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DECISION MAKING BY COMPETITION AUTHORITIES IN THE ANALYSIS OF EXCLUSIVE DEALING ARRANGEMENTS

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I - Introduction:

Exclusive Dealing arrangement is a nonprice vertical restraint [1] under which an economic agent agrees to negotiate exclusively with another. For example, if a big retailer agrees to sell exclusively the household-electric products of one manufacturer and no one else.

Some exclusive dealing arrangements catch attention of the Competition Authorities because this conduct can affect the competition in the market and its effects are very controversial. Exclusive dealing can make the market less competitive if this raises the rival's costs by relegating them to inferior distribution channels, for example. On the other hand, economic literature has increasingly emphasized in the last years that any vertical integration between companies can produce significant gains of economic efficiencies, such as the reduction of transaction costs. Due to this trade-off, the Competition Authorities should establish a balance between the possible positive and negative effects of an exclusive dealing case under investigation.

The main objective of this paper is to point out the key elements that must be taken into consideration by the Competition Authority to take a decision if they allow or forbid an exclusive dealing arrangement.

This paper is divided into five parts. The first part is this introduction. The second part analyzes the main anticompetitive and procompetitive effects of exclusive dealing arrangements. The third part focuses on the two most paradigmatic cases of exclusive

[1] Vertical restraints involve transactions between firms that are not competitors, but rather are at different

dealing arrangements of the USA antitrust history. The idea is to study how these cases were analyzed by the American Competition Authorities, the criticism made of this analysis and also to evaluate how this analysis has changed over the years. The fourth part aims to point out the key elements and questions that have to be formulated in order to analyze the possible anticompetitive effects of exclusive dealing arrangements. The last part is the conclusion.

II - Main Effects of Exclusive Dealing Arrangements:

(i) Possible Anticompetitive Effects:

The possible anticompetitive effects of exclusive dealing arrangements are generally fewer than the effects associated to other forms of vertical integration, such as vertical mergers. This happens because exclusive dealing arrangements usually don't regulate all aspects of business of the economic agent that agrees to be exclusive trader of the contracting company. And besides, exclusive dealing contracts have usually a definite stated term.

The main possible anticompetitive effects of exclusive dealing arrangements are:

i. Foreclosure of the market for other competitors. Exclusive dealing arrangements consist in agreements made by a contracting company with suppliers, distributors or retailers to negotiate exclusively among them. Then, exclusive dealing excludes the other competitors of the access to the

levels of the distribution chain.

exclusive suppliers, distributors or retailers. Exclusive dealing arrangements may produce anticompetitive effects if they foreclose a substantial portion of the downstream relevant market for a long time, by posing difficulties for the operation of the other competitors.

ii. Increase of the barriers to entry. Exclusive dealing arrangements may produce anticompetitive effects if they create the necessity of a ‘two-level entry’. If the exclusive dealing arrangements foreclose significantly the markets vertically linked, a potential competitor willing to enter one of the markets will be required to provide an entrance in both of the markets.

iii. Raise of the cost of the other competitors. Exclusive dealing arrangements may make the market less competitive if they raise the rival’s costs by relegating them to inferior channels of distribution.

iv. Make easier to coordinate cartels. The enforcement of a cartel in the upstream relevant market becomes easier to be achieved if the distributors or retailers in the downstream relevant market are attached to only one company by exclusive dealing arrangements. In this situation, companies in the upstream relevant market didn’t compete among themselves to have the best distributors or retailers, that would already be attached to the exclusive dealing arrangements. This reduces the chance of desertion, making the cartel more stable.

Exclusive dealing arrangements should meet very restrictive conditions in order to foreclose the market for the other competitors [2]. The production of this anticompetitive effect is seen with reservation by the antitrust literature. The theory on the negative effects of exclusive dealing arrangements is considered more robust when this conduct is associated with the raise of rivals' costs and the increase of the barriers to entry. Exclusive dealing arrangements can harm the competition not because they are able to banish competitors of market, but because they can increase their costs, by relegating them to inferior channels of distribution. This would occur if a company made exclusive dealing arrangements with a significant amount of the channels of distribution more effective to operate in a market (HOVENKAMP, 1999).

Even WILLIAMSON (1987), great supporter of the economies of transaction costs, admits that vertical integrations can raise concern in the area of defense of competition because they can be used strategically to increase the barriers to entry for potential competitors.

