International Competition Network

Exclusive dealing
An economic framework

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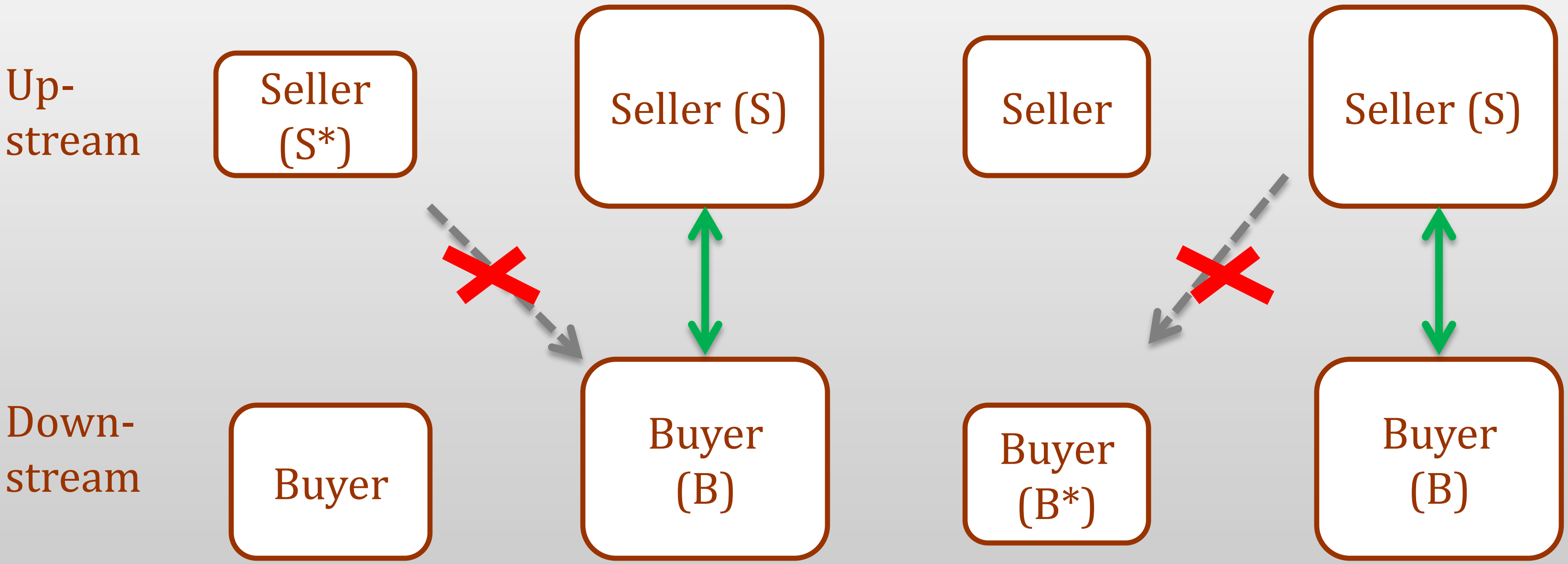
Outline

- What is exclusive dealing?
- Underlying economics
- Framework for assessment
- Key messages

Exclusive dealing (1/2)

B agrees only to buy input from S

S agrees only to supply input to B



Exclusive dealing (2/2)

- May be *de facto* rather than explicit e.g. stocking requirements
- May be one or many agreements involving multiple sellers and/or buyers (networks of agreements)
- Duration and termination conditions

Efficiency rationales for exclusive dealing

- There are many efficiency rationales for exclusive dealing (see later presentations)
- *Where B agrees only to buy input from S*
  - S's provision of a complementary good to B
  - Reduction of uncertainty for S
  - Protection of S's brand
- List of efficiencies not exhaustive and not finite

