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[*ICN Curriculum Module III-2: Analyzing Exclusive Dealing Arrangements Presented by the ICN Unilateral Conduct Working Group April 2014*]

SLIDE 2

KARIN LUNNING: Hi. I'm Karin Lunning, Director of International Affairs at the Swedish Competition Authority and also co-chair of ICN's Unilateral Conduct Working Group, together with the U.K. and Turkey. In this model, we discuss the analysis of exclusive dealing arrangements under the monopolization rules. It's based on ICN work product and the materials produced for the 2013 Unilateral Conduct Workshop in Stockholm, Sweden.

We will hear first from Adrian Majumdar, economist from RBB, on the framework of analysis. Martin Mandorff, deputy chief economist, at the Swedish Competition Authority, and Robin Rander, economist at Compass Lexecon, will delve a little deeper into the analysis of competitive effects.

We welcome your feedback and suggestions for additional models in this series of unilateral conduct.

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[*Exclusive Dealing and Customer Foreclosure: Initial Review*]

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ADRIAN MAJUMDAR: Hello. My name is Adrian Majumdar from RBB Economics. I'm going to talk about exclusive dealing. I'm going to focus on one aspect of exclusive dealing, which is exclusive purchasing. Exclusive purchasing arises where a buyer commits or is induced to purchase all or a large majority of its requirements from a single supplier.

So, in the diagram, we have S1, which is a dominant supplier, because here we are going to focus on unilateral conduct only. We have the buyer, B1, that commits to purchase either all of its requirements from S1 or the large majority of its requirements from S1. As a result, it buys nothing or relatively few volumes from rival suppliers.

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ADRIAN MAJUMDAR: Exclusive purchasing is sometimes called single branding. The idea is that the buyer purchases only from Supplier 1, and therefore can display only the brands of Supplier 1, hence single branding.

Exclusive purchasing can arise in many ways. It can be contractual. For example, there may be a specific contract that says the buyer can purchase only from Supplier 1. The contract specifies exclusive purchasing.

An alternative example would be de facto exclusive purchasing. In that situation, it may be that the buyer requires 100 units a quarter. It may be that the buyer agrees to purchase 80 units a quarter from Supplier 1. In that case, in effect, the buyer purchases the large majority of its needs from Supplier 1. And, so, we have de facto exclusive purchasing or in that example, near-exclusive purchasing.

The following example where exclusive purchasing may arise would be where it is induced, for example, by a discount scheme. It may be, for example, that the supplier says to the buyer, if you source 80 percent of your requirements from me, I will give you a very large discount.

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ADRIAN MAJUMDAR: Normally, when we're thinking about harmful effects from exclusive purchasing we think about customer foreclosure. Customer foreclosure may occur where rival suppliers are unable to access a sufficient number of buyers to operate efficiently. And, as a result of operating inefficiently, they fail to act as a strong competitive constraint on a dominant firm, thereby allowing the dominant firm to increase prices or reduce quality, such that consumers end up worse off.

It is important to remember that customer foreclosure is not a necessary outcome from exclusive purchasing. In fact, exclusive purchasing arrangements can be benign, having no effects on the market at all; or pro-competitive, benefitting end customers. For this reason, sometimes we distinguish between foreclosure and anti-competitive foreclosure, whereby anticompetitive foreclosure we mean exclusion that has a harmful effect through dampening competition.

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ADRIAN MAJUMDAR: Now, in this following slide, we're going to think about a framework for assessing customer foreclosure. In the diagram we have, in the top left- hand corner, a dominant supplier. The dominant supplier has been accused of causing exclusive purchasing that gives rise to harmful foreclosure. For example, there may be a complainant, a rival supplier, in the top, right-hand corner of the diagram. And the rival supplier may say that it fails to have sufficient access to the market because it cannot access a certain group of buyers.

In the diagram, that group of buyers are called locked-in buyers.

Now, at the same level of the supply chain as the locked-in buyers, there may also be other buyers through which rival suppliers could sell to reach end customers shown at the bottom of the diagram. So, that's the vertical structure, the typical vertical structure one sees in a foreclosure case.

Now, we have to think about some initial questions that you can ask yourself at the start of an investigation. These questions help you assess whether or not the case is worth taking forward. They help you look to see if foreclosure is feasible.

The first question is to what extent does the dominant firm have substantial market power? Now, of course, the assessment of dominance is an assessment of substantial market power, so it may be that that step has already been completed.

One additional point to make, though, is that certainly from economics perspective, foreclosure is more likely to be feasible when the dominant firm has a very substantial degree of market power. So, that was the first question, assessing market power for the alleged dominant supplier.