Regarding the coordination of cartels, exclusive dealing arrangements should meet some conditions in order to facilitate the enforcement of a cartel: (i) the upstream relevant market should have a market structure that makes collusion easier and more likely; and (ii) the exclusive dealing arrangements should be spread through all the downstream relevant market, by foreclosing a significant number of the distributors/or retailers (HOVENKAMP, 1999).

However, exclusive dealing arrangements can be spread for all the market

[2] This point will be discussed in the next section.

because they produce significant gains of efficiency and not in order to make easier the coordination of a cartel. Then, the theory that sees exclusive dealing contracts as facilitators for cartels should be applied very carefully for not leading to a less efficient market structure. Such an issue can be solved by establishing shorter term contracts to make possible the competition for the exclusive distributors or retailers.

(ii) Gains of Efficiency Produced by Exclusive Dealing Arrangements:

Exclusive dealing arrangements as an informal vertical integration can produce substantial gains of efficiency, such as: big economies of scale as a result of an increasing distributor specialization and reduction of transaction costs among suppliers and distributors.

Regarding the reduction of transaction costs, exclusive dealing arrangements can produce such an effect when (FLORENCIO, 2002):

i. <u>Suppliers have specific assets and distributors are able to benefit opportunistically from these assets.</u> The asset's specificity is defined in broad terms and can be associated to marketing and learning investments, that are considered specific since they generally have an application that is limited to a particular company. For example, marketing is a kind of investment that can lead consumers to search for a particular product in one distributor or retailer, but these agents might offer other similar goods in order to have larger profit. In this case, the distributor or retailer are free-riders because they take advantage of the supplier's investment. In the same way, distributors or retailers might take advantage of training courses and secret technical information from a company. An exclusive dealing arrangement can eliminate this opportunistic behavior.

ii. Exclusive dealing arrangements stimulate the distributor or retailer to supply the sales effort that it's considered adequate by the supplier. For example, sometimes the effort to sell products to marginal consumers tends to increase, what may lead the distributors to shift their selling to products that present a better cost benefit relationship to marginal consumers. An exclusive dealing arrangement can solve this question by making the distributors and suppliers' interests aligned; and

iii. It's possible for the distributor or retailer of a particular product to replace it for similar goods of inferior quality by leading consumers to think they are consuming a higher quality good supplied by a well know company in the market. This hypothesis occurs when information asymmetries don't allow consumers to distinguish the products and the monitoring cost for suppliers is too high. An exclusive dealing arrangement can prevent this behavior.

III - Exclusive Dealing Cases in the USA:

This part focuses on the two most paradigmatic cases of exclusive dealing arrangements of the USA antitrust history. The idea is to study how these cases were analyzed by the American Competition Authorities [3], the criticism made of this analysis and also to evaluate how this analysis has changed over the years.

[3] Two agencies are in charge of the enforcement of the antitrust laws in the USA: the Justice Department's

The first important case of exclusive dealing arrangement in the United States was Standard Oil Company of California vs. United States (**<u>Standard Stations, 1949</u>**). This case became a classic case in the analysis of exclusive dealing arrangement because the Supreme Court applied what is known as the "quantitative substantiality" test. In order to analyze if an exclusive dealing arrangement violates the antitrust laws, <u>this test considers the percentage of the relevant market[4] that is covered by the exclusive dealing arrangements.</u> This percentage indicates if an exclusive dealing arrangement foreclose competition in a substantial share of the relevant market.

In this case, the Supreme Court considered that the exclusive dealing arrangements held by Standard Oil Company with independent retail stations violate the antitrust laws because they lock up 6,7% of the fuel market of seven northeastern states of the USA. This percentage of foreclosure was considered as a substantial part of the market.

In Standard Stations case, some important elements such as the term of the contracts and the level of the barriers to entry in the fuel retail market were not considered. The fact that the main competitors of the Standard Oil Co. also took advantage of similar exclusive dealing arrangements was also not pondered in that decision.

Antitrust Division and the Federal Trade Commission (FTC).

[4] A 'relevant market' is defined according to both product and geographic aspects. A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by reason of product characteristics, prices and intend use. The relevant geographic market comprises the area in which the understakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighboring areas, because the conditions of competition are appreciably different in those areas. In:

According to POSNER (1978), one of the main failures of the analysis carried out in Standard Stations case was not to consider the low barriers to entry to become a retail fuel station. The exclusive dealing arrangements wouldn't be able to harm competition because the current and potential competitors of Standard Oil Co. could easily to get other fuel retail stations if necessary due to the low barriers to entry.

