TOPIC 5: VERTICAL RESTRAINTS

Introduction to Vertical Restraints

- Vertical restraints on competitive behaviour operate across different functional levels of the production and distribution of goods or services in a market **(Alex Bruce)**
- **Vertical restraints are treated more leniently than horizontal restraints** (see examples below)
    - There are a few justifications as to why people choose to enter into vertical restraints
    - ☺ <u>Economists recognise efficiency rationale</u>
        - **Principal agent theory** – Upstream distributor is the principal and downstream person is the agent and having that restraint is a way to help align the parties' interests and make sure the agent is working in its interests
        - **Transaction costs approach** – You could either choose to set up your own distribution system or go to market and sign an independent distributor (internalise or externalise your costs) and if you choose to appoint an external person to be your distributor, then having a vertical restraint is a way to minimise opportunistic behaviour by the person you appoint

POTENTIAL PRO-COMPETITIVE AND ANTI-COMPETITIVE EFFECTS OF VERTICAL RESTRAINTS

<u>Deficiencies in our current law</u>

- **Our current law does not allow us to consider pro-competitive justifications (this is a huge shortcoming!) ******
    - **Pro-competitive justifications not considered in an effects test**
    - **It is not within the ambit of the SLC test**
    - **Conduct has to be authorized or notified**

- Usually, vertical trading restrictions are unlikely to cause any significant competitive harm
    - **Vertical restraints can also be commercially advantageous both to the parties to the agreement and to consumers**
    - The restrictions are a means by which independent traders can align their commercial interests and objectives to the benefit of each and can, as a result, offer consumers a better quality product

Pro-competitive effects ☺	Anti-competitive effects ☹

• Can help with inter-brand competition
  o E.g. Myer selling Nike, Adidas etc. (different types of runners in a store) so each brand of runners is competing against each other
  o E.g. ***Melway Publishing v Robert Hicks*** → HC recognised that although Melway's segmented and restrictive distribution system restricted competition for Melway Street Directories (intra-brand competition), it may have encouraged rival producers of street retailers to become more efficient, thus enhancing inter-brand competition
• Can incentivise less free riding in the downstream market
	• Increase barriers to entry at the upstream market
	  o May not have an opportunity to enter upstream markets because there's no one to enter distribution agreements in the downstream market (they are all tied up)
	• Vertical non-price agreements that involve product restrictions have the potential to lessen inter-brand competition
	  o E.g. Manufacturer (Nike) agrees to supply shoes to A (Myer) on condition that Myer buys 90% of its shoes

o Free-riding: Idea that if there isn't a vertical restraint, retailer has to invest less in wholesale services, and if they had a restraint, <u>may have more an incentive to provide services to consumers</u> ▪ E.g. Online retailers can free-ride on services and training of staff in stores, and promotions (of other retailers) so you don't offer those services ▪ Free riding on someone else's investment in quality etc. ▪ Vertical restraints, since it takes out competition on price, you compete on other aspects e.g. providing the better service during the sale experience or post-sale • Benefits to co-ordinating distribution – e.g. complex skills – streamlining o Technical efficiencies, distribution efficiencies • Allows companies to protect brand prestige and exclusivity (limiting price can be crucial in maintaining product image) • Could devote more time to R&D o Encourages people to invest in R&D • Can prevent loss-leader selling - Where X discounts one particular product which they know will get people through the door, which attracts them to buy other products which kind of makes up for them selling that one product at a loss • Vertical restraints on resale are likely to give rise to significant technical efficiencies where there are costs to be saved in the coordination of distribution (**Alex Bruce**) • Vertical restraints on resale are unlikely to have significant anti-competitive effect unless the party imposing the restraint has substantial market power, or there exists horizontal collusion or a likelihood of it, which depends on the widespread use of vertical restraints in the market	from Nike → Competition for different brands of shoes is thus reduced • Intra-brand competition – A consumer can shop around at different retailers for the same product to get the best price so if e.g. there's a territorial restriction, they may not be able to o E.g. Myer and David Jones both selling Nike shoes • Co-ordination among levels such as manufacturers which could facilitate collusion (such as price collusion) in the upstream market (more common) or downstream market • Restrictions may lead to less choice, poorer product quality o This is likely to occur when a significant proportion of the market for a particular product becomes subject to such restrictions o E.G. this might occur if a particular manufacturer enjoys a position of market dominance for its product and supplies the product to retailers on condition that they not acquire any competing products. It may then become difficult for a competing manufacturer to gain access to the retail market • Leveraging upstream market power into the downstream market where they actually face competition

NON-PRICE VERTICAL RESTRAINTS – SECTION 47

- Section 47 prohibits vertical non-price restraints in two ways:
  - Majority of vertical non-price restraints prohibited where the restraint substantially lessens competition in the relevant market.
  - Some forms of vertical restraint are prohibited per se (no analysis of whether the restraint actually harms competition in the market)

