Alternative Approaches to Vertical Restraints:

Theoretical Models and Current Practices

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This is one of three reports on vertical restraints as they relate to supermarkets and the grocery trade in Canada. Together the reports are designed to answer whether it would be desirable to establish a more explicit set of competition guidelines that would define appropriate versus inappropriate behaviour in relation to the vertical restraint practices that often arise in the grocery sector. In this particular study I look at competition policy, guidelines and proposed codes of conduct being considered by the United Kingdom (UK), the European Community (EC), the United States (US), Australia and New Zealand relative to current Canadian practice. Stress is laid on the theoretical reasoning lying behind such proposals with less emphasis on the specific structural characteristics that have influenced each individual decision. To inform this survey, the report begins with an overview of the theoretical literature in relation to buyer and seller market power, particularly as it applies to a subset of vertical practices often undertaken by manufacturers in relation to retailers and by retailers in relation to manufacturers. On the side of primary producers, food processors and manufacturers, I consider the role of two specific vertical restraints: the practice of requiring exclusive product dealerships and the assigning of exclusive retail territories. On the retail side, I consider the practice of requiring slotting allowances of manufacturers, pay-to-stay pricing policies, exclusive supply agreements, refusals to supply and the threat to delist manufacturers products. Typically, all of these practices involve elements of

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efficiency enhancement, redistribution, and anti-competitive behaviour.

VIII. General Introduction, Background and Overview:

Vertical restraints arise within the retailing activities of the grocery sector in Canada because distribution generally and retailing specifically add something of value to final output.[2] This simple statement both explains and disguises a host of complicated vertical trade issues. That something substantive arises between primary farm production and the final consumption of grocery products by consumers is strongly suggested by the large amount of value added created in these sectors. To illustrate, Sexton and Chen (2000, p.1) report that in 1996 U. S. consumers spent about $547 billion on food products, excluding imports and seafood. Of this total value, only $123 billion was accounted for by farm production, leaving $424 billion in value added (or 77% of the total) as arising within the distribution network. Not only have the retail and other distribution sectors multiplied market value to the consumer, but the relative importance of their contribution to final value continues to rise. Again in the U.S., the value added by non-farm food processing and distribution has risen from 59% in 1950 to 69% in 1980 to 76% in 1990. While Canada's distribution network differs somewhat from that of the U.S., the same basic pattern is evident.[3]

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[2] For a more general discussion of the economic function of the distributive sectors see Acheson and Ferris (1988).

[3] Canadian numbers are more difficult because of the relative importance of exports and imports compared to the U.S. Nevertheless, Agriculture Canada reports 1998 value added figures for primary food production of roughly $14 billion dollars (revenues of $28.5 billion minus purchased inputs of $14.6 billion) compared to net retail and food services sales of roughly $52.9 billion (food and liquor retail sales plus food services of $104.7 billion minus food and beverage food processing purchases of $51.8 billion). This is a value added ratio of roughly four to one for the distribution sector relative to the primary output sector.

If the distribution sector in the grocery trade were perfectly competitive, competition among manufacturers, among wholesalers and among retailers would ensure that vertical constraints did no more than transfer to final consumers the full potential of the new gains from trade realized through their use. Vertical restraints enhance value to consumers by restructuring the incentives of interacting agents on the margin to better exploit joint trading gains and provide mechanisms for distributing discretely the resulting surplus to ensure overall compliance. On the other hand, because coordination within the distribution sector is enhanced by the use of coercive restraints, the pursuit of ever greater joint returns may result in manufacturers and/or retailers acquiring (deliberately or inadvertently) a better set of tools for coordinating collusive behaviour. In the presence of market power, there is the fear that vertical restraints can and will be used to the detriment of final consumers.

In this report, then, I begin by discussing some of the ways in which the distribution sector adds value to consumers and illustrate how the use of vertical restraints can promote greater efficiency and add benefit to final consumers. With this as a background, I illustrate how market power allows the realization of anti-competitive outcomes by using vertical restraints as mechanisms either to enhance market power through horizontal foreclosure or to permit the segmentation of markets for price discrimination.

It follows from even this brief discussion that the use of vertical restraints does not in itself provide evidence of anti-competitive behaviour. Nor does the potential benefit provided allow us to simply follow Bork (1978) and advocate blanket approval for their use. Rather, as we will see, the probability of anti-competitive harm will depend upon entry conditions underlying the degree of market power as well as upon the characteristics of the particular product and the

specific features of the activity being marketed. In the later sections of this report, I illustrate how different other countries compare with Canada in dealing with the trade-off between efficiency enhancement and anti-competitive behaviour.

IX. Seller Market Power: How vertical restraints work and why the use of vertical constraints can create surplus

In this section I explain why vertical restraints can enhance market efficiency and convey economic benefits to final consumers even in the presence of market power. To do so I present a simple model where a monopolist producer generates primary output at a constant cost, c, and sells that output indirectly to consumers through a retail outlet that is owned and operated independently.[4] To capture the fact that retailing enhances final value, the retailer is assumed to sell the primary output as part of a commodity bundle that consists of units of the primary output, q, together with a level of retail service, s. By construction, the producer's and the retailer's activities are interdependent and, implicitly, the retailer serves as the agent for the monopolist in the final good market. That is, the retailer utilizes the market power conveyed by the uniqueness of the monopolist's product but does not itself offer anything distinctive (compared to alternative

[4] Note that the primary producer could always market the product to consumers directly or the retailer produce the primary product. Hence implicit as a starting point for all such distributional issues is the assumption that transactions costs exist that make the inclusion of these activities within an integrated firm unfeasible. The current problem then assumes that the two contractual arrangements discussed are a) equally feasible and b) dominate the net returns possible when the separate activities are required to be integrated.

potential retailers) and so does not have independent market power.[5]

Consumers valuation of successive units of a commodity bundle at the retail level is represented through a demand curve, $q(p, s)$, where $q_p < 0$ and $q_s > 0$.[6] That is, the demand curve is assumed to be downward sloping with respect to price and to rise with an increase in retailer service. The retailer's problem is then to choose its optimal retail selling price, p, along with the level of store service to offer, s. To begin discussion we assume that the retailer buys his product from the manufacturer at the unit price of w and produces service at the cost of c(s) where $c_s > 0$ and $c_{ss} > 0$.[7] With this background, the retailer's two first order conditions for profit maximization are:

$$(p - w)\partial q/\partial p + q = 0, \quad \text{or} \qquad \text{PMB of raising price } [q] = \text{PMC } [(p - w)\partial q/\partial p] \qquad \textbf{(1)}$$

$$(p - w)\partial q/\partial s - c_s = 0, \quad \text{or} \qquad \text{PMB of raising s } [(p - w)\partial q/\partial s] = \text{PMC } [c_s] \qquad \textbf{(2)}$$

In essence, the retailer will raise its selling price as long as the private gain to it (the unit price rise times the number of intramarginal units still sold, q) equals its private marginal cost (the unit profit lost, p-w, on each unit no longer sold, $\partial q/\partial p$). In terms of service, more is provided until the point where the additional profit earned on the new output sold just equals its marginal cost of producing the extra service. Designating the solution with the superscript C, the equations

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[5] Because the net benefit of integrating is negative (otherwise the primary producer would market the product directly), the transaction costless fully integrated solution cannot serve as our benchmark case. Rather the analysis seeks tp compare only the benefits and costs of alternative contracts within the same institutional setting.

[6] Throughout the text I follow the convention of representing the partial derivative $\partial p/\partial x$ as p_x, x = q,s, etc.

[7] Profit for the retailer is $\pi^R(p. s) = pq(p,s) - wq(p, s) - c(s)$, and for the primary producer is $\pi^P = wq - cq$. Hence joint profits are $\pi^{Total} = (p - c)q(p, s) - c(s)$.

together imply a optimal price and optimal service level, p^C and s^C, as a function of the wholesale price set by the primary producer. The full solution of this problem would now go back one stage and consider the primary producer's choice of its optimal wholesale price, w^M (given its knowledge of what the retailer will do at each different wholesale price and its known cost of production, c).

A coordination difficulty in "normal" contracting, however, is already apparent from the first order conditions of the retailer's choice problem. This arises because the incentive of the retailer diverges from the incentive of the group. That is, the retailer makes its choices in order to maximize private profit, rather than the profit that could be generated for the group jointly. More particularly, when the retailer raises its selling price, it gains all of the price increase on each intramarginal unit still sold. On the other hand, by raising the retail price it sells fewer units and hence foregoes the profit that it would have been made on these items, $(p - w)\partial q/\partial p$. The retailer does not, however, take into account the fact that selling fewer units will also reduce the profit that the primary producer would have earned, $(w - c)\partial q/\partial p$. Because the retailer does not bear that cost, the cost to the two parties jointly, $(p - c)\partial q/\partial p$, exceeds the private cost to the retailer, $(w - c)\partial q/\partial p$, and hence from the perspective of the group, the retail price is set too high. In the literature, this result is know as the double marginalization problem.[8] The necessity of collecting profit by raising the unit selling price means that first the primary producer then the retailer will raise their selling price above their acquisition cost and so introduce a cumulative departure of price from the underlying private and social cost.

[8] Note that further increases in w by the monopolist price setter serve to increase the divergence between w and c and thus the discrepancy between private and joint cost facing the retailer. Hence the retailer is led to make a decision that is yet further from the joint maximizing decision. See Spengler (1950).

For exactly the same reasons, the level of retail sales effort will be set too low. Along the service dimension, the retailer bears the full (marginal) cost of its extra sales effort, c_s, but retains only a portion of the new benefit created for the group as a whole (through additional sales).[9] On the margin, the retailer gets $(p - w)\partial q/\partial s$ in incremental profit, while $(w - c)\partial q/\partial s$ goes to the primary producer. The private benefit of sales effort $(p - w)\partial q/\partial s$ falls short of the group benefit $(p-c)\partial q/\partial s$, so that from the point of view of the group, too little sales effort will be expended.

To better coordinate trade and increase joint profits, the marginal incentives facing each decision maker must be changed to better reflect the net benefits available to the group. One way of ensuring that the retailer takes the group benefit into account would be to allow the retailer all of the return available on the margin. In our example this would be having the primary producer sell to the retailer at cost, i.e., set $w = c$. When choosing both the retail price and level of sales effort the retailer now faces the full marginal cost and full marginal benefit of his or her decision and so choses appropriately (from the point of view of the group). In the absence of other changes, however, the equality of the average and marginal price means that the retail store would now realize all of the group's profit. Hence to recapture the full return generated by the product's uniqueness, the monopolist must reclaim all the profit in a way that does not distort the retailer's incentives. The simplest way of doing this is to charge a lump sum fee (sometimes called a franchise fee) for the right to distribute its output. This nonlinear structure then presents the retailer with a discrete, all-or-nothing choice: either it can earn normal profits by setting the

[9] As long as the service provided is complementary with output it is in both the retailer's and primary producer's interest to provide service. Hence the service argument under double maginalization does not need to be restricted point-of-sale information and will consist of such "standard" retail services as providing greater customer convenience, a more attractive shopping environment, quicker service, etc.

jointly optimal retail price, p*, and service level, s*, and handing over the lump sum fee; or it can choose not to handle the product at all.[10] The assumption that retail services are not scarce means that the retailer can retain no profit so that the monopolist can extract all of the higher profit (monopoly rent) through the nonlinear pricing scheme.[11]

In this problem, the inability to capture all potential trading gains arises from the necessity of using a linear pricing scheme that is too blunt to provide the appropriate incentive to each separate agent in the joint coordination problem. The ability to contract nonlinearly – in this case to use a discrete payment for the right to purchase at $w = c$ – reintroduces flexibility by freeing the price to serve only an incentive role and allowing the lump sum fee to transfer rents. In this problem double marginalization produced only one coordination inefficiency and this, as we have seen, could be internalized through the use of one additional instrument (or constraint).