In the view of HOVENKAMP (1999), the Standard Stations case created a rule *per se* to analyze the exclusive dealing arrangements, according to what the foreclosure of about 7% of a market would be presumptively unlawful. By reaching this percentage, there wouldn't be any space for an analysis of the real anticompetitive effects and of the gains of efficiency produced by the contracts.

The strictly numerical analysis of the "quantitative substantiality" test was object of several critics, which led to the incorporation of other elements in the evaluation of the possible anticompetitive effects of the exclusive dealing arrangements.

The **Tampa Electric Co. vs. Nashville Coal Co. case (1961)** involved an exclusive dealing arrangement between a generator and trader of electric energy and a coal producer. According to the contract, Tampa Electric could only buy coal from Nashville Coal for 20 (twenty) years.

The analysis carried out in this case by the Supreme Court is very important to the purpose of this paper because the decision pointed out some key elements that must be taken into consideration in order to analyze if an exclusive dealing arrangement can harm competition. Two points of this analysis should be emphasized here: 1) the importance of the correct definition of the relevant market for the calculation of the percentage of foreclosure of the market; and 2) the application of the "rule of reason" for the analysis of the possible anticompetitive effects of the exclusive dealing arrangements.

The exclusive dealing arrangement between Tampa Electric and Nashville Co. was considered unlawful by the District Court and Appeal Court. These decisions were greatly criticized by the American antitrust literature because they didn't pay attention to the implications related to the definition of relevant market. According to Handler et al. (1997, p.766):

> *"it appears clear that both the Court of Appeals and the District Court have not given the required effect to a controlling factor in the case - the relevant competitive market area. This omission, by itself, requires reversal, for, as we have pointed out, the relevant market is the prime factor in relation to which the ultimate question, whether the contract forecloses competition in a substantial share of the line of commerce involved, must be decided".*

The market share of Tampa Electric was 18% of the production of coal in the State of Florida and less than 1% if considered the totality of the American market. Hence, depending on the definition of the geographic relevant market, the percentage of foreclosure of the market could vary greatly. And besides, it's necessary to evaluate if other sources of energy are good substitutes for the coal in the generation of electric energy. The percentage of foreclosure of the relevant market could also vary greatly if the coal has good substitutes. Thus, an improper definition of the relevant market can produce an inaccurate measurement of market foreclosure due to the exclusive dealing arrangements.

In its decision, the Supreme Court considered the totality of the American market of coal as the relevant market, which implied a foreclosure inferior to 1% of the market.

And besides, the Supreme Court's decision wasn't based only on the calculation of the market foreclosure. Other elements were considered in that decision in a approach what became known as the application of "rule of reason" in order to evaluate the effects of the exclusive dealing arrangements on the competition. The following elements were taken into consideration: (i) the level of the barriers to entry in the relevant market; (ii) the term of the exclusive dealing arrangement; (iii) the period of the notice for termination of the contract; and (iv) the gains of efficiency produced by the exclusive dealing arrangement.

In Tampa Electric case, the analysis carried out by the Supreme Court about the contractual clauses of the exclusive dealing arrangements (the term of the contracts and the period of the notice for termination of the contracts) remained as an important contribution for the current analysis of the possible anticompetitive effects of exclusive dealing arrangements. Regarding to this point, GELLHORN & KOVACIC (1994, p.343) observe that:

> *"Whether an exclusive dealing contract can foreclose competitors depends not only on the number of outlets or the share of sales foreclosed but also on the agreement's length. If the agreement can be terminated on short notice, as in Standard Stations, and there are available outlets, the*

exclusionary effect is likely to be minimal because a competitor could enter simply by offering the retailers better terms".

According to this point of view, contracts of short term (less than an year) and of a medium term (until five years) are considered with low probabilities of producing anticompetitive effects on the market. Only the contracts of long term (above 5 years) should deserve a careful analysis.

