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The “practical” use of economics: vertical agreements

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Putting economics into practice

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- Back to Basics: Why intervene?
- Back to Basics: Theory of harm
- Making use of theory: restriction of competition
- Example: selective distribution
- Example: retail price maintenance
- Economics in practice: the ‘as-efficient competitor’ (AEC) test

Back to Basics: Why intervene?

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- For many economics is all about “market forces” or “supply and demand”
- For most markets that is all you need to know. End presentation.
- Market failure is economic rationale for intervention – not “failure of the market” – quite different, e.g. pollution
- Competition authorities rationale for intervention is based on exertion of significant market power
    - Grain farmer in Australia has positive margins but no pricing power – not a rationale for intervention

Back to Basics: Market definition

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- Vertical restraints cases are today heard before competition authorities and courts

- Market definition – determining who competes with whom for what and where – is crucial to calculating market shares but…

- Market shares do not necessarily imply (significant) market power
  - Some firms have no pricing power
  - Block Exemption market share thresholds are there to suggest that little reason for intervention in vertical contracts;
  - Differentiated products may mean market shares do not tell us a lot about market power

Back to Basics: Theory of harm

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- Proper use of economics involves identifying why one wishes to intervene – the theory of harm
- Harm is not the same as lack of freedom of action. Economic approach is about thinking about market impact of restrictions between (vertical and horizontal) parties
- It is not about whether online platforms can buy and sell brands. It is whether any restriction placed on an online platform has an appreciable impact on competition
- Before intervening start thinking about how a particular contract (restriction) impacts on competition

Making use of theory:
Restriction of Competition

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- Commission Block Exemption Guidelines lay out the principles:
  - Inter-brand competition
  - Intra-brand competition
- Can begin to get a hierarchy of competitive effects: inter versus intra; exclusive versus selective agreements etc.

Intra-brand competition: Service and quality issues

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- Potentially problematic without vertical restraints:
  - Retailers' service efforts insufficient
- Reasons:
  - Free rider problem (positive externality) when the returns of providing quality cannot be appropriated (pre-sale service)
- Externalities - single retailer: vertical externality; multiple retailers: horizontal externality
- Free rider problem if multiple manufacturers – lower pre-sale service
- Vertical agreement: balance of efficiencies and foreclosure

Inter- vs. intra-brand: Commission guidelines

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"*On a market where individual distributors distribute the brand(s) of only one supplier, a reduction of competition between the distributors of the same brand will lead to a reduction of* ***intra-brand*** *competition between these distributors, but may not have a negative effect on competition between distributors in general. In such a case, if* ***inter-brand*** *competition is fierce, it is unlikely that a reduction of* ***intra-brand*** *competition will have negative effects for consumers."* (Para 102)

"The market position of the supplier and its competitors is of major importance, as the loss of ***intra-brand*** *competition can only be problematic if* ***inter-brand*** *competition is limited."* (Para 153)

Selective distribution: Efficiencies

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- Removal of free-rider problem, creation of brand image
- Selective distribution efficiencies applicable to new products, complex products, products whose qualities are difficult to judge before consumption (‘experience’ products) after consumption (‘credence’ products)
- Distribution economies, increased retailer incentives, investment protection
  - Examples include: sports footwear, luxury goods (handbags, cosmetics, perfumes, watches, jewellery etc.)

Selective distribution:
Online

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- E-commerce - shaken SD out of its ‘comfort zone’
- SD schemes under attack for restricting online, especially price promoters
- Balance of brand preservation (SD) vs. general online benefits
- Overall equivalence of SD criteria for offline and online sales?

Recent competition authorities' actions

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- Germany:
  - Ban on online sales of scout satchels via eBay upheld by higher regional court of Berlin – subsequently the Court of Appeals of Berlin ruled in favour of the retailer (discount bricks and mortar stores were also selling same *discontinued* models of the bags)
  - FCO – Sennheiser (high quality headsets/headphones) restricted sales on Amazon *marketplace* (even though Amazon an approved seller). Case dropped once Sennheiser removed restrictions
  - FCO and courts recently made Adidas and Casio drop ban on online market places
- Is focus on intra-brand competition warranted?

RPM: approaches, cases, and efficiencies

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- Approaches: US (effects-based) vs. EU (formalistic) approaches. 2010 EU Guidelines – a move towards an effects-based approach and scope for efficiency defence

- Example cases: Leegin (US, creative leather products) and Sphinx (Poland, restaurant chain) – demonstrate use of the efficiency defence

- Efficiencies: some evidence for and against – but necessary to argue on a case by case basis

RPM:
good or bad?

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- A maximum price typically benefits consumers; can benefit producers if there is market power downstream (but: collusion?)
- A fixed or a minimum price can reduce competition or increase efficiency (or both)
- Reduced competition: typically requires markets prone to collusion and/or market power
- Efficiency: typically involves stimulating non-price (service) competition. Commission examples:
  - Introductory period for a new product
  - Coordinated short-term price campaign in a franchise system
  - Prevention of free-riding at the distribution level

Economics in practice:
the ‘as-efficient competitor’ (AEC) test

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- The AEC test is used to inform the assessment of whether or not, amongst others, a loyalty rebate is anti-competitive

- Conceptually, it is relatively straightforward; it involves a comparison of price with a measure of cost – long run average incremental cost (LRAIC) or average avoidable cost (AAC). However, applying the test in practice involves significant challenges – concepts such as LRAIC and AAC do not align easily with the categories in a from company’s accounts. Moreover, the test requires these cost concepts to be applied to specific products.

- The calculation of LRAIC or AAC can therefore be very time consuming and subject to significant margins of error.

Economics in practice: applying the AEC test

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- CEG commissioned to conduct an AEC test as part of an overall assessment of a rebate scheme for a “dominant” company
- Case specific data issues
- Conducted a ‘high level’ AEC test using company rather than product level revenues and costs
- The AEC test was ‘passed’ - simplified approach but used series of sensitivity tests.
- Since our conclusions proved to be robust, we were able to conclude that the AEC test had been’passed’ without conducting detailed or speculative analysis

Economics in practice:
the need for pragmatism

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- Competition policy needs to be based on a sound theoretical underpinning and its application requires the use of robust empirical evidence

- However, it is equally important for practitioners to take a pragmatic approach: where data limitations exist these need to be recognised – as, despite the use of ever more sophisticated quantitative tools – the reliability of any conclusion ultimately depends on the accuracy of the data on which it is based

- There is no point investing significant time inputs to develop detailed cost estimates (which may in fact only offer spurious accuracy) when there are readily available data that may be fit for purpose

Contact details

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