

RAISING RIVALS' COSTS AND EXCLUSIVE DEALING

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One of antitrust law's primary concerns is prohibiting firms with market power from using that power to eliminate rivals or protect themselves from competition. Courts and commentators have coined the word predation to describe such behaviour. Predation takes two forms, price or nonprice. With price predation a predator sells its products at a loss so as to drive its victims from the market, then increases prices to recoup its losses and reap monopoly profits.

Nonprice predation involves a predator acting so as to raise its rivals' or potential rivals' costs. This forces the rivals to raise their price. Such action enables the predator to do likewise and make a profit. Under certain circumstances the predator can gain exclusionary market power and thus indirectly power over price. This creates inefficiencies and reduces consumer welfare. Despite commentators having long realised that raising rivals' costs can cause anticompetitive harm,¹ courts and commentators have focused mainly on price predation. The reason was that no one had developed an economic model for courts to use to assess nonprice predation.

This has changed. Professors Steven Salop, Thomas Krattenmaker and David Scheffman have developed a model of nonprice predation - the Raising Rivals' Costs (RRC) model. They claim courts should analyse all types of nonprice predatory behaviour using the model as it offers advantages over conventional antitrust analysis. Dr Timothy Brennan has stated: "A good test for the usefulness of any new antitrust theory is whether it identifies bad practices that are currently legal without adding to the set of good practices that are inappropriately condemned."² This article will adopt that test to assess the RRC model's proponents' claims. Part I of this article introduces the concept of RRC and how it is a more attractive strategy than predatory pricing. Part II discusses Salop et al's RRC model. To determine whether the model's proponents' claims are correct I will examine exclusive dealing using the model. Exclusive dealing is a paradigm RRC scenario. To that end Part III discusses the economics of exclusive dealing. Part IV examines the United States, Canadian and Australian case law on exclusive dealing. Part V applies the RRC model to a New Zealand case: *Fisher & Paykel v Commerce Commission*³ and discusses whether the model is of value. I argue it is and that had the High Court applied an RRC analysis it would have reached the same result. Part VI offers some conclusions.

I. RRC - INTRODUCTION

The phrase Raising Rivals' Costs has entered the antitrust lawyer's lexicon. Generally, it refers to the work of Salop, Krattenmaker and

* I thank Susan R Frankel for her constructive criticism on previous drafts of this article. Needless to say the views in this paper and any errors are mine.

1 R Bork, W Bowman, H Blake & W Jones, "The Goals of Antitrust : A Dialogue on Policy" (1965) 65 Columbia Law Review 363 at 367 and 402.

2 T Brennan, "Understanding "Raising Rivals' Costs" "(1988) 33 Antitrust Bulletin 95 at 96.

3 [1990] 2 NZLR 731.

Scheffman who have developed a model for examining predatory conduct.⁴ However, Salop et al did not invent the concept. Earlier commentators had argued Raising Rivals' Costs could be anticompetitive.⁵ RRC is a form of nonprice predation. It is the most prominent theory of nonprice predation, but it is not the only one.⁶

RRC is a form of strategic behaviour. This is conduct designed by the predator to decrease the attractiveness of the offers against which the predator must compete.⁷ The theory works as follows: the predator raises its victim's costs by increasing the price of a critical input of its victim. This causes the victim to decrease its output. The predator raises the victim's costs above market price, so making the victim's business unprofitable.

Raising rivals' costs can succeed even if the predator does not eliminate its rivals.⁸ Generally, a firm's output decreases when its marginal cost increases. If a predator increases the marginal cost of all or most of its rivals, the decrease of the rivals' supply will decrease market supply, thus raising the market price. This gives the predator three choices. It could:

- (a) Keep its output constant and enjoy a higher market price.
- (b) Expand its output to make up for the rivals' decreased output and enjoy a greater share of the market at the original market price.
- (c) Make up some, but not all, of the rivals' reduced output and enjoy a greater share of a somewhat smaller market at a somewhat increased price.⁹

RRC will not be plausible if market entry is easy. If increased prices lead to new firms entering, the predator will not earn long-term monopoly profits. However, a predator can raise the cost of prospective entrants, thus inhibiting entry. It can do this by abuse of judicial and administrative processes.¹⁰

A predator can use RRC to raise the market price. It can also use RRC to prevent price from falling. For example, current producers may be threatened by the development of new products or new technology that would decrease the demand for their products, thereby effectively lowering the market price for their products. An RRC strategy would involve raising the costs of reaching the market for the new product or technology, thus stabilising price. Because RRC can lead to market prices rising or staying stable when they would otherwise fall, it is worthy of competition law concern.

Another reason for concern is that, unlike predatory pricing, RRC is a rational and plausible strategy. Predatory pricing involves a predator selling its product at a loss so as to drive its rivals from the market. The predator

4 See Krattenmaker & Salop, "Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power over Price" (1968) 96 Yale Law Journal 209. Krattenmaker & Salop, "Exclusion and Antitrust" (1987) II Regulation 29; Krattenmaker & Salop, "Competition and Co-operation in the Market for Exclusionary Rights" (1986) 76 American Economic Review 109; Krattenmaker & Salop, "Analysing Anticompetitive Exclusion" (1987) 56 Antitrust Law Journal 71; Salop & Scheffman, "Cost Raising Strategies" (1987) 26 Journal Industrial Economics 19; Ordovery, Saloner & Salop, "Equilibrium Vertical Foreclosure" (1990) 80 American Economic Review 127.

5 See O Williamson, "Wage Rates as a Barrier to Entry : The Pennington Case in Perspective" (1968) 82 Quarterly Journal Economics 85 at 90-101.

6 T Campbell, "Predation and Competition in Antitrust : The Case of Nonfungible Goods" (1987) Columbia Law Review 1625 (dealing with spatial oligopoly); J Ordovery & R Willig, "An Economic Definition of Predation: Pricing and Product Innovation" (1981) 91 Yale Law Journal 8 (dealing with predatory product innovation).

7 H Hovenkamp, "Antitrust Policy After Chicago" (1985) 8 Michigan Law Review 213 at 260.

8 American Bar Association Antitrust Section, Monograph No 18, "Nonprice Predation under Section 2 of the Sherman Act" (1991) at 9.

9 Ibid.

10 See P Scott, "Abuse of Judicial and Administrative Processes - An Antitrust Violation?" (1993) 21 Australian Business Law Review 389.

then increases prices to recoup its losses and reap monopoly profits.¹¹ To be successful predatory pricing requires certain conditions. A predator must be able to eliminate its victims quickly because selling below cost is expensive. Not even the most well financed predator can sell below cost indefinitely and therefore predatory pricing is necessarily a temporary tactic. The victim must not have counterstrategies which enable it to survive the predatory pricing.¹² Barriers to entry into the market must be high so that once the predator has eliminated its victim and started monopoly pricing, new entrants cannot enter quickly. The monopoly pricing will attract new entrants. Because of the rigorousness of these conditions predatory pricing is likely to be uncommon.

RRC, on the other hand, is a more plausible and attractive tactic.¹³ It does not involve the predator suffering significant short term losses. The tactic may inflict losses on the predator which are likely to be small in comparison to the costs the victim must face. A normal business arrangement may raise rivals' costs. The tactic does not depend on the total exclusion of rivals for its success. The return from the strategy does not involve either an extended waiting period or the uncertainty inherent in predatory pricing. However, as with predatory pricing, RRC will be ineffective if market entry is easy. If supracompetitive prices induce entry, the predator cannot expect to earn long term supracompetitive profits. But, as mentioned above, the predator can use RRC against prospective entrants.

Liability for RRC must be imposed carefully. Not all conduct which raises rivals' costs is anticompetitive. It may be extremely procompetitive. For example, an oven manufacturer may develop a wonder oven which enables duffers to cook meals worthy of Anton Mosimann. This will inevitably raise the costs of rival manufacturers who will have to spend significant amounts to develop a similar oven. They will probably also have to undertake extensive advertising and distribution programmes to sell their existing now outdated ovens. The new oven would give the originator manufacturer power over price in the sense it could sell the oven above marginal cost. Much normal competitive behaviour will raise rivals' costs. For example, bidding for the services of a key employee will inevitably raise the cost of a rival who also wants the employee.¹⁴ Advertising will press rivals to spend more on their own advertising to maintain sales, thus increasing costs. Normal price cutting will often require rivals to spend more on product improvements to improve sales. Property rights in all forms tend to raise costs for those who do not own the property.¹⁵

Normal rivalry demands that a firm keep its costs low. One way of doing this, is to acquire exclusive commitments from the lowest-cost suppliers. By excluding rivals from these suppliers, the firm has raised rivals' costs. In certain, but not all, circumstances this is worthy of antitrust concern. To condemn such behaviour for simply raising rivals' costs would be to condemn normal business behaviour. It would also ignore the efficiency enhancing benefits of actions that raise rivals' costs. Thus, before imposing liability for raising rivals' costs, certain criteria must be met. Any model which condemns raising rivals' costs must distinguish between normal behaviour that unobjectionably raises rivals' costs and behaviour which

11 G Hay, "Predatory Pricing" (1990) 58 *Antitrust Law Journal* 913.

12 F Easterbrook, "Predatory Strategies and Counterstrategies" (1981) 48 *University of Chicago Law Review* 263.

13 Salop & Scheffman, "Raising Rivals' Costs" (1983) 73 *American Economic Review* 267 at 268.

14 ABA, *op cit* n 8, at 8-10.

15 *Ibid* at 37.

competition law should outlaw. It must explain how rivals' costs are raised and only impose liability when rivals' costs are raised for a significant time. The model should also take account of any efficiency explanations for action that raise rivals' costs. Krattenmaker and Salop have developed a model which they claim meets these criteria.

II. KRATTENMAKER AND SALOP'S MODEL OF RRC

A. The First Stage of the Model

Krattenmaker and Salop, in a seminal Yale Law Journal article,¹⁶ developed a model of RRC for courts to use. They argue that American courts' traditional analysis of tying arrangements, exclusive dealing, refusals to deal, group boycotts, vertical mergers and other exclusionary activities is economically incoherent and in disarray. A lack of a coherent economic model of anticompetitive exclusion has prevented courts from developing sound legal rules. RRC provides the proper underpinning for analysing these various practices. Courts should analyse these practices using an RRC framework.¹⁷ This involves courts applying a two-stage analysis which will permit them to devise rules that allow competition which benefits consumers, while deterring strategic behaviour which harms consumers.

First, one asks does the conduct unavoidably and significantly raise rivals' costs? If so, secondly, do the rivals' raised costs allow the predator to exercise market power, i.e., raise prices above the competitive level. Thus, the model inquires not only into injury to competitors (first step) but also into injury to competition (second step).

Courts should view all the types of exclusionary conduct as means of purchasing exclusionary rights (ER). An ER is a right to exclude competitors from equal access to inputs to their production or marketing process. For example, under an exclusive dealing agreement a retailer that contracts to be the exclusive outlet for a manufacturer has purchased the right to exclude competing retailers. When a particular retailer agrees to carry only one manufacturer's product, that manufacturer has purchased the right to exclude competing manufacturers. Thus, the purchaser of an ER may be the buyer or seller in the underlying transaction.