It is important to notice that while forcing arrangements other than the lump sum fee are not needed, the same q*, s* solution could be adopted through a variety of alternative forcing arrangements.[12] For example, a contract by the primary producer that requires the retailer to purchase a minimum quantity, q*, at then resell that output at the fixed price, p*, accomplishes the same result. Here the wholesale price, w, needs to be set such that sum extracted from the retailer requires the retailer to provide the jointly optimal level of service, s*, to continue to earn normal profits. In many countries, retail price fixing is per se illegal so that such solutions are

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[10] Here the (p*, s*) solution equals the (p^C, s^C) solution for the special case of $w = c$.

[11] The assumption that the primary producer holds all the market power is made for convenience. No matter how overall market power is divided between the two groups, the optimal strategy (for the group) is always to maximize the joint return and then discretely divide the largest feasible amount appropriately.

[12] See for example, Mathewson and Winter (1984, 1986, 1987) and Butz (1996).

often not feasible. Even so, there remain other forcing combinations that would allow the same p*, s* solution to be maintained. Hence, if the level of service provision can be observed, for example, a contract that forced a quantity, q*, and a level of sales effort, s*, would accomplish the same result as the retail price maintenance scheme.[13] For a policy makers this multiplicity of equivalences implies that the disallowance of any one particular forcing arrangement (for anti-competitive reasons) will often be ineffective since close alternatives may exist for substitution.[14]

The proposition that a sufficient number of vertical restraints will always allow trading partners to realize a greater portion of potential profit generalizes. However it does not follow that what increases joint profit will also increase consumer surplus. Joint profits can rise at the expense of consumers. Before outlining these possibilities, however, it is important to see that the pursuit of joint profit maximization is not inconsistent with the enhancement of consumer surplus. In the current example, this is almost immediately apparent. Here consumers benefit from the use of vertical restraints because the lowering of the retailer's incentive to raise price results in lower final retail price than otherwise. This increases the consumer surplus realized on each intramarginal unit purchased. In addition, the lower retail price leads to a larger quantity of the good consumed in equilibrium. Lastly, the vertical restraint induces a larger level of valued retail services. In this example, the consumer gains on all margins.

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[13] Alternatively, a separate contract could be written over service provision (to share costs) with output sold to the retailer at w = p* (under a quantity or price forcing rule). Note that these types of contracts may be relevant to the case of slotting fees (to be discussed more fully below).

[14] In the example above, all vertical arrangements produce the same result because there is no differential cost to their use. The introduction of one or more real world complication (asymmetric information, retailer risk-aversion, product and/or cost uncertainty) means that the different forms of restraint are not equivalent and implies that one arrangement dominates the others. See Marvel and McCafferty (1996), and Rey and Tirole (1986).

X. Horizontal elements that motivate the use of vertical restraints: exclusive territories and exclusive dealerships

In the problem above, the coordination difficulty arises because the level of price and service are set by the retailer alone while the benefits and costs of that decision are shared by both the retailer and the primary producer. Linear pricing scheme coordinates independent behaviour but does not in this case have sufficient flexibility to allow the right incentives (from the point of view of the group) to be set at the margin. Here the divergence between private and group benefit is in the vertical dimension. In many retail situations, however, the price charged and the level of retail service provided by one retailer will spillover and affect the decisions of the retailer's competitors. To capture the ability of vertical constraints to deal with horizontal externalities, the model is expanded to incorporate at least one additional retailer, in our case a second retail store.

In almost all cases, constraints on horizontal competition are not desired. The willingness of the individual retailer to ignore the effects of its price cut on the group creates the competition of retailer against retailer in price that undermines the incentive that retailers have as a group to restrict output and raise final selling prices. The divergence between private and group pecuniary benefit results in private actions that benefit consumers. When the retailer provides more than one dimension of output, however, competition on the margin for customers may induce distortions in the optimal output combinations that vertical constraints can account for. To see this, I follow Winter (1993) and assume that with two retailers, 1 and 2, retailer 1's profit can be represented as:

$$\pi_1 = (p_1 - w)q(p_1, s_1; p_2, s_2) - c(s_1)$$

where p_i, and s_i, 1 = 1, 2 are the prices and service level set by the two retailers and demand and cost conditions are assumed identical across retailers. If we now assume that the upstream monopolist sets w = c and uses a lump-sum fee to extract abnormal profits from its downstream agents (and to eliminate the vertical externality), we can rewrite retailer 1's choice problem as one of maximizing,

$$\pi_1(p_1, s_1) = \pi_{Total} - (p_2 - c)q_2(p_2, s_2, p_1, s_1) + c(s_2).$$

Private maximizing behaviour by retailer 1 leads to the following first order conditions:

$$\partial\pi_1/\partial p_1 = \partial\pi_{Total}/\partial p_1 - (p_2 - c)\partial q_2/\partial p_1 = 0, \qquad \textbf{(3)}$$

and, $$\partial\pi_1/\partial s_1 = \partial\pi_{Total}/\partial s_1 - (p_2 - c)\partial q_2/\partial s_1 = 0. \qquad \textbf{(4)}$$

From the point of view of the group as a whole, both price and service should be raised until the first terms in (3) and (4) equal zero, meaning that the second terms in both (3) and (4) represent horizontal inefficiencies from the group's perspective. Individually competitive behaviour leads to action, part of which simply redistributes profit between members of the group. In pursuing private profit objectives, however, group profits fall. From (3), for example, it can be seen that the private return from retailer 1 raising its price includes the fact that higher relative prices transfer sales to retailer 2. With $\partial q_2/\partial p_1 > 0$, retailer 1's private return from raising its price falls short of the return that could be earned by the group and, since retailer 2's private return is similarly affected, noncooperative behaviour leads to "too low" a selling price. In addition, if

retailer 1's sales effort generates a positive spillover to retailer 2 (i.e., $\partial q_2/\partial s_1 > 0$), the private return to retail sales effort will fall short of that achieved by the group so that each individual's sales effort will be too low.[15] Overall there is too much price competition and too little service competition in the final equilibrium from the perspective of the group as a whole.[16]

One vertical restraint that would immediately induce group optimal behaviour would be for the primary producer monopolist to assign exclusive selling territories to each retailer.[17] If such arrangements can be enforced costlessly, the last terms in both (3) and (4) become zero and the separate private decisions become realigned to those that are optimal for the group. The resulting equilibrium would provide both higher service levels and higher product prices (as well as generating higher profits for the monopolist producer).[18]

As suggested earlier, however, the use of exclusive territories provides both benefits and costs to final consumers. The consumers benefit from the higher level of service provision while losing from lessened price competition and facing higher prices. The net result depends upon the elasticities of response to the two choices. Winter (1993) shows that when the divergence

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[15] There is often some publicness to the services provided by retailers carrying similar products. For example, each store in a supermarket chain gains from the inference consumers make that other stores in the chain are as clean, pleasant and tidy. Local advertising, product demonstration or adoption of new products also spillover to benefit other retail outlets in the same general area (and hence encourage lagging behind).

[16] Depending on the retail service, the derivative sign may switch and imply too much of one service relative to another. Foreclose can then rechannel competition in more efficient ways. See Ferris (1990, 1991).

[17] Winter (1993) and Tirole (1988), among others, show that other vertical arrangements (such as the use of retail price maintenance) can achieve similar results. In the presence of uncertainty, exclusive territories allow for the better use of asymmetric information while retail price maintenance has better insurance properties.

[18] In one test of the exclusive territories hypothesis, Sass and Saurman (1996) found that the banning of exclusive territories to beer distributors in Indiana did result in both lower beer prices and lower sales (implying that exclusive territories had stimulated dealer services). See also Mixon and Upadhyaya (1996). Katz (1978) looked at territorial exclusion in syrup production (for soft drinks) and found both service and price competition losses. The net effect on welfare was found to be ambiguous.

between private and group benefits in price exceeds the corresponding divergence in services (i.e., the cross elasticity among stores is higher in price than in service), then the use of exclusive territories can result in both higher group profits and higher overall efficiency.[19] In such cases, what the average consumer loses from lessened intrastore price competition is more than offset by higher realized service levels.[20]

When we move away from the case of a pure monopoly, exclusive territories can give the monopolist the ability to separate retail markets and an oligopoly the ability to enhance market power by reducing obstacles to setting the collusive monopoly price at the retail level (Rey and Stiglitz, 1995; Spiegel and Yehezkel, 2000). Here the profit maximization goals of the group come into direct conflict with consumers' interests.[21] The significance of this effect can be seen in the size of the last term in equation (3). The larger is the gap between retail price and primary production cost, that is, the less competitive is the vertical market, the larger is the horizontal price externality and hence the larger the gain to the group (and the larger the loss to consumers) of suppressing that competitive effect.

While exclusive territories reduce competition across the same product (*intrabrand* competition), exclusive dealerships do the same thing across similar products and so reduce the

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[19] Unfortunately there seems to be no simple necessary or sufficient condition for distinguishing between the two outcomes. Winter (1993) reports on the use of a specific simulation model to illustrate that both types of outcomes are possible.

[20] This is an example of Spence's (1975) demonstration that with public elements, economic competition responds to the marginal consumer while efficiency is determined by the average consumer. Vertical restraints then increase profit and efficiency by altering incentives so that the bundle is now closer to the tastes of the average.

[21] There are a number of models that illustrate the way in which exclusive territories reduce competition at the retail level and perhaps, also reduce competition at the upstream level. See Comanor and Frech (1985), Rey and Stiglitz (1988), Bolton and Whinston (1993), Mathewson and Winter (1994), and Dutta, Heide, and Bergen (1999).

scale of *interbrand* competition. The service efficiency argument was first advanced (Telser, 1960; Bork, 1978; Marvel, 1982) to illustrate just how a reduction in interbrand competition could promote efficiency (rather than necessarily enhance market power). Suppose, for example, a complicated new product would be purchased only if a prospective customer received a certain amount of instruction.[22] If the provision of the service cannot be tied to the specific product and if the consumer will not buy before the value of the product is recognized, then the consumer has the incentive to receive instruction and buy a similar product at a lower price (but without the now unneeded instruction). In these cases, the ability of consumers to free ride on the services provided means that retailers cannot collect for service provision so that too little service is provided in equilibrium. In such cases, the use of exclusive dealerships can prevent interbrand competition within the same store and so permit service provision by increasing the cost of substituting into a low-cost, low-service competing brand.[23] In one of the few surveys done of managers responsible for making distribution decisions within firms, researchers found that firms were more likely to use exclusive dealing contracts when other manufacturers were able to free ride on their services and were less likely to use them when costs of determining adherence to exclusivity rose.[24] These actions are consistent with the service provision efficiency hypothesis

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[22] For Bork this was store service to help customers select among cutting designs for clothing. The same argument can be made for instruction on common new car features, computer operation, electronic games etc. Marvel argued that exclusivity was needed to prevent low quality designers from free-riding on successful designs.

[23] For similar reasons senior and junior department stores are typically not in the same shopping mall. As another example of the multiplicity of vertical restraint solutions, many authors have argued that retail price maintenance will be particularly effective in this case since consumers will have no price incentive to search across retailers and instead will search over service (Telser, 1960; Romano, 1994).

