth?

[5] Conditioning is the process by which we influence the perception of the other party about the nature of the market, the players, the costs or the need. A price list which is then subject to a 40% discount is a conditioning device. We are persuaded the price is really much higher, but that we are getting a good deal. Why are prices rising? "Demand in China!" these are conditioning messages designed to make us more likely to accept that prices should rise.

9. Is there any evidence that the supplier is trying to 'lock us in' by specification, systems or contracts to restrict our freedom to resource.
10. Does the supplier behave intransigently in negotiations, refusing concessions and seeking rate increases?

You may feel that all your suppliers behave in this way! But if you reflect upon situations where you have limited market power, and you answered "yes!" to four or more of these questions, then perhaps you are being exploited.

Buyer's responses

There are two broad ways that buyers deal with markets:

- Interacting with markets in ways that leave the market substantially unchanged. An example might be the issue of an RFI or other market enquiry. The market is the same after the process as it was before.
- Intervening in markets in ways which change the character of the market. An example might be introducing a new supplier which changes the market dynamic.

If the market has many suppliers with acceptable solutions, there may be no need for the buyer to try to change the market. However, if the market as currently operating does not allow the buyer to meet their procurement objectives, then the buyer needs to try to change the way the market operates.

The conventional 'toolkit' of market interactions may not be appropriate if the buyer has limited power.

Example

We recall one retail buyer negotiating with the market leading soft drink supplier who, frustrated with the perceived intransigence of the cola supplier, threatened the supplier "if you don't come to the party we will be forced to go to tender!"

If we reflect upon the investment of cola suppliers in achieving and supporting their market dominance, what does this crude tactic tell us about the expectations of the buyer as to how easily he could redress the imbalance in market power?

What if the 'big stick' of competition is not available? What next?

If we consider the scale of the challenge to gain market power to try and create a sustainable solution, it is clear that interventions:

- Require a medium term commitment to try and achieve change;
- Cannot only involve the procurement community, but need to involve other stakeholders within the business;
- Do not have a simple 'return on investment' target whereby a project to challenge a monopoly is targeted with achieving outcomes in 90 days with a savings target of, say, 2.5%. A project may last months and may not achieve any tangible benefit, whether in terms of cash releasing or non-cash releasing benefit.

At least give them a try – especially when you don't think they will work! Remember that monopolies are a feature of market structures, and a tactical solution is unlikely to succeed. We need a strategic response, so don't be impatient and expect a resolution within weeks. It is probable that we need a concerted response involving the whole of the organisation and perhaps involving other customers of the monopoly. This implies two things:

- that we need to plan for the "long haul", and have a short term, medium term and a long term plan;

- or that we need to galvanise managers within our own and possibly other organisations to act in a concerted way to change the situation.

1. Source globally

Procurement procedures usually stipulate a requirement to get competitive quotations and often mention the magic number "three". If there are ten suppliers of a category and you invite three quotes then statistically you have a 30% chance of finding the best supplier and a 70% probability of not finding them. No one would suggest inviting ten bids, and no professional procurement person would invite three bids at random, so we need to explore the market thoroughly, and consider sourcing from previously unexplored markets. Even if the market used to be monopolistic, new entrants may have entered the market.

Example
A buyer was buying hundreds of thousands of polystyrene mouldings which had been custom designed for him to fit a special assembly. He knew the pricing was uncompetitive, as like-for-like comparisons with other similar products revealed he was paying a premium for the moulding, which was protected by a patent held by the supplier.

Staring at the moulding one day, he looked at the patent reference embossed on the underside of one of the mouldings. He typed it into Google to see when it expired. Imagine his surprise when he found it was a real patent, but for a completely different product! He invited competitive bids and learned a lesson; even monopolies don't last forever!

Global sourcing, possibly using specialist agencies, can often break what appeared to be a monopoly supply. When the internal script is "there is no one else who can supply this category!", instead of accepting that, validate that it is true. You should not accept that you know all the suppliers in the market until you have undertaken some or all of the following:

- Used an online sourcing directory, preferably with global coverage;
- Referred to specialist trade directory for the category in which you are involved;
- Networked with peers in the same industry in other countries;
- Attended trade fairs, exhibitions or shows in another country;
- Commissioned third party market reviews by specialist agencies or consultants;
- Engaged a sourcing agent to locate suppliers in low cost countries.