Under certain conditions, the purchaser of an ER can raise its rivals' costs enough to confer market power on it. Figure One shows the analytic framework.¹⁸

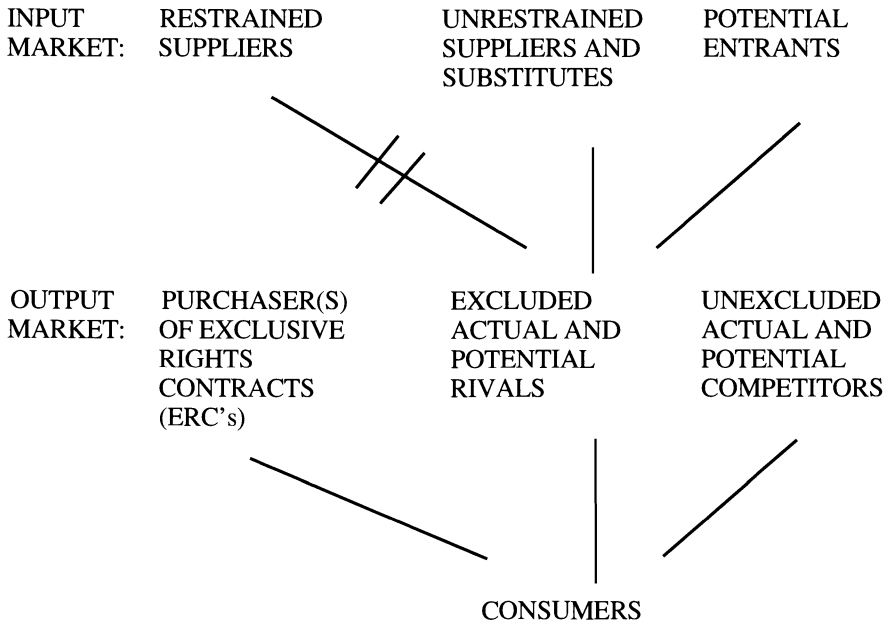
16 Krattenmaker & Salop, "Anticompetitive Exclusion : Raising Rivals' Costs to Achieve Power over Price" (1986) 96 Yale Law Journal 209.

17 *Ibid* at 211.

18 *Ibid* at 226.

FIGURE ONE

BASIC ANALYTIC FRAMEWORK



Under this framework the ER contract has removed the restrained suppliers (ER contract sellers) as a source of input to the rivals of the firm that purchased the exclusive rights. Whether this has substantially raised rivals' costs requires a court to consider the cost and availability of the input from the unrestrained suppliers and potential entrants and the availability of substitute input products. A court should then consider how significant the input is in the rivals' overall cost structure. A court can then decide whether the rivals' costs have been significantly and substantially increased. It should ignore those practices which only negligibly raise costs.

If a court decides a rivals' costs are substantially increased, it then examines the output market to determine whether the predator can price above the competitive level. To do this a court should consider the extent of competition from excluded and unexcluded, actual and potential rivals and from the producers of substitute products.

The model postulates four ways in which the purchase of exclusive rights can raise costs.

*1. Bottleneck:*¹⁹

A predator can raise rivals' costs by purchasing rights to all or most of the supply of a critical production unit. If substitute units are more expensive or less efficient, rivals will incur higher production costs. This gives rise to a

¹⁹ Ibid at 234.

bottleneck. Given that a rival has to buy more expensive substitutes, a court can directly measure the amount rivals' costs are raised.

2. *Real Foreclosure*:²⁰

Similarly, a predator may foreclose its rivals' access to an input by purchasing such a large portion of the total supply that the rivals are forced to bid up the price of the remaining supply. A predator can limit supply by over-buying, i.e., buying more than it needs or obtaining an agreement from suppliers not to supply rivals, i.e., a "supply squeeze".

Krattenmaker and Salop distinguish this from the bottleneck scenario because the bottleneck stems from the unique characteristics of the input involved, whereas real foreclosure stems from the limited availability of the input. Bottleneck forces rivals to substitute for the desired input whereas real foreclosure gives rivals the extra option of paying a higher price of the originally desired input.²¹

However, this distinction does not seem valid. In both cases the rivals pay higher prices to buy an input. Whether the input is the one originally desired or a substitute, the cost of production still increases (in the latter case because the substitute is less efficient). The nature of the input only affects the amount of the price increase. Thus, bottleneck is just a special case of foreclosure.²²

3. *Cartel Ringmaster*:²³

"Some ER may enable the predator to induce suppliers to decrease the supply of an input (i.e., form a cartel) thus raising costs. The purchaser of the ER may be better able to organise a cartel than the suppliers themselves."²⁴ The predator organises the suppliers to form a cartel which decreases supplies to the predator's rivals. This raises the rivals' costs.

However, the problem of cheating remains as with any cartel. Thus, Krattenmaker and Salop discuss the conditions under which an effective cartel is possible in a particular fact situation.²⁵

4. *Frankenstein Monster*:²⁶

The predator by removing restrained suppliers from the market may leave a concentrated market of unrestrained suppliers. These remaining unrestrained suppliers may be able to collude and fix prices. This raises rivals' costs. The predator does not orchestrate the cartel. It creates an environment where the unrestrained suppliers are likely to form and operate a cartel on their own accord.

Under the last two scenarios suppliers increased the prices as an exercise of market power. Under Bottleneck and Real Foreclosure the predator's purchasers cause the price of the input to rise even though suppliers are sufficiently numerous that no single seller can exercise market power.

20 Ibid at 236.

21 Ibid at 236.

22 J Tharp, "Raising Rivals' Costs : Of Bottlenecks, Bottled Wine and Bottled Soda" (1989) 84 Northwestern University Law Review 321 at 330.

23 Krattenmaker & Salop, op cit n 16, at 238.

24 Ibid at 238.

25 Ibid at 260.

26 Ibid at 240.

B. The Second Stage of the Model

No antitrust liability arises if a predator simply raises rivals' costs by any of the above four techniques. The cost raising strategy must give the predator power to raise its own price above the competitive level.

Krattenmaker and Salop identify key structural requirements that must exist before the above four techniques give the purchaser of the ER power over price.²⁷

1. The input market must be a significant portion of the final product. If not, an increase in the price of the input is unlikely to lead to an increase in the price of the final product.
2. Competition from unexcluded rivals or potential entrants willing to supply additional quantities of their products cannot constrain the predator's power over price. It is not enough for a predator to raise the costs of a few of its rivals because there still may be numerous unaffected rivals who prevent the predator pricing supracompetitively.

If barriers to entry are low the predator will not be able to price supracompetitively, because supracompetitive prices will attract new entry. Similarly, readily available substitutes cannot be available as these will prevent the predator pricing supracompetitively.

United States Courts have distinguished between "market power" and "monopoly power". The Supreme Court has defined "market power" as "the ability to raise prices above those that would be charged in a competitive market"²⁸ but has defined "monopoly power" as "the power to control prices or exclude competition".²⁹ Krattenmaker and Salop eliminate this distinction for their model. They define both market and monopoly power as "the ability to raise prices above levels that would be charged in a competitive market".³⁰ They distinguish between two methods of exercising market power. A firm may increase price by decreasing its output - it may control price (classical market power) or it may increase price by raising rivals' costs thereby causing those rivals to decrease their outputs³¹ (exclusionary market power).

Krattenmaker and Salop argue that classical market power does not explain RRC and the consumer welfare effects of RRC. If a predator is able to keep prices level when otherwise they would fall, classical market power will not exist yet consumer welfare will suffer because the predator has power over price.³²

Considerable consumer welfare effects arise if the predator has raised rivals' costs and consequently achieved the ability to price supracompetitively. If the predator can retain exclusionary rights that raise rivals' input costs, productive inefficiency will result. The current suppliers of the input will have reduced their production of the input resulting in higher prices in the input market. If no alternative sources of supply are available, production of the needed input simply may be reduced with consequent higher prices and reductions in production efficiency. Resources previously used to make the needed input will be directed elsewhere, resulting in less than optimal allocation of production resources.³³ Consumers of the ultimate product will pay higher prices. Some consumers will not buy

27 Ibid at 242.

28 *NCAA v Board of Regents of University of Oklahoma* 468 US 85, 109, n 38 (1984).

29 *US v E I du Pont de Nemours & Co* 351 US 377 at 391-392 (1956).

30 Krattenmaker, Lande & Salop, "Monopoly Power and Market Power in Antitrust Law" (1987) 76 *Georgetown Law Journal* 241 at 248.

31 Ibid at 248.

32 Ibid at 258. Krattenmaker & Salop, op cit, n 16, at 262-265.

33 ABA, op cit n 9, at 19.

the product and buy less satisfactory substitutes. Consumers that still buy the products will pay a higher price and have less money to buy other inputs they might otherwise acquire.

Thus, a successful RRC strategy will result in inefficiencies in the allocation of resources at the production stage and inefficiencies in the allocation of resources at the consumption stage.³⁴

Once the plaintiff has established the two elements, the exclusionary conduct is illegal - subject to a possible efficiency defence. Krattenmaker and Salop do not take a position on this. If a court permitted such a defence it would ask "whether the conduct generated any significant offsetting efficiency benefits of cost savings that can only be achieved by permitting the exclusionary practice".³⁵ If so, a court would not condemn the predator's conduct.

Exclusive dealing is a paradigm RRC scenario. I shall apply the model to a New Zealand case: *Fisher & Paykel Limited v Commerce Commission*.³⁶ Before doing so I shall examine the economics behind exclusive dealing and the case law. This will help assess the validity of the RRC model to exclusive dealing. It also helps assess whether the RRC model condemns bad practices and allows good ones.

III. ECONOMICS OF EXCLUSIVE DEALING

Exclusive is a vertical restraint of trade. It occurs when one or more distributors agree to buy only from one supplier and not to carry other suppliers' products for the agreement's duration. A requirements contract is a special type of exclusive dealing agreement. Here, the distributor agrees to buy exclusively from the supplier and the supplier agrees to supply all of the distributor's needs for the product. By itself exclusive dealing has no effect on intrabrand competition. Although when accompanied by a policy of selective distribution or resale price maintenance it may do so. Intrabrand competition occurs between distributors of the same product. Unlike most other types of vertical restraint exclusive dealing affects interbrand competition. This is competition between suppliers and distributors of different products. Exclusive dealing can have both pro and anticompetitive effects. I shall examine both.

A. Procompetitive Effects

1. Stimulate Distributors

The most common reason advanced for exclusive dealing is to stimulate distributors to sell more of the supplier's product. By only dealing in one supplier's product, the distributor will promote that product more intensively and effectively than if it had numerous suppliers. Exclusive dealing secures the distributor's attention and effort to one brand. As Richard Steuer explains, the distributor becomes an advocate for the product rather than simply a conduit.³⁷

³⁴ Ibid.

³⁵ Krattenmaker & Salop "Analysing Anticompetitive Exclusion" (1987) 56 Antitrust Law Journal 71 at 76.

³⁶ [1990] 2 NZLR 731.

³⁷ R Steuer, "Exclusive Dealing in Distribution" (1983) 69 Cornell Law Review 101 at 125.

2. Protection of a Supplier's Property Rights

Professor Geoffrey Walker, in a seminal article, first fully developed the property rights rationale for exclusive dealing.³⁸ At virtually the same time, Professor Howard Marvel provided a similar analysis.³⁹ The thrust of the argument is as follows: a supplier wishes to sell as much of its product as possible and to do so, it provides the distributor with special services. These include: advertising, technical and sales training, management systems, start up capital, architectural plans, site selection, merchandising plans, facilities to demonstrate the product, product design and after sales service, including repairs.⁴⁰ These services make the distributor more effective in selling the supplier's products. They also create more sales for the distributor, but they are expensive. Generally, the supplier charges the cost of these services by incorporating them into the wholesale price. However, this can cause a problem if the distributor sells products for the supplier's competitors. The competitors may not supply these services. Therefore, their prices will not be as high, or if they are, they will offer the distributor a larger margin. The services the supplier provides, may attract customers into the distributor's shop. The distributor takes advantage of the services and persuades the customer to buy a substitute product - which offers the distributor a higher margin. The substitution does not harm the distributor's reputation and sales. Exclusive dealing protects the supplier's property right and the services it provides, by preventing the distributor taking a free ride on the supplier's services and investments. It prevents distributors from using the supplier's investments to promote the supplier's competitors' products. Similarly, it prevents competitors who have not provided the services, from using the distributor and taking a free ride. If competitors and distributors can free ride, the supplier is less likely to provide these services. The services attract customers, and exclusive dealing ultimately allows for greater consumption than normal.