[24] In addition, the study found little overt evidence of non-efficiency motivations, such as to support market differentiation and entry deterrence. See Heide, Dutta, and Bergen (1998).

for exclusive contracts.[25]

As with exclusive territories, however, the foreclosure of other producers from a particular retail location raises the cost to store consumers of finding close substitutes and this, in turn, reduces competitive pressure to lower the final selling prices. Models by Aghion and Bolton (1987), Shaffer (1991), Chang (1992), Bolton and Whinston (1993), Dobson and Waterson (1996), Martimort (1996), and Bernheim and Whinston (1998) present complementary ways by which foreclosure may impede entry and/or extend the exercise of market power to the detriment of consumers. Other authors, such as Lin (1990), Mycielski and Wuyts (2000), have considered conditions under which it would be optimal for a monopoly producer to adopt either exclusive territories, exclusive dealing or both. Not surprisingly, the answer depends upon the degree of intrabrand competition and interbrand substitutability.

XI. Buyer Market Power and Vertical Restraints

In the sections above I have followed tradition by focussing on vertical constraints from the seller's side of the market. This highlights the efficiency gains associated with avoiding the double marginalization problem together with the efficiency case for exclusive territories and exclusive dealerships. In this section we look at vertical restraints from the other side of the market, cases where buyers rather than sellers have market power.[26] Here the focus is on the use of listing fees, slotting allowances and exclusive supply relationships.

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[25] It is sometimes argued that since food products require little demonstration, the service argument for exclusive dealing will be inapplicable to the grocery sector. However, the concern with establishing product quality that underlies the development of separate store brands (such as President's Choice) suggests that in a different form (for example, with the promotion of new products) the service argument may be equally applicable.

[26] See also Dobson, Clarke, Davies, and Waterson (2000) and Dobson, Waterson, and Chu (1998).

In principle, the analysis of buyer power is perfectly symmetric with what we have already done for seller power, but, because its development and orientation is less familiar, I take some time to emphasize its special features. Just as on the demand side, competition problems can arise on the supply side only in the presence of market power. It follows that on the supply side, vertical restraints create anti-competitive concern only when the supply curve of inputs is upward sloping.[27] Hence the test for potential anti-competitive effects from buyer power follows from the test for seller power – i.e., assessing whether the slope of the supply curve is sufficiently upward sloping versus whether the demand curve is sufficiently downward sloping. Over the longer run, the slope of the supply curve (like the slope of the demand curve) depends on substitution possibilities and the cost of entry.

I begin by showing that even if a retailer had monopsony power, the vertical externality is still present in the provision of services such that internalization would benefit both the primary producer and the retailer. In this case, vertical restraints will also benefit consumers and so enhance efficiency. To show this, assume that a single monopsonist retailer buys an input, x, from a competitive market. Primary producers are assumed to supply x at increasing cost, i.e., the unit cost of producing x, k(x), increases so that $k_x \equiv \partial k/\partial x > 0$. The monopsonist retailer uses this primary product as part of a retail bundle that includes a service with a public good characteristic, s, such that the final product sold, q, is a function of both the number of output units, x, and the level of that service. That is, $q = q(x, s)$ where both q_x, $q_s > 0$ and $q_{xs} > 0$. The latter condition implies that the two inputs into retail sales are complementary. We consider only

[27] Shea (1993) finds evidence that even in manufacturing industries where economies of scale might be expected to be more prevalent, most supply curves are upward sloping. See also Veendorp (1987).

the case where the monopsonist retailer has no independent market power in its selling market.[28]

The monopsonist purchases the quantity of the primary good, x, and its other inputs, s, that maximizes its private profit. Having chosen its optimal x, the monopsonist then sets the input price that it will pay, w, such that on the margin the last competitive supplier entering the market can earn only normal profits. That is, given the final retail price, p, the retailer

$$\text{Max } \pi^R(x, s) = pq(x, s) - k(x)x - c(s), \quad \textbf{(5)}$$

where c(s) is, as before, the cost to the retailer of producing services (with $c_s > 0$) . The first order conditions for private profit maximization by the retailer are:

$$x: \quad pq_x - (k + xk_x) = 0, \quad \textbf{(6)}$$

$$s: \quad pq_s - c_s = 0. \quad \textbf{(7)}$$

Looking first at equation (6), private profit maximization leads the retailer to purchase more units of x as long as the value of its marginal contribution to retail sales, pq_x, exceeds the marginal cost of acquiring an additional unit. If the retailer had no buying power, its marginal cost would equal average unit cost, i.e., $w = k(x)$, but having monopsony power means that the retailer takes into account its ability to influence the purchase price. Thus when buying another unit of x, the retailer knows that its private cost will be increased by an additional amount, k_x. on each of the units already purchased, x. Hence profit maximization leads the retailer to choose the level of x that sets $k(x) + xk_x$ (called marginal factor cost, MFC) equal to pq_x. Given that level

[28] If the retailer also has market power in its selling market, the final selling price becomes a function of retail output and marginal revenue replaces price in the first order conditions. See Dobson et. al. (1998).

of $x = x_M$, the monopsonist uses its price setting power to set the input price at the corresponding average cost, $k(x_M)$. This leaves the marginal primary producer earning only normal profits, just enough to continue producing.

This use of buyer power is the symmetric with what the nondiscriminating monopolist does in the output market. The constraint of using linear pricing means that the monopsonist cannot completely exploit its market power and extract all (producer) surplus, but instead uses its ability to restrict input use to lower price and transfer surplus from suppliers to itself. Note also that because primary output can be increased only at increasing cost, rents exist for producers inside the margin. These rents derive from the scarcity of those factors that allow some firms to produce at lower cost than others. Hence although the last entrant into the primary product market earns only normal economic profits, the difference between the price set by the monopsonist, $w = k(x_M)$ and the unit cost curve $k(x)$ (for x running from 0 to x_M) measures the surplus that arises to the intramarginal primary producers.

Compared to competition, the use of buyer power results in the loss of both consumer and producer surplus, as the monopsonist retailer restricts input use (and hence final output) to affect better price terms from its suppliers. This is reflected in the same type of triangle loss that arises in monopoly. The fact that monopsony power serves to disadvantage consumers, however, says nothing yet about the welfare implication of using vertical constraints. Hence, using the same strategy as above, I look first at the provision of retail services to see whether there is a similar external effect that a vertical restraint could remedy. If so, I then ask whether the increased benefits captured by the group will also translate into benefits for consumers.

To better illustrate the point, consider Figures 1 and 2 below. Figure 1 represents the first

order condition for the privately optimal use of input, x. Here the position of the marginal value product curve, pq_x, is shown to be a function of the level of s chosen (held constant at s_0). The rent received by intramarginal primary producers is represented by the horizontally shaded area below w_M and above k(x) and the traditional welfare loss associated with buyer power is shown as the vertically shaded triangle on the diagram.

Figure 2 shows the effect that follows the decision to provide an additional unit of retail sales effort on the retailer's choice of x, the effect represented by equation (7). That is, an increase from s_0 to s_1 shifts the value of the marginal product curve upwards for each unit of x (since s is complementary to x). This means that retailer profits rise by the area between the two marginal value product curves, i.e., $pq_x(s_1) - pq_x(s_0)$, through x_M. The retailer then compares this incremental benefit to the marginal cost of providing the additional service, c_s. What Figure 2 also illustrates is that the increase in s has increased the marginal value of using x. The upward shift of the marginal benefit curve leads the retailer to purchase more x from its suppliers and through this bid up its purchase price, w. In the new equilibrium, the retailer buys more inputs (x_M rises to x_M') and pays its suppliers a higher price (w_M rises to w_M'). In doing so it generates new surplus not only for itself but also for primary producers. This is the horizontally shaded trapezoidal area (i.e., $w_M' - w_M$, through x_M') on the diagram.

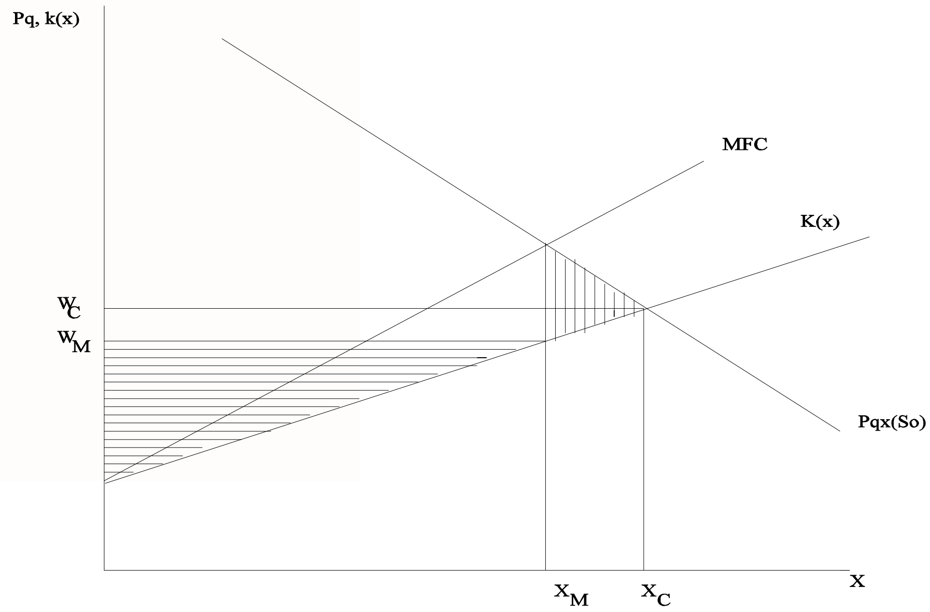

Figure 1

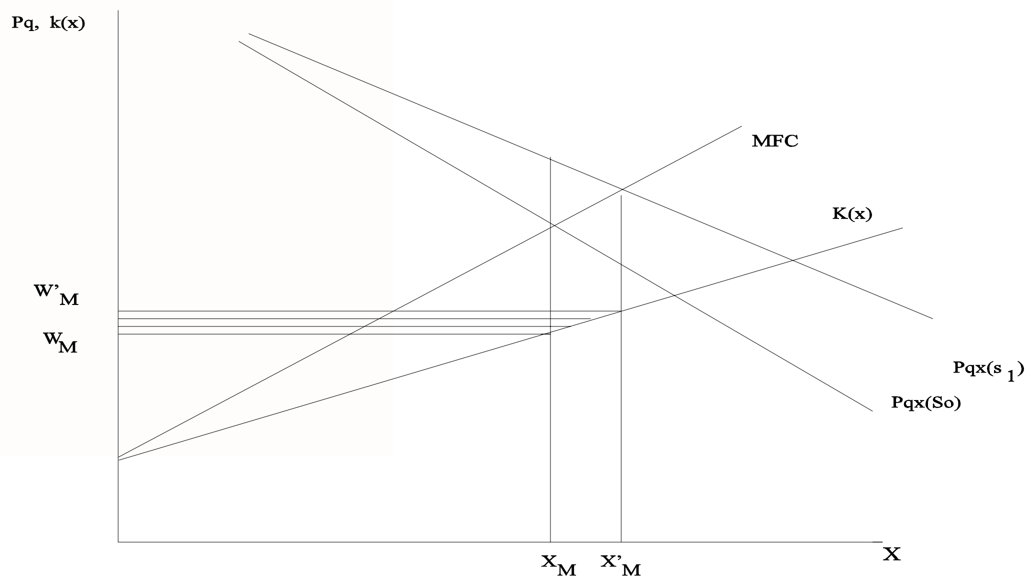

Figure 2

It follows that when services are provided by the retailer, not all of the benefit realized by the vertical group will accrue to the retailer.[29] From the group's perspective, too little service is provided. This is symmetric with the service case looked at above (when sellers had the market power). Because of the divergence between private and group benefits, there is an advantage to both parties of finding an alternative contractual arrangement that will internalize the externality and induce increased service. In particular, it is in the private interest of primary producers to pay a portion of the bill incurred by the monopsonist retailer to effect additional service.

