THE E.C. GREEN PAPER ON VERTICAL RESTRAINTS: OPTION IV DEFENDED

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Abstract

This paper responds to the editorial in *European Competition Law Review*, Issue 3, 1998 (The E.C. Green Paper on Vertical Restraints: An Economic Comment). Contrary to the views expressed in that editorial, it is argued that an evaluation of the potentially anti-competitive effects of exclusive distribution and exclusive purchasing-type agreements requires an examination of conditions in both the upstream and downstream markets.

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The views expressed in this paper are the author's and do not necessarily reflect the views of the Department of Economics, Trinity College, Dublin.

The E.C. Green Paper on Vertical Restraints: Option IV Defended

I. Introduction

This paper responds to the editorial by Zoltan Biro and Amelia Fletcher which appeared in *European Competition Law Review* (The E.C. Green Paper on Vertical Restraints: An Economic Comment, Issue 3, 1998). Biro and Fletcher commented on the E.C. Green Paper on Vertical Restraints (1997) and, in particular, on Option IV which aims to reduce the number of agreements that fall under Article 85(1) through the introduction of a "negative clearance presumption". Implementation of Option IV would require examination of concentration in both the upstream and downstream markets in the context of both exclusive distribution-type and exclusive purchasing-type agreements.

Biro and Fletcher proposed an alternative formulation for Option IV and, in particular, supported the adoption of a more focused filtering mechanism whereby downstream concentration would be ignored when examining exclusive distribution-type agreements and upstream concentration would be ignored when examining exclusive purchasing-type agreements. This alternative version of Option IV has the undoubted advantage of reducing the workload with respect to examinations of market concentration details. Biro and Fletcher, however, also concluded that the alternative Option IV is more appropriate in terms of capturing the maximum number of anti-competitive agreements and the minimum number of pro-competitive agreements. Following a brief introduction to vertically restrictive agreements, this paper highlights examples of anti-competitive agreements which escape Biro and Fletcher's refined filtering mechanism. The paper concludes by arguing that Option IV provides a more appropriate filtering mechanism.

II. Exclusive Distribution and Exclusive Purchasing Agreements

Exclusive distribution-type agreements

Through an exclusive distribution agreement, sole reselling rights for an upstream firm's product(s) in a particular geographical area are conferred on a single downstream firm (say, distributor). A selective distribution agreement is somewhat similar in that the number of downstream sellers of an upstream firm's product(s) in a particular geographical market is limited, but not necessarily to one.

Biro and Fletcher (p.134) note that non-linear pricing agreements in which the average price paid by the downstream firm is increasing in quantity (e.g. due to the presence of slotting allowances) is also somewhat similar in that it is in the upstream firm's interest to limit the number of downstream sellers.

Exclusive purchasing-type agreements

Through an exclusive purchasing agreement, a downstream firm's (say, distributor) range of products in a particular product market is limited to the product(s) of a single upstream firm (say, manufacturer). A selective purchasing agreement is somewhat similar in that the number of upstream firms' products in a particular product market carried by a downstream firm is limited, but not necessarily to one.

Biro and Fletcher (p.134) note that non-linear pricing agreements in which the average price paid by the downstream firm is decreasing in quantity (e.g due to quantity discounts) is also somewhat similar in that the downstream firm has an incentive to limit the number of upstream firms' products carried.

III. Potential Anti-Competitive Effects of Vertical Restraints

Biro and Fletcher consider three potentially anti-competitive effects of vertical restraints: foreclosure, dampening competition and facilitating collusion. For the purpose of commenting on the alternative version of Option IV this paper accepts this classification. However, it is worth drawing attention to the important difference between motivations and effects in the context of vertical restraints and their welfare characteristics.[1] Vertical restraints which stem from anti-competitive motives may have welfare-increasing effects and vertical agreements which stem from pro-competitive motives may have welfare-decreasing effects. As examples, exclusionary exclusive purchasing agreements may be efficient when viewed from society's perspective (due perhaps to excessive/inefficient entry in the non-exclusionary equilibrium) and service-enhancing minimum resale price maintenance agreements may be inefficient when viewed from society's perspective (due perhaps to a divergence of interests between marginal and infra-marginal customers).[2]

Vertically restrictive agreements may be initiated/imposed by the upstream firm(s) or by the downstream firm(s). Economic theories

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[1] Biro and Fletcher (p.130) make a similar point - "It is well recognised that all vertical restraints can, depending on circumstance, have both *anti-competitive effects*, which tend to harm welfare, and *efficiency benefits*, which will tend to be pro-competitive and enhance welfare. The overall balance of these two sets of effects must be carefully assessed, and cannot be inferred directly from the form of a vertical restraint, or even the motivation behind it.".