The second screening question is to think about the rival supplier and whether or not it can access end customers through alternative ways. It is important to remember that foreclosure is not about foreclosure to a particular customer but foreclosure of access to the market as a whole. It may be, for example, that the rival supplier has other buyers through which it can access end customers. In that situation, we need to assess whether those buyers have sufficient demands to allow the rival supplier to obtain the necessary scale to operate efficiently.

Other possibilities for the rival supplier would include forward integration. Now, that may not always be possible, but in some industries, it may be possible for the rival supplier to set up its own distribution outlet and supply end consumers itself without needing to access the locked-in buyers.

Finally, it may be possible for the rival supplier to miss out the middle section of the diagram completely and supply end customers directly. Now, an important question to think about is to what extent does the denial of scale economies to this rival really matter.

We've been talking about the rival supplier being unable to operate efficiently because it cannot access the locked-in buyers. For this to be a problem, it has to be the case that absent the exclusionary agreement, the rival supplier would be an important constraint on the dominant firm and that, as a result of the agreement, the lost scale economies mean that the rival supplier cannot constrain effectively the dominant firm.

Now, a third screening question shown in the diagram assesses whether or not the alleged locked-in buyers are locked in at all. This really goes back to the question of is there or is there not an agreement that gives rise to exclusive purchasing. We've talked about that before, but just to recap, it could be that there is contractual exclusivity, de facto exclusivity, or it could be that the buyer, the locked-in buyer, had actually gone to market and said I am going to have a competitive tender and I'm going to invite suppliers to bid for the rights to be my only supplier.

In that situation, it may be that DomCo, the dominant supplier, is the winning supplier, so that ex post we have a situation where the locked-in buyer purchases exclusively from the dominant supplier. However, we have to remember that prior to that situation the rival supplier had a genuine opportunity to compete for the locked-in buyer's customer. It may, therefore, be that in that situation the exclusive purchasing is not anti-competitive.

A final point is that in some situations there is still room for the rival supplier to access the so- called locked-in buyers. For example, suppose that the locked-in buyers source 80 percent of their requirements from the dominant firm. It may be that if they source the remaining 20 percent from the rival supplier that that is sufficient to allow the rival supplier to operate at an efficient scale and, therefore, not to be foreclosed in a way that would harm competition.

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[*Analyzing Competitive Effects: Pro-competitive efficiencies*]

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MARTIN MANDORFF: Hi. I'm Martin Mandorff from the Swedish Competition Authority, and in this section, we will focus on the pro-competitive efficiencies that can be obtained through exclusive dealing. So, why do we even begin to think that there might be efficiency motivations behind exclusive dealing? Well, one important observation is that we find exclusive dealing among market participants with little or no market power, in instances where there is no ability to exclude competitors.

Take the world of literature. Virtually every author has an agreement with their literary agent that provides for exclusivity. But in these instances, it's quite clear that there are no attempts by literary agents to monopolize the agency market. So, adding that restrictive term to a contract must serve another purpose to the contracting parties. It must provide some benefits that go beyond exclusion.

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MARTIN MANDORFF: Another thing to consider when analyzing exclusive dealing is that it's one of many possible types of vertical controls. The same supplier can even choose to mix different types of vertical controls on the same market. With some retailers, the supplier can offer unit price with no other vertical controls, whereas to another retailer the supplier can enter into very complex promotional arrangements, for example, setting up a shop-in-shop or requiring a lot of shelf space.

In yet another retailer there might be exclusivity provisions preventing the retailer from selling competing goods. And, finally, the supplier can vertically integrate, so as to manage and own the retailer itself.

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MARTIN MANDORFF: So, why do we see all these arrangements? Well, one reason is that first we need to worry about the whole distribution chain, how to provide high end value at minimal cost. This often requires efforts and investments both at the supplier level and the retail level. So, for example, the supplier might provide global marketing and invest in the product concepts, whereas at the retail level the supplier might need to invest in training the retailer's staff, so as to provide customer service.

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MARTIN MANDORFF: Take a situation where the supplier needs to train the retail staff in order to provide good customer service. If the supplier and retailer cannot write an agreement where the retailer can commit to not use the trade name for selling competing products, the supplier will not have the right incentives to provide the training.

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MARTIN MANDORFF: One far-reaching solution to this problem is to vertically integrate. There is a field within economics, "theory of the firm," which especially studies why firms sometimes choose to integrate and sometimes use the market mechanism when trading with each other.