"Driving a desk" is the behaviour that involves reviewing markets from the comfort of your own desk. Google is not an effective sourcing tool on its own; the data is filtered by others, and it is of variable quality.

2. Redefine the market that we are dealing with!

Can you reframe the market with which you are already dealing and explore a similar or related market you may be able to develop to supply you? The ease with which you can do this will depend upon the barriers to entry in the market, but consider the opportunity at least.

Example
An airline was faced with a strongly distorted market for the design of cabin interiors. They challenged "what market are we dealing with?" Instead of answering "the market for aircraft cabin interiors", they reframed the market as "the market for interior design in a confined space". A small change, maybe, but that prompted them to consider "who else can supply similar services in related industries that could be adapted to supply our industry?" The

opportunity that fell out of this reframing was to consider the market for interior designers for pleasure boats, or for caravans, yachts and maybe even motorcars.

3. Develop another Supplier: Supplier Development

Explore the supply market to see if another supplier could be developed. You will have to make clear to potential suppliers the benefits that could be realised. There are a number of incentives which you can consider bargaining with a potential supplier; "If you agree to enter this new market, then we could:

- offer to lend expertise, for example seconding project managers or perhaps some technology transfer in a joint development exercise;
- [if the supplier's liquidity and their solvency warrants it] consider arranging payment terms to enable you to finance any necessary work which would be reflected in an adjustment in the final price to be paid;
- subsidise some of the start-up costs, or purchase dedicated machines/tools or inject capital by taking a financial stake in a joint venture;
- offer a long[er] term contract, with some flexibility for each party to protect the parties against significant market developments;
- gradually increase the complexity of the work scopes given to the supplier on a technological progression to enable them to adapt to more complex work in a measured and developmental way".

Example

Car companies have reduced their supply base of first tier suppliers by extending the range of services undertaken by individual suppliers, sometimes called supplier tiering. Let's say supplier A supplies the plastic casing for a wing mirror, supplier B supplies the electrics and motor assembly, and supplier C supplies the glass. In the past, the assembly of the wing mirror would be done in house. However, if supplier A could be developed to become a first tier supplier, then suppliers B and C could supply to supplier A who could then supply the completed assembly to the car company. The [first tier] supply base has fallen from three to one, and the proportion of the value bought-in has increased. The parallel in the services sector is the use of turnkey or 'management' contracts.

4. Increase Mutual Dependency

Buyers often see themselves as being at a disadvantage because 'they need the supplier more than the supplier needs them'. This may be validated by exploring what is the supplier's total sales revenue, and what share of their sales do we represent? If the supplier's annual reports do not disclose sales in your market, ask the supplier's account manager. If that doesn't work, visit their factory/offices and estimate their capacity based upon their equipment or staffing levels. More than two or three percent of total sales and you are a large[ish] customer. More than five percent and you are a big customer![6]

Many suppliers are divisionalised, so consider also the percentage of sales for the particular division responsible for the category you buy, and not [just] the suppliers' total turnover. If you

[6] A model of the importance of customer accounts to suppliers, Supplier Preferencing is presented by Steele and Court in their book, Profitable Purchasing Strategies, McGraw-Hill, 2005. All markets are different, but as a rule of thumb, if you are more than two or three per cent of a supplier's turnover, you are a relatively significant account. How many customers would a supplier need if all their customers were worth 3% of their total sales? However, telecommunication providers would have much lower levels of customer concentration. We need to understand our importance to the supplier!

really are a small customer, you could consider redressing this imbalance by actually putting more business with a monopolistic supplier thus increasing their dependency on you! This works well when the supplier has monopoly rights over some categories, but not others. This can effectively increase your leverage if the additional business that is not in a monopolistic supply situation is used as a bargaining counter. Clearly we need to avoid 'bundling' the requirement so that we create a package that can only be met by one supplier! But if we can use the 'discretionary' component as a bargaining chip, we may be able to change the value obtained on both components.