[2] For an example of the former, see G. Mathewson and R. Winter, "The Competitive Effects of Vertical Agreements: Comment", *American Economic Review*, Vol.77, No.5, December 1987, 1057-63. For an example of the latter, see F. Scherer and D. Ross, Industrial Market Structure and Economic Performance, Third Edition, 1990, p.547.

consistent with manufacturer power tend to focus on upstream-imposed agreements whereas economic theories consistent with retailer power tend to focus on downstream-imposed agreements. Article 85 must, of course, be able to cater for both possibilities.

IV. Exclusive Distribution Agreements

Biro and Fletcher highlight two potentially anti-competitive effects of exclusive distribution agreements: foreclosure at the downstream level and dampening of competition.

In the context of foreclosure at the downstream level, the authors draw attention to the importance of market concentration and the level of entry barriers at the upstream level. In particular, there must be very limited access to actual or potential suppliers, i.e. the market at the upstream level must have a high degree of concentration (and coverage) and be difficult to enter.

Exclusive distribution, almost by definition, dampens price competition at the downstream level (intrabrand price competition) and allows downstream firms to increase their prices and mark-ups. Intrabrand competition can be so dampened, it is argued by the authors, if interbrand competition is already relatively weak which in turn can only be true if the market at the upstream level has a high degree of concentration and be difficult to enter.

The authors note that the above two potentially anti-competitive effects of an exclusive distribution agreement can be ruled out if the market at the upstream level does not have a high degree of concentration or is not difficult to enter. In short, the authors propose a negative clearance presumption which is independent of the structure of the market at the downstream level.[3]

Exclusive distribution and downstream market concentration

When viewed from the upstream level and from an anti-competitive perspective, exclusive distribution agreements may also serve the purpose of dampening interbrand competition.[4] In particular, exclusive distribution agreements may be awarded by a number of upstream firms so as to facilitate collusion among the chosen downstream firm(s).[5] Awarding market power to the downstream level may seem irrational but it may be in the upstream firms' joint interest to do so as interbrand price competition may be dampened sufficiently. More specifically, the granting of market power to the downstream level decreases (increases) any individual upstream firm's incentive to decrease (increase) price as only a portion of such a price decrease (increase) is passed on by the downstream firm. As Schwartz & Eisenstadt (p.55) argue in the context of the relationship between manufacturers and distributors - "While any one manufacturer generally would be hurt by collusion that included only his dealers, the manufacturer could benefit if downstream collusion also included dealers of other manufacturers.". In attempting to encourage collusive behaviour at the downstream level, it is in the firms at the upstream level's joint

[3] "By contrast, there is nothing to be gained from examining the market share of the *downstream* firm, barriers to entry and expansion at the downstream level, or the proportion of the downstream market that is covered by this agreements and other similar agreements" (Biro and Fletcher, p.136).

[4] Biro and Fletcher (p.132) note that exclusive distribution agreements dampen competition upstream but do not consider the implications of this point when they make suggestions with respect to widening the scope of the negative clearance presumption (p.135-6).

[5] See M. Schwartz, and D. Eisenstadt, Vertical Restraints, Economic Policy Office Discussion Paper 82-8, Antitrust Division, Department of Justice, 1983.

interests to limit the number of firms at the downstream level.[6] Ideally, but not necessarily, the upstream firms would seek to extract much of the downstream firms' increased profits through the use of fixed fees-type contracts. If the upstream market is not highly concentrated, it is essential that the downstream level be highly concentrated and that entry be relatively difficult. These downstream market conditions limit the opportunity for any individual upstream firm to enlist new distributors.

In summary, this dampening of interbrand competition argument is particularly relevant in the context of a relatively non-concentrated market at the upstream level and a highly concentrated market with significant barriers to entry at the downstream level. Such a situation clearly escapes Biro & Fletcher's negative clearance presumption for exclusive distribution agreements, i.e. the alternative Option IV. It is, however, covered by Option IV as contained in the Green Paper on Vertical Restraints.

V. Exclusive Purchasing Agreements

Biro and Fletcher highlight two potentially anti-competitive effects of exclusive distribution agreements: foreclosure at the upstream level and dampening of competition.

In the context of foreclosure at the upstream level, the authors draw attention to the importance of market concentration and the level of entry barriers at the downstream level. In particular, there must be very limited access to actual or potential distributors, i.e. the market at the downstream

[6] In particular, it would not be in the upstream firms' interest to attempt to impose exclusive purchasing, as well as exclusive distribution, restrictions. Somewhat paradoxically, the combined use of exclusive purchasing and exclusive distribution agreements would be less anti-competitive in the present scenario than the use of exclusive distribution agreements alone.

level must have a high degree of concentration (and coverage) and be difficult to enter.