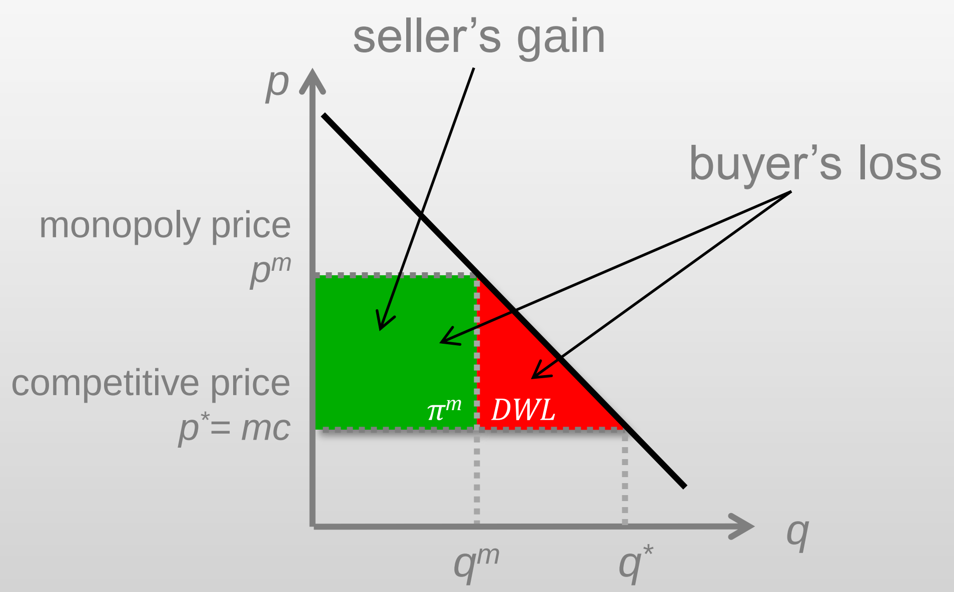
Anticompetitive rationales for exclusive dealing

- Basic concern is that exclusive dealing forecloses rivals
- *Where B agreed only to buy input from S*
  - Risk of upstream foreclosure of rival supplier(s) S*, due to lack of access to buyers
  - Available buyers may not be sufficient for rival supplier to achieve minimum efficient scale (MES), so it may not enter
  - This may allow incumbent S to raise prices in the future (or keep them high)
- Concern can be foreclosure of entrant or marginalisation of smaller rival
- Mirror image where operative upstream

Chicago School

- *Where B agrees only to buy input from S*
  - Unless properly compensated, B would never agree to sign contract which stifles competition and gives S power to raise future prices to its detriment due to exclusion of rival S*
  - Need to pay this compensation makes exclusive dealing unprofitable for B, unless it also has efficiency justification
  - Therefore, wherever exclusive dealing is observed it must have (net) efficiencies
- Exclusive dealing may also intensify *ex ante* competition
- Implies there is never a need for competition policy intervention

Chicago critique with simple pricing



Not enough money to buy exclusivity

Post-Chicago

- Multiple theories showing that observed exclusive dealing can have (net) anticompetitive effects; for example
  - Suppose there are 100 buyers and supplier entrant (S*) needs 50 buyers for minimum efficient scale (MES)
  - If incumbent S enters exclusive dealing agreement with 51 buyers, S forecloses his rival S* from all 100 buyers
  - But S only needs to compensate (at most) 51 buyers
  - So foreclosure strategy can be profitable absent efficiencies
- Implies need for an economic approach to minimise costs of type I and type II errors

