UNCTAD/ITCD/CLP/Misc.8

Distr.
RESTRICTED

12 January 1999

Original: ENGLISH

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# COMPETITION POLICY AND VERTICAL RESTRAINTS

Note by the UNCTAD secretariat

## Executive summary

Vertical restraints refer to the wide range of arrangements between independent firms linked to each other in a buyer-seller relationship, such as that existing, for example, between a car manufacturer and its dealers. This note provides an analysis of some of the issues with which policy makers of newly-established competition authorities are confronted when reviewing vertical restraints and deciding whether these practices result in enhanced or reduced competition and welfare in the markets concerned. Inter-firm vertical arrangements have been a constant feature of economic activity, but no clear consensus on their welfare consequences and policy implications has ever been reached. At one extreme, vertical restraints have been viewed as tools employed systematically to distort competition and reduce welfare. More specifically, these restraints are allegedly put in place by manufacturers and distributors to reduce competition and to raise entry barriers for competing products so as to increase profit margins, at the expense of consumers and society at large. At the other extreme, all arrangements between parties at different stages of the vertical chain have been considered as contributing positively to the efficient production and distribution of goods and services. While no clear-cut consensus has yet emerged, there is a growing recognition of the need to consider the various and sometimes opposite effects the vertical restraints have on competition and efficiency, depending on the specific structural conditions of the market concerned. In concentrated markets with substantial barriers to entry, firms with a dominant market position may be able to employ vertical restraints for anti-competitive and exclusionary purposes, leading to a further increase in market exploitation. For unconcentrated markets, vertical restraints are expected to have pro-competitive and welfare-enhancing effects.

GE.99-50036 (E)

**CONTENTS**

Annex

## INTRODUCTION

1. By the term “vertical restraints”, we refer to the wide range of arrangements between independent firms linked to each other in a buyer-seller relationship, such as that existing, for example, between a car manufacturer and its dealers. These arrangements constrain the freedom of action of downstream or upstream firms to operate in an unfettered manner in the market and may influence downstream prices, outputs or other resale conditions. While vertical restraints are employed at any stage of the production-distribution chain, the attention of competition policy makers has been drawn particularly to arrangements concerning the distribution stage. Also, specific opportunistic behaviours which may be dealt with through vertical restraints may arise at the manufacturer-distributor level; such behaviours are considered less likely to occur at other stages of economic activity. Although inter-firm vertical arrangements have been a constant feature of economic activity, no clear consensus on their welfare consequences and policy implications has ever been reached. Rather, quite opposite views have emerged, among both academics and competition policy enforcers.

2. At one extreme, vertical restraints have been viewed as tools employed systematically to distort competition and reduce welfare. More specifically, these restraints are allegedly put in place by manufacturers and distributors to reduce competition and to raise entry barriers for competing products so as to increase profit margins, at the expense of consumers and society at large. At the other extreme, all arrangements between parties at different stages of the vertical chain have been considered as positively contributing to the efficient production and distribution of goods and services. While no clear-cut consensus has yet emerged, there is a growing general recognition of the need to consider the various and sometimes opposite effects that vertical restraints have on competition and efficiency, depending on the specific structural conditions of the market concerned. In concentrated markets with substantial barriers to entry, firms with a dominant market position 1/ will be able to exercise “market power”. This is the ability of firms to raise prices above the competitive level for a significant amount of time and to profit from such anti-competitive pricing. When market power is present, vertical restraints can be successfully employed for anti-competitive and exclusionary purposes, leading to a further increase in market exploitation.

3. This note was prepared as a background document for the technical assistance activities of the Competition Law and Policy and Consumer Protection Section of UNCTAD. Its purpose is to provide an analysis of some of the issues with which competition policy makers are confronted when reviewing such practices. In particular, the elements that need to be considered when deciding whether a given practice (or combination of practices) will result in enhanced or reduced competition and welfare in the market concerned are reviewed. While the objectives of competition policy vary from jurisdiction to jurisdiction and often include broader social and political goals, there is increasing agreement on the need to maintain an effective degree of rivalry among firms and to maximize efficiency as the primary objective to be pursued when applying competition law and policy. Accordingly, this note reviews the effects of vertical restraints on overall efficiency, separating, where possible, the effects on consumer and producer welfare. A brief overview of the treatment of vertical restraints in a few jurisdictions is contained in Annex I.

## A. TYPES OF VERTICAL RESTRAINTS

4. A wide range of vertical restraints can be found in all economies, being very often employed in a bundle. Among the most widely used, one can mention: (a) resale price maintenance; (b) refusal to deal; (c) exclusive dealing; (d) territorial exclusivity; (e) quantity fixing; (f) tie-in selling; (g) full-line forcing. This list is not intended to be exhaustive and does not cover all existing types of vertical restraints which can be found in commerce. Also, as new and more innovative distribution systems are introduced into the market, the emergence of new forms of vertical contractual arrangements can be expected as well.

5. **Resale price maintenance** (or vertical price-fixing) refers to an arrangement whereby the manufacturer sets the price distributors are allowed to charge for the resale of the product or service. Often, simply a maximum (price ceiling) or minimum (price floor) price is set, thus allowing for greater flexibility to downstream firms in their pricing decision. Also, in many cases, rather than imposed, a “recommended price” is simply suggested to the retailer, who still maintains the final say on the price charged to final consumers. In any event, it can be noted that retailers may cut prices also by providing more favourable conditions for the terms of payment, delivery charges, etc.

6. **Refusal to deal** refers to the practice of refusing to supply a product to a purchaser, often a retailer or wholesaler. It is often used to ensure compliance with requirements aimed at fixing resale prices.

7. **Exclusive dealing** occurs when distributors are required to carry only the goods supplied by a given manufacturer and are not allowed to sell competing brands. Exclusive dealing, taken as a generic term, may refer to different vertical restraints such as territorial exclusivity, refusal to deal, etc. However, since this paper differentiates territorial exclusivity, we have chosen to define the term “exclusive dealing” as above. It is also sometimes referred to as “reciprocal exclusivity”.