One important strand has to do with investment incentives. If the parties need to make relationship- specific investments but cannot contract about the returns to these investments, ownership needs to be assigned so that the investing party gets the benefit from the investment. So, for example, if the supplier is making an investment in the retailer, if the supplier has ownership of the retailer, the supplier's incentives to invest will increase.

But vertical integration also carries costs. So, if the supplier integrates and buys the retailer, the retailer will lose some incentives. In this case, it can sometimes be better to write contracts instead of to vertically integrate, so, for example, when you write an exclusive dealing contract.

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MARTIN MANDORFF: Back to the earlier example. So, one possible solution to the investment problem is for the supplier and retailer to write an exclusive dealing arrangement where the retailer commits to not selling competing products. In this way, the supplier is guaranteed that its training efforts will only include his own products.

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MARTIN MANDORFF: In general, several types of efficiencies can be obtained through exclusive dealing. Here's a list that's not exhaustive. Firstly, like in the previous example, exclusive dealing can encourage the supplier to provide marketing and service to the retailer. In this case, exclusive dealing protects investments of the supplier. And the way this happens is by preventing inter-brand free-riding.

Secondly, exclusive dealing can encourage the retailer to service and promote the supplier's products more vigorously. In this instance, exclusive dealing protects the retailer's investments. And the way it does this is by preventing inter-brand free-riding or incentivizing the retailer's promotional activities.

Thirdly, exclusive dealing can eliminate incentive problems that arise due to common agency. In this case, exclusive dealing aligns the retailer incentives with the supplier incentives, which allows the supplier to provide efficient contracts to the retailer.

Note that not all problems are solved by exclusive dealing. For example, if the relationship- specific investment is purely internal to the parties concerned, then exclusive dealing might not necessarily solve incentive problems. Also, it's not always that exclusive dealing is the least restrictive means to solve the incentive problem.

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MARTIN MANDORFF: So, how do you analyze efficiencies in a specific case? Well, there is no step-by-step approach, but a good starting point is to look where you might expect efficiencies, given what kind of exclusive agreement you're looking at. If you're looking at an agreement where the retailer is prevented from using other suppliers, then we can expect there to be investments coming from the supplier that need to be protected. In this case, exclusive dealing prevents the retailer from receiving these investments and using them and selling competing suppliers' products.

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MARTIN MANDORFF: And vice versa. If we have an agreement where the supplier is prevented from using other retailers, then we could expect the retailer to be making investments that need to be protected. In this case, exclusive dealing prevents the end customers from using the investment from the retailer and buying the supplier's products at other retailers.

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MARTIN MANDORFF: More generally, when analyzing exclusive dealing, it's important to keep in mind the distinction between vertical and horizontal agreements. With horizontal agreements, the parties are combining substitutes. In this case, we want the other party to worsen the product offering, for example, raising the price. On the other hand, when you have a vertical agreement, as for example an exclusive dealing agreement, you're combining complements. And in this case, you want the other party to improve their product offering, for example, lowering their price.

Therefore, to get a full understanding of a case involving vertical agreements, such as exclusive dealing, it's important to look at what could this vertical agreement be trying to achieve in terms of efficiencies. Could it be that the parties are actually trying to improve each other's product offerings? Or could there be other anti-competitive explanations?

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[*Analyzing Competitive Effects: Assessing Anticompetitive Foreclosure*]

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ROBIN RANDER: Hello. I'm Robin Rander. I'm a senior economist with Compass Lexecon, an economic consulting firm. I'm here today to talk to you about the economics of exclusive agreements.

So, what may the anti-competitive rationales for exclusive dealing be? Well, the basic concern is that exclusive dealing will foreclose rivals in the upstream market, that is, the main concern is reduced competition in the upstream market. It is not the case that the main concern is typically that customers, buyers, are being somehow exploited. The main concern is reduced competition in -- among the sellers.

What could be the anti-competitive effect on an exclusive agreement between a buyer and a seller? Well, it could be the case that you get upstream foreclosure due to the rival seller, S*, being deprived access to buyers. And the available buyers, the ones that are not in exclusive agreements with the Incumbent S, may not be sufficient for the rival supplier to achieve a minimum efficient scale. So, it may choose not to enter the market; or it may choose to exit the market.

And this, in turn, could allow the incumbent, S, to raise prices in the future or keep them high. It's a -- it could be a means of maintaining its position in an upstream market.

Clearly, it need not be so extreme as to force the rival seller to exit. It could be the case that it is marginalized, for example, because it does not get sufficient resources to make ongoing investments in research and development.