Your negotiation strategy is to try to create a 'package deal' whereby the total account value is recognised by the supplier. Your script is "if you can show some flexibility on cost, then we can consider offering you <category X> as part of the total deal."

In subsequent negotiations the relative bargaining strengths may then be more balanced. The supplier may well want to 'partition' the categories and keep the two issues separate as it is likely that the monopolistic element accounts for a greater profit contribution to the seller, which means:

- they will want to protect the revenue stream;
- they have greater latitude to concede value to the buyer if they could be persuaded.

If the 'headline' price of the monopoly category can't be altered, what else can they do? Can they discount the other category disproportionately?

5. Better information on the supplier

So we know everything about the supplier, huh? "Buyers buy from companies, sellers sell to people", the saying goes, and it means that buyers tend to study graphs, while sellers believe that companies don't make decisions, people do. Tick off how many of these issues you know about the supplier:

1. When is their analyst briefing cycle? What is the market saying about their performance?
3. When is their next financial report due?
2. What level of utilisation is their staff working at, or what level of unused capacity do they have?
3. What is their policy on corporate social responsibility? How well does their behaviour sit with their stated ethical standards and values?
4. What are the KPIs of your Account Manager? When is their next performance review?
5. What is the key strategic goal of the company's executives? It is margin growth? Share protection? Market share growth?
6. How are their shares performing, or if privately held, how do the owners regard current performance?
7. What is the name of the CEO? On what basis are they incentivised?
8. What is the net margin of the category that the supplier has a dominant position? How does this compare with the company's overall profitability?
9. What worries their CFO?
10. What is the principal threat to their market dominance?

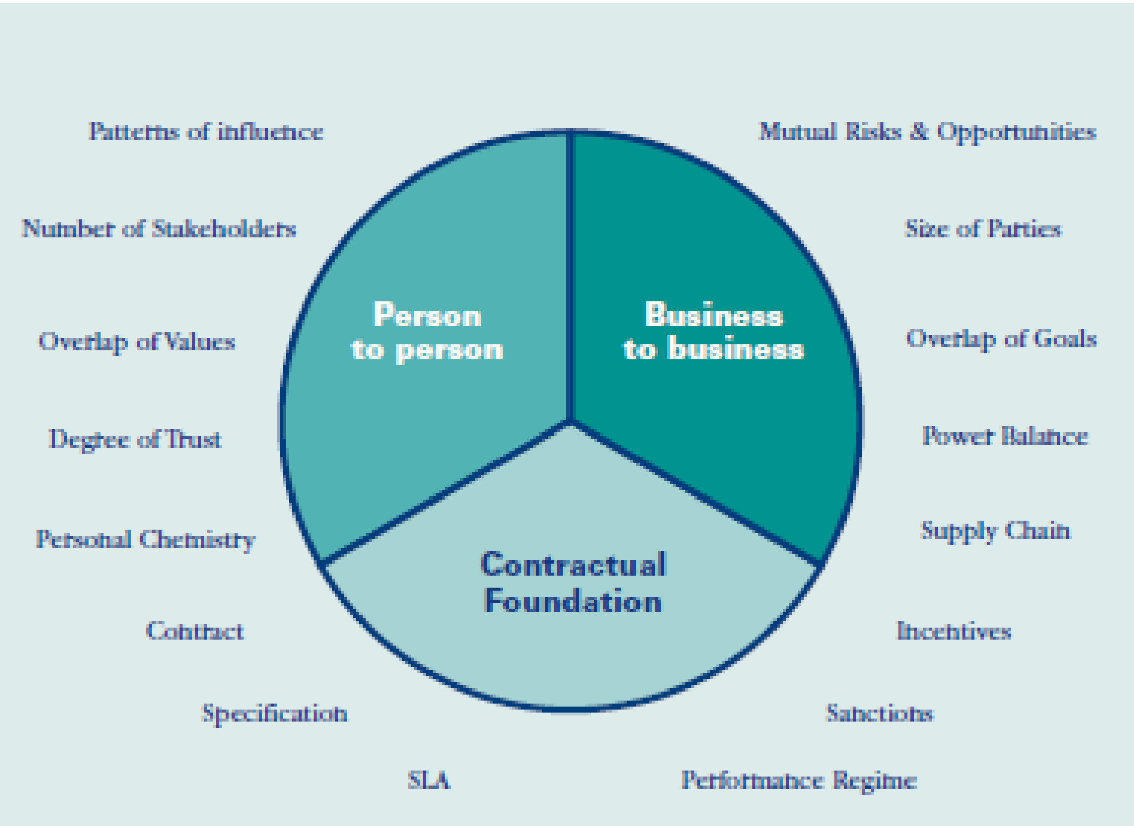
6. Challenge the 'reputation' of the suppliers