8. **Territorial exclusivity** assigns a portion of the retail market to a specific retailer. No other competing distributor is allowed to supply customers in the same territory, thereby reducing or eliminating intra-brand competition. The territory assigned by the manufacturer to the distributor is usually defined in terms of geographic scope, but the segmentation of the retail market can also be based on the type of customer served, or method of distribution. For example, a distributor may hold exclusive distribution of a given product for orders placed by mail. Also, there are varying intensities of territorial exclusivity, depending on the degree of intra-brand competition which is still maintained. Manufacturers may simply decide on the specific location of the retail outlets carrying their goods, committing themselves not to allow additional distributors to be set up in those areas, but at the same time allowing shipments from other areas. A stricter version of the territorial exclusivity requires distributors not to sell goods to customers not belonging to the specific territory assigned to them.

9. **Quantity fixing** refers to vertical contractual arrangements establishing the quantity of goods retailers are required to buy from the manufacturer. When the demand facing the retailer is known and directly linked to the final price,

quantity fixing can be very similar to resale price maintenance; parties may simply agree on a maximum or minimum quantity purchased.

10. **Tying-in** (or “tied selling”) refers to the situation where a manufacturer will only sell a product to a distributor, or a retailer will only sell a product to a consumer, if the buyer purchases an additional, unrelated product. Such a sale is also called a “tie-in sale”.

11. **Full-line forcing** (which can be viewed as a particular form of tie-in) involves distributors being required to hold the whole range of products of a given manufacturer.

12. A clear distinction can be observed in most jurisdictions regarding the treatment of resale price maintenance, usually unequivocally prohibited, and the other types of vertical restraints, most often reviewed on a case-by-case basis through an assessment of the pro-competitive and anti-competitive effects. This distinction is related to the fact that resale price maintenance is perceived as resulting in greater distortionary effects for competition, and that the alleged efficiencies deriving from its use can be obtained with other, less anti-competitive means.

## B. THE EFFECTS OF VERTICAL RESTRAINTS ON COMPETITION AND EFFICIENCY

13. There are several reasons for the widespread use of vertical restraints by firms in all sorts of business activities, as reviewed below. It is important to note that upstream and downstream firms belonging to the same vertical production-distribution chain are strictly related to each other: the decisions in terms of pricing, quantity and services supplied taken by one firm have a direct consequence on the other firms.

### Double price mark-up

14. When downstream distribution firms are in a position to exercise market power, they have an incentive to raise prices and restrict output in order to extract extra profits from the market. If the upstream manufacturer also enjoys market power and adds up his own extra profit margin, then the final price charged to consumers will be subject to a double mark-up margin. This double mark-up, set independently at the two stages of production and distribution, will result in a reduction in total welfare for upstream and downstream firms, as well as for consumers, as compared with a more cooperative solution, since coordination would increase the overall efficiency of the enterprises concerned, and consumers would benefit from lower prices.

15. In order to deal with double mark-ups, besides the option of full vertical integration, manufacturers can employ different vertical restraints which result in their elimination or reduction. One way is to impose (maximum) resale prices so as to minimize or eliminate distributors' excessive profit margins. Another possibility is to require the distributor to purchase a minimum quantity of the product, which would match the quantity leading to the profit-maximizing equilibrium for the vertical structure as a whole. However, to estimate this value, the manufacturer needs detailed information about the demand conditions facing each distributor. Such information is rarely precise and reliable. Another solution to the double mark-up problem is for the manufacturer to promote sufficient competition among retailers so as to eliminate excessive retail

margins. However, in certain market circumstances the elimination of the market power of the distributor is not possible, or not desirable. 2/

**Free-riding in the distribution sector**

16. Retailing is an essential input in the process whereby enterprises sell their goods and services to the end-consumers. As with any other input, upstream manufacturers want to pay as little as possible for it. In particular, as mentioned above, once they have decided on the most suitable wholesale price for their products (which might be higher than the competitive price when market power can be exploited), it will be in their own interest to ensure that the firms handling their goods sell the largest quantity at the lowest price, since this is expected to maximize demand for their products as well as total profits. They have, therefore, a vested interest in maintaining competition among dealers.

17. Nevertheless, several of the vertical restraints most often used by manufacturers (such as resale price maintenance and territorial exclusivity) appear to allow distributors to set prices above the level that might be otherwise expected. This result is achieved directly by setting distributors' resale price, or, indirectly, by allowing retailers to exercise market power, for example by granting them total or partial market exclusivity at a specific location. 3/ The effect is to reduce competition among distributors of a same brand (intra-brand competition), leading to an apparent welfare-reducing outcome from the manufacturer's point of view (in addition to higher prices for consumers), with fewer goods sold and lower profit levels realized.

18. This apparently paradoxical situation can be explained, however, by realizing that the sale of a manufacturer's products is also very much a function of the quality of pre- and after-sale services provided by its distributors. This holds particularly true for complex products such as computers or cars. The customer often requires information about the specific features of these products, particularly for models only recently introduced into the market; very often he will need to try them out, before being convinced of the purchase. It will therefore be in the manufacturer’s interest for its products to be sold along with certain services. While these distribution-related services may be associated with costly, well-trained personnel and specialized investments, they might also contribute to an increase in overall sales as well as in profits. 4/ The benefits of these extra sales and profits can then be shared by both the manufacturer and his distributors. If the added services are beneficial to both upstream and downstream enterprises, why should the market not be able to provide autonomously the desirable amount of sales-related services?

19. In this respect, it can be observed that some (but not all) of the services related to distribution can be consumed separately from the product itself. For example, a customer may go to a computer retail outlet where he can receive all necessary information and assistance with respect to the latest version of a personal computer, and then go to another “no-frill” discount store (which has lower distribution costs) to make his purchase at a lower price. As a consequence, outlets offering few or no services might be expected to “free-ride” on those stores providing more assistance, customers and increasing their market share to the detriment of those who provide service. Ultimately, full-service stores could be expected to go out of business, resulting in a lower level of distribution services than the level desired by the manufacturer, hence reducing

overall sales and profits or affecting the desired high-quality image of the brand in question.

