VERTICAL RESTRAINTS

NATIONAL TRAINING WORKSHOP ON COMPETITION POLICY AND LAW

MALAWI
29TH – 31ST AUGUST, 2007

PRESENTATION
BY
JAMES M. MUTISYA
MONOPOLIES AND PRICES COMMISSION, KENYA

1. VERTICAL RESTRAINTS

1.1 Introduction

Vertical restraints refers to restrictive agreements made between firms at different levels of the production/distribution process e.g. between a manufacturer and a wholesaler or a manufacturer and a retailer.

It is recognised that vertical restraints may have positive effect, e.g. by removing price distortions, optimizing investment levels and eliminating avoidable transaction costs, but may also have undesirable effect not only by foreclosing markets to new entrants but also by dampening competition between existing rivals through stifling inter-brand and/ or intra-brand competition. For example, exclusive dealing facilitates manufacturer investment in distribution activity, but it tends to raise manufacturer margins. In the same way, exclusive distribution (which grants retailers exclusivity within a geographic area or over a particular class of consumers or goods) allows retailers to plan on the basis of particular market, but tends to increase retailer margins. Trade offs of this nature are common and the challenge to competition authorities is determine the market conditions under which bad effects are likely to exceed the good ones , and vice versa. The market conditions include market power at one or both levels, nature of the agreement between successive levels, the extent of economic of scope in retailing and the existing degree of inter and intra-brand competition.

Due to the divergence of opinion on vertical restraints in some jurisdictions they are treated as per se offences while in others they are subjected to "rule of reason" approach. The per se treatment assumes that they are anti-competitive irrespective of the advantages they may have while the " rule of reason" assumes that vertical restraints may have some net public benefit, in which case they are said to be pro-competitive. In some countries they are viewed as efficiency enhancing and therefore they are rarely challenged.

This paper examines types of vertical restraints and how to deal with them.

1.2 Types of Vertical Restraints

There are various types of vertical restraints including Retail Price Maintenance (RPM), exclusive dealing, tying arrangements, exclusive territory or territorial market restrictions, quantity forcing, refusal to supply and service requirements.

1.2.1 Resale Price Maintenance

RPM or vertical price fixing is the practice in which the manufacturers seek to fix the minimum or maximum retail price of their products. The retail price may be imposed on the retailer by the manufacturer or it may be a joint agreement between the two on the prices to be charged.

RPM can be detrimental to consumers as it prevents them from negotiating discounts on the price of products/services. The other concern caused by RPM is that the differences in the retail costs of various retailers are not passed to the consumer in the form of different retail prices. As a result consumers do not enjoy lower prices as this practice effectively does away with intra brand competition. RPM may also facilitate collusion at the retail level. Owing to this RPM is treated as a per se prohibition in some jurisdictions.

On a positive note RMP encourages inter-brand competition, and helps overcome problems in the supply/distribution chain like free riding by retail price discounters and damaging competition between retailers located close to one another. It also assists in establishing optimal number and density of dealers and in capturing economies of scale and scope in distribution.

RPM works well in markets where there is adequate and effective competition as is the case in developed countries. However, in cases where markets are highly concentrated, as is the situation in developing countries, it may not be beneficial and therefore it should be treated as a per se offence.

1.2.2 Excusive Dealing

In exclusive dealing, the retailer enters into an agreement with the manufacturer or wholesaler not to stock competitor products. Franchise agreements contain agreements of this nature.

Exclusive dealing is considered necessary to maintain product image, reputation and also to assure product safety, quality and availability. It also affords manufacturers the opportunity to exercise control over their distribution chains for strategic reasons.

Exclusive dealing may also be anti-competitive especially if it has market foreclosure effect. This is likely to be the case if the manufacturer entering into exclusive dealing arrangements with his dealers has a dominant position in a particular market. The market foreclosure will correspond to the degree of market share that the dominant firm has thus heightening entry barriers in that market. This problem may be severe if the dominant firm has control over essential raw materials or facilities.

1.2.3 Tying Arrangements

Tie in sales occur when a firm or group of firms require buyers of their products to take other products which they would ordinarily not purchase. In the extreme case of full line forcing, a buyer is compelled to buy an entire product range in order to obtain the one or two that are really needed.

Suppliers may appoint exclusive dealers for their products and then insist that they stock the whole range, for example cosmetics. This affords the products effective advertising and saves customers the inconvenience of shopping around.

This practice allows a dominant firm to preserve or strengthen its market power by unfairly damaging its competitors business and foreclosing the markets to new firms. A classic example of a company that was accused of using tying arrangements to consolidate its market power is Microsoft Corporation. The Department of Justice claimed that the company was tying its web browser (Windows Internet Explorer) to its pc operating system where it had a monopoly. The effect would be to strengthen Microsoft's share of the web browser market and thus lessen competition in that market.

In Kenya, this problem of tie in sales is experienced in times of shortage especially that of sugar. Traders force buyers to buy sugar say with bread and milk.

1.2.4 Territorial Exclusivity

It occurs when a manufacturer assigns distributors exclusivity within a geographical area or over particular class of consumers or goods; e.g. newspaper distribution. In this arrangements distributor are not expected to operate outside allocated areas. The advantage with this arrangement is that retailers are able to plan on the basis of allocated sales territory. However, this may also allow retailers to exercise market power in their areas of operation.

1.2.5 Quantity Forcing

This happens when manufacturers/suppliers specify the minimum amount of goods that a distributor can buy. The manufacturer may also determine the number of orders to be received from a particular dealer.

1.2.6 Refusal to Supply

This is the case when a manufacturer limits the number of distributors of its products. It is legally in order for manufacturers to refuse to sell to dealers who are not credit worth or who do not meet its dealership standards.

Refusal to supply can be used by vertically integrated firms to fight off competition from smaller firms in the downstream market.

1.2.7 Service Requirements

In this case a franchisor imposes on a franchisee a specified level of pre- and post- sales service or promotional effort; e.g. motor vehicle distribution.

1.3 SANCTIONS

Sanctions are used to discourage anti-competitive behaviour by firms or punish them for engaging in practices that hurt consumer welfare by reducing competition.

Sanctions may apply in the following conditions: a) when there is violation of the law; b) failure to comply with decisions or orders of the appropriate authority; c) refusal to furnish information or supply documents within specified time limits; d) wilfully supplying false information or making untrue statement.

Possible sanction for violating competition rules include fines, jail terms, interim orders or injunctions, cease and desist orders or orders to remedy, divesture and restitution to injured consumer/s.

In Kenya, sanctions include consent agreement, ministerial order, and compensation to injured person not necessarily monetary, fines and prison terms. The maximum fine for restrictive trade practices under the Restrictive Trade Practices, Monopolies and Price Control Act (the Act) is Kshs 100,000 (US$1,428) and or imprisonment of up two years. The fine provided for in the Act is low and therefore is unlikely to deter anti-competitive behaviour among firms given that prison sentences are rarely meted out to offenders.