International
Competition
Network

ICN Unilateral Conduct Regional Workshop

Exclusive dealing and customer foreclosure: an economic approach

Adrian Majumdar

September 17, 2013

Introduction

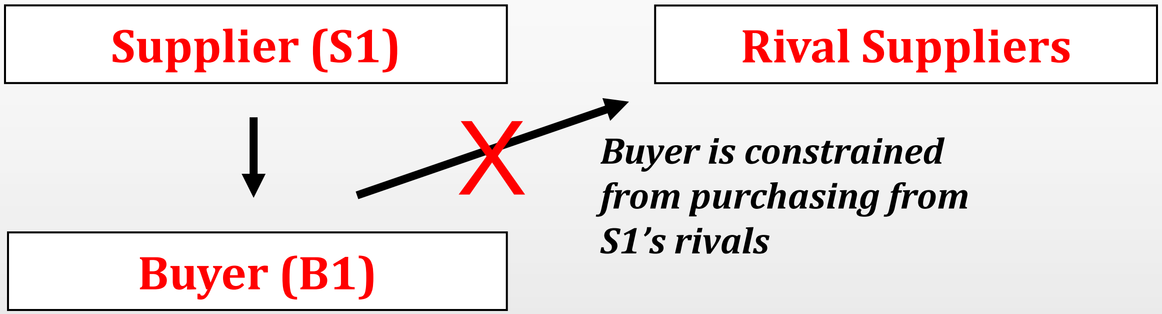
- In line with UNILATERAL CONDUCT WORKBOOK CHAPTER 5: EXCLUSIVE DEALING we shall focus on exclusive dealing (ED) where the **buyer is restricted in making purchases from certain suppliers** (as opposed to the supplier being restricted from dealing with certain buyers).

- And we shall assess ED under **unilateral conduct**, focusing on cases where the supplier is dominant.

Please see:

http://www.internationalcompetitionnetwork.org/uploads/library/doc906.pdf

Exclusive dealing



Sometimes called "single branding" (the buyer is constrained from distributing other brands)

- ***Contractual***
- *B1 must <u>only</u> source from S1, or B1 must source (e.g.) <u>at least 80%</u> of its requirements from S1*
- ***De facto (contractual)***
- *B1 must stock S1's ice-creams in S1's freezers… but B1 has room only for one freezer;*
- *B1 must source 80 or more units per quarter from S1… but B1 requires only 100 units on average per quarter.*
- ***Induced***
- *B1 receives a rebate if it sources 80% or more of its needs from S1.*

Customer Foreclosure by Unilateral Conduct

When assessing ED, the standard theory of harm is customer foreclosure.

Customer foreclosure:

- A practice whereby a dominant supplier prevents a rival supplier from accessing sufficient customers…

… such that the rival supplier operates at a substantial competitive disadvantage…

…the effect of which is to raise prices for end customers.

While ED may give rise to harmful customer foreclosure **it may be benign or pro-competitive**.

European Commission makes a distinction between harmful exclusion “anticompetitive foreclosure” and other types of exclusion.

Customer Foreclosure ("Traditional Case") Initial Screens

Dominant Supplier

Rival supplier

1: dominance?

- *What degree of market power?*

2: alternative routes to market to become a viable competitor?

- *Are 'locked-in' buyers the gateway to the market?*
- *Is forward integration viable? (No entry barriers in downstream market)*
- *Is direct supply viable?*
- *How great are scale economies? And what is the competitive role of the rival pre/post exclusion?*

'Locked-in' buyers

Other buyers?

3: how exclusive?

- *Contractual, de facto, induced?*
- *Competition "for" the contract?*
- *Contestable units allow rivals to obtain sufficient scale?*

End customers

Is foreclosure feasible?