20. Similarly, more motivated distributors may invest to a greater extent in promotion and advertising. However, these efforts - which can have a clear beneficial impact on demand for the manufacturer’s product - can also greatly benefit other retailers who do not contribute to the costs involved. Vertical restraints can, therefore, be used by manufacturers to encourage distributors to provide those services which can be consumed by customers separately from the product itself. 5/ In fact, they ensure that distributors are rewarded to a fuller extent for their investments in promotional and distributional efforts. It is important to observe that the free-rider problem is less likely to arise in the provision of after-sales services. For example, a high-service distribution outlet can provide repair services not covered by the standard warranty to customers and can charge separately for these services without fearing free-riding from low-service distributors.

21. Vertical restraints introduced to deal with distributors' free-riding problems can be expected to increase manufacturers’ and distributors’ sales and profits. Does the expansion in output also result in an increase in overall welfare? To answer this question, one needs to look also at the effects on consumers of the use of vertical restraints to reduce free-riding opportunities. 6/ With the use of vertical restraints, consumers can expect to be supplied with products at a higher price but with the benefit of more sales-related services.

22. In considering the overall loss or gain to consumers, one must determine whether the increase in services promoted by vertical restraints is considered overall to be worth more than the increase in the price of the product. In this respect, one needs to remember that not all consumers share the same preferences with respect to the trade-off between more services and lower prices. In fact, one can distinguish between those customers at the margin in their preferences, who will be induced to purchase the product only when certain services are provided along with the product, and those customers who would purchase the product anyway, even in the absence of these additional services. For example, with respect to pre-sale demonstration services, consumers already familiar with the product (or with similar products) will not receive much satisfaction from having available retail outlets working hard and investing resources to show the qualities and features of the product on sale. Rather, they will consider the extra costs incurred as a useless waste and will prefer products supplied with less services but at a cheaper price. Other customers, however, might be led to attribute greater value to the product concerned and to buy it.

23. Ultimately, an evaluation of the benefits deriving from vertical restraints to cope with dealers' free-riding problems needs to balance the expected increase in producers’ surplus (profits) and the effects on consumers’ surplus: i.e. the net effect of the increase in consumer satisfaction from the customers benefiting from the extra services and of the decrease in consumer welfare from the effects on customers not requiring those services.

24. A factor certainly having an influence on whether vertical restraints can be beneficial to consumers is the novelty of the product or brand concerned: a larger number of consumers will require information on recently introduced products or brands. On the other hand, for established and well-known products

and brands, the impact on consumers is more likely to be negative. Another factor is the degree of sophistication of the product. Also, if consumers have a sufficient choice of brands, they will be able more easily to switch purchases toward products that are more in line with their personal price-services trade-off. When sufficient choice is available, it is more likely that vertical restraints dealing with free-riding will also increase consumers’ satisfaction as well as total welfare.

25. As mentioned earlier, resale price maintenance and territorial exclusivity are types of vertical restraints sometimes employed by manufacturers to guarantee to distributors an adequate margin with the aim of encouraging them to promote sales with greater zeal. If a sufficient degree of inter-brand or intra-brand competition exists, the extra margin will be passed on to consumers in terms of increased services. While both resale price maintenance and territorial exclusivity are expected to determine an increase in retailers’ profit margins, differences may arise, however, with regard to their impact on the market. Exclusive territory, in particular, allows for a greater degree of flexibility when compared with resale price maintenance. In fact, the specific size of the exclusive territory allocated to a distributor can be modified according to local demand, so as to avoid excessive profit margins for each distributor. This flexibility is less obvious with respect to resale price maintenance. However, as pointed out by Scherer and Ross 7/ the alleged greater flexibility is only apparent. Distributors may strongly oppose any proposed change in the extent of their geographical coverage, even in the presence of changed demand conditions, viewing such change as unacceptable attempts to override their established property rights. This type of opposition emerged in the United States soft drinks industry during the 1970s, where wholesalers strongly opposed any revision in the geographical scope of their exclusivity, in spite of substantial changes in transportation costs greatly increasing potential economies of scale in wholesale activity.

**Free-riding in the manufacturing sector**

26. Another free-rider problem that may arise in the manufacturer-distributor relationship is opportunistic behaviour among upstream firms. Manufacturers, to ensure the development of efficient retail networks, often opt to contribute resources to distribution organizations, providing, for example, training and know-how for the sales force of downstream (independent) firms. Likewise, they may provide start-up capital at preferential rates and help in the choice of retail locations and in the development of marketing plans. Competing manufacturers could free-ride on these investments by using the same outlets and would therefore be able to outprice the enterprises which had invested in downstream activities. Also, manufacturers may exchange information with dealers on market survey results and marketing strategies, which could be passed on to competing manufacturers. A solution available to manufacturers to overcome this possibility of free-riding among competing manufacturers is to enter into exclusive dealing arrangements with distributors: downstream firms will engage themselves to carry only the goods of a single manufacturer, which will then be able to recover its investments in the development of downstream activities.

**Foreclosing markets**

27. While exclusive dealing arrangements can be employed to deal with the free-rider problem among manufacturers, they can also have an anti-competitive

impact (and may be used expressly for this purpose) when they result in raising barriers to entry for potential competitors or in impeding the market growth of firms already positioned in the market. The restriction of competition might not necessarily be the outcome desired by the parties concerned, but rather an unintended side-effect of the vertical contractual arrangements. Nevertheless, whether the effect is intentional or not, the reduction of competition (and the possible adverse consequences on economic welfare) might be substantial. When exclusive dealing arrangements tie up a predominant share of existing outlets, competing suppliers are forced to find alternative distributors or to build up their own independent networks. Exclusive dealing arrangements might therefore represent a substantial barrier to entry whenever the share of tied retail outlets is significant.

28. With regard to the option of entering into the distribution activity directly, this might not be a feasible or excessively costly alternative, especially for small and medium-sized enterprises, since developing a retail network requires financial resources and specific know-how that are not always easily available. In addition, a significant amount of time and effort may be required to set up an effective distribution network. Also, economies of scope are very often prevalent in the distribution in the same outlet of different lines of products, (as in the case of the retailers selling thousands of different products and brands). Therefore, distribution costs would be much higher if new entrants were impeded from using existing networks, especially those of dominant firms. Raising barriers to entry has particularly harmful consequences on competition for those manufacturing and distribution markets where collusion among incumbent firms is a more real and direct threat. The risk of collusion is more likely to occur in markets where concentration is relatively high, products are homogeneous and demand is relatively inelastic. In these markets, in fact, collusive agreements may be able to thrive for a longer time when entry is barred, since no outsiders are able to expand and underprice incumbent firms.