With the retailer has market power and the ability to set the input price, the monopsonist is likely to suggest adopting either a different (non linear) pricing contract or some other quantity forcing arrangement. Simply offering its suppliers a lower price to cover the cost of providing additional services would create the wrong incentive along the supplier's output margin (it introduces what is essentially a second price margin on the input side). Rather, to preserve the incentive on the product margin, the payment for services must be set independently of x. Thus to induce the jointly optimal level of service, the level of payment should be related to the level of services provided and unrelated to x. The payment for service then appears as a lump-sum franchise or listing fee when the retailer uses a nonlinear payment schedule to contract with its suppliers.

In this case the adoption of a listing fee to handle a producer's product or requiring a special payment for jointly valued local product promotion is one way by which the retailer can be compensated for providing a level of service and promotion beyond the level that would be

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[29] This is, of course, also true of the opposite case where advertising (for example) is most efficiently done by the primary producer (rather than the retailer).

privately profitable under uniform pricing arrangements. The return to the group increases, even if the use of the forcing contract allows the retailer to extract most of the gain from the higher level of service. Finally, because the lump sum part can be collected only as an all-or-nothing offer, the threat to delist or switch suppliers completely will be part of the negotiating process. Given that suppliers share somewhat in the rents created, suppliers will find it in their interest to accept (or solicit) the offered restraint.

Because trade is voluntary, it is not surprising to find that vertical constraints enhance the surplus enjoyed by vertical participants. What might appear more questionable is whether consumers can also benefit. As in the earlier case of seller power, it is quite easy to show that consumers must benefit. Here the vertical restraint permits larger service levels that in turn lead through complementarity to higher levels of use of the primary output. With final retail prices to consumers remaining unchanged at p, the level of retail output, q, must also be higher. For all these reasons, then, consumer surplus will be larger.

The analysis of service provision in a vertical market with buyer market power follows directly that done earlier for buyer power. The existence of vertical restraints allows trading partners to overcome the inefficiency associated with having to use linear prices both to provide the incentive for allocative use and to be the mechanism for redistributing the resulting rent among the parties. With nonlinear pricing, price can be used to transmit the relevant signal on the margin while the lump-sum or discrete part of the contract allows transference of more or less of the realized trading gain without producing allocative loss. As in the case of the monopolist, vertical restraints also produce the (unintended) byproduct of raising the welfare of consumers. Consumers have an interest in promoting vertical restraints that more fully exploit coordination

gains on the margin.[30]

The use of slotting allowances represents a special case of lump-sum fee discussed above. In the case of slotting allowances, the retailer extracts a discrete up-front charge (a slotting fee) from producers/manufacturers for listing a new product. A listing fee, on the other hand, charges a fee for continuing shelf life (and are sometimes called pay-to-stay fees). The literature tends to treat slotting allowance more favourably than listing fees and has suggested a number of reasons for why special charges for a new product could be efficiency enhancing (see the summary in Federal Trade Commission Staff, 2001). Some writers suggest that slotting fees compensate the retailer for a portion of the additional cost that arises from the greater riskiness of handling new and unproven products. Other writers point to the one time cost of introducing new products into the retailer's ongoing product list (see Bloom, Gundlach, and Cannon, 2000). Other writers emphasize that slotting fees provide a mechanism for purchasing exclusive shelf space for an introductory period that allows for producers of new products to compete with established products in the market (Sullivan, 1997).[31] Finally, both listing fees and slotting allowances have been treated as simple market mechanisms for allocating scarce shelf space. In the case of slotting fees, the willingness to make an upfront payment signals to the buyer the sellers a more credible belief in the value of its new product. As such they can help to overcome the cost of asymmetric information, particularly in the presence of sunk costs (Klein and Murphy, 1988). Over the longer run and in the absence of barriers to entry, any abnormal payments for slotting

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[30] Continuing the analogy with monopoly, vertical restraints create anti-competitive effects if they restrain horizontal (rather than vertical) competition. See the discussion below.

[31] Sullivan finds evidence consistent with the new product promotion hypothesis.

fees will lead to an expansion in shelf space and thus benefit consumers through larger stores that offer greater product selection.

On the other hand, the use of slotting fees to purchase exclusive shelf space may give an oligopolistic buyer the ability to foreclose horizontal competition and so generate welfare losses for consumers. In this context, some writers have seen the use of listing fees as a mechanism for raising rivals costs and so helping to eliminate competition and preclude competitive entry (Shaffer, 1991). Under this scenario, a dominant supplier offers to accept a lump sum fee in return for charging higher purchase prices to all retailers. Higher input prices then raise retailer's costs and signal to other retailers a desire for less aggressive price competition. As other retailers follow, the originating supplier gains through the feedback effect (of reduced retail competition and higher final prices). In much the same way as retail price maintenance changes individual incentives, higher industry costs imposed by the primary seller decreases the profitability of individual action. Vertical contractual restraints can then be used strategically as a mechanism to facilitate greater horizontal retail cooperation at the expense of final consumers.

It is important to recognize, however, that the use of slotting fees to purchase exclusive shelf space need not be successful in reducing retail competition and would not be so if the market for such exclusivity were competitive. Here the arguments for the anti-competitive effects of exclusivity hinge on an asymmetry – the value of that exclusivity must be sufficiently higher to incumbents than to a potential entrant. For Salop (1979), Salop and Krattenmaker (1986) and others, this asymmetry arises because any potential entrant can expect to earn at best the return associated with the competitive (n+1) producer, whereas incumbents can realize the return associated with n producers, if the exclusive arrangement prevents entry. Then because

aggregate profits fall with entry, the latter will always dominate the former so that the incumbent can always win a bidding war for exclusivity (Borenstein, 1988).[32]

To complete the argument, it remains to answer Bork's question for this case, i.e., why would a retailer cooperate with its supplier to create market power and so reduce its own sources of supply? This can happen for two reasons. First, because a single retailer ignores the effect of his decision on others, the supplier can more than compensate a single retailer for the harm that will fall on it from the loss of rents created by the anti-competitive use of exclusivity.[33] Second, if the retailer believes that an potential entrant will fail because other retailers already grant exclusives to incumbents, then it would not require significant compensation to grant exclusivity itself (Rasmusen, Ramseyer and Wiley, 1991).[34]

Turning from the incentives facing an individual retailer to the incentives facing the group, Salop (1986), has described a set of seemingly innocuous contractual (buying or selling) vertical clauses which if adopted by an industry would credibly facilitate horizontal collusion. They do so by increasing the speed and accuracy by which information of price cutting behaviour is transferred among those with the potential to collude.[35] An industry practice of including a "most favoured nation" clause, for example, guarantees to a seller that they will not be stuck with

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[32] Because the bidding advantage arises only from the incumbent being established, entry costs have arisen "artificially". In the sense of being an artifical cost, the payment of slotting fees may constitute a barrier to entry.

[33] Even though aggregate rents are lower so that all retailers cannot be compensated profitably, the loses will be borne disproportionately by those outside the colluding group. The rents received by that subgroup can rise.

[34] Both of these points utilize the notion that competition is public good.

[35] That is, it is typically the ability to hide and or disguise individual price cutting that protects final consumers from collusion by increasing the incentive of individual primary producers and/or retailers of cheating on collusive agreements. The points following are really just a generalization of the early (seemingly paradoxical) observation that open (rather than closed) bidding is the most effective for enforcing auction bid collusion.

a lower selling price if its rivals succeed in negotiating a higher price later. This assists collusion because it reduces the individual gain that can be expected from offering a price decrease and hence reduces the incentive to cheat on a collusive agreement (to maintain higher prices). Similarly a "meet-or-release clause" whereby a buyer must meet a competitors higher price or release the buyer from its agree price discourages rivals from offering selective price premiums without the original buyer learning and receiving the opportunity to match its competition. Similarly the meet-or-release helps to coordinate cooperation on a lower purchase price, since it guarantees that customers are not lost to rivals (who may lag in lowering their price) in the transition. A combination of both contractual provisions offers yet more credibility. The buyer must now match all price increases even when it is not in his or her individual interest to do so. This ties buyers hands and thus makes the threat of matching price increases much more credible than otherwise. However, because these clauses often promote beneficial competition and have the appearance of being pro-competitive even when they are not, it is often difficult to both detect and prove their anti-competitive use.

V. Current Practice in relation to Vertical Restraints:

This section summarizes the approaches currently taken by a number of different countries towards vertical restraints. In particular, it looks at how vertical restraints are treated in the United Kingdom, the European Community, Australia, New Zealand and the United States. Each has tended to focus on a different dimension of the problem of preventing the abuse of dominance through vertical restraints. I begin by outlining Canada's position with respect to vertical restraints and then consider how other countries compare.

F. Canada's approach to vertical restraints

Canada deals with most vertical restraints not as activities that either are or are not per se illegal (the exception being retail price maintenance) but as a class of potentially anti-competitive activities that fall under its general guidelines for the abuse of market power.[36] These guidelines set out the bounds of legitimate competitive behaviour for dominant firms or groups of firms in Canada and propose remedies when such firms go beyond accepted bounds. In this section I discuss only the bounds of acceptable competitive behaviour.

To begin, Canadian legislation through the Competition Act (1986) and the Competition Tribunal (1986) Act divides responsibility for competition policy into two parts. The two parts separate the investigation of a charge of anti-competitive behaviour (given to the Commissioner of Competition (CC)) from the responsibility for adjudicating these charges (given to the Competition Tribunal). Only the CC can apply to the Tribunal for remedial action from anti-competitive behaviour and, in turn, the Tribunal can consider only those matters submitted to it by the CC. In doing so, however, the CC must act as a litigant before the Tribunal and produce sufficient evidence to justify the action it requires of the Tribunal.

Examinations by the CC typically begin with the receipt of an industry complaint. On receiving the complaint the Competition Bureau will undertake a preliminary investigation to determine a) whether or not there is potential for remedy under the Act; b) whether there are grounds for moving on to a more formal application for remedy; and c) under which parts of the

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[36] See Competition Bureau, *Enforcement Guidelines,* 2001.

Act it will proceed.[37] How the CC proceeds depends upon whether or not there is evidence of the required elements of the "abuse of dominance" as set out in Section 79 (1) of the Competition Act. If they are not present, the inquiry is discontinued. The CC must then produce a formal report to the Minister of Industry that sets out what information was received and why the investigation was discontinued. The target of the investigation is also to be informed of the investigation results.

When the CC decides there are grounds for applying to the Tribunal for a remedial order, that application can come forward on a consent basis or as a filed application. The former means that both the CC and the respondent have agreed on an appropriate remedy. When agreement on a consent order is not obtained, an application is filed with the Tribunal. In either case the Acts require the Tribunal to hold open hearings and allow for third parties to apply for intervener status. In addition they set out rules for governing the Tribunal's proceedings and the procedures for the appearance of witnesses and the production of documentary evidence, etc.

Subsection 79 (1) of the Competition Act states that where the Tribunal finds

(a) that one or more persons substantially or completely control a business activity, and

(b) that those person either have or are engaged in anti-competitive practices and

(c) that those practices have the effect of lessening competition substantially in a market,

then the Tribunal may make an order prohibiting these persons from engaging in these practices.