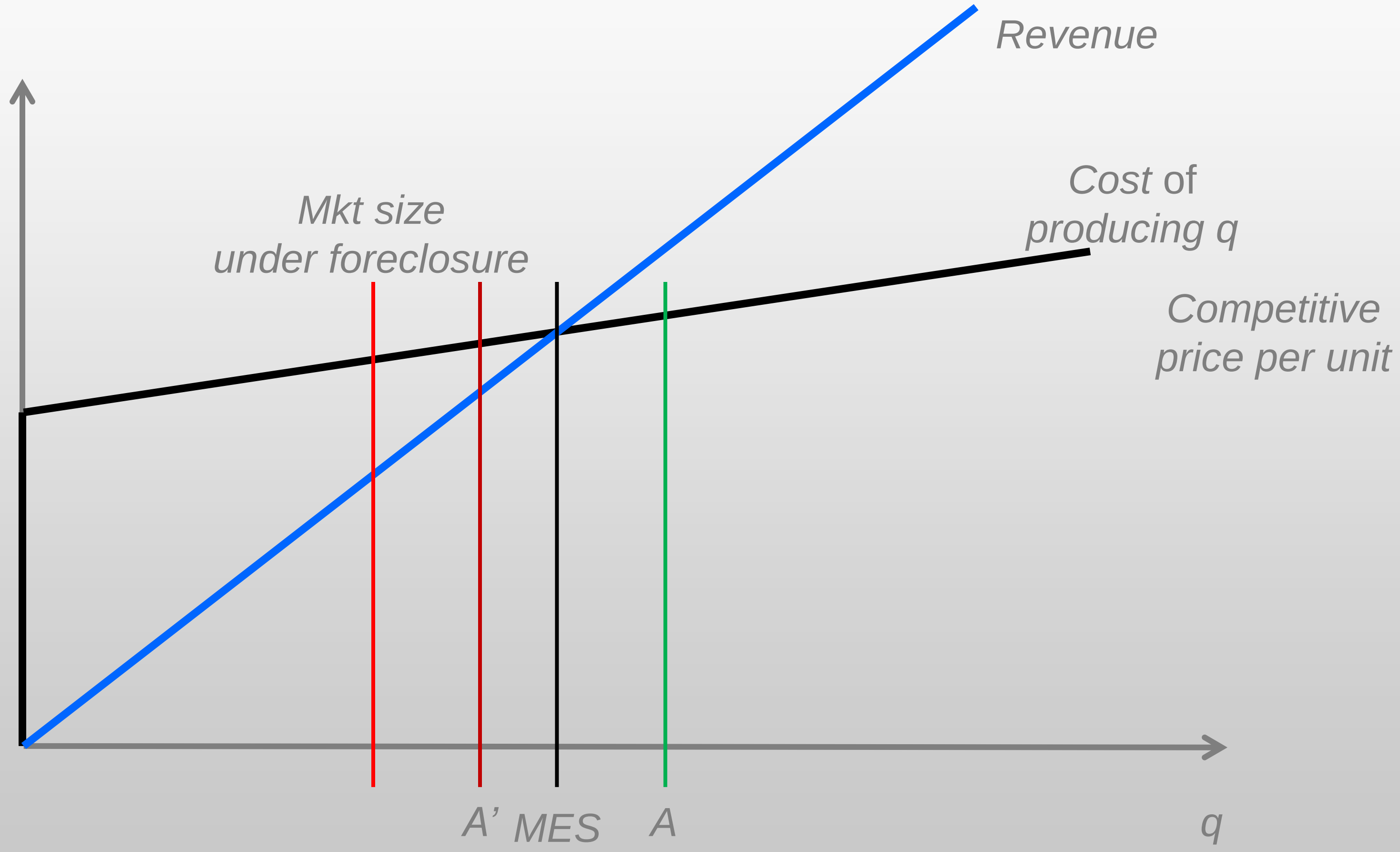
Framework for assessing exclusive dealing

- **#1 – Ability** of the identified exclusive dealing to foreclose competitors
- **#2 – Negative effects**; in particular whether the foreclosure would lead to an increase in market power (the anticompetitive incentive)
- **#3 – Positive effects/net effects;** in particular arising from efficiencies (the pro-competitive incentive) and whether these dominate negative effects
- Explanation of why the Chicago School critique does not hold in particular case (to reduce risk of type I errors)
- Application of framework in following slides assumes exclusive dealing where *B agrees only to buy input from S*