29. In the absence of the above-mentioned market characteristics which facilitate collusion or the existence of dominant firms, the potential of exclusive dealing agreements to undermine competition can be expected to be less pronounced and the incentive to enter into exclusive dealing arrangements to reduce competition is greatly reduced. There is no reason why distributors should be willing to enter into exclusive dealing arrangements if to do so is likely to cause them financial losses, due to the fact that they will only be able to carry a narrow range of goods. However, they might be willing to do so anyway if they are rewarded adequately by manufacturers, that is, if they share in the extra profits deriving from the reduction in competition.

30. Hence the impact of exclusive dealing agreements on competition can be expected to be to a large extent related to the degree of concentration, as well as to other structural characteristics of the retailing sector concerned. In this respect, the share of outlets with exclusive dealing contracts is clearly an important indicator of concentration at the distribution level. Equally important, however, are the number and strength of potential new suppliers of retail services who are ready to enter the market. The relative importance of three alternative forms of distribution 8/ needs to be assessed in analysing the potential impact of foreclosing access to distribution networks. First, existing distributors may be able to switch to new suppliers in a relatively limited period of time (particularly when the exclusive contracts are limited in time) or

they may be able to open new outlets in favour of competing brands. Second, dealers from other industries may expand into the relevant downstream market. Third, new dealers may be willing to enter the market if there are sufficient profit opportunities.

31. Other types of vertical restraints which have effects similar to those obtainable with exclusive dealing arrangements can also raise barriers to entry for potential new competitors. For example, by assigning an exclusive territory to a distributor in a given area, a manufacturer can ensure that the latter will act aggressively and engage in a local price-war against any competitor entering the area. More specifically, the retailer may be willing to cut prices drastically in order to exclude a competitor, without having to worry about the consequences of his price cuts in other geographic areas. In contrast, a manufacturer who has made no exclusive territory arrangements (and therefore is not able to apply price discrimination), might be less willing to respond aggressively to a geographically limited competitive entry, because of the consequences of his price cuts on the price level in other geographic areas.

32. The foreclosure of market entry is clearly a fundamental issue for both competition and trade policy. The removal of tariff and non-tariff barriers might not necessarily lead to free flows of goods and services even in liberalized markets if incumbent firms (domestic enterprises or local subsidiaries of transnational corporations) impede market access through the use of exclusive dealing arrangements and other vertical restraints. 9/ If such arrangements succeed in blocking entry, frictions among trading parties may also arise, since potential exporting countries may realize that the benefits of trade liberalization are in fact impaired or even nullified by autonomous enterprise behaviour.

**Favouring collusive behaviour**

33. Vertical restraints may play a facilitating role in promoting and maintaining the cartelization of markets when certain structural characteristics prevail. Resale price maintenance, in particular, may facilitate the task of monitoring effective compliance with a manufacturers’ cartel. With retail prices fixed, manufacturers have less incentive to undermine cartels and to underprice competitors by offering discounts to retailers, since the latter, in turn, cannot reduce the prices they charge to final consumers. As a consequence, the solidity of the upstream cartel would be increased. In fact, with regard to the duration and strength of cartels, one of the biggest problems encountered in maintaining the internal stability of collusive agreements is the monitoring of compliance by members with cartel rules. All cartel participants have an incentive to undercut the cartel's agreed price if they can do so without being detected and with impunity. This said, it has to be observed that even in the presence of fixed resale prices, manufacturing price-cutting in favour of wholesalers and retailers may allow downstream firms to employ some indirect form of price-cutting, for example by offering more favourable credit terms or providing extra services to the final customers. This would achieve a result similar to price-cutting at retailer’s level.

## C. BALANCING THE EFFECTS OF EFFICIENCY AND COMPETITION IN THE EVALUATION OF VERTICAL RESTRAINTS

34. The previous sections have shed some light on the different effects of vertical restraints on economic welfare and competition. Such effects depend to a very large extent on the specific context surrounding their application. In fact, a simple analysis of the particular form of a vertical contractual arrangement does not reveal, by itself, whether the arrangement will lead to a reduction or an enhancement of economic welfare. The same vertical restraint (or combination of vertical restraints) may reduce efficiency and competition under certain market conditions, but enhance competition and efficiency under other circumstances. Resale price maintenance, for example, can be employed by upstream firms to prevent double price mark up by retailers in a position to exploit market power or to eliminate free-riding in the provision of distribution services. In other circumstances, it can be used as a tool to facilitate the detection of violations of cartel agreements and can have clear anti-competitive effects. In fact, none of the vertical restraints mentioned, can be defined as always harmful or always beneficial to economic welfare and competition.

35. Market structure and the intensity of inter-firm rivalry are the main factors in determining whether vertical restraints will reduce or increase efficiency and strengthen or weaken competition. In particular, when the market is characterized by the presence of a sufficient number of competing vertical structures (manufacturers and their downstream distributors) and by relative ease of entry at both the upstream and downstream stages of the market, inter-brand competition can be expected to ensure that the use of vertical restraints will lead to increased market efficiency as well as to consumer satisfaction. For example, when consumers are faced with a variety of brands, vertical restraints employed to ensure a greater provision of distribution services (and thus to determine higher retail prices) can be expected not only to lead to greater profits within the vertical manufacturer-distributor structure but also to benefit consumers. In fact, additional consumers attracted by the provision of extra sales-related services will benefit from the new combination of prices and sales-related services, while those consumers not happy with such arrangements will be able to switch to alternative brands. Analogously, when competition among manufacturers is intense and a large number of retail outlets are available, vertical restraints will not be able to impact substantially on the degree of competition. For example, exclusive dealing arrangements will not be able to reduce competition and foreclose market entry when alternative outlets are easily available.