Reputation is another property right a supplier can protect through exclusive dealing. A supplier will invest and create a uniform reputation among distributors, if it can capture the value of that reputation.⁴¹ It will not do so if its competitors can free ride and share the benefits of its investment. Professor Gregory Frasco notes exclusive dealing is not the only way of solving the problem and protecting a supplier's property rights.⁴² An alternative is to charge the distributors for the benefits they receive.⁴³ For example, the supplier could demand a percentage of all sales revenue or a lump sum fee from the distributor for all brands the distributor sells which benefit from the supplier's investment. The problem with this is it is likely to lead to large administrative problems. If the distributor pays a royalty system, it has the incentive to misreport sales. Such a system will also be very expensive to monitor.

38 G Walker "Exclusive Dealing and Property Rights" (1979) 53 Australian Law Journal 70.

39 H Marvel, "Exclusive Dealing" (1982) 25 Journal of Law and Economics 1.

40 R Steuer, op cit, n 37 at 127; S Ornstein, "Exclusive Dealing and Antitrust" (1989) Antitrust Bulletin 65 at 75; K Strasser, "Antitrust Policy in Agreements for Distribution Exclusivity" (1984) 16 Connecticut Law Review 969 at 978-981.

41 J S Chard, "Economic Effects of Exclusive Purchasing Agreements in the Distribution of Goods", in L Pellegrini and S Reedy (eds) Marketing Channels, Lexington Books, New York (1986), p 39 at 45-53, L Shishido-Topel, "An Economic Analysis of Exclusive Dealing (1984) unpublished PhD dissertation, University of California (Los Angeles) pp 40-44.

42 G Frasco, *Exclusive Dealing, A Comprehensive Case Study*, University Press of America, Lanham, 1991, pp 6-7.

43 Ibid at 7.

3. Reduce Costs and Business Uncertainties

Exclusive dealing may reduce the costs of distribution for both suppliers and distributors and protect them from business uncertainties.⁴⁴ Exclusive dealing may enable the supplier and distributor to engage in long-term planning. The distributor has an assured source of supply. This is important in periods of fluctuating demand, as it helps eliminate the costs of selling and buying. Suppliers with an assured distributor can have smaller product runs. Another cost saving is that it decreases the number of distributors the supplier has to deal with. The U.S. Supreme Court in *Standard Oil Co. of California v U.S.*⁴⁵ recognised this. Justice Frankfurter noted exclusive dealing may assure a steady supply, give protection against increases in demand, enable long-term planning on the basis of known costs and obviate the expenses and storage in the quantity necessary for a product having a fluctuating demand.⁴⁶ Exclusive dealing can also lead to lower input costs for suppliers. Smaller buffer inventories are necessary and the parties can share them among themselves. These cost savings may well help a new entrant into the market.⁴⁷

Exclusive dealing can also lead to greater exchange of information - not only between suppliers and distributors, but also, between the distributors themselves. The problems and solutions one distributor encounters, may be used by all. Distributors are more likely to exchange information if they are not going to use it to sell competitors' products. Similarly, a supplier is likely to provide management assistance if the distributor only sells its products. In this way the entire distribution systems act as one and they become more efficient. The whole system can run more generally and efficiently respond to supply and demand variations.⁴⁸

4. Protect the Product's Quality and Reputation

Exclusive dealing may ensure a supplier's product's quality and reputation. Chard notes that a product's quality varies with its safety, durability, and reliability.⁴⁹ A product's quality may be difficult to inspect on purchase and may only be discernible after purchase. A supplier will consider that after-sales services are important in ensuring the product's quality. If a product goes wrong after purchase, a customer may have difficulty in deciding who was at fault - the distributor or supplier. The distributor could cut back on pre and post sales servicing of the product, and the customer may blame the supplier. This can impair the supplier's product's reputation and/or harm sales by other distributors. Thus, the supplier could insist on exclusive dealing. This enables the supplier to monitor the distributor and ensure the distributor services the product adequately. A distributor who has an exclusive dealing contract and who is subject to being terminated if it provides inadequate servicing, may be induced to provide a greater supply of services. In its report on the LPG

44 G Frasco, op cit, n 42, pp 6-7; Strasser, op cit, n 40, at 977; J Kattan, "An Outline of the Economic Effects of Vertical Restraints (1993) ABA Section of Antitrust Law, Antitrust Fundamentals Programme 17-28; V Korah & W A Rothnie *Exclusive Distribution and the EEC Competition Rules* (2nd ed, 1992), Sweet & Maxwell, London, pp 29-30; Shishido-Topel, op cit, n 41 at 37-39; E T Sullivan & J L Harrison, *Understanding Antitrust and its Economic Implications*, Matthew Bender, New York (1988), pp 178-179.

45 337 US 293 (1949).

46 Ibid at p 306.

47 P Areeda & L A Kaplow *Antitrust Analysis Problems, Text and Cases* (4th ed, 1988).

48 Strasser, op cit, n 40, at 972-974.

49 Chard, op cit, n 41, at 45.

industry, the British Monopolies Commission found that exclusive dealing improved safety, as it enabled suppliers to better control their distributor's storage and handling of LPG cylinders. The LPG cylinders' safety and reputation for safety were important to suppliers. Suppliers did not want their cylinders to be associated with cylinders from rival suppliers, whose safety standards were not as high as their own.⁵⁰

Professor John Chard notes the following conditions are necessary for this hypothesis to be valid and effective.⁵¹

1. The distributor must be able to influence a product's quality.
2. The consumer must be able to perceive differences between products.
3. The consumer cannot ascertain quality before he or she buys. Also, brand names must help the consumer ascertain quality.
4. It is more effective for the supplier's brand name to be used as a signal for quality than the distributor's. If consumers rely on distributors to signal quality, the supplier does not need to control the distributor's behaviour.

Exclusive dealing can help maintain quality in other ways. If a distributor carries many brands, it may substitute (by mistake or not) one supplier's part into another supplier's product. This can decrease reputation and safety.⁵² Chard gives the example of LPG cylinder consumers fitting inappropriate cylinders to their gas appliances. Suppliers could insist on their distributors undertaking strict operating procedures to prevent this. However, exclusive dealing is cheaper.⁵³ Not only safety is at issue, but also reliability.⁵⁴ As mentioned above, a distributor may under-invest in pre and post sale services that affect quality.

5. *The Keeping of Trade Secrets*

Steuer notes that exclusive dealing can help a supplier keep trade secrets and other confidential information from competitors.⁵⁵

6. *Prevention of Opportunistic Behaviour over Specialised Investments*

Professors Benjamin Klein, David Crawford and Armen Alchian argue exclusive dealing prevents opportunistic behaviour by users of specialised assets or investments.⁵⁶ An investment is specialised if its value is highly specific to a particular firm. Its next best use is less than its value to the particular firm. These specialised investments include:

- (a) machinery made for a particular firm's business,
- (b) locating refining facilities for a raw material near extraction operations.

A firm may make specialised investments in another firm. The other firm may threaten to contract with a third party, unless the firm which has made this specialised investment accepts the value of the specialised investment at its next best use, or at a quantity just enough to cover variable costs (i.e. its opportunity costs) - whichever is the greater. Exclusive dealing prevents this and protects specialised investments. These specialised investments may also result in cost savings.

50 British Monopolies Commission, *Supply of Liquefied Petroleum Gas* HC 147 (London: HMSO, 1981).

51 Chard, *op cit*, n 41, at 46-47.

52 *Ibid* at 47-48.

53 *Ibid* at 48.

54 *Ibid* at 48-50.

55 Steuer, *op cit*, n 37, at 130.

56 Klein, Crawford & Alchian, "Vertical Integration, Appropriable Assets and the Competitive Contracting Process" (1978) 21 *Journal of Law and Economics* 297; Ornstein, *op cit*, n 40 at 71; Frasco, *op cit*, n 42 at 7.

Klein et al give the example of General Motors and Fisher.⁵⁷ G.M. hired Fisher to make car bodies. Fisher had to invest in G.M. specific car bodies. Once Fisher had invested, G.M. could decrease its purchase price to Fisher's opportunity costs in making car bodies. As the bodies were specific to G.M., this would be very low. To prevent this, Fisher required G.M. to enter into an exclusive dealing contract with it (i.e. buy its car bodies only from it). The exclusive dealing contract eliminated G.M.'s alternative, and prevented G.M. from buying bodies from anyone else if Fisher didn't lower its price once it made the bodies.

7. *Monitoring Effectiveness*

Dr Lynn Shishido-Topel has developed an alternative explanation for exclusive dealing. She claims her explanation shows how exclusive dealing enhances efficiency.⁵⁸ She analyses exclusive dealing under the model of the supplier as principal and the distributor as the supplier's agent. She says that in normal principal-agent relationships, the principal is unable to monitor its agents' efforts perfectly. The principal hopes its agent will act so as to maximise the total income of the principal and agent. As the principal cannot perfectly monitor the agent, the agent can provide less service than it contracted to provide. This can occur more often, when the agent deals with more than one principal's product. As mentioned above, if the agent does this, it can affect the principal's product quality. This affects the principal's sales and reputation. It would also seem to affect the agent's sales as well. Shishido-Topel argues the agent will find the skimping of services beneficial, as the principal cannot perfectly monitor the agent and the latter could spread the costs of it so acting over other agents. For example, an agent who skimps will decrease sales of the principal's product, but will still benefit if other agents share the decrease in sales of the principal's product. Product quality and consumption will fall below socially optimal levels. Exclusive dealing enables better monitoring and thus, means agents will more likely provide the services at the socially optimal level and protect product quality.

8. *Lower Prices*

As mentioned above, exclusive dealing can lead to improved efficiency in the distribution of products. This is a form of productive efficiency. The supplier chooses exclusive dealing because it allows cost savings and improvement of quality at a lower cost than would be the case without exclusive dealing. The supplier passes these efficiencies on to consumers as lower prices. This is especially so with small towns with only one or few retail shops. Retailers in these small towns are monopolies and can charge consumers a monopoly price. To get these retailers to enter into exclusive dealing contracts, suppliers must offer these retailers something extra. The something extra is lower prices. Economic theory suggests retailers will pass some of these lower prices on to consumers.⁵⁹

57 Klein, Crawford & Alchian, *op cit*, n 57, at 309-310.

58 Shishido-Topel, *op cit*, n 41, at 45-48.

59 R H Bork, *The Antitrust Paradox : A Policy at War with Itself* (2nd ed, 1993), Foundation Press, New York, p 307.

9. Helping Small Suppliers

Exclusive dealing may help new market entrants become established. As mentioned above, exclusive dealing can stimulate distributors to greater efforts in selling a supplier's product.⁶⁰ This is especially worthy when a new entrant faces established suppliers. Exclusive dealing can also lead to the preservation and deconcentration of markets.⁶¹ It may also stop concentration in markets where large firms are expanding.

B. Anticompetitive Effects

1. Foreclosure

The primary anticompetitive concern over exclusive dealing is foreclosure. Exclusive dealing may foreclose the access of a supplier's rivals and potential rivals to distributors. Thus, the rival suppliers cannot find distributors for their products. However, the trouble with this argument is that every supply contract excludes competitors in the sense that competitors cannot carry out the transactions which the supply contract specifies.⁶² Not every exclusive dealing contract will lead to anticompetitive foreclosure. One must consider a number of factors to determine whether exclusive dealing effectively forecloses competitors.

(a) Alternative Methods of Suppliers Distributing Products⁶³

This is the most important factor. For exclusive dealing to be anticompetitive, rival suppliers cannot have alternative methods of distributing their product, i.e. the elasticity of supply from alternative sources must be low. If suppliers can distribute their products in other ways, the anticompetitive foreclosure of exclusive dealing decreases. A supplier may be able to find alternative methods of distribution in a number of ways. It can use distributors who have never sold the product before. It can establish new distributors. It can use new methods of distribution, such as mail drops or door-to-door selling.⁶⁴

(b) Size of Supplier

Exclusive dealing is more likely to lead to effective foreclosure if the supplier using it, has a large market share. The larger the share, the more distributors it can tie into exclusive dealing. Professor Oliver Williamson believes exclusive dealing can only be anticompetitive in the case of structural dominance, or in a tight oligopoly.⁶⁵ He defines structural dominance in a market as where the dominant firm's market share is at least 60 percent and market entry is not easy.⁶⁶

60 Areeda & Kaplow, *op cit*, n 47, at 773-777.

61 S F Ross, *Principles of Antitrust Law*, Foundation Press, New York (1993), p 311.

62 Strasser, *op cit*, n 40, at 985.

63 Steuer, *op cit*, n 37, at 123-124.

64 *Ibid* at 123.

