The Treatment of Vertical Restraints Under Competition Law

Introduction.

Many contractual relationships between manufacturers and their distributors or retailers include restrictions on the commercial freedom of one or both parties. Such restrictions are commonly referred to as vertical restraints. Common examples of such arrangements include:

- Exclusive distribution where the manufacturer gives an individual distributor or retailer exclusive rights to handle its products within a designated territory;
- Exclusive purchasing where the retailer or distributor agrees with a manufacturer not to sell a competing manufacturer's products; and
- Resale price maintenance (RPM) where the manufacturer fixes the price at which distributors and retailers must sell the product.

Agreements between manufacturers and distributors may include a combination of different vertical restrains, e.g. an exclusive distribution agreement may include RPM.

Inter vs. Intra Brand Competition.

While there is considerable agreement among economists in respect of horizontal agreements, they are more divided on the merits or harm of vertical restraints.Some argue that all vertical restraints should be considered to be anti-competitive, while at the opposite end of the spectrum there is a minority who consider that all vertical restraints should be legal per se. The majority lie somewhere in between and agree that the assessment of such restrictions must be based on the specific market circumstances in each case.

Vertical restraints might appear to be prima facie anti-competitive. Exclusive distribution agreements, for example, prevent other resellers within a specific territory from selling the supplier's products, while exclusive purchasing may deny rival producers access to the most able distributors. Although vertical restraints may reduce or even eliminate competition between retailers in respect of an individual brand (intrabrand competition), by providing retailers with a greater incentive to sell a particular supplier's brand they enhance inter-brand competition, i.e. competition between different brands. A reduction in intra brand competition may be more than offset by greater inter-brand competition.

The Principal-Agent Problem.

Vertical restraints may be designed to increase efficiency and to deal with principle - agent problems that can arise in supplier-distributor relationships. Common principal-agent problems that can arise include:

- Double marginalisation. This arises where both the manufacturer and the retailer/distributor have market power. The supplier will set its price to the distributor at the monopoly level and earn monopoly profits. However, the monopoly distributor will take this price as its cost and add its own monopoly mark-up. The result is higher prices and lower sales than would occur if distribution was a competitive activity.
- Input Substitution. Input substitution arises where the product supplied by the upstream firm is one of a number of inputs used by the downstream firm. If substitution between inputs is possible, the downstream firm may substitute lower quality inputs for those of the upstream supplier, e.g. a fast food franchisee may use lower quality inputs thereby adversely affecting the image of the entire franchise network.
- Free riding. Retailers often provide promotional services in the form of information about the product, instruction in its use, the holding of larger stocks and the like. In

the absence of exclusive arrangements consumers would avail of such free services and then purchase the goods in question from lower cost outlets which would effectively 'free ride' on the services provided by others. Retailers would be discouraged from providing such services, thereby reducing sales of the product.

Competition Concerns.

Vertical restraints may either be unnecessary or exceed what is required to deal with principle-agent problems. For example to eliminate double marginalisation it is only necessary to set a maximum retail price, yet RPM frequently involves fixing a minimum resale price. Similarly the 'free riding' argument may be overstated if most consumers do not require pre sales promotional services.

Vertical restraints may be welfare enhancing but in different market circumstances they may reduce economic welfare. Manufacturers may adopt vertical restraints for strategic purposes and may use them to restrict upstream competition. Exclusive agreements may be used to create a barrier to entry at the upstream level by forcing new entrants to set up their own distribution networks. They may also result in market foreclosure by denying rival firms access to the best distributors or retail outlets. Vertical restraints may facilitate collusion or protect dominant-firm monopoly power.

Some Conclusions.

While vertical restraints may be efficiency enhancing, they may also have anticompetitive effects in a variety of situations. The clear implication is that non-price vertical restraints should not be considered either pro or anti-competitive per se. Competition authorities must develop a framework for case by case analysis of vertical restraints and provide guidance to business indicating the basis on which they will reach their conclusions. Factors to be taken into account include:

- the presence or absence of market power at either the supplier or distributor level,
- the degree of market concentration,
- actual evidence of efficiency gains,
- the existence of economies of scope at retailer level and the impact on horizontal competition.