- **Does dominant supplier (Domco) have the ability to foreclose?**
  - **Substantial market power**? To what degree is Domco an "unavoidable trading partner" – how credible is it for Domco to say: if you buy from me, you buy only from me? Or can other suppliers credibly compete to access a sufficient share of any given buyer's requirements ?
  - **Alternative routes to market for Domco's rivals?** (As per the diagram above.)
  - Can Domco **target buyers selectively** – e.g. those most likely to be important for Domco's rivals? Domco maybe had first mover advantage – the chance to contract before its rivals (e.g. relevant when foreclosure relates to new entrants)?
  - Are **scale economies** important (whether supply side economies or demand side network effects), otherwise why does it matter if rivals operate on a smaller scale? Are key rivals denied the scope to secure substantial scale economies such that they compete less effectively?
  - NB – issue is harm to <u>competition</u> and not competitors – see "Effect" below.

Inducing buyers to purchase exclusively

- **How does Domco persuade buyers not to source from rivals?**
  - Purchasers do not usually have an incentive to see competition harmed among their suppliers, so how does Domco persuade buyers to forego buying from its rivals?
    - Offers lower price? (NB – check – why isn't this competition working well!)
    - Invests in its buyers (e.g. its distributor)? (NB this could also be pro-competitive.)
  - **"Coordination failures":** if all buyers acted together, they might encourage a new entrant or a rival to compete with Domco, but when they act independently, Domco can exploit their lack of coordination or engage in a "divide and rule" strategy.
  - <u>Stylised example:</u> imagine 5 identical buyers with staggered five year contracts. Every year, one buyer's purchases are put out to tender. If Domco already serves the other four buyers, it may be better placed to serve the fifth (e.g. if due to scale economies, efficient operation requires serving two buyers).

Assessing the effect of ED

- **Harmful <u>effect</u>?**
  - How much weaker do rivals become as a result of the agreements in terms of their ability to compete?
  - Are the rivals that are harmed substantially of great importance to ensuring Domco offers low prices, high quality or high innovation? In other words, what is the actual (or potential) competitive significance of the rivals that are foreclosed?
  - Are final consumers diverted from their optimal choices (and insufficiently compensated by lower prices)?
  - Are there likely "counter-strategies"? Can those that are harmed (rivals and customers paying higher prices or suffering lower quality and choice) "team up" to undermine the dominant firm's foreclosure strategy?
  - To what extent do efficiencies (e.g. discounts or specific investments benefiting tied distributors) that would otherwise not have taken place offset any possible price raising or quality lowering effects?

Efficiencies arising from ED

- **Why might restrictions be necessary from the supplier perspective?**
  - Supplier makes specific investments in distributor and does not wish to be subject to ex post hold up or free-riding.
    - Example 1: S1 sinks an investment in B1 that makes B1 a better distributor and so S1 does not wish its rivals to benefit from (i.e. free-ride on) that investment.
    - Example 2: S1 builds a plant specifically to serve B1 (with no alternative use). To recover investment costs, S1 requires B1 purchases only from S1 for a certain period of time.
  - To align distributor incentives to promote or invest in supplier's product (e.g. S1 would find it too costly to monitor B1's marketing efforts otherwise and ED limits its need to monitor B1).
  - To assure achievement of scale economies / certainty of demand. (e.g. S1 may gain a greater incentive to invest or may be able to procure inputs on better terms).
  - Buyers may ask suppliers to bid to be their only supplier to obtain lower prices – **ED may be an outcome of effective competition**.
- **Contractual exclusivity may be beneficial or harmful; its effect should be assessed on a case-by-case basis**

Effects-based analysis of ED

- There should be a coherent theory of harm to competition and consumers
- Identify key assumptions / intuitions in that theory
- Test those against the evidence
- Does the evidence support the theory of harm to competition substantially more than any other competing theory of benign or pro-competitive behaviour?
- Standard of proof: “capable of harm” or “likely to harm”?
- Consider the precedent set by remedies and intervention (as well as the practicalities of the remedy / monitoring requirements)