65 O Williamson, "Assessing Vertical Market Restrictions : Antitrust Ramifications of the Transaction Cost Approach" (1979) 127 *University of Pennsylvania Law Review* 953 at 965.

66 O Williamson, "The Vertical Integration of Production : Market Failure Considerations" (1977) 61 *American Economic Review* 112 at 234-247.

(c) Number and Nature of Distributors the Exclusive Dealing Covers

The larger the number of distributors, the exclusive dealing covers, the more likely foreclosure is to be anticompetitive. This is especially so, if the distributor is a dominant firm. However, Steuer notes the simple percentage of distributors foreclosed is not an adequate means of assessing anticompetitive effect.⁶⁷ One has to measure the percentage of sales those distributors account for. That an exclusive dealing contract forecloses 25 percent of distributors does not necessarily mean that rival suppliers are foreclosed from reaching 25 percent of consumers. The foreclosed distributors may have more or less than 25 percent of sales. Sales percentage alone is not enough. One has to take account of consumer loyalty to the distributor.⁶⁸ Some distributors have more consumer loyalty than others. Consumers will stay with these distributors if they switch to another supplier's product via exclusive dealing. Thus, exclusive dealing is likely to foreclose these distributors from rival suppliers.

Closely related to loyalty is the effectiveness of the distributors foreclosed.⁶⁹ Some distributors are more effective than others. If the supplier enters into an exclusive dealing contract with these, the distributors left for rival suppliers will be lower quality and less effective. Thus, foreclosure will be greater.

One has to consider whether the distributor is a wholesaler or retailer.⁷⁰ Retailers have more consumer loyalty than wholesalers. Foreclosure will be more effective if retailers are subject to exclusive dealing than wholesalers.

(d) Prevalence of Exclusive Dealing in the Market

Exclusive dealing is more likely to lead to anticompetitive foreclosure, if the industry concerned has a trend to exclusive dealing.⁷¹ This is especially so, if the supplier level is tightly concentrated and all suppliers use exclusive dealing.

(e) Type of Product

One can divide products into shopping products and convenience products.⁷² With shopping products, consumers shop around before they buy. They compare different brands and prices before buying. If a distributor has only one brand, consumers will look elsewhere before buying. Foreclosure of distributors is not likely to be effective if shopping products are involved.

Convenience products are products which consumers buy where they first find them, without comparing price or other brands. They do so, either because they are perishable or cheap. Exclusive dealing in these products is more likely to result in anticompetitive exclusion.

(f) Length of the Exclusive Dealing Agreement⁷³

The longer the exclusive dealing agreement, the more effective foreclosure will be. However, short agreements can result in effective

67 Steuer, *op cit*, n 37, at 117.

68 *Ibid* at 118-119.

69 *Ibid* at 119.

70 *Ibid* at 118-120.

71 Strasser, *op cit*, n 40, at 985-986.

72 Steuer, *op cit*, n 37, at 121-123.

73 Strasser, *op cit*, n 40, at 985.

foreclosure if other suppliers have no alternative ways of distributing their products.⁷⁴

(g) Presence of Economies of Scale

Shishido-Topel has noted that: “[e]conomies of scale and distribution or supply together with rivals having insufficient demand to support outlets alone can allow exclusive dealing to become a relatively reasonable way of foreclosing competitors”.⁷⁵

Professor Frederic Scherer has argued:

“[t]he automobile industry provides the clearest example of this last case. There are moderate economies of scale in retailing. Established brands are able to have a good sized exclusive dealership even in relatively small towns and the opportunity to sell a well accepted make is attractive to would be dealers. Therefore, the largest producers have first pick among candidates and can engage the most able ones. This in turn gives G.M. and Ford a lasting product differentiation advantage, for auto buyers flock in disproportionate numbers to the authorised parts and service in both large and small cities. This may influence the car purchase decisions of mobile customers. Lack of an extensive first rate sales and services network is one of the reasons why Studebaker-Packard was forced to discontinue passenger automobile production, why foreign cars have a difficult time penetrating the U.S. market and why A.M. and to a lesser degree Chrysler have not found it easy to build up and sustain their sales volume. If all formal and informal pressures toward exclusive dealing in automobiles could be eliminated and if a sufficient number of dealers were willing to take on additional makes, competition from smaller and foreign automobile producers would be greatly stimulated.”⁷⁶

The foreclosure effect will only be long lasting if there are substantial economies in production.⁷⁷ If not, rival suppliers can sell first in larger markets. If they are successful there, their product will then penetrate smaller towns. The excluded suppliers may be able to defeat the foreclosure effect due to economies of scale by banding together, to take advantage of economies of scale in retailing, and selling their products together in alternative outlets. The events of history and the success of the Japanese have overtaken Scherer’s concern about the inability of foreign automobiles to enter the United States market.

Thus, many factors contribute to whether an exclusive dealing contract leads to foreclosure. One has to analyse each exclusive dealing contract on a case by case basis. However, it seems exclusive dealing will never lead to truly effective foreclosure as foreclosure of distributors will lead to an increase in demand for distributors which will attract new entrants.

2. Entry Barriers and Raising Rivals' Costs

Exclusive dealing can raise entry barriers to rival and potential rival suppliers.⁷⁸ The factors that are relevant in assessing foreclosure effects are relevant in assessing whether exclusive dealing raises entry barriers. While as mentioned above, exclusive dealing may not achieve truly effective foreclosure, it can raise entry barriers. It does so by raising rivals’ costs. It

74 D Bok, “The Tampa Electric Case” (1961) Supreme Court Review 267 at 272.

75 Shishido-Topel, op cit, n 41, at 31.

76 F M Scherer, *Industrial Market Structure and Economic Performance* (2nd ed, 1980), Harvard, New York, p 586.

77 B P Pashigan, *The Distribution of Automobiles: An Economic Analysis of the Franchise System*, Little Brown, New York, 1961, p 219.

78 Strasser, op cit, n 40, at 984-990.

can force new entrants, at either the supplier or distributor level, to compete at both levels, i.e. force new entrants to become vertically integrated. This is likely to be prohibitively expensive.

3. Reducing the Demand Rival Suppliers and Distributors Face

Frasco argues that incumbent distributors and suppliers can use exclusive dealing to reduce the demand for rivals' products.⁷⁹ This is anticompetitive because if a firm succeeds in decreasing the demand for its rivals' product, then the demand for the firm's product (in the absence of new entry) will increase, as well as its capacity to earn profits.

Frasco argues a firm can do this by its exclusive dealing contracts having staggered expiry dates. He uses two related models to show this. The first model has the following assumptions in the case of a potential entrant:

- (1) There are a number of existing exclusive dealing contracts between upstream and downstream producers.
- (2) The exclusive dealing contracts have different expiry dates.
- (3) Producing the product subject to exclusive dealing entails a range of increasing returns to scale.
- (4) Entering the market at supplier and distributor level is prohibitively expensive, compared to entry at one level.

From assumptions one and two, a potential entrant only has part of the market demand available when it chooses to enter. The structure of the model forces losses upon new entrants for a certain number of time periods (corresponding to the expiration of the exclusive dealing contracts) after entry. The existing distributors and suppliers establish the expiry date of the exclusive dealing clauses so as to hinder entry, to whatever extent maximises their own present value.⁸⁰

In the second model, assumptions one, two and three remain, but four goes. Frasco shows that the existing suppliers can give the existing distributors the incentive to stop decreasing quantity of output even if entry at both supplier and distributor were to occur. The existing suppliers do so by structuring the charge for their products to distributors such as to leave distributors with a suitable low average variable cost. Suppliers do so by dividing the charge for the product into two components, one a relatively low per unit price and two a relatively high lump sum. Knowing that existing distributors will not decrease their output discourages entry.⁸¹

Professors Frank Mathewson and Ralph Winter argue exclusive dealing can decrease demand in the case where the market can profitably support more than one brand of product, but where one brand is much more popular than others. If distributors have the choice of selling the popular brand exclusively or selling all brands, the distributors may choose to do the former as they see it being more profitable. Suppliers of the popular brand could use exclusive dealing as a way of keeping rival brands off the market, thus decreasing their demand.⁸²

⁷⁹ G Frasco, "Exclusive Dealing and Entry Deterrence" (1986), unpublished working paper, Cornell University.

⁸⁰ *Ibid.*

⁸¹ G Frasco, "Exclusive Dealing and Entry Deterrence : The Case of Vertically Integrated Entry" (1986), unpublished working paper, Cornell University; Frasco, *op cit*, n 42, at 24-25.

⁸² G Mathewson & R Winter, "Is Exclusive Dealing Anticompetitive?" (1985), unpublished working paper, University of Toronto.

4. Price Discrimination

Exclusive dealing may lead to price discrimination. Professor Lester Telser notes that: “[e]xclusive dealing may be a necessary adjunct of a price discrimination scheme”.⁸³ Some consumers may value a product more than others and thus be prepared to pay a higher price for it. That product may have two uses. First, its use in a competitive market and second, it can be substituted for a second product in a less competitive market. The supplier may therefore wish to charge a price above marginal cost for use of the product in its first use, but below its marginal cost in its second use in the less competitive market. The supplier price discriminates amongst different classes of consumer for the second use. This would not work if consumers could buy the first product from other sources, or if the supplier did not have a monopoly in this second market.⁸⁴ Thus, exclusive dealing can exploit but not create market power. Whether this is anticompetitive depends on how one views price discrimination.⁸⁵

5. Increased Collusion

Commentators believe that exclusive dealing can lead to collusion at either supplier or distributor levels.⁸⁶ They argue that widespread exclusive dealing amongst suppliers limits the number of distributors, which makes collusion easier because of the fewer numbers. Fewer numbers makes it easier to detect cheating. Professor Kurt Strasser comments exclusive dealing alone does not seem likely to establish a supplier cartel or interdependent pricing.⁸⁷ Suppliers who have exclusive dealing contracts with their distributors have a partial indirect influence over price. The supplier sets a wholesale price which can have some influence on the retail price the distributor sets. Two other characteristics of exclusive dealing make the collusion more possible:

1. If a supplier increases its wholesale price, the distributor cannot easily switch to other suppliers of the product.
2. The exclusive dealing as a restraint can lead to fewer competitors, which can decrease the likelihood of price competition and making cheating more detectable.

Strasser notes that these characteristics are not overwhelming but they can increase the potential for exclusion by collusion.⁸⁸

Exclusive dealing and resale price maintenance together are more likely to help collusion.⁸⁹ Exclusive dealing makes it difficult for distributors to change suppliers. The resale price maintenance lowers the probability of price cutting by making it easier to detect. Some commentators see the relationship between exclusive dealing and resale price maintenance as a quid pro quo one. The suppliers decrease current price competition in the distributor's market by resale price maintenance in return for providing a

83 L Telser, “Abusive Trade Practices” (1963) 36 *Law and Contemporary Problems* 488 at 491.

84 Shishido-Topel, *op cit*, n 41, at 36.

85 Telser argues price discrimination may increase social output. Telser, *op cit*, n 83, at 489.

86 Strasser, *op cit*, n 40, at 991; M MacCrimmon & A Sadanand, “Models of Market Behaviour and Competition Law : Exclusive Dealing” (1989) *Osgoode Hall Law Journal* 709 at 739.

87 Strasser, *op cit*, n 40, at 991.

88 *Ibid*.