36. On the other hand, when rivalry among competing vertical structures is weak as in many of the markets in developing countries, the effects of vertical restraints on competition and efficiency are more ambiguous. Vertical restraints aimed at promoting greater coordination between upstream and downstream firms will allow them to benefit from greater profits. This increase in producers' profits, however, may be associated with an even greater reduction in consumer welfare when firms are able to exploit their market power and are not forced to pass on the efficiency gains to final consumers. Also, in markets where competition is weak, vertical restraints can determine a further reduction in the intensity of rivalry among actual competitors, increasing the risk of cartelization, as well as reducing the likelihood and feasibility of entry by new market players.

37. While a comprehensive economic analysis of the specific market conditions appears essential if one is to draw definite conclusions on the competitive effects of vertical restraints, a case-by-case analysis may represent an

excessive burden for any competition agency, in view of the significant enforcement costs (as well as administrative costs for the firms) associated with reviewing the very large number of vertical contractual arrangements entered into by companies. This is certainly the case for newly established competition authorities, which have limited enforcement capacity and experience. To minimize enforcement costs, and at the same time to avoid the harmful effects of the vertical restraints most likely to have anti-competitive effects, Rey and Caballero-Sanz (1996) 10/ suggest the adoption of enforcement guidelines establishing different rules depending on the state of inter-brand competition, identifying situations where the risks of anti-competitive effects are more likely and a more detailed analysis is desirable. Such a procedure should increase the predictability of reviews by competition authorities.

38. For unconcentrated upstream and downstream markets, it is suggested that vertical restraints (both of the price and non-price type) should be automatically allowed. Market structure criteria should then be established by setting market share thresholds below which no competition policy intervention would occur 11/.

39. For more concentrated markets, and especially for markets with firms holding dominant market positions, additional in-depth analysis would be necessary, in order to verify the effects on competition as well as the efficiency gains brought about by the vertical restraints under scrutiny. Also, dominant firms should be requested to demonstrate that comparable efficiency gains, allegedly associated with the use of vertical restraints, could not be realized through alternative means, that are less harmful to competition.

40. Another comprehensive analysis of the effects produced by vertical restraints on welfare, with policy recommendations for their treatment, has been recently presented by Dobson and Waterson. 12/ They suggest an approach based on considering three main issues requiring attention in the initial screening of vertical restraints: a full-scale investigation of the possible welfare-reducing effects of vertical restraints is suggested only in the case in which such initial screening would lead to welfare concerns.

41. The first issue to be dealt with is whether significant market power is present at either the upstream or downstream stages of the market. If market power is not present, then vertical restraints are unlikely to have relevance for competition policy-makers. The emergence of high profits, stable and substantial market shares, and high and stable concentration levels are signs pointing to the presence of market power.

42. If the exploitation of market power is likely, it is necessary to look at the effects of the restraints on competition and on efficiency. In particular, one needs to analyse whether the reduction in product/service variety resulting from either reduced intra-brand or in-store inter-brand competition is deemed to affect the consumer negatively. This can be assessed by looking at the degree of substitutability between products and distribution outlets for consumers and the extent of economies of scope in distribution. Also, it is important to examine the extent of the efficiency gains deriving from the restrictions on the number of dealers or their product range. This would be assessed looking at the type of goods, the search costs for the consumers and other market characteristics (see table 1). In particular, for expensive, highly complex and relatively unknown products, the efficiency benefits deriving from the use of vertical restraints

can be expected to be more important.  On the other hand, in retailing markets characterized by the presence of significant entry barriers and substantial economies of scope, the risk of distortion of competition is greater.

**Table 1: The Strength of the efficiency argument for vertical restraints across different product/distribution conditions**

| Product/distribution nature | Strongest case | Weakest case |
|---|---|---|
| Product complexity | Highly complex or technical | Simple or non-technical |
| Cost for consumer | Expensive large part of budget | Inexpensive |
| Consumer buying habits | One-off purchases | Repeat purchases |
| Shopping format | Non-convenience outlet | Convenience-outlet |
| Consumers’ product information | Limited knowledge | Details/features widely known |
| Price/quality comparability | Experience or credence goods | Search goods |
| Perceived product differentiation | Unclear - weak branding | Clear strong branding |
| Position in product life cycle | New | Established or mature |
| Entry barriers in retailing | Low | High |
| Economies of scope in retailing | Insignificant | Substantial |

Source:  P.W. Dobson and M. Waterson, “Vertical restraints and competition policy”, Office of Fair Trading, Research Paper 12, December 1996, p. 56, United Kingdom.

Notes

1/ A dominant position is always with reference to a properly defined relevant market.  In order to delimit the relevant market, an assessment of all products (or services) that are perceived as directly interchangeable by consumers is conducted.  To verify the substitutability, reference is usually made to the cross-elasticity of demand:  two goods are often considered in the same market when the increase in the price of the first one causes a non-marginal increase in demand for the second.  However, in view of resources and time constraints, competition authorities do not very often have access to actual estimates of cross-elasticity in its determination of relevant markets. Therefore, other types of evidence, such as market surveys of consumer preferences, are used. The relevant market also has a geographic dimension: this is defined as including all areas where concerned consumers are able and willing to redirect their purchases. Once the relevant market has been identified, the next step in the evaluation of a dominant market position is the analysis of the market position of the firm involved. The concept of dominant position goes beyond the simple structural characteristics of the market and the market share held by the firms. Nevertheless, a constantly high market share is an important indication of a dominant position. Another very important element in the evaluation of market dominance is the extent of potential competition and relative ease of market entry acting as a constraint against the use or abuse of market power.

2/ For example, in small towns, retailers often have a local monopoly position.

3/ By restricting the number of distributors in a specific area, a manufacturer restricts downstream local competition. This has a direct impact on the resale price and consequently on the profit margin retailers can extract in a given area.

4/ This holds true when the positive effect related to the increase in demand for the manufacturer's product outweighs the negative effect due to the increase in the costs related to the provision of distribution services.

5/ It is assumed that a certain degree of differentiation exists among products supplied by competing manufacturers. If products are very much substitutable, then the free-riding problem would also be present among distributors of different products.