This approach shows that exclusive dealing arrangements don't make a market necessarily less competitive. Indeed, depending on the contractual clauses of the agreements, companies can compete between themselves for the distributors or retailers at the moment of renewal of the contracts. This competition can produce positive effects on the market. According to HOVENKAMP (1999, p. 438):

> *"Indeed, a market saturated with exclusive dealing contracts could be fiercely competitive, if the contracts were short term and the parties bid vigorously for the contracts themselves".*

In Tampa Electric case, the exclusive dealing arrangement was a long term (20 years of duration). Then, this arrangement should be scrutinized carefully. It's necessary to evaluate if there is an economic justification for this long contractual period and also to deepen the analysis on its possible anticompetitive effects.

At the end of its analysis, the Supreme Court found no violation due to the circumstances of the electrical power industry. A 20-year agreement was acceptable in the case of public utilities because it's necessary to assure a steady and ample supply of fuel in order to incentive investments.

In Tampa Electric case, the analysis observed the following steps: (i) first, the relevant market was defined; (ii) secondly, the contractual clauses of the contracts were analyzed in order to observe the term of the contracts and the period of the notice for termination of the contracts; and (iii) finally, as the contracts were long term, it was necessary to analyze the plausibility of the economic justification for this long contractual period. These key elements of the analysis carried out in Tampa Electric case remained as an important contribution for the current analysis of the possible anticompetitive effects of exclusive dealing arrangements.

From the 1990's, the analysis of this conduct has incorporated another key element: the market power of the company involved in the exclusive dealing arrangement under investigation. Indeed, the analysis carried out in several cases shows that the market power became the main key element to be observed in the evaluation of the possible anticompetitive effects of the exclusive dealing arrangements (STEPTOE & WILSON, 1997).

On this new point of view, exclusive dealing arrangements that involve a company with market power should be scrutinized carefully even if you have short term contracts or a low percentage of foreclosure of the market. The concern is related to the possibility of a company with market power makes more difficult or even prevents their exclusive distributors or retailers to become free to make deal with another competitor at the end of the contracts. According to STEPTOE & WILSON (1997, p. 50-51):

> *"the Division has signaled that even moderate-term exclusive dealing arrangements can be anticompetitive when imposed by a company with significant market power. Moreover, short notice of termination periods may no longer be considered a safety valve if other contractual terms or the industry structure effectively obviate the termination option".*

The exclusive dealing arrangements under investigation in the cases US vs. Microsoft (1994), US vs. Topa Equities (1994) and US vs. Toys `R` Us (1998) were analyzed by considering the market power as main key element to be observed in the evaluation of the possible anticompetitive effects.

IV - <u>The Key Elements and Questions:</u>

This part aims to point out the key elements and questions that have to be formulated in order to analyze the possible anticompetitive effects of exclusive dealing arrangements.

<u>What is the Percentage of Market Foreclosure?</u>

The percentage of the market that is foreclosed by the defendant's contracts is a very important indicator of the access of the other competitors to the raw material suppliers, distributors or retailers. If the access of the other competitors to the supply or distribution channels is strongly restricted, the exclusive dealing arrangements can produce anticompetitive effects, by reducing the inter-brand competition.

However, it’s important to observe that the calculation of percentage of market foreclosure shouldn’t be enough to make conclusions if an exclusive dealing arrangement is able to produce anticompetitive effects. Other key elements must be taken into consideration as we could observe in the analysis of Standard Stations and Tampa Electric cases.

Calculation of the Percentage of Market Foreclosure:

Exclusive dealing arrangements occur between a company located in the upstream of the production chain and firms located in the downstream market (for example, distributors or retailers). Then, in order to calculate the percentage of market foreclosure, first it’s necessary to define the relevant market within which the contracting company of exclusive dealing and its competitors operate (that is called as the ‘*upstream relevant market*`) and also to define the relevant market within which the exclusive suppliers, distributors or retailers operate (that is called as the ‘*downstream relevant market*`).

The percentage of market foreclosure is calculated by considering the portion of the downstream relevant market that is foreclosed by the defendant company’s contracts. For example, if a soft drink company makes exclusive dealing arrangements with some bars and restaurants. We can define the upstream relevant market as the soft drink companies and we can define the downstream relevant market as the bars and restaurants that sell soft drink. The percentage of market foreclosure should be calculated by considering which percentage of the downstream relevant market is foreclosed to the other soft drink companies due to the exclusive dealing arrangements. The percentage of market foreclosure shows us if they are enough bars and restaurants available in the market in order to allow the other soft drink companies to sell their goods.