89 L Telser, “Why Should Manufacturers Want Fair Trade?” (1960) 3 *Journal of Law and Economics* 86 at 97.

more secure market by exclusive dealing.⁹⁰ The resale price maintenance prevents the distributors from price cutting to increase sales. This decreases the supplier's incentive to decrease wholesale price. Exclusive dealing prevents suppliers from trying to obtain special treatment from selected distributors over other suppliers via secret price cuts. The exclusive dealing also stops suppliers attracting distributors from other suppliers via secret price cuts. The exclusive dealing thus, increases the probability of detecting cheating. How great a threat this all is is questionable, as certain conditions have to apply for a durable cartel⁹¹ and it appears that exclusive dealing with resale price maintenance is the exceptional rather than the usual resale price maintenance situation.⁹² Telser argues: “[B]oth practices are needed to make effective collusion among the suppliers”.⁹³

6. *Decreased Consumer Choice*

Exclusive dealing arguably decreases consumer choice by making comparison shopping more difficult. Consumers who wish to compare brands and see whether price differences are justified cannot make a considered decision as easily, if exclusive dealing exists.⁹⁴ This is more so, if the consumer has only one distributor in his or her town. However, if the product is a shopping product, the consumer is more likely to go into other centres where the choice is available. One also has to trade off the decrease in choice for small town consumers against the exclusive dealing allowing lower prices.⁹⁵

7. *Increased Price for Some Consumers*

Exclusive dealing, as mentioned above, leads to suppliers supplying special services to distributors. These may initially increase the cost of the product. However, they can lead to greater sales, which results in ultimately cheaper prices. However, not every consumer values these special services.⁹⁶ Consumers who want the product without these special services cannot buy it. Exclusive dealing means the product comes with these special services or not at all. Bork argues the: “[t]echnology distribution ... [does] not allow the preferences of both groups of customers to be met, [i.e. those who value services and those who do not] - ... a manufacturer will choose to satisfy the largest number”.⁹⁷ This is the efficient thing to do.

Thus, exclusive dealing has both pro and anticompetitive effects. The general economic view is that its advantages outweigh the negatives and the anticompetitive effects only exist in certain conditions. I now turn to the legal treatment of exclusive dealing.

90 B Yamey, *The Economics of Resale Price Maintenance*, London (1954) p 19-21; W Bowman, “The Prerequisites and Effects of Resale Price Maintenance” (1955) 22 *University of Chicago Law Review* 825 at 838-839 and 844-848; Shishido-Topel, *op cit*, n 41, at 34-35.

91 G J Stigler, *The Theory of Price* MacMillan, New York (3d ed, 1966), p 230-236.

92 R Posner, “The Rule of Reason and the Economic Approach : Reflections on the Sylvania Decision” (1977) 45 *University of Chicago Law Review* 1 at 7.

93 Telser, *op cit*, n 89, at 10.

94 Strasser, *op cit*, n 40, at 992; R Ahdar, “Exclusive Dealing and the Fisher and Paykel Saga” (1992) 15 *New Zealand University Law Review* 1 at 12-13.

95 See text accompanying notes 59-71 above.

96 W Comanor and H Frech, “The Competitive Effects of Vertical Agreements?” (1985) 75 *American Economic Review* 539; W Comanor, “Vertical Price-fixing, Vertical Market Restrictions, and the New Antitrust Policy” (1985) 98 *Harvard Law Review* 483 at 991-1000; Ahdar, *op cit*, n 94, at 13-14.

97 R Bork, “Vertical Restraints : Schwinn Overruled” (1978) 1977 *Supreme Court Review* 171 at 181.

IV. LEGAL TREATMENT

A. United States Law

Three statutes govern exclusive dealing in the United States. Section 3 of the Clayton Act prohibits exclusive dealing where such arrangements' effect: "may be to substantially lessen competition or tend to create a monopoly in any line of commerce".⁹⁸ Section 3 only applies to "goods, wares, merchandise, machinery and supplies of other commodities".⁹⁹ Section 1 of the Sherman Act¹⁰⁰ and Section 5 of the Federal Trade Commission Act¹⁰¹ cover exclusive dealing which does not fall within the Clayton Act. The Sherman Act prohibits exclusive dealing when it restrains trade. The Section 3 and Section 1 standards are now viewed as identical.¹⁰² Section 5 of the Federal Trade Commission Act prohibits exclusive dealing contracts if they are "unfair methods of competition". Exclusive dealing's legal history has varied widely. Professor Milton Handler notes: "the law's treatment of exclusive dealing arrangements has had a long history marked by sharp swings of the pendulum from extreme positions both of legality and invalidity".¹⁰³

Initially, under both the common law and the Sherman Act, courts viewed exclusive dealing as benign.¹⁰⁴ Congress enacted the Clayton Act and the Federal Trade Commission Act, in part to counter this.¹⁰⁵ The first key Supreme Court case was *Standard Fashion Co. v Magrane-Houston Co.*¹⁰⁶ Standard manufactured dress patterns. Margrane-Houston ran a retail dry goods shop in Boston. Standard contracted with Margrane to supply patterns on the condition Margrane, inter alia, did not sell any other patterns. Standard controlled 40 percent of the 52,000 pattern agencies in the United States. Together with its three major competitors it controlled 90 percent of pattern agencies. Exclusive dealing contracts covered most agencies. Margrane breached the exclusive dealing contracts. Standard sued. The Supreme Court held the contract breached s.3 of the Clayton Act and thus, the contracts were unenforceable. The Court found it relevant that Standard controlled 40 percent of the market. It imposed a market dominance standard, which prohibited relatively large firms from using exclusive dealing. If they did, it would lead to market foreclosure. Subsequent courts however, upheld exclusive dealing if the market share foreclosed was not sufficient to lessen competition.¹⁰⁷ They also took into account other economic factors.¹⁰⁸ Thus, the courts employed a rule of reason approach and evaluated the competitive effects of exclusive dealing.¹⁰⁹

98 15 USC 14 (1982).

99 Ibid.

100 15 USC 1 (1982).

101 15 USC 45 (1992).

102 Ross, op cit, n 61, p 304; *Twin City Sportservice, Inc v Finley* 676 F 2d 1291, 1320 (9th Cir 1982), cert denied 459 US 1009 (1982).

103 M Handler, "Statement Before the Small Business Administration" (1966) Antitrust Bulletin, 417 at 425.

104 M Handler, op cit, n 104, at 425; D Robinson, "Restraints on Trade and the Orderly Marketing of Goods" (1960) 45 Cornell Law Quarterly 254 at 275.

105 A D Neale, *The Antitrust Laws of the United States of America* 178 (1970).

106 258 US 346 (1922).

107 *Pick Manufacturing Co v General Motors* 299 US 3 (1936); *FTC v Sinclair Refining Co* 261 US 463 (1923); *Pearsall Butter v FTC* 292 F 2d 720 (7th Cir 1923).

108 Ibid.

109 Ross, op cit, n 61, p 312.

This changed in *Standard Oil of California and Standard Station Inc. v United States*.¹¹⁰ Standard was the largest seller of petrol in the western area (made up of five states) of the United States. It sold 23 percent of total petrol in the area - of which 6.7 percent was sold under exclusive dealing. It controlled 16 percent of the retail market. Its six leading competitors sold 42.5 percent of total petrol sales through service stations. These competitors also used exclusive dealing. Over 70 other companies supplied the balance of the petrol. The United States Government challenged Standard's exclusive dealing contracts under s.3 of the Clayton Act. The issue was whether showing that a "substantial portion" of the relevant market was affected breached s.3, i.e. did this mean that the exclusive dealing contract's effect "may be to substantially lessen competition".¹¹¹ In essence, the issue was whether the standard then applying to tying arrangements applied to exclusive dealing. Justice Frankfurter, in the majority opinion, noted that tying agreements "... serve hardly any purpose beyond the suppression of competition".¹¹² He then stated that exclusive dealing could be economically advantageous to both buyers and sellers and thus, to consumers. He noted that this seemed to require courts to evaluate exclusive dealing's competitive effects on a case by case basis. He then held that such an evaluation was beyond the competence of courts. He held that s.3 was satisfied "by proof that competition has been substantially foreclosed in a substantial share of level of commerce".¹¹³ He concluded that Standard met this test. Commentators called this a quantitative substantiality test.¹¹⁴ It meant that exclusive dealing breached s.3 if a significant dollar value of sales had been foreclosed to competitors. Justice Jackson dissented, claiming the majority's test established a per se rule.¹¹⁵ He agreed that an exclusive dealing clause which foreclosed 6.7 percent of the market amounted to a substantial share of the market. However, he believed this alone did not breach s.3. He believed courts can and should weigh the benefits to competition from exclusive dealing contracts against their detriments. He pointed at the advantages of exclusive dealing in this case. These were the advantages that Justice Frankfurter had identified.¹¹⁶ Justice Douglas also dissented on the basis that invalidating the contracts would lead to more harmful alternatives, viz; the large firms entering the retail market by vertical integration and eliminating the small firms.¹¹⁷

Commentators have severely criticised Justice Frankfurter's opinion.¹¹⁸ Not only was it contrary to precedent and s.3's legislative history,¹¹⁹ but it also ignored economics. Professors Thomas Krattenmaker and Steven Salop argue Justice Frankfurter disclaimed the relevance of the only possible antitrust problem (the impact on competition), ignored a procompetitive explanation for the contracts (they were efficiency enhancing) and focused on a competitively neutral fact (the substantial amount of commerce involved).¹²⁰

110 377 US 292 (1949).

111 Ibid at 299.

112 Ibid at 305.

113 Ibid at 314.

114 Ross, op cit, n 61, p 312; Steuer, op cit, n 37, at 118.

115 377 US 293, 323.

116 Ibid at 306; see text accompanying notes 44-46 above.

117 Ibid at 320-321; Justice Douglas proved to be correct.

118 Bork, op cit, n 59, p 299-301; Ross, op cit, n 61, p 312-313.

119 Ross, op cit, n 61, at p 313.

120 Krattenmaker & Salop, op cit, n 16, at 219-220.

As Justice Jackson noted, the majority opinion virtually imposed a per se ban on exclusive dealing.¹²¹ A plaintiff only had to prove the exclusive dealing contract foreclosed a significant dollar volume to rival stock. Whether exclusive dealing affected the ability of rivals to compete was irrelevant.

However, this changed in *Tampa Electric Co. v Nashville Coal Co.*¹²² Tampa was a public electric utility. Nashville was a coal company. Tampa contracted with Nashville for Nashville to supply all of Tampa's coal requirements for 20 years. Tampa could only buy from Nashville, while Nashville could only sell to others after it had fulfilled Tampa's requirements. Nashville stopped supplying, claiming the requirements contract breached the antitrust laws. Although the contract foreclosed \$128 million of coal sales, the Supreme Court held that it did not breach s.3 of the Clayton Act. The contract only foreclosed 0.77 percent of the relevant market. However, the Court did not base its decision on market share. It established a three-part test for assessing exclusive dealing under s.3 of the Clayton Act:

1. The Court must identify the relevant product market to determine the line of commerce affected.
2. The Court must identify the relevant geographic market.
3. The competition which the exclusive dealing foreclosed must constitute a substantial share of the relevant market, i.e., "the opportunities for other traders to enter into or remain in the market must be significantly limited".¹²³

This was not a statistical test of market share. The Court held that to determine the standard of foreclosure one had to analyse, "the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce involved in the relevant market area and the probable intermediate and future effects of the agreement on effective competition in the market".¹²⁴ By doing so, the Court rejected the *Standard Oil* test and substituted what commentators called the qualitative substantiality test.¹²⁵ In essence, the Court introduced a broad rule of reason enquiry. While it gave a list of relevant factors to assess exclusive dealing contracts, it provided no guide on how to rank them or link them with anticompetitive effect.¹²⁶

In *F.T.C. v Brown Shoe Co.*,¹²⁷ the Supreme Court held the *Tampa* standard did not apply to s.5 of the Federal Trade Commission Act. The F.T.C. ruled that Brown Shoe (then the U.S.'s second largest shoe manufacturer) had entered into exclusive dealing arrangements with 650 retail shoe shops in the United States. This, the F.T.C. claimed, breached s.5. The Supreme Court affirmed, stating the F.T.C. had broad powers to prevent practices "which conflict with the basic policies of the Sherman and Clayton Acts even though such practices may not actually violate these laws".¹²⁸

The next, and perhaps most important case is not an exclusive dealing case, viz; *Continental T.V., Inc. v G.T.E. Sylvania*.¹²⁹ This involved territorial

¹²¹ 377 US 293 at 323.