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ROBIN RANDER: The Chicago School offered a seemingly compelling argument as to why exclusive agreements are not the competitive problem. They argue that a buyer will not enter into an agreement with a seller if this agreement produces competition in the upstream market. This is simply not in the buyer's best interest.

In order to enter into such a contract, the buyer would need to be compensated by the seller, and the gains that the seller would make from increased market power in the upstream market would not be sufficient to cover the payment that would need to be made to the buyer.

I'll get back to this in a bit.

Exclusive dealing can also intensify ex ante competition because you're bidding for the market type of setting rather than bidding for small chunks of the market. So, I mean, if we accept the Chicago argument, there would not be a need for policy intervention against exclusive dealing.

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ROBIN RANDER: Here's a diagram to illustrate the Chicago critique. You see the buyer's loss illustrated as to areas beneath the (inaudible). There's a triangular area, red, which represented dead weight loss that arises due to the buyer buying fewer units. And there's a green rectangle which represents the loss to the buyer due to paying a higher price for the unit, it actually does buy at the higher price.

The seller's gain, however, is equal only to the rectangle, the green area, and that is again due to getting a higher price per unit. So, the seller does not benefit from dead weight loss, but the dead weight loss is a loss to the buyer, so the net gains to the seller will not be sufficient to compensate the net loss to the buyer.

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ROBIN RANDER: There are many unstated assumptions underlying the Chicago argument, however, and several theories have been developed to investigate whether the Chicago critique actually stands up to relaxing those assumptions. The most credible among these theories show that it is, in fact, not always necessary for the seller to compensate the buyer. The seller may compel the buyer to enter into an agreement -- an exclusive agreement with virtually no compensation.

Here’s an example. Suppose there are 100 buyers and the seller needs to have at least 50 buyers to achieve the minimum efficient scale. If she sells to less than 50 buyers, she will not make a profit. It will not cover its costs.

So, if the incumbent, S, enters into exclusive contracts with 51 buyers, there will only be 49 buyers available in the market. This is insufficient to allow the rival seller, S*, to recover its cost, because it would be operating beneath its minimum efficient scale. So, S, the incumbent seller, only needed to compensate 51 buyers, but it has 49 buyers, which it can charge a high anti-competitive price from.

This observation implies that there is actually a need for an economic approach to minimize the costs of over-intervention and the costs of under-intervention, because we know that there are bad -- potentially bad things about these arguments, but there are also potentially good things about them.

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ROBIN RANDER: So, here’s a framework for assessing exclusive dealing. This is a three-step framework. The first step involves assessing whether the agreement has the ability to foreclose competitors. The second entails assessing whether there are any negative effects from this foreclosure. Effectively, is there harm to competition and consumers, or is it actually the case that it’s only competitors that are being harmed by this agreement?

Third step is balancing the positive effects against the bad effects to arrive at a net effect. I also think that it’s a good idea to have a reasonable explanation as to why the Chicago critique does not apply in a given case. Is it, for example, the case that the seller has not had to compensate buyers to any appreciable extent in order to enter into these exclusive agreements?

This reduces the risk of making type I errors, i.e., over-intervention.

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ROBIN RANDER: So, let's first talk about the ability. Does the agreement have the ability to foreclose an upstream market? Well, first of all, you need to establish whether it is, in fact, an exclusive agreement. And as I -- we've already seen, it need not be that an exclusive agreement is obviously an exclusive agreement. It could also be de facto exclusive. That can arise for several reasons. It could, for example, arise due to quantity forcing. It could arise due to an English clause or be otherwise induced.

Now, if there are multiple exclusive deals out there, you also need to think about which agreements are out there except for the one we're looking at right now. From the standpoint of a competition authority, this may not be a problem, because a competition authority can use its power of discovery to map out the entire existence -- the entire universe of exclusive contracts. But from a firm conducting a self-assessment, this is a real problem because a firm conducting a self-assessment does not know whether competitors do have exclusive agreements or not.

Points three and four here pertain to whether the agreement actually deprives rival sellers of reaching a minimum efficient scale and whether, in the absence of the agreement, they could actually enter the market profitably. I've prepared a figure to illustrate these points.

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ROBIN RANDER: In this diagram, we see the costs of producing a certain quantity for a firm with increasing returns to scale. We can also see the revenue it makes from selling a certain quantity. Where the blue line, the revenue, crosses the black line, the cost, you'll have breakeven. This is the minimum efficient scale the firm will need to have in order to operate profitably.