It’s important to observe that the upstream relevant market and the downstream relevant market can have distinct geographic boundaries. For example, a dairy products company could compete nationally, but this company could buy its requirements of raw material in a local relevant geographic market.

The definition of the downstream relevant market should be make carefully. For example, if the exclusive dealing arrangement under investigation involves distributors, only the equally efficient distributors should be taken as part of the downstream relevant market. Hence, in order to define the downstream relevant market properly, it’s necessary to analyse if the distributors have significant differences in terms of efficiency (for example, different costs of capillarity or transaction). If these cautions aren’t observed, the Competition Authority runs the risk of obtaining an insignificant percentage of market foreclosure, that isn’t a good indicator of the obstruction of the distribution channels caused by the exclusive dealing arrangement under investigation. It’s important to notice that an exclusive dealing arrangement can produce anticompetitive effects if this raises the other competitors’ costs by relegating them to inferior distribution channels.

In the same way, if the exclusive dealing arrangement under investigation involves retailers, it’s necessary to evaluate if there are retailers with some peculiarities that are important for the form of competition that occurs in the upstream relevant market. In order to illustrate this point, we quoted the following example given by HOVENKAMP (1999, p. 431):

> *"But suppose that geographic location is critical to business survival, and two or three sites for resale locations are substantially better than alternatives. In that case, a dominant upstream firm could 'foreclose' competition - thus making entry more difficult - by entering into exclusive dealing contracts with all of the preferred downstream locations".*

On the same approach, if the exclusive dealing arrangement under investigation involves suppliers of raw materials or machinery, it's necessary to consider differences of cost, technology and quality of the product in order to decide which suppliers should take part of the downstream relevant market.

The percentage of market foreclosure can be calculated over different units of measurement, such as the amount of sales, the amount of revenue or the number of suppliers or retailers that operate in the downstream relevant market. The more appropriate unit to measure the percentage of market foreclosure would depend on how the companies compete in the upstream relevant market and which downstream market is involved.

For example, in the soft drink market, it's important to the competitors to be able to put their goods in several bars and restaurants because the consumption of soft drink is impulsive and very spread. Then, if the exclusive dealing arrangement is made between a soft drink company and bars and restaurants (retailers), the number of bars and restaurants that sell soft drink seems to be the more appropriate unit of measurement to calculate the percentage of market foreclosure.

Differently, if the exclusive dealing arrangement involves distributors, it's important to consider that large distributors or distributors with big capillarity can make a difference for companies in the upstream relevant market. Then, in this case, the amount of sales could be the more appropriate unit of measurement.

<u>Should the analysis be finished if a small percentage of market foreclosure is detected?</u>

On this point, the Tampa Electric (1961) case is very paradigmatic because even having detected an insignificant percentage of market foreclosure (0,77%), the American Supreme Court didn't make a conclusion, by understanding that other key elements should be taken into consideration in order to decide if the exclusive dealing arrangement under investigation could produce anticompetitive effects. In its decision, the Supreme Court states that:

> *"To determine substantiality [of foreclosure] in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce […] and the probable immediate and future effects which preemption of that share of the market might have on effective competition therein".*

As observed in the second part of this paper, exclusive dealing arrangements can harm the competition not because they are able to banish competitors of market, but because they can increase their costs and increase the barriers to entry.

Another question is related to the potential growth of exclusive dealing arrangements made by a contracting company. If a contracting company can make exclusive dealing arrangements with an increasing number of suppliers, retailers or distributors, the percentage of market foreclosure will reflect a statistical situation that will be apart from the reality in a short time.

In order to evaluate if the percentage of market foreclosure can increase easily, the following elements should be observed:

i. the level of barriers to entry in the upstream relevant market. If the barriers to entry are low, the exclusive dealing arrangement won't produce anticompetitive effects because others suppliers, distributors or retailers can easily start operating in that market, by eliminating any harm to competition. Otherwise, if the barriers to entry are high, the exclusive dealing arrangement should be scrutinized carefully because they are more likely to produce anticompetitive effects.

ii. the price paid by contracting company in order to have exclusive suppliers, distributors or retailers. In order to agree to sell only the products of the contracting company, one distributor or retailer should believe that its gains obtained by exclusive dealing will be bigger than its losses due to not to sell products of the other companies. The exclusive dealing should be worthwhile making for suppliers, distributors and retailers. The contracting company must offer advantages for these economic agents to agree not to sell the products of other competitors. If the cost of these advantages is very high, the contracting company won't increase the number of exclusive dealing arrangements in a substantial amount.

iii. the market power of the contracting company. If the contracting company has market power, the potential growth of exclusive dealing arrangement will be bigger.