¹²² 365 US 320 (1961).

¹²³ *Ibid* at 327-328.

¹²⁴ *Ibid* at 329.

¹²⁵ Ross, *op cit*, n 61, p 312; Steuer, *op cit*, n 37, at 118.

¹²⁶ P Mahinka, "Vertical Restraints as Exclusionary Practices : Current Issues in Regulated and Deregulated Industries" (1989) 58 *Antitrust Law Journal* 921 at 923.

¹²⁷ 384 US 316 (1966).

¹²⁸ *Ibid* at 321.

¹²⁹ 433 US 36 (1977).

restrictions and location clauses. The facts are unimportant here. The Court rejected the *U.S. v Arnold Schwinn & Co.*¹³⁰ doctrine, that nonprice vertical restraints are per se illegal. The Court held that nonprice vertical restraints could promote competition by enhancing efficiency. They could also restrain competition. Thus, they deserved careful analysis on a case by case basis. The Court said one had to balance the harms and benefits of each vertical restraint. It explicitly focused on what the economic purpose and effect of the challenged vertical restraints were or were likely to be. It did so more rigorously than previously. Thus, the Court applied a broad rule of reason standard. The importance of *Sylvania* to exclusive dealing is that lower courts now employ the *Sylvania* rule of reason to exclusive dealing. Some do not even quote *Tampa*.¹³¹

*Beltone Electronics Corp.*¹³² shows how important *Sylvania* has been. Beltone was a manufacturer of hearing aids. It had exclusive dealing arrangements with 7-8 percent of the United States hearing aid dealers. The dealers accounted for 16 percent of sales. The unanimous Federal Trade Commission opinion did not rely on the number of outlets foreclosed in deciding - instead it undertook a full rule of reason enquiry. The Federal Trade Commission stated "a proper analysis of exclusive dealing arrangement should take into account, market definition, the amount of foreclosure in the relevant market, the duration of the contracts, the extent to which entry is deterred and the reasonable justification of any for the exclusivity".¹³³ It held exclusive dealing only breaches s.5 of the Federal Trade Commission Act, if on balance there is a "probably adverse effect on interbrand competition".¹³⁴ It found no breach. *Beltone* shows the Federal Trade Commission will undertake a searching approach in evaluating exclusive dealing.

A minority of the Supreme Court revisited exclusive dealing in *Jefferson Parish Hospital District No. 2 v Hyde*.¹³⁵ This concerned a five-year exclusive contract between a hospital and a group of anaesthesiologists. The majority viewed and decided the case as involving tying. The concurring minority treated it as exclusive dealing as well as tying. Justice O'Connor stated:

"In determining whether an exclusive dealing agreement is unreasonable, the proper focus is on the structure of the market for the products or services in question - the number of sellers and buyers in the market, the volume of their business and the ease with which buyers and sellers can redirect their purchases or sales to others. Exclusive dealing is an unreasonable restraint on trade only where a significant fraction of buyers or sellers are frozen out of a market by the exclusive dealing."¹³⁶

The opinion concluded the exclusive dealing contracts, which foreclosed 30 percent of the market, were reasonable as they did not freeze anyone out of the market.

Judge Posner provided the next significant analysis of exclusive dealing in *Roland Machinery Company v Dresser Industries, Inc.*¹³⁷ His analysis is consistent with the Federal Trade Commission's searching approach in

130 *US v Arnold Schwinn and Co* 388 US 365 (1967).

131 See text accompanying notes 140-157 below.

132 {1979-1983 Transfer Binder} Trade Reg Rep (CCH) para 21, 934 (FTC 1982).

133 *Ibid* at 22, 387.

134 *Ibid* at 22, 393.

135 466 US 2 (1984).

136 *Ibid* at 45.

137 749 F 2d 380 (7th Cir 1984).

Beltone. Dresser manufactured farm machinery. Roland was a large construction equipment dealer in Illinois. Dresser and Roland entered into an exclusive dealing agreement. Either party could terminate the agreement on 90 days notice. Roland then agreed to sell products made by Komatsu, one of Dresser's rivals. Komatsu was the second largest manufacturer of construction equipment in the world. Dresser sought to end its agreement with Roland. Roland sought and obtained an injunction at first instance. The Seventh Circuit Court of Appeals reversed. While Judge Posner's comments on exclusive dealing were obiter, he announced a two-part test for exclusive dealing to breach s.3 of the Clayton Act. A plaintiff must show:

1. Exclusive dealing actually foreclosed at least one significant competitor from the relevant market.
2. The probable (not certain) effect of the exclusion will be to raise prices above (and therefore decrease output below) the competitive level. "He must show in other words that the anticompetitive effects (if any) of the exclusion outweigh any benefits to competition from this."¹³⁸

Judge Posner held the exclusive dealing here, did not breach s.3. It was of short duration. Competitors in the relevant market could easily establish their own distributors. He emphasised the procompetitive effects of exclusive dealing. It leads distributors to promote each manufacturer's brand more vigorously, it lowers quality adjusted price and it prevents distributors and rival manufacturers from free riding on manufacturer's effort on brand promotion.¹³⁹

Thus, United States courts undertake a rule of reason analysis in evaluating exclusive dealing. Once they have identified the relevant market, they examine a number of factors in determining the legality of the exclusive dealing. One must emphasise United States courts undertake a full enquiry. No one of the following factors by itself will be determinative.

1. The Percentage of Market Foreclosed

Historically, courts have found exclusive dealing reasonable with market shares of less than 20 percent.¹⁴⁰ As the percentage foreclosure share rises beyond 20-30 percent the probability of courts finding violations increases.¹⁴¹ However, courts are increasingly blessing market foreclosure of over 40 percent.¹⁴² Indeed, one court found no violation when the defendant had an 80 percent market share.¹⁴³

¹³⁸ Ibid at 394.

¹³⁹ Ibid at 394-395.

¹⁴⁰ See eg, *Satellite Television and Associated Resources Inc v Continental Cablevision*, 714 F 2d 351, 357 (4th Cir 1983), (foreclosure of 8 per cent of households), cert denied 465 US 1027 (1984); *American Motor Inns v Holiday Inns*, 521 F 2d 1230, 1252 (3d Cir 1975), (14.7 per cent); *Cornwell Quality Tools Co v CTS Co*, 446 F 2d 825, 831 (9th Cir 1971) (10-15 per cent), cert denied 404 US 1049 (1972).

¹⁴¹ See eg, *Twin City Sportservice v Finley*, 676 F 2d 1291 (9th Cir 1982) (long term foreclosure of 24 per cent of market illegal); However, since *Hyde* (see supra, note 153) courts are more willing to bless foreclosure of over 30 per cent, see eg, *Kuck v Bensen*, 647 F Supp 743 (BD Mo 1986) (foreclosure of 37 per cent legal).

¹⁴² See eg, *Sewell Plastics v Coca-Cola*, 720 F Supp 1186 (WDNC 1988) (40 per cent market share lawful), aff'd mem 912 F 2d 463 (4th Cir 1990); *Gonzales v Insignares*, {1985-1986 Trade Cases}, (CCH), para 66, 701 (ND Ga 1985) (foreclosure of 40 per cent lawful); *Hendricks Music v Steinway*, 689 F Supp 1501 (NDI 1988) (48 per cent market share upheld); cf *Kohler Co v Briggs and Stratton Corp* 1986 - I Trade Cases (CCH) para 67,047 (ED Wis 1986) (62 per cent market share, preliminary injunctions issues); *Oltz v St Peter's Community Hospital*, 656 F Supp 760 (D Mont 1987) (84 per cent market share illegal), aff'd 861 F 2d 1440 (9th Cir 1988).

¹⁴³ *Barry Wright Corp v ITT Grinnell Corp*, 724 F 2d 227 (1st Cir 1983); *City of Chanute, Kansas v Williams Natural Gas Co*, 955 F 2d 641 (10th Cir 1992) arguably may have

2. Duration of Agreement

The shorter the agreement, the more likely a court will find it reasonable.¹⁴⁴ The length of an agreement is important as some courts will not invalidate the contract as a whole, but will rather decrease its length.¹⁴⁵ Judge Posner has held that, "exclusive dealing clauses terminable in less than one year are presumptively lawful".¹⁴⁶ However, it is only a presumption.

3. Ability to End an Agreement

Closely related to the agreement's duration, is the ability to end it easily. If the parties can end it without reason, on short notice, courts will likely hold that it is reasonable.¹⁴⁷

4. Nature of Purchaser

A retailer needs to show a greater level of foreclosure resulting from exclusive dealing than a wholesaler does.¹⁴⁸

5. Ease of Entry

The easier it is for firms to enter the market, the more likely courts are to uphold exclusive dealing. High entry barriers make it more likely that a court will invalidate.¹⁴⁹

6. Presence of Alternative Distribution Channels

If alternative distribution channels exist and enable a supplier's competitors to reach the market, the courts are more likely to find the exclusive dealing reasonable.¹⁵⁰

7. Type of Product

Courts will most likely uphold exclusive dealing if it involves a shopping product.¹⁵¹

involved a greater market share as may have *Fleer Corp v Topps Chewing Gum Inc* 658 F 2d 139 (3rd Cir 1981).

¹⁴⁴ *Twin City Sportservice v Finley*, 676 F 2d 1291 (9th Cir 1982) (10 years plus duration found unlawful), cert denied, 459 US 1009 (1982); *Ferguson v Greater Pocatello Chamber of Commerce*, 848 F 2d 976, 982 (9th Cir 1988) (six year lease upheld); *Barry Wright Corp v IIT Grinnell Corp*, 724 F 2d 277 (1st Cir 1983) (two year limit upheld); *US v Pfizer*, 246 F Supp, 464, 470-471 (EDNY 1165) (one year upheld); *Satellite Fin Planning Corp v First National Bank*, 633 F Supp 386, 397 (D Del 1986) (exclusive dealing contract terminable on 180 days notice upheld).

¹⁴⁵ *FTC v Motion Pictures Advertising Co* 344 US 392 (1953) (Supreme Court cut exclusive dealing contract's duration from five years to one).

¹⁴⁶ *Roland Machinery Co v Dresser Industries Inc*, 749 F 2d 380, 395 (7th Cir 1984).

¹⁴⁷ *Denison Mattress Factory v Spring-Air Co* 308 F 2d 403, 412 (4th Cir 1962) (upheld contract terminable without cause on six months notice); *Beltone Electronics Corp* 100 FTC 68 at 210 (1982) (dealer could terminate on thirty days notice).

¹⁴⁸ *Ryko Manufacturing Co v Eden Services*, 823 F 2d 1215, 1235-1236 (8th Cir 1987).

¹⁴⁹ See *Brown Shoe*, 104 FTC 266 (1984); *E & J Gallo Winery*, 101 FTC 727 (1983); *Beltone Electronics Corp* 100 FTC 68, 204 (1982).

¹⁵⁰ *Haagen-Dazs Co Inc v Double Rainbow Gourmet Ice Cream Inc*, 895 F 2d 1417 (9th Cir 1990); *Refrigeration Engineering Corp v Frick Co*, 370 F Supp 702 (WD Tex 1974); *Bowen v New York News Inc*, 366 F Supp 651 (SDNY 1973); *Seagood Trading Corp v Jenico Inc*, 924 F 2d 1555, 1572-1573 (11th Cir 1991); *Stitt Spark Plug Co* 840 F 2d 1253, 1258 (5th Cir 1988).

¹⁵¹ *US v JJ Case Co* 101 F Supp 856 (D Minn 1951).