There are then three necessary stages to be passed before remedial action from alleged anti-competitive behaviour can be obtained. First, the Bureau must prove the actions involved a

[37] Various sections of the Competition Act (1986) give the Competition Bureau the authority to use the courts to acquire evidence, require oral testimony, etc. to further their investigations

dominant group(s) with market power [defined as the ability to raise price profitably above its competitive level (or keep nonprice competition below its competitive level) for a significant period of time, usually one year]. To assess the existence of market power, the Bureau first looks across products and across space to define the market relevant to the inquiry. Then because the determination of market power is difficult, the Bureau considers a set of interrelated factors that include (as a minimum): market share, barriers to entry, industry excess capacity, and degree of countervailing power. In relation to market share, the Bureau considers a market share less than 35% not to normally give rise to anti-competitive actions that can substantially reduce competition. If the firm's share is 35% or more, then, the Bureau will normally continue its investigation.[38] It is also recognized that without barriers to entry, an attempt to exercise the market power suggested by a large market share would be futile. Because entry can be prevented by large cost differences between the incumbent and the entrant and where entry requires large investments that cannot be recovered (sunk costs), the presence or absence of these features will form part of the investigation. Finally there is an implicit connection between market share and entry barriers in that as the market share of the dominant firm rises, Canadian jurisprudence has required greater evidence of ease of entry into the industry (e.g., when Tele-Direct, 1997, was found to have an 80% share of its market, it was held that strong evidence of "ease of entry" would have been needed to overcome the presumption of control).

Once the existence of market power has been found, the second necessary element is

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[38] In addition to the market share of the dominant firm, the Bureau also considers the distribution across the remaining market. Other things equal, the Bureau considers the likelihood of maintaining a high price increases in market share and in the disparity between the dominant firm's share and that of its competitors. That is, it is believed that a firm with 55% of the market is constrained more effectively by a single competitor with 45% than with a bunch holding 5% each.

determining whether the person or persons with dominance have engaged in an anti-competitive act. That is, it is conduct that must be found to be anti-competitive and not market power per se. In general, the Tribunal tests for anti-competitiveness by asking whether a sustained practice was undertaken for predatory, exclusionary or disciplinary reasons. Here purpose or intent can be established by inference or by the evidence gathered in the case. To assist in this task, **Section 78 (1)** of the Act sets out a non exclusive list of examples of anti-competitive practice. These examples represent three different types of anti-competitive conduct and include:

(1) conduct that raises rivals costs and/or forecloses the market.

Paragraph (a) categorizes the practice of vertical margin squeezing by a dominant firm spanning different stages of a distribution system as anti-competitive. Here the Bureau's problem is one of distinguishing between anti-competitive and legitimate efficiency effects.[39] To determine anti-competitive squeezing the Bureau looks for structural preconditions. First there must be significant market power upstream in the wholesale market. Next there must be an anti-competitive rationale.[40] That is, the group of integrated firms must find it profitable to squeeze for exclusionary or disciplinary purposes and this, in turn, requires the reduction of competition downstream to be possible. The existence of entry barriers, the absence of close substitutes, or that the dominant firm or group already has a dominant share downstream is sufficient. Next, it must be shown that a squeeze occurred and was sustained sufficiently. Lastly the dominant firm

[39] That is, the vertically integrated firm may well be more efficient in distribution and this may result in smaller vertical price margins that further competition by lowering the final price paid by consumers.

[40] Avoiding the double marginalization problem is one example of where apparent squeezing would not contravene the act. Here the price squeeze that results is not intended to exclude others.

must be shown to have had sufficient motive to extend market power. This can be demonstrated by showing that dominant's firm current ability to exploit its market power is limited.

Paragraphs (b), (e), (f) and **(h)** describe purchasing behaviour by a dominant firm that would either raise cost or deny access to current competitors or potential entrants. This can be done by either acquiring a common supplier (paragraph (b)), or preemptively acquiring scarce facilities or resources (paragraph (e)), or buying up product for the same purpose (paragraph (f). The firm may be able to achieve the same outcome by requiring exclusive dealing contracts with its supplier (paragraph (h)). In addition, a dominant firm can increase rivals costs by adopting a specific technology or impose a set of contracts that increase the costs to consumers of switching to rivals and so foreclose entry. **Paragraph (g)** describes as anti-competitive the adoption of specifications that are incompatible with rivals. Long term contracts with switching fees and exclusive buying arrangements may also raise costs artificially and so foreclose entry.[41]

(2) predatory conduct

The Bureau distinguishes predatory from competitive behaviour when the dominant firm has the ability to raise prices profitably after rivals have been disciplined or eliminated. Three steps are involved. To establish dominance the Bureau must show that market power exists and therefore that recoupment is possible. After dominance, the Bureau must establish that the firm is selling below cost. Finally barriers to entry must be sufficient to preserve predatory gain. The Bureau also considers whether there is an attempt to deter entry by establishing a reputation for predation.

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[41] For example, in Laidlaw, 1992, the threat of legal action against purchasers considering switching suppliers was considered to constitute abuse of the judicial process and thus an attempt to raise switching costs.

Several paragraphs in Section 78 (1) cover predation explicitly. **Paragraph (i)** deals with the dominant firm selling "at a price lower than acquisition cost for the purpose of disciplining or eliminating a competitor". A variant is also found in **paragraph (c)** which deals with cases where a firm prices selectively on the basis of the freight rate difference from a rival's plant. Lastly, **paragraph (d)** indicates that the introduction of a "fighting brand" can be an anti-competitive act. Eddie Match is the case usually referenced here.

(3) acts intended to facilitate coordinated behaviour

The last set of anti-competitive acts addressed by Section 78 are arrangements facilitating the joint control of a market by a group of otherwise competiting firms. They include the use of "meet-or release" or "most favoured nation" clauses in vertical contracts that make cheating on group collusion more difficult and costly. Because such clauses can be invoked for legitimate business reasons beyond that of establishing market control, the Bureau must take care in establishing the motive for such arrangements.

Once the Tribunal finds the existence of market power and evidence of anti-competitive practices, the third element that the Bureau must demonstrate is that these practices have "prevented or lessen competition substantially".[42] The requirement for establishing "lessening of competition" is now well established in case law. In NutraSweet (1990) the Tribunal stated "the question to be decided is whether the anti-competitive acts engaged in by NutraSweet preserve or add to NutraSweet's market power". NutraSweet's requirement of exclusive dealing contracts in over 90 per cent of its markets coupled with high switching costs was judged to have prevented

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[42] Note that it must be market competition rather than any specific competitor that is harmed. In Tele-Direct (1997), for example, the Tribunal noted that "seizing market share from a rival by offering a better product or a lower price is not, in general, exclusionary since consumers in the market are better off".

competitive entry. In Nielsen (1995), 100 percent control together with practices designed to prevent entry were sufficient to maintain and enhance market power. More generally, however, to examine whether anti-competitive act of creating or erecting barriers to entry can lessen competition unduly, the Bureau must determine the state of competition in the absence of these acts. If it can demonstrate that but for these acts an effective competitor or group of competitors would have arrived, the Bureau will conclude that the acts in question constitute a substantial lessening of competition. The Bureau considers two years to be a reasonable period of time for acceptable entry.

When all three elements are found to be present, the Tribunal will grant remedy.

If we now turn to ask whether Canadian competition policy through enforcement of the abuse of dominance guidelines can be applied to the food distribution sector in Canada for the types of vertical restraints discussed in this report, the answer is clearly yes. Specifically, all of the non price trade practices discussed, i.e., the use of contracts that require exclusive product dealing or promote exclusive territories for sales and negotiation practices that involve refusals to supply and the threat to delist customers, can be found to be listed as anti-competitive in terms of Section 78. On the other hand, the pricing practices of requiring either slotting allowances for new product listing and/or listing fees for established products are not mentioned explicitly in Section 78 (1) as anti-competitive acts. This implies that while such practices can be found to be anti-competitive (i.e., sustained practices undertaken for predatory, exclusionary or disciplinary reasons), greater care must be taken in establishing the anti-competitive purpose or intent by the evidence gathered in making the case.

Whether the finding of anti-competitiveness can result in an abuse of dominance decision

then depends upon whether the market setting for these anti-competitive acts is consistent with the remaining two required elements. That is, are the agents involved in these practices dominant in their market and have the acts resulted in a substantial lessening of market competition? In relation to the former, a finding of the ability to exercise market power requires, at a minimum, a market share in excess of 35% with evidence of barriers to entry.[43] On the buying side of the retail grocery market, where most of the anti-competitive supermarket questions are being raised, this relatively straightforward condition is complicated by the existence of countervailing power held by sellers. Relatively high concentration ratios among food manufacturers suggests that the required market share (and/or demonstration of entry barriers) would need to be somewhat higher. In relation to the second condition, whether the vertical restraints used by the dominant firms result in the lessening of competition substantially requires a more detailed investigation of what could be expected in the absence of these practices. Where it can be shown that specific practices did raise competitor's cost and/or entry conditions to such a degree that viable entry was foreclosed, then the remedies allowed for under the Act would become applicable.

B. The United Kingdom

In 1998 the United Kingdom (UK) revised and updated its Restrictive Trade Practices, Resale Prices Act, and much of its earlier (1980) Competition Act in a new Competition Act (of 1998). The new Act was designed to correct features of previous acts that prevented some trade practices that were now felt to be innocuous while permitting other activities that are now viewed

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[43] The most concentration ratios presented in Table 3 of Wen (2001) suggests that food retailing would not meet this standard at least on a national basis.

as harmful. The revisions also brought UK competition policy into line with what was Articles 85 and 86 of the Treaty of Rome and are now Articles 81 and 82 of the Treaty of Amsterdam.

The UK Competition Act (1998) puts forward two basic prohibitions: Chapter I prohibits **agreements** to prevent, restrict, or distort competition; while Chapter II prohibits **conduct** that allows the abuse of dominant market position.

Agreements infringe on Chapter I only if the agreement has an appreciable effect on competition where, in practice (see OFT Major Provisions), an agreement will not have an appreciable effect if the combined market share of trading parties is less than 25%. An agreement that a) fixes market prices or fixes market shares or b) imposes minimum resale prices or c) is one of a network of similar agreements that has a sufficient cumulative effect can be judged to have had an appreciable effect without meeting the 25% threshold. The law permits two types of exemptions. An individual exemption can be given when it can be shown that the agreement contributes to the improvement of production, distribution, technical progress or economic progress. To qualify, the agreement must be essential for securing these improvements and must not foreclose competition over a large part of the market. In addition, certain block exemptions are given to categories that meet the same criteria as the individual exemptions.

Chapter II prohibits abuses of dominant market power, where an undertaking gives evidence of dominant market power if "it can behave to an appreciable extent independently of competitors and customers" when making market decisions. This decision is made relative to the appropriate market through an assessment of a) the type of good or service marketed and b) the geographical extent of the market. There are no exemptions from the abuse of market power, but there are some exclusions (e.g., undertakings that fall under the Financial Services Act,

Broadcasting, Environment and Companies Acts, etc.).

While the summary above applies generally, Section 50 of the 1998 Competition Act provides an exclusion order for vertical agreements. That is, vertical agreements are not viewed as giving rise to competition concerns unless they involve undertakings that possess market power. This means that business has a reasonable degree of certainty over the agreements covered and avoid for all the cost of having to justify large numbers of essentially benign agreements. This exclusion does not apply to vertical restraints that fix prices nor to agreements that impose a minimum or recommended price if, in practice, pressure or incentives are added to make that price fixed.