Some monopolistic suppliers are embarrassed by the position they hold, and react defensively if accused of exploiting their position. Anti-trust legislation in the US and trade practices legislation in Europe and in Australia and New Zealand seek to regulate markets and prevent abuses of dominant market positions. The increasing adoption of Corporate Social Responsibility is an example of how share value is linked to public image.

Market regulators vary in their willingness to intervene, for example The Sherman Act in the US is not intended to prevent the dominance of an industry by a specific company, but rather to prevent the artificial raising of prices by restriction of trade or supply. However most regulators have a 'whistleblower' option. What evidence do you have that the supplier or suppliers are behaving poorly? Is there a large imbalance in negotiation power? Are they placing your company under economic duress? Behaving 'unconscionably'? You would have to possess clear evidence to support your case. And it would be a long, slow process.
Could you ally with other buyers and create a buyer's group or collective action? Perhaps you would not even have to approach the regulator. Even the prospect of poor publicity may lubricate the supplier's position. The pitch to the supplier might highlight the 'last resort' that you would rather avoid, but may consider if all other options are exhausted. As this article is written, two airlines have been fined US$0.6bn for anti-competitive practices, so the penalties for breaching the law are substantial.

7. Separate the Personal and Business Components

Business relationships have a variety of dimensions. Commercial relationships can be represented as follows:



As buyers we tend to focus upon the business to business dimension; conversely most sellers adopt the maxim: "companies don't make decisions, people do!" That means that they try to influence individuals within the business, rather than pretend that the whole business makes decisions.

"Strategic selling" involves the seller reviewing the key stakeholders who will make the sourcing decision, analysing their role and orientation towards their value proposition, and selectively influencing key decision makers and political processes.

All managers have some discretion, and typically the higher up the structure, the more discretion the manager, the more discretion that the manager has. We want senior managers in the supplier to exercise whatever discretion that they have, and to exercise that discretion in our favour. So we can borrow the behaviours of sales personnel, and review the stakeholders in the suppliers, and ask:

- Do we know the management structure of the supplier?
- Do we have relationships with senior managers above the Account Manager who manages our account?
- Who has the relationships, or if they don't currently exist, who should have the relationship?
- How can we open channels of communication?
- What is the content of the messages?

The challenge is to develop a persuasive case why our company should be given some preferential treatment. Because we are pitching to people, we might try to answer the question "what's in it for me?" from the other party's perspective? What will they get more of, and what will they get less of?

8. Non price negotiation variables

The supplier may insist on applying the 'headline or 'ticket' price, knowing the product or service cannot easily be obtained elsewhere. The emergence of buyer's groups who network regularly and price index providers actually encourages suppliers to charge the same price to broad market sectors, with no preference shown to individual buyers. However, the supplier may be persuaded to make other non-price concessions of value to you. Price is not the only negotiation variable. In order to optimise our deal, we must be aware of the total cost of doing business, and think outside the 'price tunnel.' Every element of the total cost provides an opportunity to negotiate a saving, often with surprising results. The following list of opportunities is intended to stimulate ideas, but you should consider your own.

