Exclusive Dealing and Competition: A US FTC View

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Introduction: Exclusive Dealing Basics

- "An exclusive dealing contract is a contract under which a buyer promises to buy its requirements of one or more products exclusively from a particular seller." Hovenkamp, *Federal Antitrust Policy* (2016)

- Variations on "full scale" exclusive dealing (partial, de facto)
  - **Loyalty discounts**, discounts tied to percentage of purchases from a seller
  - **Slotting allowances**, supplier pays fee for preferred or exclusive shelf space
  - **Requirements contracts,** agreements to buy all needed units from one seller, also de facto agreements under which firms won't buy from other sellers

- Exclusive dealing may confer substantial procompetitive benefits but also may pose significant anticompetitive risks
  - case-specific analysis is key
  - Exclusive dealing assessed by most authorities under antitrust "rule of reason"

Evaluating Exclusive Dealing – ICN Review

- 2013 ICN Unilateral Conduct Workbook, Chapter 5 – Exclusive Dealing

  - Outlines elements for flexible rule of reason analysis, focus on evidence

  - Potential exclusive dealing efficiencies include:
    - Encouraging distributors to promote a manufacturer’s products more vigorously
    - Encouraging suppliers to help distributors by providing key services of information
    - Addressing problems of free riding between suppliers
    - Addressing “hold up” problems for customer-specific investments
    - Allowing suppliers to control distribution quality more easily

  - Potential harms related to market foreclosure (including raising rivals’ costs)
    - Price increases due to output reduction, also overall reduction in market output
    - Increase in dominant firm’s market share unexplainable by quality, supply/demand
    - Exit of existing competitors due to an exclusive dealing arrangement
    - Entry deterrence (preventing deterrence by potential competitors)

Evaluating Exclusive Dealing – U.S. Approach

- ***In Re Beltone*** (FTC, 1982). FTC, assessing case law, says "a proper analysis of exclusive dealing arrangements should take into account
  - market definition,
  - the amount of foreclosure in the relevant markets,
  - the duration of the contracts,
  - the extent to which entry is deterred,
  - and the reasonable justifications, if any, for the exclusivity"

- ***Roland Machinery*** (7th Cir. 1984, Judge Richard Posner). Provides framework for analysis:
  - Agreement excludes at least one significant competitor from relevant market
  - Plaintiff must prove probable (not certain) effect of the exclusion will be to raise prices and thus to reduce output below competitive level, or otherwise injure competition
  - Plaintiff must therefore show that anticompetitive effects outweigh benefits

- Harm to competition may be shown by **direct evidence** - best approach, prices rise/output falls relative to but-for world of no agreement - and also **indirect evidence** - observable market factors allow court to infer that anticompetitive effects likely to have occurred in market (e.g, *Dentsply* (2005), long duration of exclusionary tactics, anecdotal evidence of their efficacy make it clear market power existed and was effectively used)

Evaluating Exclusive Dealing in U.S., cont.

- Categories of indirect evidence include:
  - estimate of the significance of market foreclosure caused by exclusive dealing agreement (“significant degree of market foreclosure” required, *Microsoft*, 2001)
  - duration
  - terminability of contract (*Omega Envtl*., 1997)

- Many courts have held contracts of one year or less are presumptively legal (e.g., *Concord Boat* (2000), *Omega*), but others have noted that short duration and early terminability do not prohibit liability in all cases (e.g., *Dentsply* (2005), large market share of Dentsply and its conduct excluding competing manufacturers were the key factors)

- Other relevant factors include whether distributors are a significant gateway to end users and evidence of ease of entry (e.g, *Omega*)

Issues Raised by Foreclosure

- Before anticompetitive foreclosure can occur a firm with a relatively large percentage of upstream market must foreclose a significant percentage of access to downstream market (Hovenkamp, 2016)

- Also, important to look at entire range of distribution channels through which efficient distribution can occur – exclusive dealing that shuts off only one distribution channel might permit ample competition through others

- Also, always important to remember that vertically related markets do not necessarily have same geographic boundaries

  - E.g., suppose a hospital with a dominant position in a relevant geographic market that it serves agrees to use services of only one particular pathologist – but if pathologists can be recruited in a national market, no single pathologist would be able to insist on charging monopoly prices through that hospital (*Collins v. Associated Pathologists* (1988), foreclosure to be assessed in relevant market where pathologists competed for jobs)

Raising Rivals' Costs Through Exclusives
(see Hovenkamp, *Federal Antitrust Policy* (2016))

- Rather than exclude rivals from a market altogether, exclusives may raise rivals' costs by relegating them to inferior distribution channels