In April 1999, the Director of Fair Trading referred to the Competition Commission an investigation of the supply of groceries from large supermarkets controlled by owners of 10 or more stores (Supermarkets, 2000). For purposes of inquiring into the possible abuse of market dominance, the market relevant to the concerns expressed was defined as one-stop grocery shopping in stores of 1,400 sq. metres (15,000 sq. ft.) or more. Customer shopping practices were considered to be local with customers rarely travelling more than 10 minutes in urban areas and 15 minutes anywhere else. On this basis, five of the parties (Asda, Morrison, Safeway, Sainsbury, and Tesco) were found to be able to exercise market power. Five pricing practices (on which complaints had been made) were studied, three of which were judged to have distorted competition and/or led to a complex monopoly situation. Their findings were:

I. All five used loss leaders, the practice of persistently selling some frequently purchased items below cost. While it was recognized that this practice did allow some low income individuals to gain, it was viewed that older and less mobile customers would lose. On net, this practice was judged to have worked against the public interest.

II. The practice of varying price by location in light of economic circumstance was viewed

as against the public interest.

III. A large number of grocery sellers (including Asda, Safeway, and Tesco) focussed their aggressive pricing on a relatively small range of product lines. This was viewed as distorting competition. However, because this practice did not appear to generate excessive profits and/or lead to higher prices overall, the practice by 18 of the multiple stores, the practice was not found to be contrary to the public interest.

In spite of these findings, the commission proposed no remedial action. In relation to I) above, the commission found that prohibitions in the past had not been successful (prices overall rose when tried) and in relation to the cost of monitoring and intervention, the harm caused was viewed as insufficient to justify prohibition. In relation to II), the commission considered the alternatives of national pricing, a requirement that prices be based on cost, and even considered internet price posting and found that all alternatives were either undesirable or disproportionate to the harm imposed.

The commission also surveyed the multiple grocery stores on 52 alleged vertical restraint practices that could affect the competitive position of suppliers and so distort competition. They concluded that five of the multiples (the major buyers-Asda, Safeway, Sainsbury, Somerfield, and Tesco), each having at least an 8% market share, had sufficient market power. In addition, 30 of the 52 practices were judged to have resulted in a distortion of competition and given rise to secondary monopoly. Finally, 27 of the 30 practices undertaken by the five major buyers meeting the 8% criteria were judged to have operated against the public interest.[44]

To remedy the vertical practices isolated as anti-competitive (primarily on the buying side), the commission advocated the adoption of a Code of Practice. "Any multiple meeting the

[44] For example, the practice of requiring payments as a condition of stocking products or as a precondition for listing the product "when carried out by a multiple with buying power, adversely affects the competitiveness of some suppliers and distorts competition in the supply of groceries...". *Supermarkets*, 2000, section 2.476 (c), p.102.

8% criterion should be required to give undertakings to comply with the Code of Practice, which should be designed to meet the concerns we have identified. It should include provisions for independent dispute resolution. The Code would be best drawn up by retailers and representatives of suppliers, but it should be approved by the DGFT as meeting (the commission's) concerns" (p. 8).[45] This report was submitted to parliament in October 2000.

Over the last decade the UK Competition Commission (previously the Monopolies and Mergers Commission (MMC)) has investigated an number of specific cases of the potential abuse of market dominance though vertical restraints with the following results (see Howe, 1998). In the sale of petroleum, oil company ownership of retail outlets was reinforced through the use of five year exclusive dealing contracts. After investigating the MMC determined that the wholesale market for gasoline was competitive with little brand loyalty so that the use of exclusive contracts were not harmful to competition. Automobiles are sold using both selective and exclusive dealerships. Here the MMC found that these types of contracts did convey efficiency benefits and did not prevent effective interbrand competition. Beer distribution represents one of the most interesting cases. At one stage 75% of all the 60,000 public houses in the UK were owned by brewers and all these outlets were tied to their brewer for the supply of both beer and all other drinks. In the remaining 'free houses', about half were tied to particular brewers in the same way through their acceptance of favourable loans from brewers. The MMC found these practices did restrict competition and produced retail problems that were complicated because entry is restricted through tight licensing laws. Here the government's response was to substantially reduce the number of tied public houses, to allow tied customers to buy their non-

[45] See also *Supermarkets*, 2000, sections 2.578-2.597, pp. 149-153.

beer drinks elsewhere, and to serve at least one additional beer. Since this decision there have been more mergers among brewers combined with the rapid growth of pub chains. There has been little downward pressure on prices but there has been the growth of greater choice among beers and additional services provided within the pubs.

Two other cases have been more successful. First Raleigh bicycles used a selective distribution network "to protect specialist bicycle retailers from free-riding on service." The MMC found this practice significantly reduced intrabrand competition and restricted retail entry. In a similar way, Black and Decker withheld supplies from a retailer who resold their output at less than specified margins. This was not treated as a case of retail price maintenance, rather the withdrawal of supply was challenged and found to be harmful to intrabrand competition. Again the service argument was rejected. Lastly, the use of exclusive contracts to foreclose competition was also upheld in the case of Coca-Cola and Schweppes Beverages. Here the suppliers withdrew those practices that restricted the range of both products and customers that could be dealt with by each distributor.

If we compare the specific approach taken in the UK with that in Canada, a number of subtle differences emerge. First on the institutional side, Canada stands out for its structural separation of the functions of investigating charges of the abuse of market power from the adjudication of the relevant evidence and for the relative independence of both activities from the relevant department of government. Second, aside from prohibiting price fixing, the UK Act does not provide a specific list of practices (as does Section 78 (1) of the Competition Act in Canada) that define anti-competitive behaviour. This makes UK enforcement of competition policy relatively more dependent on proving the presence and cost of market power relative to

possible efficiency considerations.[46] In the UK, the Commission must demonstrate that a controversial practice is “against the public interest”. Third, the exclusion of vertical restraints from the abuse of dominance provisions for trading arrangements encompassing less than 25 percent of the market (as compared to 35 percent for Canada) means UK coverage is more extensive and suggests that the UK Commission will be more interventionist than is the Bureau in Canada. For example, the UK appears to be relatively more willing than Canada to initiate investigations into networks of relationships where individual participants often fall well below the 25% rule (e.g. the five UK supermarkets with more than 8 percent of the market). Fourth, the finding that certain practices are “against the public interest” in the UK need not lead to the adoption of remedy (unlike the finding of the abuse of dominance in Canada). In the grocery investigation discussed above, for example, the finding of a large number of price and nonprice infractions resulted in no remedial action being proposed. Rather, the finding that a current undertaking is “against the public interest” appears closer to the second stage finding in Canada that a certain practice is anti-competitive. That is, the size and significance of the cost of the action are yet to be considered relative to the gain expected from alternative remedies. What this does allow the UK, however, is the ability to use the finding of “against the public interest” to publically coerce behavioural changes that could not otherwise be enforced economically. This appears to be the strategy in the Code of Conduct recommendation by the UK Supermarket inquiry.

C. The European Community

[46] On the other hand, the asymmetry by which different potential anti-competitive acts are treated may result in asymmetric enforcement as acts specifically listed as anti-competitive become easier to prohibit.

For the European community as a whole, the market power held by retailers is viewed as an area of potential competition policy concern. Especially in food retailing, the pursuit of economies of scale has led to large capital investments that have dramatically increased the size of food stores. Many supermarkets offer as many as 20,000 different products and require sophisticated supporting logistics and distribution systems to support final sales (Dobson et al, 2000). At the same time, retail grocery chain concentration has grown both at both the national level and in Europe as a whole.[47] In 1992 the largest ten grocers in Europe accounted for 28 percent of the market. By 1997 this had increased to 36.2 percent (p.1).

In their study of European market power in grocery retailing, Dobson et al (2000) looked specifically at five representative supermarket product categories (washing powder, instant coffee, roast and ground coffee, butter, and margarine) across four European countries and found the following stylized facts. First, buying power was a feature of food retailing in all four countries considered, but with significant differences among them. The UK was dominated by four retail chains outside of which buying groups played no major role. In the other countries, buying groups were more important and accounted for a significant proportion of sales. Second, retail buying power was in many countries also associated with significant retail selling power. Using a five firm concentration ratio as a measure of market power, the UK had the highest concentration ratio (56%), followed by France (51%), Germany (45%) and Spain (32%).

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[47] An issue that seen as a potential exclusionary devise in Supermarkets is the growing use of house brands. Particularly in the UK, house brands are increasingly developed and used to displace nationally branded goods. In the Canadian grocery industry, only Loblaws has been successful in introducing its President's Choice brand.

The legislation supporting European competition policy is contained in Articles 81 and 82 of the Treaty of Amsterdam, together with a number of implementing regulations. It is directly applicable throughout the European Community (EC) including the UK in cases where there is an effect on trade between member states. Like the UK legislation discussed earlier, the legislation consists of two basic clauses that prohibit, first, agreements in restraint of competition and, second, abuses of dominant market position.

Article 81 prohibits agreements that affect trade between member states and have as their effect the restriction or distortion of competition within the common market. Contracts that fix prices, share markets, restrict production and impose discriminatory conditions of supply etc. are automatically void unless granted an exemption by the European Commission. Grants may be given if the agreement improves production, distribution, technical or economic progress while allowing consumers a fair share of the benefits and does not impose any indispensable restriction nor provide the opportunity to eliminate competition. The European commission may grant an individual exemption if notified and has provided blanket exemptions for certain categories of agreements. Article 82 prohibits the abuse of market dominance insofar as it may effect trade between member states.

One important difference between the EC and UK approaches to vertical restraints is that the EC tends to treat vertical restraints as illegal unless demonstrated otherwise and in its earliest legislated form required advance notice to be given for a vertical agreement to escape being declared void automatically. This approach to dealing with vertical restraints reverses entirely the onus of proof by requiring private trading partners to prove the economic desirability of any vertical arrangement before its use. In general, the need to produce evidence of efficiency

enhancement before such contract are considered valid and binding introduces higher cost and greater uncertainty into many of the common contractual arrangements used without question in both Canada and the UK.[48] To help minimize these costs, vertical arrangements that involve less than 10 percent of the market are not considered to fall under Article 81. To allow more attention to be focussed on those agreements that are more likely to generate negative overall effects, the European Commission (September 2000) drafted new regulations to replace Regulation 17, the regulation that implemented Articles 81 and 82. Among many other changes, that draft proposed ending the requirement of prior administrative authorization for restrictive agreements. It is now proposed that from the outset, restrictive agreements will either have met the terms of Article 81 and be legal or not (europa.eu.int/comm/competition/antitrust/others/com_2001_175).

On October 13 2000, the Official Journal of the European Communities published the Commission's *Guidelines on Vertical Restraints* that highlights the "safe harbour" created by the EC's Block Exemption Regulation.[49] This exemption creates a presumption of legality for vertical agreements that involve less than 30 percent of the relevant buying or selling market. Even within the "safe harbour" of the Block exemption, however, there is a set of "hardcore" restrictions that exclude certain types arrangements from the presumption of legality given to arrangements involving small market shares. These include the arrangements of resale price maintenance (paragraph 47), price fixing agreements (47, 48), the partitioning of markets by

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[48] Only in a world of zero transactions costs would the Coase Theorem prediction of no allocative difference arise from an arbitrary reassignment of the right to use vertical restraints. Requiring firms to prove competitive benefit rather than to require competition authorities to prove anti-competitive effects would be efficient if the expected benefits of their use were primarily negative. This is the justification for making retail price maintenance and other price fixing arrangements per se illegal. There is much less justification for assuming that all other vertical restraints are likely to generate net competitive harm.

[49] Official Journal of the European Communities, (2000/C 291/01) paragraph 21.

restricting sales to a territory or customer type (49), and vertical agreements among competitors (26). Vertical agreements outside of the Block exemption threshold are now not presumed to be illegal (62) nor any longer is there need to give precautionary notification for exemption under Section 81 (3) that the arrangement will convey sufficient economic benefit to offset its anti-competitive harm (63). The effect of all these changes is to move the EC much closer to the UK model while still slanting the requirement for supplying the standard of proof against competitive benefit.