<u>'Should the analysis be finished if a high percentage of market foreclosure is detected?' or 'How are the barriers to entry in the downstream relevant market'?</u>

The evaluation of the barriers to entry in the upstream relevant market is a very important element to make a conclusion if an exclusive dealing arrangement could produce anticompetitive effects. If barriers to entry are low, an exclusive dealing arrangement will hardly produce any anticompetitive effect even if a high percentage of market foreclosure is detected. According to HOVENKAMP (1999, p. 431): *"As long as new downstream facilities can readily be constructed, effective foreclosure is unlikely"*.

The level of barriers to entry in the downstream relevant market should be evaluated according to the same methodology used to analyze the horizontal mergers.

It's important to observe that exclusive dealing arrangement is also less unlikely to produce anticompetitive effects if competitors that operate in upstream relevant market can integrate vertically without increasing its costs or losing gains of efficiency. In order to illustrate this point, we quote **<u>Omega Environmental, Inc vs. Gilbarco Inc case (Ninth Circuit, 1997)</u>**, under which the exclusive dealing arrangement under investigation was considered as legal:

> *"The Court found that any anticompetitive effect Gilbarco's actions may have had was mitigated by the fact that competitors had the opportunity to sell their goods to end users directly or develop new distributors with which to work"* (SULLIVAN & HOVENKAMP, 1999, p. 504).

Otherwise, if the barriers to entry are high and the other competitors must entry in the downstream relevant market due to the restrictions caused by the exclusive dealing arrangement under investigation, this practice can produce anticompetitive effects, by raising the other competitors' costs and also the potential entrants' costs due to the necessity of a 'two-level entry'.

<u>Are there alternative modes of distribution?</u>

It's necessary to analyze if the exclusive dealing arrangements under investigation are concentrated in one channel of distribution and if there are other modes of distribution available for the other competitors. An exclusive dealing arrangement that forecloses a large percentage of one mode of distribution will have little anticompetitive effect if another mode is available (HOVENKAMP, 1999).

On this point, the analysis should consider two elements:

i. The first element has already discussed before, that is related to the efficiency of the different channels of distribution. If an exclusive dealing arrangement raises the other competitors' cost, this conduct will be very likely to produce anticompetitive effects. In order not to produce anticompetitive effects, the other modes of distribution should be at least as efficient as the channel of distribution where the exclusive dealing arrangements are made. If the other modes of distribution aren't as efficient as this channel, they couldn't be considered as alternative ones.

ii. Secondly, if there are alternative modes of distribution as it's defined above, the analysis will have to measure if these other channels of distribution are able to fulfill the demand of the other competitors.

This analysis should be made in the stage of definition of the downstream relevant market. Doing so, the indicator of market foreclosure would already reflect the real situation of the restriction of access to the channels of distribution caused by the exclusive dealing arrangement under investigation.

Do the contractual clauses make more difficult to the exclusive economic agents to move to another competitor at the end of the contracts?

Some contractual clauses, especially those related to the term of the contracts and to conditions for termination, are very important for the analysis of the possible anticompetitive effects of the exclusive dealing arrangements. If an arrangement can be easily terminated on short-term, the exclusionary effect is more likely to be not significant because a competitor could access that supplier, distributor or retailer by offering better terms at the time of renewal of the contract.

Exclusive dealing arrangements should have a stipulated term to terminate and it's desirable that this term is less than five years. Some Competition Authorities like the

European Commission[5] consider the exclusive dealing arrangements as indeterminate term if they are renewed automatically in case of not being denounced by any party.

Other contractual clauses besides the term of the contracts should be scrutinized carefully in order to verify if they make more difficult to the exclusive economic agents to move to another competitor at the end of the contracts. It's necessary to observe if there is any contractual clause that could block or make more difficult in anyway the option of terminating an exclusive dealing arrangement by the exclusive economic agent.