8. Use of Exclusive Dealing by Competitors

Courts may view exclusive dealing less favourably if a supplier's competitors use it. However, widespread use is not determinative.¹⁵²

9. Actual Competitive Impact

Generally, courts require proof that exclusive dealing has harmed competition before finding exclusive dealing unlawful.¹⁵³ Courts have examined the link between the exclusive dealing contract and the alleged antitrust harm for antitrust injury standing.¹⁵⁴

10. Procompetitive Effects and Justifications

Courts will consider the justifications and procompetitive effects a defendant claims flow from an exclusive dealing contract.¹⁵⁵ The courts expressly consider any prevention of free riding claims.¹⁵⁶

11. Seller's Market Power

Courts increasingly will not invalidate exclusive dealing unless a seller possesses market power. They do so because a seller without market power cannot cause any anticompetitive harm.¹⁵⁷

B. Canadian Law

Section 31.4(2) of the Combines Investigation Act used to govern exclusive dealing in Canada. In 1985 the Canadian Legislature enacted the Competition Act. Section 77 of that Act now governs exclusive dealing. However, the two provisions are virtually identical. The first Canadian exclusive dealing decision was *Director of Investigation v Bombardier*.¹⁵⁸ This involved the Combines Investigation Act. Bombardier produced snowmobiles. It was the only Canadian manufacturer. However, there were no tariffs on imports. The other manufacturers were Japanese and American companies. Bombardier had 30 percent of all the North American sales, 60 percent in Quebec and 40 percent in Ontario. It entered into exclusive dealing contracts with its distributors. The distributors agreed not to carry Bombardier's rivals' products. The contracts lasted for a year. The Restrictive Trade Practices Commission upheld the exclusive dealing. The

152 See *Tampa*, 365 US 320, 344 (1961); *Standard Oil* 377 US 293, 309 and 314 (1949); but see also *Joyce Beverages Inc v Royal Crown Cola Co* 555 F Supp 271, 275 (SDNY, 1983) (exclusive dealing may enhance interbrand competition when all competing suppliers use it); *United Airlines Inc v Austin Travel Corp* 681 F Supp 176 (SDNY 1988); *Aff'd* 867 F 2d 737 (2nd Cir 1989) (exclusive dealing lawful where other major competitors have similar five year contracts).

153 *Joyce Beverages*, 555 F Supp 271 (SDNY 1983) (exclusive dealing lawful in market with fierce interbrand competition); *Ralph C Wilson Industries Inc v Chronicle Broadcasting Co*, 794 F 2d 1359 (9th Cir 1986); *Westman Commission Co v Hobart International Inc*, 796 F 2d 1216 (10th Cir 1986); *Taggart v Rutledge*, 852 F 2d 1290 (9th Cir 1988) (no evidence that competition harmed).

154 *Interface Group v Massachusetts Port Authority*, 816 F 2d 9 (1st Cir 1987) (no connection between agreement and antitrust harm); *Community Hospital v Tomberlin* 712 F Supp 170 (MD Ala 1989).

155 *Tampa*, 365 US 320 (1961); *Ryko Manufacturing Co v Eden Services*, 823 F 2d 1215 (8th Cir 1987); *Roland*, 749 F 2d 380 (7th Cir 1984).

156 *Roland*, 749 F 2d 380, 384-385 (7th Cir 1984); *Sewell Plastics*, 720 F Supp 1196 (WDNC 1989); *Haagen Dazs Co*, 895 F 2d 1417 (9th Cir 1990) (exclusive dealing, inter alia, prevents free riding).

157 *Assam Drug Co v Miller Brewing Co* 798 F 2d 311 (8th Cir 1986); *Graphic Products Distributors Inc v Itek Corp*, 717 F 2d 1560 (11th Cir 1983).

158 (1981) 53 CPR (2d) 7 (RTPC).

Commission held Bombardier was a major supplier. It stated that the essential question in determining whether Bombardier's exclusive dealing substantially lessened competition was whether Bombardier's rivals were able to find a sufficient number of dealers to market their product.¹⁵⁹ It held Bombardier's rivals could and that entry into the retail market was easy and therefore the exclusive dealing did not impede rivals. It held so because only relatively low numbers of sales were necessary to maintain a snowmobile distributorship. Distributors could supplement this business by carrying complementary goods and services. There was also a considerable turnover of distributors. Most communities had more than one distributor. However, some communities only had a Bombardier distributor. The Commission admitted that the easiest way for Bombardier's rivals to enter these communities was to have Bombardier distributors carry their product or "dual".¹⁶⁰ It conceded that until Bombardier's rivals obtained their own distributors consumer choice was reduced. However, it held that once the rivals obtained their own distributors consumer choice was greatly increased. Consumers then had a choice of product and distributors. Thus, exclusive dealing ultimately leads to an increased number of dealers in an area and thus actually increases competition.¹⁶¹

Dr Geoffrey Takach says this shows that the Commission recognises that some exclusive dealing situations, rather than merely not lessening competition, actually have the positive effect of encouraging it.¹⁶² The Commission also held that it was easy for Bombardier's rivals to obtain their own distributors.¹⁶³

The other significant Canadian case is *Director of Investigation and Research v Nutra Sweet Co.*¹⁶⁴ Nutra Sweet manufactured aspartase, a sweetener used in soft drinks. Canada authorised aspartase use in 1981. In 1987, Nutra Sweet's patent expired. Nutra Sweet was responsible for all U.S. and Australian sales (where a patent still applied). It had 80 percent of the market in Europe and 95 percent in Canada. It had 65 customers in Canada - although five percent of the customers purchased approximately 84 percent. The only other supplier was Tosoh, who had five percent of the market. Tosoh started production in 1987, when the Nutra Sweet's patent expired. Nutra Sweet then entered into one year requirements contracts with its customers. Nutra Sweet bought some of its aspartase from a Japanese company called Ajinomoto. Ajinomoto had agreed not to enter the North American market until 1996. Nutra Sweet's requirements contracts were subject to (inter alia) the following conditions: a "meet or release" clause, this required Nutra Sweet to release a customer from its contract if the customer received a more favourable offer which Nutra Sweet refused to meet; a "most favoured nation" clause. This guaranteed a customer "the lowest price paid by any customer for an equivalent volume".¹⁶⁵ When this happened, the customer received a rebate cheque for the difference at the

¹⁵⁹ Ibid at 25.

¹⁶⁰ Ibid.

¹⁶¹ Ibid at 27.

¹⁶² G Takach, "Exclusive Dealing after Bombardier : The Law is not a great deal clearer than before" (1983-84) 8 Canadian Business Law Review, 266 at 230.

¹⁶³ Gideon Rosenbluth criticises the decision. See G Rosenbluth, "Competition Policy Bombs Again : The Bombardier Case" (1981), unpublished paper, University of British Columbia.

¹⁶⁴ (1990) 32 CPR (3d) 1; see P Collins, "The Law and Economics of "Abuse of Dominant Position" : An Analysis of Nutra Sweet" (1991) University of Toronto Faculty Law Review 275; D Thompson, "Nutra Sweet : The Evolution of Law on Abuse of Dominant Position" (1991) 18 Canadian Business Law Review, 17.

¹⁶⁵ *Nutra Sweet* (1990) 32 CPR (3d) 1, 66.

year's end. Nutra Sweet also supplied customers a discount (of up to 40 percent) if customers used the Nutra Sweet name on packaging and advertising. This meant customers had to pay substantially more if they did not qualify for the discount. In essence, Nutra Sweet offered a monetary incentive to use its aspartame. The Competition Tribunal held Nutra Sweet had breached both the s.77 (Exclusive Dealing) and s.79 (Abuse of a Dominant Position) provisions of the Competition Act. Discussing s.77 the Tribunal noted:

"The exclusivity in [Nutra Sweet's] contracts, which includes both the clauses reflecting the agreement to deal only or primarily in Nutra Sweet brand aspartame and the financial inducements to do so, impedes 'toe-hold entry' into the market and inhibits the expansion of other firms in the market. Since exclusive use and supply clauses appear in virtually all of [Nutra Sweet's] 1989 contracts and thus cover over 90 percent of the Canadian for aspartame, it is clear that during the currency of those contracts there is little room for entry by a new supplier".¹⁶⁶

The Tribunal held that the meet or release clauses dissuaded entry and that they discouraged rivals from submitting bids. It emphasised the anticompetitive elements of the fidelity rebates associated with the use of the Nutra Sweet logo.¹⁶⁷ It also considered the evidence of customers that they were reluctant to switch from Nutra Sweet and go to Tosoh. However, the Tribunal did not reconcile this with the fact that two of Nutra Sweet's customers, Cadbury Schweppes and Stafford Foods had switched to Tosoh.

Again, the case seems to show a benign attitude to exclusive dealing. Nutra Sweet's market share was huge. It had the advantage of enormous economies of scale and distribution of up to one third of the world's production. The discount and use of the Nutra Sweet logo were extremely relevant in finding a breach of s.77. Indeed, the Tribunal indicated that the contract's term might not be anticompetitive, were it not for the effect of the long term use of the logo on entry conditions in the future.¹⁶⁸

C. Australia

Section 47 of the Trade Practices Act governs exclusive dealing. Section 47(2)(d) prohibits the practice where it has the purpose or is likely to have the effect of substantially lessening competition. *Ford Motor Co. of Australia Ltd*¹⁶⁹ is the leading case in Australia. Ford held about 22 percent of the Australian market for new vehicle sales. It controlled sites accounting for 45 percent of its total sales. It had exclusive dealing contracts with 14 percent of its dealers. It applied to the Trade Practices Commission for authorisation of its agreement.¹⁷⁰ The Trade Practices Commission denied authorisation. Ford applied for review to the Trade Practices Tribunal. The Tribunal also denied authorisation. It held that foreclosure of 14 percent of dealers impeded entry for Ford's current and potential rivals. It noted that 86 percent of other dealers were not available to rivals because many of them might be unwilling to acquire another franchise. It also found the exclusive dealing lessened the degree of competition between dealers. The Tribunal found that by eliminating the agreements, Ford would lose 1-5 percent of the market share. The Tribunal concluded the agreement thus resulted in the

¹⁶⁶ Ibid at 48-49.

¹⁶⁷ Ibid.

¹⁶⁸ Ibid at 49-51.

¹⁶⁹ (1977) 32 FLR 65.

¹⁷⁰ ATP Commission Decisions June 1976-January 1977, 16, 563.

substantial lessening of competition. It rejected Ford's procompetitive benefits of the agreements, viz; greater efficiency, the prevention of rural monopolies, the demonstration of relative efficiencies between different distribution systems, dealer assistance, increase in Australian employment, product improvement and improved product service. The Tribunal held Ford did not prove these or show they flowed from the exclusive dealing arrangement. While accepting the exclusive dealing arrangement maximised Ford's sales, the Tribunal held this did not mean it benefited competition.¹⁷¹ Benefiting the strongest supplier was irrelevant in assessing the effect on competition. The Tribunal found Ford's exclusive dealing contracts had anticompetitive effects, viz; constriction of dealer freedom and an elimination of side by side selling.¹⁷²

Commentators have severely criticised this decision.¹⁷³ Because Ford controlled sites accounting for 45 percent of its sales, the exclusive dealing agreements only foreclosed 12 percent of total market sales volume. How is this significant? It is certainly far below the foreclosure percentage courts have found detrimental in the U.S. and Canada. Why is a possible loss of 1-5 percent a substantial lessening of competition? If it is, very little exclusive dealing will escape condemnation. The decision is delphic in its reasoning. As David Shannon has asked, what did the tribunal mean by saying:

"In reaching our conclusion that the lessening of competition resulted from the restriction in substantial, we have placed considerable weight on the significance of Ford in the motor vehicle industry. We would have arrived at the same conclusion without the experts giving any evidence of the loss of market share by Ford in the event of the restrictive provision being removed."¹⁷⁴

As Shannon notes, in fact, the Tribunal failed to indicate any alternative basis on which it could have concluded the degree of lessening of competition was substantial.¹⁷⁵ One must also wonder why the Tribunal found that 86 percent of the non-Ford dealers were potentially unavailable to Ford's rivals. If Ford's rivals offered a superior product, which would mean more sales for dealers, the dealers should have been willing to shift. The Tribunal did not consider in any great detail how easy it was for Ford's rivals to establish new outlets. Presumably the number of dealers was not finite.

However, as both Shannon and Dr James Farmer Q.C.,¹⁷⁶ have noted, perhaps the only explanation for the decision is the lack of involvement of economists. Ford called no economic evidence and its lawyers thought up all economic arguments.