- E.g., *Standard Oil* (1912) likely enlarged its monopoly by agreeing with railroads that they would give it preferential scheduling and lower prices than any competing petroleum shipper (Granitz & Klein, 1996)

- *American Can* (1921) for a time bought full output of can machine makers, forcing rivals to use inferior technology

- *Toys 'R' Us v. FTC* (2000), largest U.S. toy buyer forced suppliers to promise that competing discounters would receive only differentiated versions of toys or large bundles that consumers would have to buy all at once (in affirming FTC, appeals court stressed horizontal effects)

Exclusive Dealing as Cartel Facilitator

- Exclusive dealing may facilitate collusion by denying buyers ability to force sellers to bid against each other, undermining cheating on cartel

- E.g., if gasoline refiners are colluding, gas distributors might be able to force refiners to bid against each other and reach agreements with individually negotiated secret terms – but exclusive contracts that made dealers “branded” resellers could reduce that bidding
  - Exclusive dealing should be condemned under this theory only if (1) upstream market appears conducive to collusion and (2) exclusive dealing sufficiently widespread to create inference it is being used as a cartel facilitator

- Be careful – fact that exclusive dealing is efficient in a market also makes it widespread, be very careful before condemning in such case

Exclusives as Efficient "Relational" Contracts (Draws on Hovenkamp (2016))

- Exclusive dealing a classic example of "relational" contracting – contracting that permits parties to make long term arrangements that reduce their risk and account for the fact that knowledge about the future is limited (Hovenkamp, citing Williamson, Carlton, MacNeil)
- Long-term, flexible contracts can minimize costs and risks to both parties of dealing with future uncertainties
  - E.g., gasoline retailer uncertain about future sales and suppliers, while refiner, by contrast, wants steady outlet for its product (customers benefit by knowing they can buy a particular brand at a particular location)
  - Exclusives give both refiners and ultimate consumers benefits of outright station ownership, but avoids high capital costs of investing in stations
  - Exclusives also give incentives for independent retailers to maximize sales – retailers are not mere employees, but businesspersons interested in profit maximization

Efficient Relational Contracts, cont.

- Vertical integration by contract also gives both parties to agreement economic interest in productive facilities
  - By arranging in advance for steady stream of sales, exclusive dealing contract allows refiner to share the risk of investment in station with retailer
  - If refiner builds without this assurance, retailers can later take advantage of refiner’s sunk costs, bargain for any price that covers variable costs of refining
  - As a result, refiner unsure of future demand likely to build smaller refinery than it would if demand were more certain, or not build at all
  - This situation exacerbated if market information is poor – refiner who does not know what competing refiners plan to fears excess refining capacity
  - Long term requirements contract can spread this risk and reduce uncertainty

Efficient Relational Contracts, cont.

- Exclusives may also prevent **interbrand free riding**, which occurs when a dealer with an ongoing supply relationship with one supplier sells a second brand at same location and takes advantage of facilities or goodwill contributed by supplier of the first brand (gasoline example)
    - If gasoline dealer pumps the second brand, neither the supplier of the first brand nor the dealer could segregate all the facilities or amenities provided by the first brand supplier (e.g., help in financing and maintaining equipment, trademark brand value)
    - The first brand supplier’s solution is to require that its gas be sold exclusively
- Empirical literature suggests that exclusive dealing most likely to be used in markets that are subject to free riding of this sort
- But exclusives can be costly to the extent they limit customers’ ability to compare brands within same retail store – so manufacturers may have to trade off efficiency gains against the possibility of lost sales because consumers prefer multiproduct retailers

Efficiencies of Exclusive Dealing, cont.
(draws on Abbott & Wright (2008))

- Other free riding stories – because manufacturers often compensate dealers for provision of promotional services such as premium shelf space, dealers have incentive to use these additional promotional efforts to switch consumers to other products upon which dealer earns a higher profit – exclusives prevent this

- Exclusive dealing also mitigates incentive of dealers not to provide agreed upon promotional inputs (see *Roland Machinery* case (1984))

- An exclusive allows a retailer to intensify manufacturers' competition for its business and improve purchase terms by committing a substantial fraction of its customers' purchases to favored supplier

Conclusions

- Exclusive dealing is widespread in business settings, often a sign of efficiency, with benefits to parties on both sides of the transaction
  - Exclusives may also be partial or de facto – look to substance, not formalities
- In instances of substantial market foreclosure that excludes competitors or raises their costs of market access, exclusive dealing may raise serious antitrust issues, normally under rule of reason
  - May be special case of exclusives as a sham to facilitate a collusive deal
- Under rule of reason, direct or indirect showing of harm to the competitive process must be shown, and weighed against the magnitude of efficiencies, e.g., benefits from relational contracting

References

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