6/ This part of the paper draws from the article by W.S. Comanor, “Vertical price-fixing, vertical market restrictions, and the new antitrust policy”, Harvard Law Review; Vol. 98, 1985, p. 983.

7/ F.M. Scherer and D. Ross, Industrial Market Structure and Economic Performance (3rd ed.), Houghton Mifflin, Boston 1990, pp. 558-560.

8/ See S.I. Ornstein, “Exclusive dealing and antitrust”, The Antitrust Bulletin, Spring 1989, pp. 84-86.

9/ See, for example, UNCTAD, World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy, New York and Geneva, 1997 (United Nations publication, sales No. E.97.II.D.10) pp. 156-159.

10/ See P. Rey and F. Caballero-Sanz, “The policy implications of the economic analysis of vertical restraints”, Economic Paper No. 119 of the European Commission Directorate-General for Economic and Financial Affairs, November 1996.

11/ It should be observed that information about market share distribution in developing countries is often very limited.

12/ P.W. Dobson and M. Waterson, “Vertical restraints and competition policy”, Office of Fair Trading, Research Paper, 12 December 1996, United Kingdom.

**BIBLIOGRAPHY**

W. S. Comanor, "Vertical price-fixing, vertical market restrictions, and the new antitrust policy", Harvard Law Review, Vol. 98:949 (1985), pp. 983-1002.

Commission of the European Communities, "Green Paper on vertical restraints in EC competition policy", Brussels, 22 January 1997 (COM(96) 721 Final).

P. W. Dobson and M. Waterson, "Vertical restraints and competition policy", Office of Fair Trading, Research Paper 12, December 1996, United Kingdom.

T. G. Krattenmaker and S. C. Salop, "Anticompetitive exclusion: raising rivals' costs to achieve power over price", The Yale Law Journal, Vol. 96, Number 2, (December 1986), pp. 209-293.

H. P. Marvel, "Exclusive dealing", Journal of Law and Economics, Vol. XXV, April 1982, pp. 1-25.

Organisation for Economic Co-operation and Development (OECD), Competition Policy and Vertical Restraints: Franchising Agreements, Paris OECD, 1994.

S. I. Ornstein, "Exclusive dealing and antitrust", The Antitrust Bulletin, Spring 1989, pp. 65-98.

P. Rey and F. Caballero-Sanz, "The policy implications of the economic nalysis of vertical restraints", Economic Paper No. 119 of the European Commission Directorate-General for Economic and Financial Affairs, November 1996.

F. M. Scherer and D. Ross, Industrial Market Structure and Economic Performance, (3rd ed.) Boston, Houghton Mifflin, 1990.

UNCTAD, World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy, New York and Geneva, 1997 (United Nations publication, Sales No. E.97.II.D.10).

M. A. Utton, Market Dominance and Antitrust Policy, Aldershot, Edward Elgar, 1995.

I. Van Bael, J.-F. Bellis, Competition Law of the European Community, CCH Editions, 1994.

M. Waterson, "Vertical integration and vertical restraints", Oxford Review of Economic Policy, Vol. 9, No. 2, Summer 1993, pp. 41-57.

O. E. Williamson, Antitrust Economics, Oxford, Blackwell, 1987.

**Annex**

## A BRIEF OVERVIEW OF THE TREATMENT OF VERTICAL RESTRAINTS IN SOME JURISDICTIONS

### Australia

1. Sections 47 and 48 of the Trade Practices Act of Australia refer explicitly to non-price and price vertical restraints. While the different forms of non-price vertical restraints are reviewed on a case-by-case basis and prohibited only if they lead to a substantial reduction of competition, resale price maintenance is prohibited under all circumstances. Under Australian competition legislation, firms can notify non-price vertical restraints to the competition authority, the Trade Practices Commission. Once notified, vertical arrangements enjoy exemption from anti-trust prosecution unless the Commission takes an explicit stance declaring the restraint anti-competitive and not leading to a net public benefit. The promotion of economic development and the expansion of employment have been some of the different factors considered by the Commission as enhancing public benefit. a/ The burden of proving that a non-price vertical restraint under scrutiny is anti-competitive and detrimental to consumers lies with the Commission.

### European Union

2. Article 85 (1) of the Treaty of Rome (establishing the European Community) prohibits agreements affecting trade among member States which have as an effect or object the restriction of competition in the common market. Agreements which would be prohibited pursuant to article 85 (1) can still be exempted, as stated in article 85 (3), so long as they meet four conditions. First, they must contribute to the improvement of production or distribution of goods, or promote technical or economic progress. Second, they must allow consumers a “fair share of the resulting benefits”. In addition, agreements should not impose restrictions on the enterprises concerned which are not indispensable to the attainment of the stated objectives (economic efficiency and consumer satisfaction) and should not afford such enterprises the possibility of eliminating competition in respect of a substantial part of the products in question.

3. Article 85 applies, therefore, to all competition-restricting agreements, horizontal as well as vertical. To be exempted, these need to bring about direct and substantial benefits to consumers: improvements in the efficiency of production alone are not considered sufficient for a waiver. From the wording of article 85, it is clear that in the evaluation of the effects produced by vertical restraints, relatively more weight has been attached to the welfare of consumers. b/ The Commission therefore, recognizes that vertical restraints may bring about both anti-competitive as well as pro-competitive effects. Particularly, it is recognized that these practices may reduce distribution costs for new entrants, giving final consumers the benefit of access to new goods and services, and may be authorized provided that a substantial part of the benefits are passed on to consumers.

4. Another important feature of the European Union's competition policy which is particularly relevant in the context of vertical restraints is the political objective of market integration, which has received as much prominence as the

goal of promoting competition and efficiency. Practices having the effect of partitioning the common market along national lines conflict with the market integration goal and they have been consistently proscribed and sanctioned as serious violations of the competition rules. In view of the importance for the Community of achieving market integration, a considerable proportion of the competition enforcement activities carried out by the European Commission and the European Court of Justice since the early years of enforcement have concerned distribution practices.