1. Volume discounts
2. Retrospective rebates
3. Price stability
4. Price variation formulae
5. Price / cost breakdowns
6. Payment terms
7. Currency of payment
8. Deferral of price increases
9. Delivery costs
10. Delivery lead times
11. Payment terms
12. Delivery location[s]
13. Delivery frequency
14. Emergency response

15. Maintenance contracts
16. Spare parts pricing
17. Collection of surplus goods
18. Installation costs
19. Commissioning costs
20. Manuals, drawing and plans
21. Consequential loss
22. Training and support services
23. Health and safety issues
24. Packaging
25. Returnable packaging
26. Insurance
27. Specifications
28. Samples for testing purposes
29. Translations
30. Buy back agreement
31. Performance guarantees
32. Warranties
33. Promotional support
34. Priority during shortages
35. Consignment stock
36. Packaging cost
37. Extended warranties
38. Special storage facilities
39. Supplier inventory
40. Contract duration
41. Terms and conditions
42. Access to modification/update
43. Confidentiality
44. Liquidated damages
45. ‘Guinea pig’ customer
46. Product endorsement
47. Resources for joint projects
48. Access to white papers / research
49. Access to QA resources
50. Provision of specialist tools

You may find that on some of the variables the supplier argues that “its not our normal policy” or “head office won’t let us!” It isn’t easy to negotiate from a position of weakness. However, you may be able to find some non-price concession which results in a reduction in your overall cost of ownership. “You miss all the baskets that you don’t try.”

9. Involve other stakeholders

Most procurement managers are third or fourth tier officers, and so the organisational ‘traction’ needed to address market distortions will not be located solely in the procurement department. We need to create a coalition of other stakeholders, aligned to the project and with realistic expectations about what can be achieved and over what timescale. Opportunities may exist if the buyer co-operates with others in our organisation, or in customers or supplier organizations to adopt a coherent approach.

Specifiers in our organisation may not realise the consequences of specifications that limit our commercial freedom. We can explore with them the implications of reducing our dependence upon a single source. Our other suppliers may be part of a network in which they also have relationships with the supplier or suppliers who are exploiting a commercial position with us. They may have knowledge or expertise about alternatives or be willing to explore entering the market. Finally, customers expect their suppliers to be proactive in reducing cost, so approaching key customers and exploring how we can jointly reduce our dependency may open up opportunities.

Example
A team of 'rotating equipment engineers' were planning a multi-million dollar investment in a large train of compressors for a gas company in the Middle East. The engineers were planning an EPIC contract, although there had been a history of poor reliability of turbines rotor blades in the dry and sandy environment.

The facilitator was addressing the Business Need and was asking 'what are we buying?' The engineers stated the obvious, replying "we are buying a train of compressors!" One engineer was silent, and as the debate progressed, the facilitator asked that engineer if he supported the team's direction. He responded that he thought that the Business Need was compressed gas, rather than a compressor train. The investment in an asset was the means to an end, rather than an end in itself.

The team did not 'own' the suggestion, and pointed out that the suppliers were equipment companies, not service providers. Eventually, the team accepted that the risk of poor reliability was best borne by the supplier – if they could be persuaded to accept an EPICOM contract.

10. Make 'In House'

Procurement managers should constantly monitor the costs of significant items with a view to considering the 'make or buy' decision. The original decision to 'buy' may have been based upon historical cost levels. If we revisited that question, would the outcome still be the same?

A monopolistic supplier may be tempted to raise prices to the level where the 'in-house' option becomes economic. Conditioning statements to the effect that in house supply is being considered may be sufficient to stimulate some flexibility by the supplier. For example, a service or good that is currently completely outsourced could be subject to some in-house processing before or after the contribution of the external supplier; this may stimulate them to review whether the revenue stream is as assured as they had thought.

Example
A supplier had maneuvered themselves into a dominant market situation through acquisition, and was now a de facto monopolist. Supplying a key ingredient to a fast moving consumer goods company, the latest round of price rises were clearly unrelated to any movement in factor costs and the supplier's attitude - "take it or leave it!"- revealed that they assumed that the buyer had no alternative.

The buyer convened a team to review the 'in-house' solution, and informed the supplier that they were doing this. The supplier still showed no flexibility. The review team found that the cost of setting up their own supply capability was too high for the project to be viable. They decided that to go back to the negotiating table now would put them in a worse position than before, as they would clearly have no alternative.

So they took a short term lease on a unit on an industrial estate and erected signs indicating that they planned to open their own supply capability for this ingredient. Only the review team and the senior leadership team knew that this was not going to happen. They then asked their existing supplier for advice about setting up their new capability! He could not know their level of sincerity, and decided to negotiate on a more flexible basis. This shows the importance of stakeholder alignment, and acting coherently as one business.