A classic example is the so called "English clause", which guarantees the right of preference in the renewal of the contract for the current contracting company. In the case of exclusive dealing arrangements, an English clause means that the exclusive economic agent (supplier, distributor or retailer) must communicate any offer received of other competitors to the current contracting company. The current contracting company has the right of renovating the contract if this company makes an proposal with the same conditions/advantages offered by their competitors to the exclusive economic agent. This kind of contractual clause is usually considered anticompetitive, especially if it is practiced by a company with market power.

Some authors consider that contractual clauses that stipulate a short-term and do not hinder the option of termination of the contracts can neutralize possible anticompetitive effects caused by exclusive dealing arrangements that are made in highly concentrated markets. For example, the decision of the American Supreme Court in

[5] Communication nº 84/C 101/02 of the European Commission.

Standard Fashion x Magrane-Houston Company case (1992) has been criticized on the grounds that such question wasn't taken into consideration.

The **<u>Standard Fashion x Magrane-Houston Company case (1922)</u>** involved exclusive dealing arrangements made by a dress-pattern manufacturer with about 40% of the retail stores. Standard Fashion and three more companies controlled 90% of the retail stores so that this market was highly concentrated. The Supreme Court condemned the exclusive dealing arrangements made by Standard Fashion, by understanding that these arrangements foreclosed a substantial part of the market and they also increased the barriers to entry in a market already concentrated.

BORK (1978) severely criticizes such a decision, based on two main arguments. Firstly, he supports that economic literature demonstrates that oligopolies can be more competitive than a market structure with a greater number of economic agents. Secondly, he argues that the Standard Fashion's contracts were short-term (an average of two years), what would be able to nullify any anticompetitive effects. In his words:

> *"we ought to take a closer look at those fierce, entry-barring contracts. The Magrane contract had a term of two years. If Standard's other contracts with approximately 20.800 outlets had similar terms, this means that an average of 10.400 outlets were relieved of contractual obligations to Standard every year"* (BORK, 1978, p. 306).

VISCUSI, VERNON & HARRINGTON (1995) also criticize the Supreme Court's decision in Standard Fashions case, by arguing that the cost faced by the contracting company to make exclusive dealing arrangements wasn't considered in the analysis carried out by the Supreme Court:

> *"This is not sound analysis, however, since it ignores the issue of what a pattern manufacturer must give up to obtain an exclusive dealing arrangement in the first place. That is, the dry-goods stores can benefit by tough bargaining with potential pattern suppliers before signing up with a particular one"* (VISCUSI, VERNON & HARRINGTON, 1995, p. 247).

The criticism of the authors above cited raises a very interesting issue to the analysis of the possible anticompetitive effects of the exclusive dealing contracts. This issue is related to the effects of the cost of making exclusive dealing contracts to the market foreclosure. In order to agree to sell only the goods of the contracting company, one distributor or retailer should believe that its gains obtained by exclusive dealing will be bigger than its losses due to not to sell goods of the other companies. The exclusive dealing should be worthwhile making for suppliers, distributors and retailers. Then, the contracting company must offer advantages to these economic agents to agree not to sell the goods of other competitors. If there is a competition for these economic agents at the end of the contracts, the price paid by contracting company in order to have exclusive dealing will be higher. The increase of the cost of making exclusive dealing contracts may decrease or restrain the growth of the percentage of market foreclosure.

Then, the authors above cited support that contractual clauses that stipulate a short-term and don't hinder the option of termination of the contracts can neutralize the anticompetitive effects caused by exclusive dealing arrangements that are made in highly concentrated markets. However, there are some important reservations for this argument:

i. The existence of an effective competition for exclusive economic agents demands that the upstream relevant market is characterized by an oligopolistic market structure in which none of the competitors have dominant position over the others. Otherwise, a company with market power in the upstream relevant market could nullify the pro-competitive effects of short-term contracts. The argument supported by the authors above cited does not consider the effects of the market power on this analysis.

ii. And besides, a large percentage of market foreclose and the need to compete for exclusive economic agents at the end of the contracts increase the barriers to entry. Hence, depending on the concentration of the market, the exclusive dealing arrangements could produce anticompetitive effects even if the contracts are short-term.

Therefore, the analysis should consider the market structure in order to evaluate if contractual clauses could really decrease or neutralize possible anticompetitive effects due to a high percentage of market foreclosure.

What happens if the contracting company has market power?

From the 1990's, the analysis on exclusive dealing arrangements has been very cautious regarding arrangements which have the following characteristics: (i) made by a company with market power; and (ii) made with economic agents that operate in a downstream relevant market with high barriers to entry.