In an interesting paper that comments directly on the 1997 EC Green Paper, Biro and Fletcher (2000) advance a general rule for dealing with the foreclosure potential of exclusive contracts by extending the use of negative clearance presumptions.[50] They argue that since exclusive dealing will lead to a downstream foreclosure problem only if a) there are a sufficient number of upstream suppliers covered, b) there are significant barriers to entry upstream, and c) the agreements are long term in nature, the following rule is both desirable and administratively feasible. "A presumption of negative clearance should exist for any exclusive distributive agreement for which a) either the portion of the upstream market that is tied up by the downstream firm is less than 20%, b) or the proportion is less than 30% and there are low barriers to entry and expansion upstream, and c) unless the totality of all similar agreements between upstream and downstream firms accounts for over 60% and the additional portion to be tied up by the agreement is over 10%" (p.8). For exclusive purchasing contracts, the concern is only with upstream foreclose so that the conditions can be reversed with upstream replacing

[50] Negative clearances define conditions under which there would be a rebuttable presumption of compatibility with a particular Article or Section of the Act.

downstream.[51] The potential for "selective" distribution agreements leading to anti-competitive effects is similar to the exclusive case and can thus be treated in the same way. More generally, all arrangements that are similar in effect to exclusive dealing (i.e., selective distribution, non-linear pricing where the average price increases with the quantity sold) would follow the rule governing exclusive dealing. Arrangements analogous with exclusive purchasing agreements (selective purchasing, tying and bundling, non-linear pricing when the average price falls with the quantity sold) would be treated under the exclusive purchase rule. In this way a bound can be placed on the number and type of arrangements that would require positive vetting before normal trading arrangements can proceed.

D. Australia[52]

Competition policy in Australia is handled by the Competition and Consumer Commission (ACCC), an independent authority that administers the Trade Practices Act 1974 (TPA), the Prices Surveillance Act 1983 and parts of other legislation. Broadly speaking the TPA covers anti-competitive and unfair market practices, mergers or acquisitions of companies, product safety/liability, and third party access to facilities of national significance. Vertical restraints are addressed in sections 47 and 48. More explicitly, section 47 deals with prohibitions in regard to exclusive dealing and section 48 deals with resale price maintenance (RPM).

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[51] That is, a presumption of negative clearance should exist for any exclusive purchasing agreement for which a) either the portion of the downstream market tied up by the upstream firm is less than 20%, b) or the proportion is less than 30% and there are low barriers to entry and expansion downstream, and c) unless the totality of all similar agreements between upstream and downstream firms accounts for over 60% and the additional portion to be tied up by the agreement is over 10%.

[52] This section relies heavily on a survey written by Tabitha Bonney, Coordinator of International Research and Communications, ACCC, August 3, 2001.

Section 48 of the TPA contains a general prohibition on RPM, with section 96(3) specifying six relevant types of RPM. For example, a supplier cannot:

(a) make it known that it will not supply goods unless a specified resale price is maintained;

(b) induce the sale of goods supplied by the supplier at or above a specified price;

(c) agree to supply goods for resale, at or above a price specified by the supplier;

(d) withhold goods or services unless the buyer agrees not to sell below a specified price;

(e) withhold the supply of goods from a second person because a third person who obtains the goods from the second sells, or will not agree not to sell, below the price set by the supplier; or

(f) use a price statement likely to be understood as a price below which goods may not be sold.

On the other hand, section 90(8)(a)(iv) provides the Commission with the ability to authorise RPM conduct, pursuant to section 88(8A), should a public benefit test be satisfied. The ACCC also has the power to authorise conduct that might otherwise be anti-competitive on the rational that in some cases the public benefit of the conduct may outweighs the cost of its anti-competitive nature. This process provides immunity from legal action under the relevant provision, effective from the date of authorisation (not application).

Section 47 of the TPA indicates that exclusive dealing is illegal only if "a substantially lessening of competition"results in the relevant market. Here exclusive dealing is defined in section 47 as:

a) supplying goods or services on condition that:

i) the buyer will not acquire goods or services from a competitor;

ii) the buyer accepts some restrictions on its right to resupply goods or services;

iii) the buyer acquires other goods or services from a third party [third line forcing -

illegal per se];

b) refusing to supply goods or services because:

i) the buyer has dealt or refused to cease dealing in a competitor's products;

ii) the purchaser has failed to accept some restriction on its right to resupply;

iii) the purchaser refused to acquire other goods or services from a third party.

The "substantial lessening of competition" test requires consideration of the relevant market and the nature of competition therein. The case of Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd (1982) *[ATPR* 40-315, at 43,887-43,888] both posed and answered the question "when has competitive trading in the market been substantially interfered with?" Its answer is now included in the Explanatory Memorandum to the Act; i.e., "it is intended to mean an effect on competition which is real or of substance, not one which must be large or weighty".[53] This case also allowed for considered of the likely effect on other parties within the market. While the disadvantage to one retailer may not amount to a substantial lessening of competition, should the conduct have the purpose (or effect) of intimidating other traders in a relationship with the party imposing the vertical non-price restraint, this could amount to a substantial lessening of competition.

Section 47 matters are subject to authorisation and notification provisions. Pursuant to section 88(8), conduct that contravenes section 47, with the exception of Third Line Forcing, can be authorised. The test to be applied is whether the public benefit created outweighs the cost associated with the substantial lessening of competition. Third Line Forcing can also be authorised, in this case the test is whether the proposal would result in such benefit to the public

[53] Trade Practices Legislation Amendment Bill 1992: Explanatory Memorandum, paragraph 12, p. 4.

that it should be allowed (section 90(8)). Under sections 93(3) and 93(3A), traders can obtain immunity from prosecution for exclusive dealing conduct by notifying the Commission of the conduct. The conduct remains immune until a determination is made in regard to authorisation.

The case of Melway Publishing Pty Ltd v Robert Hicks Pty Ltd (2001) [75 Australian Law Journal 600] considered a complaint by Hicks that Melway's distribution arrangement amounted to a Misuse of Market Power in breach of section 46 of the TPA. Because the distribution arrangement amounted to a vertical restraint, the High Court considered the matter in the light of section 46. Here the court said "it is not the case that the adoption by a manufacturer, whether with or without a substantial degree of market power, of a system of distribution involving what are sometimes called vertical restraints necessarily manifest an anti-competitive purpose of the kind referred to in section 46." (Par 38, Joint majority judgement). For vertical restraints to be in breach of section 46, proof of market power and taking advantage of such power needs to be established. Section 46 does not amount to a secondary per se prohibition on non-price vertical restraints. As Professor Corones has pointed out (in “Non-Price Vertical Restraints After Melway”, *Australian Law Journal* 75(7), July 2001, p. 437), section 46 is concerned with free competition not fair competition. Section 51AC prohibits unconscionable conduct in business transactions. This section is concerned with vertical relationships where suppliers or buyers do not have substantial market power but are nevertheless in a position of strength vis-à-vis other firms (Corones, p. 439).

In terms of day-to-day practice, the Commission analyses its complaints for trends and emerging problems. The investigations then search for evidence of a breach, regardless of whether subsequent action involves litigation or some alternative strategy. The Commission's

selection of such enforcement actions have been influenced by whether a particular matter involves: an apparent blatant disregard of the law; a history of previous contraventions of the law; significant public detriment and/or a significant number of complaints; the potential for the action to have a worthwhile educative or deterrent effect; a significant new market issue; and, a likely outcome that would justify the use of the resources.

Finally, while vertical restraint arrangements are a specific enforcement priority of the ACCC, the TPA is not the sole the domain of the Commission. Should an individual or company feel they have been adversely effected by conduct in breach of the Act, there is a right of private action which they can pursue.

In contrast to Canada, the UK, and the EC, Australia has followed the strategy of initially defining certain acts as either illegal (retail price maintenance) or legal (exclusive dealing). Having done so, business in the former case or the ACCC in the latter are then permitted to submit evidence that would allow the overturning of the general rule if the public benefit created could be shown to outweigh the cost associated with the substantial lessening of competition. After giving more of a role to an efficiency defence, Australian practice comes closest to that of Canada in that vertical restraints can be found in breach of their Act only if both proof of market power and the taking advantage of that power can be established. The case law associated with Dandy Power Equipment reported above, however, does suggest that the Australian requirement for proving “substantial market interference” is somewhat lower than the Canadian requirement of proving the “substantial lessening of competition”. Finally, by allowing both an efficiency defence by industry and the right of private action under the Act, competition policy in Australia seems designed to promote more the active participation by those individuals directly involved.

E. New Zealand[54]

In New Zealand, the Commerce Act of 1986 is used to promote competition in markets for the long-term benefit of consumers. To do so, it prohibits the following restrictive practices:

a. arrangements with the purpose or effect of substantially lessening competition (section 27),

b. arrangements that contain exclusionary provisions (section 29),

c. price fixing arrangements between competitors (section 30),

d. where a party takes advantage of a substantial degree of market power with the purpose of harming competitors (section 36), and

e. where a supplier or another party tries to enforce a minimum resale price (sections 37 & 38).

Sections 37 and 38 of the Act relate to resale price maintenance (RPM). These sections prohibit a supplier or anyone else from making it known that they propose to engage in conduct, whether alone or in concert, that will hinder or prevent the supply of any goods to, or the acquisition of any goods from, a person unless that person agrees not to sell those goods at a price less than the price specified by the third party. Suppliers can issue recommended retail prices for products, but the supplier should not attempt to enforce any minimum recommended retail price. A retailer must be free to charge a lower price for a product, without encountering penalty action.

Section 38 relates to resale price maintenance by others. Businesses that threaten to boycott a supplier unless it refuses to deal with a discounting party will breach section 38. This

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[54] This discussion of New Zealand practice in relation to vertical restraints has benefited from a summary written by Carissa Roberts, Investigator, Business Competition Branch (25 July 2001).

might be a situation where one retailer, or a group of retailers, threatens to stop buying from a supplier, unless the supplier agrees to stop selling to another who has been selling below a specified price. [Commerce Commission versus Hewlett Packard (NZ) Ltd., High Court, Wellington, (1992)].

Genuinely recommended resale prices (RRP) are an exception to sections 37 and 38. Section 39 specifically allows suppliers to issue RRP, as long as the supplier does not attempt to enforce the recommended retail price. As long as the list or recommendation clearly states that it is only a recommendation, and there is no obligation or coercion to follow the list, a RRP will not constitute RPM in terms of sections 37 and 38.

Lastly in relation to price setting behaviour, although a business will not breach sections 37 and 38 for enforcing a maximum resale price, it may be caught under section 30 for price fixing. For example, a soft drink manufacturer may supply to retailers and stipulate a maximum resale price (acceptable according to Section 37). But, if the manufacturer also owns vending machines, it becomes a supplier and a retailer. Therefore, any agreement between the manufacturer and its other resellers would amount to price fixing, having been an agreed upon arrangement between competitors.

In relation to non-price vertical restraints, the Commission does receive many complaints about refusals to deal, and/or exclusive dealing arrangements. Many of these complaints simply reflect unsuccessful negotiations between potential trading partners. Here the Commission is anxious to emphasize that in terms of the Commerce Act, there is no absolute obligation on any business to supply, or buy goods and services from another business and that it is up to each business to decide who can best represent its product at different points in time. For exclusive

arrangements to be illegal under the Act, the particular arrangement must be of sufficient scope or content to offend against the restrictive trade provisions of the Act.