11. Lease not buy

Leasing has grown dramatically in recent years, and it is now possible to lease almost anything. So it would be possible to deal with leasing companies rather than original equipment manufacturers, and hence potentially 'bypass' the OEM market if it is distorted. The leasing company may be a bigger buyer than you and have more leverage. However, you are adding another 'mouth to feed' in the supply chain.

Example

The buyer wanted to engage an oligopolisticic[7] market in order to persuade them to compete for the acquisition of some heavy machinery. Historically, they had sourced on an ad hoc basis from only one of the four market players, and now needed to 'convince' the market that their technical stakeholders would consider any of the market solutions. The buyer actively conditioned the suppliers over several weeks that this was a genuinely competitive market, and that the best value bid would win. The offer documents went out, but only one bid was returned.

The incumbent's bid was actually higher than their last offer for a part of the total work, and it looked as if the suppliers had decided not to allow the buyer to leverage their spend. So the buyer engaged with the leasing market, to see if leasing companies would provide a different 'market' with which to deal, and undermine any co-operation between the suppliers.

Having reinforced the trust between the OEMs, the buyer may have damaged the market, and dealing with intermediaries like leasing companies adds another margin into the supply chain, though leasing may offer other benefits to outright purchase.

12. Timing of purchase

There are a number of ways in which we can be creative about the timing of a purchase, and while some of these are tactical interventions rather than strategic solutions, they may have the effect of undermining the confidence of a cartel or increasing the flexibility of a monopolist;

- If we have a regular and ongoing requirement for a non-perishable commodity we can progressively buy in excess of our current requirements to gradually [and secretly] develop an inventory. If we suddenly stop buying at all, or significantly reduce the scale of demand, this will plant the seed of doubt in the supplier's mind. We can use this doubt to negotiate when it suits us. This requires us to control the information flow out of our organisation!
- If we aggregate our requirements and buy a very large quantity [for us] for example six months inventory, we may become large enough to attract the attention of the

[7] Oligopoly is when there are only a few suppliers in a market.

supplier's sales team thus attracting a better deal. Clearly we would need to offset the inventory cost against any improvement in terms negotiated, but it is an opportunity worth considering.

- If the supplier is offered a reduction or an increase in volume at or near the end of a internal accounting period, this may attract their attention. Reductions may actually offer you more leverage as they will already have assumed that your business is accounted for. However, bear in mind the balance of power and the character of the relationship. What will be the long term consequence of your actions?

13. Long term contracts

If the category in question is likely to be required for the foreseeable future, it may be worth considering a long-term contract, increasing your leverage. This has a benefit for the supplier in assuring a revenue stream, even if it is a non-exclusive basis. The contract needs to be drawn up carefully to ensure that:

- the duration of the agreement is as long as the visibility of the technological horizon. This means that we should not commit ourselves so long that we cannot take advantage of new products or solutions should they emerge;
- we can at least influence prices; they may have to change through time, but obviously we should try to minimise any increases. Many buyers like to relate pricing to some form of index, but choose the index with care as some general indices only ever rise. Obviously never use the Consumer Price Index! Some clauses are drafted on the assumption that prices will rise and so we end up negotiating about the scale of the increase, rather than if there is an increase;
- we have adequate notice of proposed increases;
- price reductions can also be considered;
- there is an expectation that any genuine increases are offset wherever possible by counter balancing cost savings;
- any proposed increases are based upon a validated cost model or cost breakdown and are based upon agreed cost drivers;
- productivity improvements from the supplier should be expected and built into any forward pricing arrangement;
- the maximum increase in any one period is capped;
- the number of allowed price changes in any period is defined.

14. Take them over

This has to be an option, though the decision will need the whole business to act in a concerted way. If the business is making monopoly profits, it may be a better business that your own! Moving along the value chain is a legitimate business strategy, though vertical integration has declined in popularity in the last 25 years, it is still an option to consider.

15. Form a procurement consortium

In some circumstances it may be possible for you to combine with others having similar requirements and form a consortium where one party buys on behalf of all users. This gives the consortium greater bargaining power. However, bigger is not always better. It depends on situations such as capacity, or if there is a possibility of gaining a niche or marginal pricing concessions.