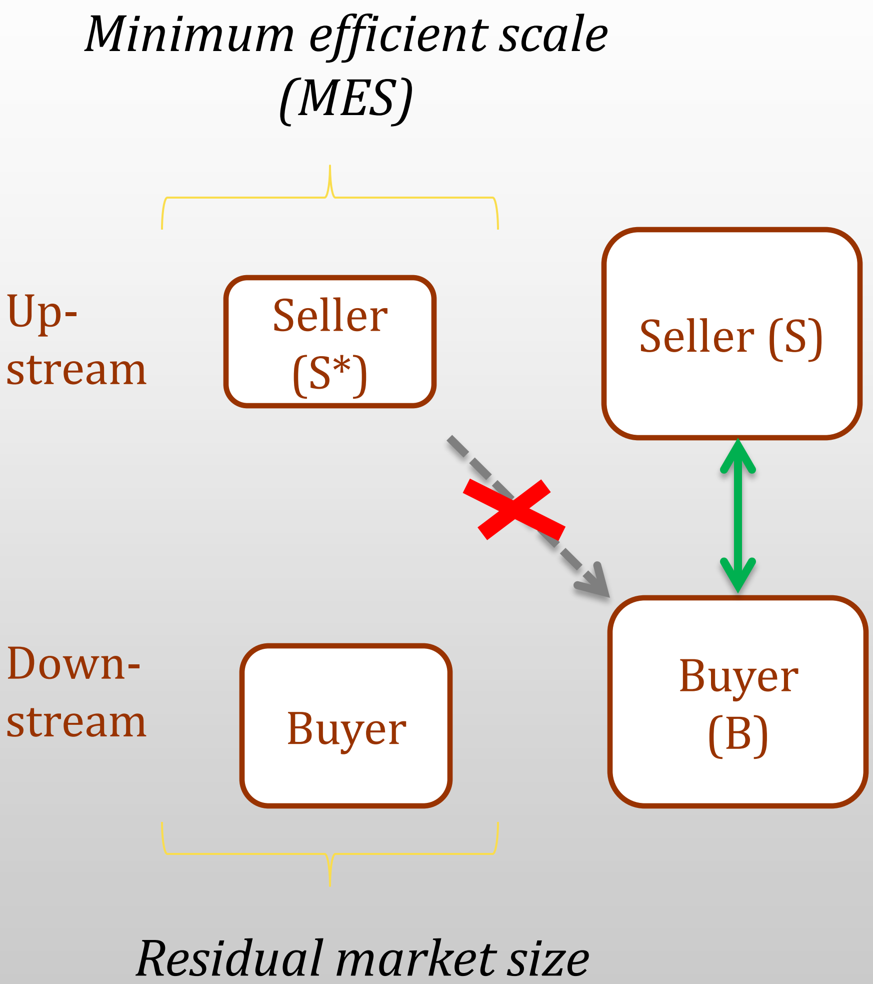
#1 – Ability (1/2)

- **Ability of the identified exclusive dealing to foreclose competitors**
- (a) Where exclusive dealing not explicit, need to show *de facto* exclusivity
- (b) Where there are multiple exclusive deals, need to identify counterfactual (should any exclusive dealing agreements be assumed?)
- (c) *Absent exclusive dealing* demand must be sufficient for rival S* to enter the market/expand to critical scale
- (d) *With exclusive dealing* residual demand (i.e. buyers not covered by exclusive dealing) must be too small for rival S* to enter the market/expand to critical scale, given S*'s minimum efficient scale (MES)

Minimum Efficient Scale



#1 - Ability(2/2)



- RMS = 30 and MES = 10 ➔ no ability to foreclose
- RMS = 20 and MES = 25 ➔ ability to foreclose
- For network cases, look at RMS over relevant time period, e.g. *per annum*
- Sources of evidence for MES

#2 - Negative effects

- **Negative effects; in particular whether the foreclosure would lead to an increase in market power (the anticompetitive incentive)**
- Exclusion of rival S* from the market must increase the market power of S but this does not follow automatically
- (a) If S* would not exert a competitive constraint on S, its exclusion does not increase S's market power
- (b) If S* was present when the exclusive deal was signed and capable of competing effectively, its exclusion does not increase S's market power
- (c) S* may have been foreclosed from traditional distribution channels but not necessarily from all routes to final consumers
- However, absent these conditions, negative effects are possible

#3 - Positive effects

- **Positive effects; in particular arising from efficiencies (the procompetitive incentive) and whether these dominate negative effects**
- Identification and quantification of efficiency gains
- Indispensability of the exclusive dealing to realise the efficiency gains
- Net effects on final consumers
- Business executives may not think like economists in terms of efficiency gains, but it does not mean those gains do not exist

Three key messages

- Need to look at residual market size (RMS) and minimum efficient scale (MES) jointly
- If excluded firms present and capable of competing effectively when exclusive deal signed, this mitigates concerns
- Good to have account of why B did not internalise competitive effects when signing to show Chicago School argument does not apply