V. APPLICATION OF THE RRC MODEL TO FISHER AND PAYKEL

In this part I propose to analyse *Fisher & Paykel v Commerce Commission*¹⁷⁷ using the RRC model.

Fisher and Paykel (F&P) is the leading manufacturer and distributor of whiteware in New Zealand. By 1990 it was New Zealand's only whiteware

171 *Ford* (1977) 32 FLR 65 and 85.

172 *Ibid* at 86.

173 See eg D Shannon *Franchising in Australia: A Legal Guide*, Law Book Company, Sydney (1982) p 172-174.

174 *Ibid* at 174.

175 *Ibid*.

176 J Farmer, "Economic Evidence - Some Practical Issues", in New Zealand Law Society Supplementary Papers : "Economics and the Law, the Application of Economics in Legal Practice (1990), p 6.

177 [1990] 2 NZLR 731.

manufacturer. The winds of the free market blew through New Zealand in the 1980's and from 1987 the government exempted all Australian whiteware from import licensing and abolished tariffs. The government abolished import licenses from whiteware from other countries and reduced tariffs to 10 percent by 1996. This led to increased competition in the whiteware market. F&P was still the major player with approximately 80 percent of the market. F&P had an exclusive dealing contract (EDC) with its dealers, which it had used for 40 years. The EDC required dealers not to stock or sell other manufacturers' whiteware. The EDC was terminable by either party on 90 days notice. F&P had 204 franchised dealers who sold through 450 outlets. There were approximately 800-850 New Zealand outlets which sold whiteware. In 1987 F&P applied to the Commerce Commission for an authorisation, which involved determining, inter alia, whether the EDC breached s.27 of the Commerce Act 1986.¹⁷⁸ In 1989 the Commission, by a majority held the EDC did. F&P appealed. Various parties joined the action. The High Court (Barker J and Mr R G Blunt) held the EDC did not breach s.27.

The primary issue in the case was "does the EDC between F&P and its retail dealer outlets have the effect of substantially lessening competition in a market for the distribution and sale to retailers of white goods?"¹⁷⁹ All parties agreed the market was New Zealand-wide. All the parties, the experts, the Commission and the High Court accepted that the EDC could breach s.27 if it raised F&P's rivals' costs. They disagreed whether it did. While the experts posed an RRC question, none expressly adopted Krattenmaker and Salop's model.

Under the RRC model the first issue is to determine what RRC scenario could be involved. There are four possibilities.

1. Bottleneck

This requires the retailers not to be equally efficient, or some of the retailers to be more important or advantageous to manufacturers. Examples would be the only shop in town or a well regarded chain of shops throughout the country. If F&P purchased an exclusionary right (or entered into an EDC) from such retailers, this would leave rivals facing higher input prices and thus, higher costs. This requires the demand of F&P's rivals to be large relative to the number of unrestrained sellers. It requires the unrestrained retailers to be unable to afford to expand their capabilities. It also requires high entry barriers to the retail market to prevent new retailers entering and meeting the rivals' increased demand for quality retail space.

2. Real Foreclosure

This requires F&P to have acquired an ER (or entered into an EDC) from such a large percentage of retailers that the market price for the supply of the remaining space is driven up, so increasing rivals' costs. Again, this requires the demand of F&P's rivals to be large, relative to the number of unrestrained retailers. It requires the unrestrained retailers being unable to

¹⁷⁸ Section 27 provides: (1) "No person shall enter into a contract or arrangement, or arrive at an understanding, containing a provision that has the purpose, or has or is likely to the effect of substantially lessening competition in a market. (2) No person shall give effect to a provision of a contract, arrangement, or understanding that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market".

¹⁷⁹ [1990] 2 NZLR 731 at 743.

meet the rivals' demand. It requires high costs of expansion and high entry barriers to potential entrants to the retail market.

3. *Cartel Ringmaster*

This requires F&P, after having acquired an ER (entered into an EDC) from a large percentage of retailers, to orchestrate a cartel among the remaining unrestrained retailers to increase prices for F&P's rivals. This leads F&P's rivals facing increased input costs and thus higher costs. This again requires F&P's rivals' demand for retail space to be large relative to the number of unrestrained retailers. It requires entry to the retail market to be difficult, as cartel pricing would readily attract new entrants. It requires the number of rivals to be small, to make it likely that F&P could orchestrate a cartel.¹⁸⁰

4. *Frankenstein Monster*

This requires F&P to have acquired an ER (entered into an EDC) from a large percentage of retailers, leaving the unrestrained retailers so concentrated, they could form a cartel and charge F&P's rivals cartel prices. Once again the rivals would have higher input costs and thus, higher costs. This again requires high entry barriers to prevent new entrants attracted by the cartel prices. Again the number of unrestrained retailers must be small to make a cartel likely.¹⁸¹

To summarise, the scenarios require the following conditions to be met before the rival's costs are raised:

Bottleneck and Real Foreclosure will require:

- (a) The existing unrestrained retailers being unable to meet F&P's rivals' increased demand for retail space.
- (b) The existing unrestrained retailers facing high costs of expansion to meet the rivals' increased demand.

Cartel Ringmaster and Frankenstein Monster require:

- (a) The number of existing unrestrained retailers to be small to make a cartel likely.

All four require:

- (a) Significant entry barriers for potential entrants into the whiteware retail market.

The next issue under the RRC model is to determine what scenarios were actually involved.

No one could possibly suggest that either the Cartel Ringmaster or Frankenstein Monster scenarios were involved. Counsel for the Commerce Commission and F&P's rivals did not. There were more than 400 unrestrained retailers. It would take a truly heroic effort by F&P to orchestrate such a large cartel. Similarly, the unrestrained retailers would have to collude to an unprecedented degree to form a cartel by themselves. Such a cartel would fly apart extremely quickly after forming - if one was ever formed.¹⁸² The two scenarios that were possibly in play, were Bottleneck and Real Foreclosure.

¹⁸⁰ Stigler, *op cit*, n 91, p 69.

¹⁸¹ *Ibid*.

¹⁸² *Ibid*.

1. Bottleneck

It was alleged and a majority of the Commission agreed that there were prime positions for retail outlets and F&P had tied up the greater proportion of these. F&P's rivals' counsel described these as best quality or key retailers and also as chain or department stores.¹⁸³

2. Real Foreclosure

Again, by virtue of having EDCs with the key best and quality retailers, one can argue F&P had employed the real foreclosure model. Similarly, tying up 400-500 out of 800-850 retail outlets is real foreclosure.

Identifying a possible RRC scenario is not enough to establish that F&P had raised its rivals' costs. One must examine the input (here, whiteware retail shop) market.

The above two scenarios only raise rivals' costs if:

- (a) The existing, unrestrained retailers cannot meet F&P's rivals' increased demand for retail space.
- (b) The unrestrained retailers cannot expand to meet the increased demand (i.e. it is prohibitively expensive for them to do so).
- (c) High entry barriers exist in the retail whiteware market which prevents new retailers entering to meet the increased demand.

The High Court did not use the RRC model but found the above conditions were not met. It held the supply of suitable retail space throughout New Zealand was relatively elastic. Existing retailers could expand their capacity relatively inexpensively by converting existing shop floor space to selling whiteware. This meant the existing retailers already had the ability to meet F&P's rivals' increased demand. They could also expand by building new retail space relatively inexpensively. Entry barriers for new entrants were not high as it was also relatively inexpensive to enter the retail whiteware market. It was also easy for restrained F&P dealers to terminate their exclusive dealing agreements and switch allegiance to F&P's rivals. Thus, under the RRC model, F&P's rivals could not establish the first limb of Krattenmaker and Salop's test. The exclusive dealing contracts did not significantly and substantially raise rivals' costs. This conclusion depends upon it being relatively inexpensive for rivals to expand and for new entrants to enter. (This requires empirical testing.) The majority of the Commerce Commission thought differently¹⁸⁴ about it being inexpensive for rivals to expand and for new entrants to enter. It expressly found the EDC significantly raised F&P's rivals' costs of distribution. Why the difference? One can only agree with Professor Benjamin Klein's (one of F&P's expert witnesses) view who noted:

"I believe the majority of the Commission failed to appreciate the Fisher and Paykel exclusive dealing arrangement had not the effect of creating commercially insurmountable entry barriers to competing whiteware suppliers by preventing them from obtaining adequate retail distribution of their products."¹⁸⁵

A court applying the RRC model would stop here. It would not consider whether F&P had power to price above the competitive level. The case is

¹⁸³ [1990] 2 NZLR 731 at 741.

¹⁸⁴ *Ibid* at 743.

¹⁸⁵ B Klein, "Perfect Competition as a Criterion for Antitrust Policy : Brand Names, Entry Barriers and Exclusive Dealing in the Fisher & Paykel Case in R J Ahdar" (ed) *Competition Law and Policy in New Zealand*, Law Book Company, Sydney (1991), p 71.

silent on whether F&P could charge supracompetitively. If a court were to analyse the second limb, it would examine the output market and consider the following:

- (a) The extent of competition from F&P's rivals.
- (b) The effect of potential rivals, i.e. whether supracompetitive pricing would attract new entrants.

In assessing this, a court would consider whether there are high entry barriers to the output market. It appears there were not, given that there was no import licensing and that Australian imports faced no tariff barriers and non Australian imports were only facing temporary tariffs. Indeed, F&P's rivals success at entering the market shows the barriers were not insurmountably high. Thus, F&P's rivals would not meet the second limb of the RRC test.

It is ironic that Professor Klein who employed an RRC-like analysis did not consider the second limb. He thought the exclusive dealing contract did not raise F&P's rivals' costs but he did not require a showing of market power. However he said: "Exclusive dealing arrangements have anticompetitive effects only if they lead to the exclusion of rivals by prohibitively raising rivals' costs of the critical input".¹⁸⁶ Presumably, if rivals' costs were raised prohibitively market power would flow from that.

Finally if the High Court had held the exclusive dealing contract raised rivals' costs and allowed F&P to price supracompetitively, Krattenmaker and Salop's model would possibly allow an efficiency test. A court would consider whether the exclusive dealing clause prevented free riding and switch selling. If so, a court would consider whether preventing these justified the exclusive dealing contracts. The High Court considered efficiency justifications in determining whether the exclusive dealing clause breached s.27. Under the RRC model, a court only considers efficiency justifications after the two limbs of the model are met.

VI. CONCLUSION

A court using an RRC model would not condemn F&P's exclusive dealing contract. The first limb is not met as the exclusive dealing contract did not significantly and substantially raise rivals' costs. The model seems a useful analytical tool and provides a coherent economic analysis of exclusive dealing. The model considers everything the High Court, using traditional analysis, did. The High Court has been indirectly criticised for, *inter alia*, not providing adequate principles which subsequent courts could follow when analysing exclusive dealing.¹⁸⁷ Arguably, the RRC model provides such principles and a strong economic underpinning of the case.¹⁸⁸ It offers a more coherent and tightly structured method of analysis than the High Court's traditional analysis. It does not condemn good practices nor bless bad ones. The case shows the model is not the simple two-stage test Krattenmaker and Salop suggest. Each of the two stages has several independent steps. The weakness of the model is that it does not sufficiently take account of efficiencies. Courts balance the pro and anticompetitive effects of exclusive

¹⁸⁶ *Ibid* at 70.

¹⁸⁷ J Farmer, "Competition Law" (1990) *Recent Law Review*, 203 at 212; For other criticisms of the decision see Ahdar, *op cit*, n 94 and W Pengilly. "Product Exclusivity in New Zealand: The Fisher & Paykel Decision - Enlightened Reasoning on Competition Naviety?" paper presented at the Second Annual Workshop of the Competition Law and Policy Institute of New Zealand, Wellington 11 August 1991.

¹⁸⁸ L Hampton, "Aspects of the Commerce Act 1986" in A Borrowdale and J H Farrar (eds) *Butterworths Commercial Law*, Butterworths, Sydney (2nd ed 1992).

dealing under s.27. Efficiencies play a large part in this. However, under the RRC model they are only considered at the end. It appears New Zealand courts could usefully employ the model in analysing exclusive dealing.