As for the market regulator, their interest would be raised if the move damaged market competition or harmed consumers. If you act in a selective way, particularly if you behave in a way which could be construed as third line forcing[8], then you should get legal advice first.

Example
The airlines which flew into the remote station knew full well that the price of aviation fuel at that station was significantly higher than at other stations. But there was only one provider with the equipment to pump aviation fuel, and they exploited their monopoly position.

The airlines responded by flying in with as large as a fuel load as was economical, so as to minimise their local purchases of fuel, but that was a tactical solution. So they jointly decided to sponsor a new player to enter the market. In return for investing in the equipment needed, the airlines would guarantee a minimum value of business over three years, after which the supplier would have to compete. The extra volume would come from flying in empty, i.e. buying more fuel locally, and buying less from the monopolist as part of a duel sourcing strategy.

When informed of the airlines' plans, the monopolist threatened to withdraw from the market, saying the demand was insufficient to sustain two players. In fact, the frequency of flights to the station had been increasing, and the opportunity was to grow the total market. The airlines ignored the threat, and now there are two sources of fuel, and the buyers co-ordinate their contracts so that they contract at staggered times to avoid giving all the business to one player.

16. Does it matter?

Finally, you must ask yourself the question 'does it matter?' Sometimes a monopoly situation can arouse an emotional reaction in buyers because no-one likes to be vulnerable or perceive that they are being exploited. We may feel annoyed at perceived arrogance or inflexibility, frustrated at lack of progress in negotiations, resentful at the suppliers' perceived complacency. Such emotional factors may cloud judgment and produce an irrational reaction. Bear in mind that there are instances where monopoly supply situations have existed for a long time to the mutual benefit of both buyer and seller. The unproductive and inefficient monopoly supplier is the one above all others that must be tackled. But, if your competitors also face the same situation, you may need to decide if the effort versus benefit ratio stacks up.

Execution

How long does it take to create a dominant market position? Months or years. How long is the attention span of your senior managers before they lose interest in the plan? Most procurement strategies have a time horizon measured in weeks, but trying to redress the balance of market power cannot be achieved with 'three bids and a cloud of dust'. In fact, the payback period may be never. But unless you want to admire the problem, you should consider organising for the long term, not the next three months.

[8] Third line forcing occurs when a supplier places a condition on the supply of its goods or services stipulating that the customer must acquire goods or services from a third company nominated by the supplier. This practice is a form of exclusive dealing that is usually prohibited and it will be illegal regardless of the supplier's purpose or its effect on competition.

The suggestions given here are not guaranteed to change what is a structural and sometimes intractable problem, but with these ideas and suggestions you may have more to bargain with than you at first thought! Always think through the options, don't be too impatient, and make sure you involve as many people in the organisation as is necessary to secure genuine commitment.

How it helps

By suggesting that there is a lot that you can do rather than "there is nothing I can do", allows us to consider what is possible to do. However, it is my observation that buyers desire immediate results and tactical solutions to what are inherently strategic dilemmas. So just as the situation probably evolved over several years, so the solution will take time to show results.

Appendix

A price fixing cartel is one in which the prices bid by the suppliers are the consequence of some agreement between the players, rather than 'fair and open competition'. The fact that bid prices are very similar may be the consequence of intense competition, rather than a cartel, so detecting and proving collusion requires evidence that the pricing behaviour was driven by prior agreement between the players.

Symptoms of a price fixing cartel may include:

1. Evidence that bidders have agreed to price their products in a certain way, to restrict supply of their products, or to sell only in certain areas or to certain customers;
2. Price increases of similar amount and occur at about the same time, perhaps using similar phrases or "explanations";
3. A reduction in the range of pricing from different suppliers which is not associated with changes in other factors which influence price, e.g. prices narrow in range while input costs and macroeconomic factors are unchanged;
4. Changes in discount structures which align discount percentages or volume price thresholds or when the 'net' prices after discounts are very similar;
5. A pattern in price changes which suggest that the price leader moves and then the rest of the market responds in an 'orderly' way, suggesting that suppliers are following the market leader;
6. Market communiqués in trade association or industry forum communications which imply a dialogue about co-ordinated changes in pricing. An example might be "In order to sustain market competition, margins need to be restored to levels that reflect the investment of the industry";
7. Amendments to bids by one supplier after feedback to another supplier about pricing, indicating an open channel of communication and an exchange of information.