CURRENTLY - PER SE PROHIBITION OF THIRD-LINE FORCING (SECTION 47)

- Both the Hilmer and Dawson Reports recommended that third-line forcing be subject to a SLC test
    - This would bring Australian competition law into closer alignment with other jurisdictions, particularly the U.S.
    - The U.S. test appreciates that not all third party tying arises from the direct exploitation of monopoly power (R I McEwin)
- Third-line forcing is a form of tying. Third-party tying can only have a harmful economic effect If the tying firm can extend that market power into the tied market (and this possibility is limited). A per se prohibition is not warranted (R I McEwin)
    - Since the HC decision in *Castlemaine Tooheys,* with its strict interpretation of s 47, third party tying can be made legal simply by ensuring that the buyer does not obtain a direct interest in the tied good

International comparison and debate

- Australia is the only comparable jurisdiction that prohibits third-line forcing per se
- US, Canada, EU, NZ leave the conduct to be dealt with by their general prohibitions against anti-competitive agreements or unilateral conduct (assessed under a competition-based test)

Harper Committee, *Competition Policy Review: Final Report* (March 2015) 524-5	
	Vertical arrangements: Third-line forcing Is third line forcing prohibited without consideration of the anti-competitive effects?
Australia	Yes
US	No • There are no specific provisions addressing exclusive dealing or third line forcing in the US • Conduct would be assessed using a rule of reason analysis, weighing the anti-competitive and pro-competitive effects
Canada	No • Third-line forcing conduct is covered by the prohibition on tied selling under the CA • Tied selling will only be prohibited where competition is or is likely to be lessened substantially
UK	No.
EU	No. • There are no specific provisions addressing exclusive dealing or third lines forcing in the EU • Tying arrangements are assessed either under Article 101 or 102 of the Treaty on the Functioning of the EU
NZ	No • There are no specific provisions addressing exclusive dealing or third line forcing in NZ • Tying arrangements (such as third line forcing) are generally analysed under the general anti-competitive and market power provisions of the Commerce Act

- Significant debate about whether the per se prohibition is appropriate

    - Both the Hilmer and Dawson Reviews recommend introducing a competition test to third-line forcing
        - Hilmer Review noted 'there is a broad spectrum of tying arrangements, with many having a positive implication for economic welfare'
- Third-line forcing conduct can be exempted by filing a notification with the ACCC
    - <u>In practice, vast majority of third-line forcing conduct notified to the ACCC is permitted, which strongly supports the view that the the conduct is not overwhelmingly anti-competitive</u>
    - ☹ Although exemption can be gained through the notification process, this imposes a regulatory cost on business

<u>Harper Recommendation</u>

- **<u>→ The Panel considers that third-line forcing can be beneficial for traders and consumers and that firms should be free to package products in a manner they believe consumers will want, provided the conduct does not SLC</u>**
- <u>→ The Panel considers that third-line forcing conduct should only be prohibited where it has the purpose, or has or is likely to have the effect of SLC</u>

COMPLEXITY OF SECTION 47 (THIRD LINE FORCING)

Harper Review Considerations

- Section 47 (third line forcing) is too complex and can be simplified
    - We see that with the different provisions of section 47 – sometimes we are artificially trying to squeeze conduct into a particular category
- <u>The Panel considers that the present form of s 47 has two deficiencies:</u>
    - 1) It attempts to describe a considerable number of categories of (non-price) vertical restriction, it is difficult for a business person to read and understand
    - 2) Despite its complexity, s 47 is not comprehensive, since it does not address every form of (non-price) vertical restriction
- Some submissions suggest that s 47 could be deleted altogether, leaving vertical restrictions (including third-line forcing) to be addressed by s 45
    - Section 45 only addresses the imposition of a trading restriction within a supply agreement – it does not address a refusal to supply or acquire
- Section 46 has an additional limitation not expressed in s 47, namely, the prohibition only applies to a corporation that has substantial market power
    - However, this will not limit the effectiveness of the law
    - It is well accepted that vertical restrictions will not SLC unless they are imposed by a corporation with substantial market power
- → The Panel considers that vertical trading restrictions, and associated refusals to supply can be addressed by a combination of s 45 and an amended s 46
    - → In effect, s 47 (non price vertical restraints) would become a redundant provision
    - **→ The Panel radically recommended s 47 to be abolished completely, because if section 46 is changed to SLC test (which the government accepted), essentially the same ground is covered**
        - Removing s 47 would be consistent with a number of comparable jurisdictions:
            - NZ Commerce Act contains no equivalent of s 47 (although the Commerce Act contains very similar comp law provisions to Australia)
            - No equivalent so 47 in the EU's comp laws
        - **→ THIS WAS REJECTED BY THE GOVERNMENT!**