Exclusive dealing arrangements made by a company with market power may pose difficulties for the operation of the other competitors and increase the barriers to entry in the upstream relevant market. According to AREEDA & KAPLOW (1997):

> *"if a firm with a very large market share enters into exclusive arrangements with dealers, other firms might find it difficult to distribute their product because their sales are not alone sufficient to support separate dealerships. In addition, such foreclosure can have an important effect on potential entrants, who would be deterred by the absence of selling prospects"* (AREEDA & KAPLOW, 1997, p. 770).

POSNER (1978) has already pointed out this issue, by considering that exclusive dealing arrangements could harm the competition if they are made by a company where the sale of its goods produces substantial economies of scale or scope for the distributors or retailers. In this case, if the distributor or retailer had to choose between selling only the goods of this company or selling the goods of other competitors, he would choose the first option. This means that this company with market power wouldn't need to pay very much for making exclusive dealing contracts and could easily increase the number of exclusive dealing contracts in the market. According to POSNER (1978), this situation would increase the scale of production required to entry in the upstream relevant market, by producing negative effects to the economic welfare.

In the same way, the exclusive dealing arrangements would be more likely to produce anticompetitive effects if the product or service offered by the contracting company arose substantial network externalities. Another example is if the contracting company sells products that are the first and the second choice for consumers.

This analysis shows that market power shouldn't be evaluated only in a quantitative way (associated to the market share of the contracting company).

The **Toys 'R' Us case (1998)** is an important example of case where market power was the main key element used to analyze the possible anticompetitive effects of exclusive dealing arrangements. At the time of the investigation, Toys 'R' Us was the largest toy retailer of the USA, with about 650 stores located throughout the country. Toys 'R' Us bought about 30 percent or more of the large toy companies' total output and was usually their most important customer. And besides, according to Federal Trade Commission (FTC):

> *"TRU's main competitors (Wal-Mart, Kmart and Target) carry less than a third of the toys carried by TRU; their floor space for toys is far less than TRU's. TRU's main competitors also carry a lower percentage of the manufacturer's lines after the Christmas season. […] Manufacturers depend on TRU for promotion. Other national chains do not advertise toys year-round or to the extent that TRU does".*

The FTC concluded that Toys 'R' Us had dominant position as a toy distributor. For the purposes of this paper, it's important to observe that the FTC's conclusion was made based not only on the market share, but also on other qualitative variables that are important to the competition in the toy market.

The FTC's investigation showed that Toys 'R' Us was suffering a robust price competition from warehouse clubs. As a result of this, instead of lowering its prices, Toys 'R' Us extracted agreements from 10 toy manufacturers[6] to stop selling to warehouse

[6] The 10 toy manufacturers who made vertical agreements are: Mattel, Hasbro, Fisher Price, Tyco, Little Tikes, Today's Kids, Tiger Electronics, Vtech, Binney & Smith and Sega.

clubs the same toys that they sold to other toy distributors. Doing so, the consumers couldn't make direct price comparisons of club prices and Toys 'R' Us' prices.

And besides, the FTC found that when toy manufacturers complained that a competitor was selling restricted toys to warehouse clubs, Toys 'R' Us threatened to stop buying that competitor's product and, as a result of this enforcement mechanism, got its renewed acquiestance to the sales restrictions.

The FTC understood that the Toys 'R' Us's was engaged in illegal practices, because the agreements made with toy manufacturers keep toy prices higher and reduce choice for consumers.

The conclusion of this topic is that exclusive dealing agreements will be highly likely to produce anticompetitive effects if the contracting company has market power and the barriers to entry are high in the downstream relevant market. In this case, the Competition Authorities should establish a balance between the positive and negative effects of the exclusive dealing arrangement under investigation.

Do the exclusive dealing arrangements produce gains of efficiency that are big enough to compensate their harm to competition?

If the exclusive dealing arrangement under investigation is likely to harm competition, the Competition Authorities should establish a balance between its positive and negative effects.

V - Conclusion:

All key elements and questions discussed in the fourth section of this paper are very important to analyse if an exclusive dealing arrangement can harm the competition. However, it's important to observe that it's not necessary always to analyse all these key elements and questions. The section fourth of this paper shows that if a contracting company has no market power and the barriers to entry are low in the downstream relevant market, there is no reason to worry about exclusive dealing arrangements.

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