Exclusive purchasing agreements can also dampen price competition at the upstream level (interbrand price competition).[7] Interbrand competition can be so dampened, it is claimed by Biro and Fletcher (p.133), if intrabrand competition is already weak which in turn can only be true if the market at the downstream level has a high degree of concentration and be difficult to enter.

The authors argue that the above two potentially anti-competitive effects of an exclusive purchasing agreement can be ruled out if the market at the downstream level does not have a high degree of concentration or is not difficult to enter. In short, the authors propose a negative clearance presumption which is independent of the structure of the market at the upstream level.

Exclusive purchasing and upstream market concentration

Contrary to the claim made by Biro and Fletcher, price competition at the upstream level (interbrand competition) can be dampened excessively through the use of exclusive purchasing agreements in the presence of a large number of downstream firms, i.e. low concentration at the downstream level. Besanko and Perry (1993) model an environment with

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[7] Y. Lin ("The Dampening-Of-Competition Effect of Exclusive Dealing", *Journal of Industrial Economics*, Vol.39, 1991.) offers excellent intuition - " ... if dealership is exclusive, there will be two dealers, each selling one brand; whereas under non-exclusive dealing, a single dealer sells both brands. How imagine manufacturer 1 unilaterally lowers its wholesale price w_1. Under exclusive dealing, when dealer 1 revises its p_1 downwards, it attracts customers from dealer 2, who would then be strongly motivated to revise its p_2 downwards. On the other hand, if dealership is non-exclusive, the sole dealer selling both products would feel less pressure to lower p_2 as p_1 is lowered, since customers switching to product 1 would not be switching dealers. Thus the net change in retail price differential is likely to be greater under non-exclusive dealing. But this suggests that as w_1 is lowered the sales of product 1 will rise by an amount greater under non-exclusive dealing than under exclusive dealing." (p.210).

two manufacturers (i.e. a concentrated upstream market) producing differentiated products and competitive retailers differentiated spatially (i.e. a non-concentrated downstream market).[8] The introduction of exclusive dealing by the manufacturers will have the initial effect of increasing transport costs for (final) consumers seeking their favourite brand. Free entry at the retail level will, however, subsequently lower transport costs for consumers. If the fixed costs of retailers are significantly lower for a retailer carrying only one product, it is even possible that transport costs may actually fall overall. It follows that welfare will only increase if economies of scope are very low, which intuitively seems unlikely. Hence, given the presence of significant economies of scope and a concentrated upstream market, a non-concentrated downstream market is not incompatible with excessive, i.e. anti-competitive, dampening of interbrand competition.

In summary, this dampening of interbrand competition argument is particularly relevant in the context of a relatively non-concentrated market at the downstream level and a highly concentrated market with significant barriers to entry at the upstream level. Such a situation clearly escapes Biro & Fletcher's negative clearance presumption for exclusive purchasing agreements, i.e. the alternative Option IV. It is, however, covered by Option IV as contained in the Green Paper on Vertical Restraints.

Example

In his prepared remarks, Vertical Restraints and Vertical Aspects of Mergers - A U.S. Perspective (24th Annual Conference on International Antitrust Policy and Law at Fordham Corporate Law Institute, October 16-

[8] D. Besanko and M. Perry, "Exclusive Dealing in a Spatial Model of Retail Competition", *International Journal of Industrial Organization*, Vol.11, 1993.

17, 1997), Robert Pitofsky (Chairman, U.S. Federal Trade Commission), provides an excellent example of a situation which would escape Biro and Fletcher’s negative clearance presumption for exclusive purchasing agreements but which would be covered by Option IV as contained in the Green Paper on Vertical Restraints.

“Last year, for example, the FTC entered into consents with Hale Products, Inc. and Waterous Company, Inc. after an investigation into their exclusive dealing arrangements. Both companies manufactured water pumps for fire engines, and they allocated their customers, fire engine manufacturers, between them through the use of exclusive dealing agreements. Together they accounted for 90% of the fire pump market in the United States, and it was clear that they each sold most, if not all, of their pumps through exclusive arrangements and had done so for fifty years.

The alleged anticompetitive effects of these arrangements were, first, to make it easier for the two companies to charge supracompetitive prices because each often acted much like a monopolist with respect to its own customers. The contracts thus facilitated de facto market division. Second, the contracts were alleged to create barriers to entry that would foreclose competitors because the business of the vast majority of potential fire-pump customers was unavailable to any new entrant. The consent orders in those cases prohibited all present and future exclusive dealing arrangements.”

VI. Conclusion

This paper has provided examples of anti-competitive vertical restraints which escape detection using Biro and Fletcher's refined filtering mechanism. As such, it is clear that Biro and Fletcher's alternative formulation of Option IV is inferior to Option IV as outlined in the E.C. Green Paper on Vertical Restraints (1997). Evaluation of the potentially anti-competitive effects of vertical restraints requires an examination of conditions in the upstream and downstream markets.