For the most part, the Commission views it as too invasive to force a business to supply others. Only if the product is so unique (and has no near substitutes) that refusing to supply could raise issues. But even then, it needs to be done with an anti-competitive purpose, and cause substantial lessening of competition. If a business is refusing to deal, a breach of section 36 requires that the business has significant market power, and takes advantage of that power for an anti-competitive purpose. This, in turn, requires a test for market power that is similar to the U.S. "ssnip" test, that is, it defines the market as the dimensions over which the manufacturer would be in a position to impose a 'small yet significant and non-transitory increase in price'. [Telecom Corporation of New Zealand Ltd. versus the Commerce Commission, 1991, TCLR, 473].[55]

In terms of its presumption of legality unless the Commission can establish market power and abuse of that power, the New Zealand procedure for handling vertical constraints seems closest to Australia and Canada. Perhaps because of its smaller size, New Zealand has not yet established as formal a set of procedures for investigating cases of potential abuse as has Canada.

E. The United States

U.S. competition policy derives from the following Statutory authorities:

The Sherman Act which prohibits contracts, combination and conspiracy in restraint of trade or commerce among states or with foreign nations. Most horizontal activities are analyzed under a

[55] This is now codified in Commerce Commission, *Business Acquisition Guidelines*, 1999, pp.11-16.

rule of reason criteria, but certain types of restraints are viewed as per se illegal: horizontal or vertical price fixing, group boycotts or concerted refusals to deal, and horizontal market division. The Act also prohibits monopolizing and attempts to monopolize.

The Clayton Act operates *prospectively* like the Sherman Act. Section 7 prohibits mergers, stock or asset acquisitions that may be to substantially lessen competition or "tend to create a monopoly". Other Clayton Act provisions cover vertical restrictions such as exclusive dealing, requirements contracts and tying arrangements.

The Federal Trade Commission (FTC) Act Section 5 prohibits "unfair methods of competition and unfair or deceptive acts or practices". It is used to fill in gaps in the Robinson-Patman and Clayton Acts. Section 5 has been applied to preclude normal antitrust offenses such as horizontal and vertical price fixing, anti-competitive boycotts, exclusive dealings, monopolization, attempted m and conspiracies to monopolize.

Robinson-Patman Act (1936) was enacted in response to the rise of supermarket chains (A&P) and congressional hearings revealing that A&P received multimillion dollar discounts and other allowances in a single year. The Act is most often used in relation to Section 2 (a) which prohibits a seller from discriminating in price (not setting price differences). Section 2 (f) prohibits a buyer from knowingly inducing a discriminatory price. Other provisions address: brokerage payments or allowances paid without services performed; discriminatory payments for services or facilities; and the discriminatory provision of facilities or services.

To supplement the statutes, the FTC publishes guidelines to describe more precisely the way certain practices will be interpreted. For example, under the FTC "Fred Meyer" guidelines, manufacturers are required to treat similarly situated U.S. customers on a nondiscriminatory basis

as far as promotional program notification is concerned.[56] More generally, the Department of Justice (DOJ) and the FTC issue periodic guidelines intended to explain to business exactly how the antitrust agencies will deal with various issues. The *1992 DOJ/FTC Horizontal Merger Guidelines,* as amended in 1997, is perhaps the best known example. For our purposes, the *FTC/DOJ Antitrust Guidelines for Collaborations Among Competitors* (April 2000) is relevant.[57] These guidelines recognize that competitors will sometimes collaborate in order to realize market efficiencies and so are designed to describe the analytic framework used by the DOJ and the FTC so that businesses can assess the likelihood of a antitrust challenge to any of their proposed collaborations.

Two types of analysis are used by the U.S. Supreme Court to determine the lawfulness of an agreement among competitors: per se and rule of reason. Agreements that are almost always intended to raise price and/or reduce output are treated as per se illegal. These are viewed as so likely to raise harm that the time and effort necessary to particularize their effects is not worthwhile. Examples include agreements among competitors to fix prices or output, rig bids, or share or divide markets by allocating customers, suppliers, territories or lines of commerce. The DOJ can also prosecute participants in cartel agreements criminally. Agreements not challenged as per se illegal are analyzed under a rule of reason and this requires a factual inquiry into the agreement's overall competitive effect.

Rule of reason analysis begins with a DOJ/FTC examination of the competitive nature of

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[56] See FTC, *1992, Guides to Advertising and Promotional Allowances.*

[57] Note that the Guidelines are interdependent since, for example, the criteria for concentration levels needed to give evidence of market power before a vertical restraint can give rise to antitrust concern will come from the *Horizontal Merger Guidelines*.

the agreement. The collaborating parties are asked the business purpose of the agreement and, if already in operation, the consequences are examined for whether they have caused anti-competitive harm. When either the nature of the agreement or the absence of market power[58] demonstrates the absence of anti-competitive harm, the DOJ/FTC does not challenge. On the other hand, if the likelihood of anti-competitive harm is apparent from either the agreement itself or from the agreement's effect in operation, the DOJ/FTC will challenge the agreement without a more detailed market analysis.

Should the initial examination raise only possible competitive concerns, but ones that cannot be substantiated without further review, the DOJ/FTC will examine the agreement in much greater depth. Here the steps involve: a more precise definition of the relevant market(s), the calculation of market share and concentration ratios in order to assess whether the agreement would create or enhance market power.[59] Then the DOJ/FTC examines whether the parties to the agreement have the ability and incentive to act independently in an environment where entry conditions may foster or prevent anti-competitive harm.[60]

If the larger investigation indicates no potential for harm, the investigation ends without considering whether there are pro-competitive benefits. If the investigation does suggest anti-competitive harm, then the DOJ/FTC examines whether the agreement is "reasonably necessary"

[58] Here the *Horizontal Merger Guidelines* are used.

[59] At each step the more precise definitions of "market power", "independence", "committed entry" etc. are used. Frequently these terms use the more precise definitions given in *Horizontal Merger Guidelines.*

[60] The *Guidelines* state that the DOJ/FTC will consider six factors when examining independence: a) the extent to which the agreement is exclusive, b) the extent to which agents retain independent control of assets, c) the nature and extent of each participants financial interest in the collaboration, d) the control competitively significant decision making, e) the likelihood of competitive information sharing, and f) the duration of the collaboration.

to achieve the pro-competitive benefits that would offset the anti-competitive harm(see 3.36(b)).

Finally, because competitor collaborations are often pro-competitive, the *Guidelines* set out safety zones that the define market shares below which collaboration is viewed as so unlikely to cause harm that the enforcement agencies presume such arrangements will be lawful (*Guidelines* Section 4). For example, section 4.2 states that,

> Absent extraordinary circumstances, the Agencies do not challenge a competitor collaboration when the market shares of the collaboration and its participants collectively account for no more than twenty percent of each relevant market in which competition is affected. The safety zone does not apply to agreements that are per se illegal, or that would be challenged without a detailed market analysis or to competitor collaborations to which a merger policy is applied (p.26).[61]

In addition to these general guidelines, current regulations exist for number of specific vertical restraints. For example, refusals to deal are not considered to inherently unlawful. The U.S. Supreme Court has stated that a manufacturer has a right to deal, or refuse to deal, with whomever it likes, as long as it does so independently. However, refusal to deal may be taken as evidence of monopolization or attempted monopolization. Here there has been much interest in the Toys R Us case. In October 1998, an Administrative Law Judge issued an initial decision that would have prohibited agreements whereby toy manufacturers were not to sell hot selling toys warehouse clubs or to sell them only on disadvantageous terms. Although Toys R Us appealed, the Seventh Circuit court upheld (August 2000) the commission's original finding of an unlawful agreement. In addition, a group boycott or a collective refusal to deal may be deemed illegal. Most cases deal with refusal by a seller, but the same criteria would apply to buyers.

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[61] There is a special safety zone given to competitor collaborations in the innovation market (section 4.3).

Second, the use of slotting allowances, i.e., the payment of lump-sum, up-front fees by food manufacturers to have their products placed on supermarket shelves, has been the subject of much recent FTC attention. A two day conference was held on the topic in February 2001 to explore the nature of these agreements together with such associated practices as pay-to-stay and exclusionary dealing arrangements.[62] A staff report on that conference (Report on the FTC Workshop on Slotting Allowances) has concluded that these set of practices should continue to be analyzed under the usual antitrust standard for exclusionary conduct and has set out a more detailed a framework for analyzing such conduct. With this report as inspiration, the FTC is currently hoping to initiate one or more detailed empirical examinations of slotting allowances with a view towards better understanding how these issues fit with other exclusionary practices and integrate with the growing concern over monopsony power in the supermarket industry. At present the DOJ/FTC has not issued any slotting allowance guidelines.

VII Conclusion

In this paper I have investigated the reasons why certain specific vertical practices that appear anti-competitive may in fact be pro-competitive in their overall effect. Ironically, this is precisely because vertical arrangements use forcing rules and/or explicitly foreclose price competition in order to channel additional competitive effort along margins where service and/or information was underprovided. Unfortunately, this means that even when vertical restraints improve unambiguously the outcome for trading partners and final consumers, anti-competitive elements will still be visibly present in the agreement. On the other hand, vertical arrangements

[62] See the discussion in Section IV above.

as a class cannot be given an unqualified stamp of approval. In the absence of externalities, the mechanics by which vertical restraints realize internalization give trading partners the means to collude at the expense of competitors and/or final consumers.

On the basis of our review of the current practices of many countries and the European Community, there appears to be relative unanimity in treating vertical restraints as potentially anti-competitive practices, with serious concern requiring more detailed examination only should the market share held by the trading partners pass some threshold of minimum market share. Even in the EC, where the legislation seems to be most strongly suspicious of the efficiency case for vertical restraints, trading arrangements involving traders with very little potential market power are excluded directly from the Act's coverage and a blanket exemption for most vertical practices that fall below a threshold market share of 30 percent is also granted. Only with respect to the treatment of slotting allowances and listing fees does there appear to be uncertainty. A close monitoring of ongoing the US inquiry into the effect of such practices is warranted before any hard decision is made on their probable anti-competitive effect.

Overall, it follows that our survey suggest no strong reason for believing that the retail pricing use of slotting allowances and listing fees together with non-price vertical restraints such as exclusive dealerships, exclusive territories, and refusals-to-deal cannot continue to be dealt with effectively by Canada's abuse of dominance guidelines. This approach is consistent with economic theory and, with many minor variations, essentially the practice that is current in all countries surveyed above. The Canadian threshold below which market power is assumed to be

absent is high relative to the minimum thresholds used elsewhere in our sample.[63] Nevertheless the large physical size of Canada relative to its population distribution may make economies of scale harder to realize and hence justify a larger minimum threshold. As an alternative to a single threshold, one might consider a progressive set of criteria for arrangements associated with ever higher degrees of market concentration (such as the 'safe harbour' standards that Australia has adopted for mergers).[64]

Even so, the growing complexity of the retail grocery trade and the bundling together of ever larger numbers of goods and services into supermarket output means that the creative use of vertical restraints of all kinds is only going to grow. Similarly, with growing store size, growing integration across the distribution stages, the potential for misuse will more likely increase rather than diminish. Because the size of the benefit and cost in each case will depend upon its market context, there seems to be little escape from the conclusion that much hard work will be needed to determine not only whether dominance is present but whether competition has or has not been lessened substantially.

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[63] That is, the Canadian minimum market share is 35 per cent compared to 30 in the EC and 25 in the UK.

[64] See Sections 5.25-5.35 of the 1993 Competition Act (http://www.accc.gov.au/merger/mgrglns4.htm).

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