The orange vertical line represents the rival's market size and the foreclosure. This is clearly below the minimum efficient size, so under foreclosure, the rival cannot profitably be active in the market. However, we also need to think about what the market would look like in the absence of exclusive dealing.

Now, it could be one of the following two cases. Assume there's no exclusive dealing. If the size of the market available to the rival seller is as large as indicated by the green line, labeled A, then the seller can potentially reach a scale where it could profitably be active in the market. However, if the size of the market that's available to the seller in the absence of exclusivity is equal to the red line, the red vertical line, labeled A', we see that the market would still be too small to allow the entrant to be profitably active in the market.

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ROBIN RANDER: Here's a few numbers to illustrate the previous point. Assume that we have a seller, S, who has entered is not in an exclusive contract with a buyer, B, that there's a rival seller, S*. The rival seller has access to what we call the residual market, that is, the customers who are not foreclosed because of exclusive contracts. Assume that the residual market size is 30 units and that the rival seller's minimum efficient scale is 10 units. Well, in that case, it is clearly the case that the rival seller can profitably be active in the market. So, there's no ability to foreclose.

On the other hand, if the residual market size is 30, that is, if the seller can't access 30 customers, and the minimum efficient scale is 35 customers, well, then the agreement has the ability to foreclose because the rival seller cannot profitably be active in the market. It would not be able to cover its costs.

If there is a network of agreements, it's important to consider the residual market size per period of time, for example, per year. In case you have staggered agreements, it could be the case that each year a limited number of customers become available, and over time that might add up to substantial number of customers.

But at each point in time, the rival seller would have access to very few customers. If there are multiple exclusive dealing agreements, it's important to keep timing in mind. And it's appropriate to consider the residual market size per unit of time, for example, per year. If you have a limited volume becoming available each year, it would be the case that a rival seller could get access to sufficient volume of customers only over time, and that may not be sufficient for it to enter or remain in the market.

So, there could be an apparent illusion of significant volumes being available but that need not mean anything if it -- if these volumes become available only slowly.

There's also a point about sources of data to evaluate the minimum efficient scale. You could look at incumbent costs; you could look at potential entrants' costs; you could do crosscountry comparisons; and you could conceivably also get testimony from expert witnesses.

It's important to keep in mind that each of these sources of data would give rise to slightly different tests. If you consider, for example, the incumbent seller's cost, you would get an "as efficient competitor test", which allows incumbents to self-assess. Other tests, other sources of data, may not give incumbents that ability.

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ROBIN RANDER: The second step in this approach to dealing with exclusive agreements is to evaluate whether there are actually any negative effects arising from any foreclosure. Negative effects cannot simply be assumed. It must be the case that exclusion of the rival, S*, actually increases the market power of the seller, S, the incumbent seller. But that does not follow -- follow automatically.

For example, it could be the case that the rival seller, S*, is actually a niche player and would not, even if it could enter the market, exert much of a competitive constraint on S. In that case, exclusion does not increase S's market power.

Also, if the rival seller, S, were present in the market at the time when the exclusive deal was entered into, it seems implausible that the exclusive deal could actually increase S's market power.

Thirdly, it's conceivable that S has not been foreclosed from alternative routes to market. For example, the rival seller may be able to sell directly to final customers. And in that case, it could also not be the case that there's been an anti-competitive effect.

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ROBIN RANDER: To finish off, I'd like to give you three key messages. First of all, you need to compare minimum efficient scale of rival sellers to the residual market size, that is, the market that's available to these rival sellers if the minimum efficient scale of rival sellers is below the market size available to them, an agreement will not have the ability to foreclose the market.

Second, keep in mind that if excluded sellers were active in the market at the time when the agreements were entered into, it seems implausible that there's actually an anti-competitive effect from the agreement.

And, thirdly, try to keep in mind the Chicago argument, why did buyers not internalize the anti- competitive effects of this anti-competitive agreement.

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ADRIAN MAJUMDAR: In fact, typically, there is some evidence in favor of foreclosure, and some methods in favor of efficiencies, pro-competitive stories, and no harmful effect. Therefore, the difficult issue is how to balance that evidence and when should intervention take place. For example, some authorities may intervene when they believe that the evidence indicates that foreclosure -- anti-competitive foreclosure -- is capable of happening. On the other hand, some authorities make take a stricter view and look for a higher standard of proof. They may say, actually, we want it to be until we can demonstrate that anti-competitive foreclosure is likely to happen. The latter case is less interventionist than the former case. This, of course, will be a legal and a policy matter that have implications for the message you send out more widely to business.

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