As an alternative to a price-fixing cartel, companies can attempt to achieve the same effect by other means, e.g. they may divide up the country between them and agree not to sell in each other's designated area, thereby enabling each to set prices knowing that the others will not undercut them. At its simplest, a market-sharing cartel may be no more than an agreement among companies not to approach each other's customers or not to sell to those in a particular area. This may involve secretly allocating specific territories to one another or agreeing lists of which customers are to be allocated to which company.

A market-sharing agreement can exist in a number of ways. Suppliers may decide on the share of the market that each player is to 'win'. For example, suppliers may agree that each will get

25% market share. Alternatively, suppliers may decide which firms will 'win' particular contracts. Rigging of bids ensures that suppliers bid for contracts, but the 'winner' is predetermined as the suppliers have planned between who will bid at what price for which contract.

Symptoms of market-sharing may include:

1. Suppliers who bid in one territory declining to supply in another territory, with reciprocal behaviour by another supplier;
2. Suppliers who bid at very different prices in different territories which affects their level of competitiveness, and which is not explained by market differences;
3. Suppliers who bid in one market but decline to bid in other markets for no strong reason;
4. Behaviour by the incumbent which demonstrates that they know that other bidders will not bid, or will not be competitive, which can only have been obtained by direct contact with the other bidders.

Market sharing is more likely to occur where there are a few dominant suppliers and buyers are fragmented or not well co-ordinated. However, many buyers will have experienced suppliers who are more competitive in some territories than others, and proving that the behaviour is the consequence of geography, logistics or other market characteristics is not easy.

Collusive bidding is a form of market sharing agreement where bidders respond to bids, but based upon some collective agreement about 'basement' pricing, or discount levels, or relative pricing levels. The more predictable the buyer, the more likely the bidders can manipulate who will win the bid.

The most common examples of collusive tendering are as follows:

- Bid suppression; one or more bidders decline to bid or withdraw a previously submitted offer, so that a competitor's offer will win;
- Complementary bidding; suppliers submit token bids that are uncompetitive, or submit a deliberately non-compliant bid;
- Bid rotation; bidders submit offers, but the lowest bidder rotates between the players, depending upon whose 'turn' it is to win the contract.

Symptoms of collusive bidding may include;
For buyers concerned that their organisation may be the victim of collusive tendering, the essential things to watch out for are circumstances that would not be expected in a normal competitive tendering situation. Obviously, what is 'normal' will vary with the product, service or project involved, but some examples are:

1. Fewer acceptable bids than normal, suggesting an agreement to withhold bids;
2. Offers which are suddenly more or less competitive than previously published prices or previous bids;
3. Offers which are substantially different from the company's cost estimate or purchase price analysis;
4. The same bidder is the lowest bidder over a period of time, and has consistently 'won' the business;
5. The lowest bidder routinely subcontracts work to bidders that were less competitive on the same bid exercise;
6. The lowest bid is so much lower than the other bids that it is hard to explain on the basis of accounting or marketing strategies [and it is not an error!];

7. One company is always more competitive in one market than in others, and the competitiveness cannot easily be explained by cost or logistics factors;
8. One company is always more uncompetitive in one market than in others, and the lack of competitiveness cannot easily be explained by cost or logistics factors;
9. When a new entrant appears, there is a sudden and significant reduction in collective pricing behaviour.

Collusive bidding may be easiest to detect if parcels of work are regularly submitted to competitive offer to the same supplier community, and the buyer has good records on relative supplier competitiveness.

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PMMS Consulting Group is a specialist procurement consultancy which has been at the forefront of innovation in procurement for nearly 30 years. Operating globally, PMMS has local offices in Sydney, Melbourne and Auckland and offers pragmatic, 'real world' solutions based upon the experience of delivering training and consultancy across Asia Pacific in a wide variety of assignments and market sectors.

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