5. In order to authorize certain efficiency-enhancing agreements which formally violate article 85 (1), while avoiding a case-by-case analysis of the many vertical practices adopted in the Community, the Commission has adopted a series of group exemption regulations ("block exemptions") which define certain categories of agreements which generally fulfil the conditions for exemption under article 85 (3). The three most important group authorizations issued by the Commission deal with exclusive dealing, c/ territorial exclusivity d/ and franchising agreements. e/ When agreements meet the conditions contained in the group exemption regulations, they do not need to be notified to the Commission.

6. Vertical practices which do not meet the requirements contained in the block exemption regulations and which have a substantial impact on competition are not automatically prohibited, and can be granted individual exemptions as long as they are pre-notified and can be shown to bring about substantial distribution efficiencies.

7. While recognizing the efficiency-enhancing effects of certain types of vertical restraints, the Commission has systematically prohibited exclusive distribution agreements involving absolute territorial protection, as well as resale price maintenance. In the Grundig/Consten case, f/ the Commission barred an agreement whereby a German manufacturer granted absolute territorial protection to its French exclusive distributor. The Commission argued that it intended to maintain intra-brand competition, pursue the goal of market integration and preserve the viability of small parallel traders. It is also stated that vertical agreements substantially reducing intra-brand competition would not be accepted even though they might contribute to an increase in inter-brand competition. Over the years, absolute territorial protection has been consistently considered as an intrinsic violation which does not require the economic effects on competition between different brands to be considered. Export prohibitions are therefore banned, even though distributors can commit themselves not to actively promote their sales outside their assigned territory.

8. Another related practice prohibited by the Commission is the charging of different prices according to the final destination of products. In the Distillers case, g/ the Commission was opposed to a surcharge the producer had imposed on wholesalers who wanted to export to continental Europe. The surcharge had been justified on the basis of the different market conditions in the two geographic areas: in continental Europe, Scottish whisky (the relevant product) had to compete with local, more popular products, and therefore exclusive distributors had to produce expensive promotional campaigns. By allowing parallel imports, alternative distributors might have been able to free-ride on the official distributors. Nevertheless, the Commission found the practice incompatible with Community competition rules.

9. In another case (Polistil-Arbois), h/ the Commission challenged the price reductions awarded by a manufacturer to exclusive dealers as a compensation for the higher promotional costs incurred by the exclusive distributors. The Commission recognized that the exclusive distributors incurred higher costs, but these were not seen as sufficient to justify the different charges. In the view of the Commission, the exclusive dealership granted by the manufacturer already represented a benefit which compensated for the cost differentials.

10. The Commission has also recognized that manufacturers may want to ensure a minimum price at retail level for pro-competitive reasons, in order to promote competition on the basis of the quality of services supplied. Still, the use of resale price maintenance has not been considered as an appropriate way to achieve that objective. Rather, selective distribution and other distribution practices have been viewed as less restrictive means of competition to ensure a level of sales-related services considered adequate for the recognition and promotion of a product. The prohibition of vertical price fixing has not included recommended retail prices, so long as these are not binding and distributors are free to set resale prices freely.

11. In early 1997, the Commission issued a Green Paper presenting possible policy options to be considered by all parties concerned (the business community, competition authorities of member States, etc.) for a revision of the treatment of vertical restraints in the Community. i/ The Commission decided to start this review process for several reasons. First, some of the block exemption regulations are about to expire. Second, most of the rules adopted by the Community for the achievement of a truly unified market have been fully implemented: private restrictions to competition and market integration are now viewed as more important impediments to undistorted intra-community trade. Third, substantial changes have occurred in the market structure and in the technological level of distribution. These changes are viewed as requiring new policy approaches.

12. Some of the options considered by the Commission would allow for more flexibility in the application of existing block exemption regulations (covering practices with effects similar to those already covered) or more flexible treatment of vertical arrangements for agreements between parties with no significant market power.

13. In the light of the comments received on the Green Paper, the Commission has put forward proposals to reform the treatment of vertical restraints j/ under Community competition policy. The proposals aim to give more weight to the analysis of market power held by upstream and downstream firms involved in vertical contractual arrangements, with less reliance on a form-based system of categories of vertical restraints. For firms with limited market share, most forms of vertical restraints would be automatically exempted, while a more thorough analysis would be required only for firms with market power, without establishing any presumption of illegality. However, a limited set of vertical restraints, such as resale price maintenance, would still be considered prohibited, regardless of the market share of the concerned firms.

**Japan**

14. In the Antimonopoly Act of Japan, vertical restraints are dealt with under article 19, the provision dealing with unfair trade practices. Guidelines have also been issued to inform the public on the approach the Fair Trade Commission would take when enforcing the competition legislation vis-à-vis vertical contractual arrangements. k/ In Japan, resale price maintenance is considered illegal per se. The prohibition has been strictly enforced not only with regard to explicit or implicit agreements on resale price, but also when indirect means (such as refusals to deal) have been used to maintain the level of resale price. In several cases, the Fair Trade Commission has imposed significant fines on the violators of the ban on resale price maintenance. l/ Vertical non-price restraints are judged, instead, on a rule-of-reason basis, by evaluating the pro-competitive and anti-competitive effects. In enforcing the law on vertical restraints, the Fair Trade Commission has paid particular attention to exclusive dealing arrangements. These are reviewed on the basis of their market foreclosure effects vis-à-vis competing firms and potential new entrants. Exclusive dealing arrangements concluded by firms with a market share of less than 10 per cent, however, are not viewed as capable of restricting competition. Another area of enforcement activity has been with respect to territorial exclusivities. These have been reviewed for their impact both on inter-brand and intra-brand competition. As for exclusive dealing arrangements, territorial exclusivities are considered as unlikely to reduce competition when they concern firms with limited market share. Tie-in sales have also been considered potentially anti-competitive when used by firms with substantial market power, as they might make it impossible for other sellers of the tied product to compete on an equal footing.

**Kenya**

15. The Kenyan Restrictive Trade and Practices, Monopolies and Price Control Act of 1988 covers vertical restraints under the provisions dealing with restrictive trade practices. Both price and non-price vertical restraints are recognized as being on most occasions likely to lead to enhancement of competition and efficiency. Potential anti-competitive effects are assessed by looking at the market shares held by firms, the market structure of the relevant markets and the ease or difficulty of entering the market.

