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Y-Knot | Problem Solving

Preventing Vendors Collusion Risk

Procurement: **Strategy & Competition**

Content #1

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Introduction

Considering the huge number of tenders / RFQs Procurement departments use to conduct on a daily basis, a question surges naturally:

Are our suppliers cooperating among themselves? This text purpose is enabling Procurement staff to identify when and how they are colluding besides demonstrating some techniques to lead them back to competition.

Firstly, it is important to note that all modern economies have a sort of legal apparatus to avoid price agreements and other arrangements to reduce or eliminate the competition. Thus, suppliers have incentive to collude but in a secret way.

Market Signs

Suppliers use to send market signs as a form to achieve the cooperation without breaking any antitrust law. Usually, they use the media (mainly newspapers and TV) to advertise their strategy to create cooperation through promotional campaigns and announcement of investment plans or new pricing policies.

In the Petroleum Industry, the most famous case was the Exxon Price Watch, a global pricing strategy based on the "meeting competition" price policy.

According to the Price Watch, Exxon is monitoring continuously the market, every time and everywhere with the precision of tiger-eyes and so astute as a tiger to prompt respond to market movements, guaranteeing to the customer always the lowest price. More than a piece of marketing, the Price Watch was a credible promise and menace, which the major role was to intimidate other competitors, demoting them of any pricing response or intention to retaliate.

Note that some of your vendors are doing the same in the supplier market. In order to increase the menace reliability, tactical movements are conducted under a *"tit-for-tat"*[1] strategy, which means the retaliation of any "non-cooperative" movement by overcoming the most aggressive offer and going backward to the original position when the competitor backs to cooperate.

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[1] *Tit-for-tat* strategy is part of the Game Theory approach and can be discussed in another article.

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Meeting Competition

A common practice is a supplier announcement of a pricing policy of "meeting competition" (also named as "Most Favorite Customer" clause). In this case, its competitors are not going to undercut prices, since the first one made a public promise to compete aggressively by offering to match any price cut. The announcement looks like an aggressive threat to competitors, but in truth means a disincentive to the competition, because if each competitor knows that a rival will immediately match its price, the willingness to offer a lower bid simply evaporates. Instead of increasing the competition, the "meeting competition" policy allows to raise the market price.

That is also a common practice in retail segments like super/hypermarkets. When hypermarkets networks like Wal-Mart and Carrefour declare their promises of matching any competitors' offer, what they do in fact is to reduce the willingness to compete as well as reduce the demand price-elasticity, since they build in the buyer's mind the perception of a good deal have already been reached.

Nevertheless, you can figure out how successful is this strategy when applied to naïve-eyes of non-trained buyers. Under the image of an aggressive competitiveness, in fact, there is a robust way to disincentive competition.

However, this policy is not a panacea for the sellers and two relevant aspects should be observed:

a. The policy is often difficult to administrate. The announcer should have a low-cost solution to determinate whether a competitor is practicing or not a lower price.
b. Meanwhile the administrative issues are not well addressed there is an eminent risk of angry customers generating lawsuits.

Preventing Collusion

As we have discussed, suppliers could adopt policies to increase prices. What can a buyer do to inhibit a conspiracy among suppliers from functioning successfully? A very interesting approach is the combination of tough negotiating skills, straight communication and some sort of Online Bidding tools (OLB), from e-catalogues to reverse auctions. They represent a powerful set of instruments to make life more difficult for the members of conspiracy.

A well-trained buyer must work to change the game, looking forward to informational asymmetry and the lowest reachable trustworthiness among suppliers.

Therefore, the buyer is able to:

a. Reduce feedback for suppliers, leading auctions with generic alias or simple rankings;
b. Set a starting price as low as the inferred price agreement;
c. Announce previously the existence of a reservation price that bidders should match at least, otherwise the contract will not be awarded. Please note that the reservation price should not be informed to bidders;
d. Bundle recurring demands, increasing the attractiveness and the risk perception on the expected cash flow represented by a customer contract. A long-term contract prevents a market share arrangement. It will work as incentive to non-cooperation, encouraging the price cutter to act in order to take the contract as a whole. Furthermore, there is no direct opportunity of a cartel retaliation to the opportunist player;
e. Verify economies of scale and/or scope by adding an aggregate lot. This approach also generates the opportunity to cease the conspiracy, allowing a second chance represented by a lump-sum bid;
f. Sponsor and invite outside players to play the role of disequilibria factor;
g. Create confusion among the members of the cartel. For example, in case of bid offered repeatedly, the buyer could establish a contracting strategy to award the contract using other attributes different from price, which will generate suspects about the reliability of (innocent) company to which was awarded the contract. This atmosphere of suspicious can lead the members of conspiracy to believe that their partners are breaking the agreement. Once they have reached this conviction, the buyer is going to be successful in his/her strategy; he/she has disseminated the seeds of discord, what is enough to break the fragile conditions to collude.

About the Author

Rodolfo Frederico is an economist specialized on pricing & competition. Former executive of large corporations, devotes his wide business and international background to serve his clients through his companies, Y-Knot|Problem Solving e Serelapp|Applied Apps.

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