**Mexico**

16. The 1992 Federal Law of Economic Competition of Mexico makes a clear distinction between so-called “absolute” monopolistic practices, which are prohibited, and “relative” monopolistic practices, which are analysed on a case-by-case basis in order to determine whether they unduly restrain competition. Absolute monopolistic practices include agreements between competitors which have the purpose or effect of fixing prices, restricting outputs, sharing markets or rigging bids. Relative monopolistic prices, listed in article 10 of the competition law, include several vertical restraints such as resale price maintenance, territorial exclusivities, exclusive dealing arrangements, unreasonable refusals to deal and tie-in sales. Relative monopolistic practices, according to article 11, are a violation of competition law only when firms have substantial market power and when the practices are carried out in connection with goods and services pertaining to a relevant market. Article 13 specifies the factors that need to be considered when determining the presence of substantial market power. They include the market share held by the firms and their ability to fix prices and restrict outputs

unilaterally, the power of existing competitors and barriers to entry for new market players.

**Republic of Korea**

17. In the Korean Antitrust Act of 1980, vertical restraints are addressed under the provision dealing with unfair trade practices. The Korean enforcement agency, the Fair Trade Commission, has clarified types and elements of unfair trade practices in a document published in 1990. m/ In view of the continuous developments in business practices, the Korean competition authority conducts a case-by-case evaluation of vertical restraints. In fact, neither exclusive dealing nor the different forms of territorial exclusivities are illegal per se: rather, their effects on competition in the relevant market are evaluated. Resale price maintenance is generally prohibited outright, but firms may ask the competition authority for an exemption. Even if a temporary exemption is granted, the resale pricing of products is subject to supervision by the competition authority. Only two products, cosmetics and pharmaceuticals, were granted exemption in the early 1980s, and since then, prohibition has been the general rule.

**United States of America**

18. In the United States, anti-trust policy on vertical restraints has evolved greatly over the years, influenced by developments in the way economic theory has weighed the competition and efficiency effects of vertical practices. It is worth noting that in the United States, unlike in the European Union, the promotion of an integrated internal market is not one of the stated objectives of competition policy.

19. In the United States, a distinction has been constantly drawn in the treatment of price and non-price vertical restraints. While non-price vertical restraints have been increasingly assessed under a rule-of-reason analysis, a per se illegality rule has generally been applied to vertical price-fixing. Since a decision in 1911 in the case of the Dr. Miles Medical Co., n/ the Supreme Court has supported the position that resale price maintenance is a violation of section 1 of the Sherman Act, under which “every contract, combination, or conspiracy in restraint of trade” is illegal.

20. The scope of the prohibition of vertical price-fixing, however, has been gradually narrowed over time. In fact, the right of refusal to deal combined with the legal acceptance of “suggested” retail prices has allowed (to a certain extent) manufacturers to impose resale prices, in view of their ability to refuse supplies to distributors not applying recommended retail prices. The right of unilateral refusal to deal was clearly upheld by the Supreme Court in the Colgate decision where it stated that, “In the absence of any purpose to create or maintain a monopoly, the Sherman Act does not restrict the long recognized right of a trader or manufacturer engaged in an

entirely private business freely to exercise his own independent discretion as to parties with whom he will deal. And of course he may announce in advance the circumstances under which he will refuse to sell.” o/

21. In a more recent decision, p/ the Supreme Court overruled the previous per se prohibition of maximum vertical price-fixing. In the decision, it is recognized that vertical maximum price-fixing can be used to restrain the exercise of market power by dealers having a dominant or monopoly position in distribution.

22. With respect to non-price vertical restraints, in the landmark Sylvania decision, q/ the Supreme Court reversed previous rulings and applied a rule of reason in deciding the case. In the decision, it recognized that while vertical restraints restrict intra-brand competition, they might increase distributors' incentives and therefore enhance competition among different brands.

23. In particular, the Supreme Court stated that “Vertical restrictions promote intra-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products ... Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers ... For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labour that is often required in the distribution of products unknown to the consumer ...”

## Notes

a/ R.I. McEwin, “Vertical restraints in the Australian Trade Practices Act”, Review of Industrial Organization, 1994, pp. 627-647.

b/ P. Rey and F. Caballero-Sanz, “The policy implications of the economic analysis of vertical restraints”, Economic Paper No. 119 of the European Commission Directorate-General for Economic and Financial Affairs, November 1996, pp. 8-10.

c/ Commission Regulation 1984/83 on the application of article 85 (3) to categories of exclusive purchasing agreements (OJ 1983 L175/5).

d/ Commission Regulation 1983/83 on the application of article 85 (3) to categories of exclusive distribution agreements (OJ L173/1).

e/ Commission Regulation 4087/88.

f/ Quoted in I. Van Bael and J.-F. Bellis, Competition Law of the European Community, Oxfordshire CCH Editions, 1994, pp. 302-303.

g/ Quoted in I. Van Bael and J.-F. Bellis, Competition Law of the European Community, Oxfordshire CCH Editions, 1994, pp. 309-310.

h/ Quoted in I. Van Bael and J.-F. Bellis, Competition Law of the European Community, Oxfordshire CCH Editions, 1994, pp. 309-310.

i/ Commission of the European Communities, "Green Paper on vertical restraints in EC competition policy", Brussels, 22 January 1997 (COM(96) 721 Final).

j/ See "Draft communication on the application of the EC competition rules to vertical restraints, DG IV, July 1998.

k/ Fair Trade Commission of Japan, "The Antimonopoly Act Guidelines Concerning Distribution Systems and Business Practices", 1991.

l/ H. Kobayashi, "Competition policy regarding vertical trade restraints: a Japanese view", in E. Hope and P. Maeleng (eds.), Competition and Trade Policies, London, 1998.

m/ Korean Fair Trade Commission, "Types and elements of unfair trade practices", Fair Trade Commission Notification 90, 7 July 1990.

n/ Dr. Miles Medical Co. v. John D. Park & Sons, 220 U.S. 373.

o/ U.S. v. Colgate & Co., 350 U.S. 300, 307.

p/ State Oil Co. v. Khan, 96-871 (1997).

q/ Continental TV v. GTE Sylvania, 433 U.S. 36 (1977).

-----