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COMPETITION POLICY: VERTICAL MERGERS AND VERTICAL CONTRACTUAL RESTRAINTS OF TRADE

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INTRODUCTION

In recent years, the legal status of contractual restraints of trade between manufacturers and distributors has been a centre of controversy. On one side of the debate are economists, who espouse these practices, and on the other side are lawyers, who regard them as being in contempt of competitive motivations. To most economists who have studied organizational institutions, a vertical contractual restraint of trade is often considered to be a contractual equivalent of a vertical merger of two firms, and the fact that it is accorded more hostile legal treatment is found to be disturbing and inconsistent with the relevant economic facts.

In this debate, the lawyers cling to the concept of the right of alienation, which has its origins in early property law, and to a market foreclosure doctrine that regards these restraints as contrary to the spirit of competition. On the other hand, the economists embrace the concept of freedom to contract, and cite the benign motivations of contractual parties that attempt to reduce both transaction and agency costs associated with vertical exchange.(1)

These positions are solidly entrenched, and will likely not come together for some time to come. But a rapprochement is inevitable. The legal status of vertical restraints of trade is best understood in a

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(1) Transaction costs are defined generally as resource expenditures consumed in the process of allocation. More specific detail is provided later in this paper. Agency costs are defined as resource expenditures incurred by both the principal(s) and agent(s) in trying to reduce to zero any divergence of interest between the parties in a principal-agent relationship; most notable are monitoring costs made by the principal and bonding costs made by the agent.

historical context, and history is replete with evidence that suggests that competition law gravitates towards conventional wisdom - albeit slowly.

At its inception, Crown law held middlemen activities to be pernicious to competition, but further study suggests these strategies were designed to circumvent the pervasive regulations established by guild associations. Their illegal status merely reflected the interests of these guilds, which suggests that the guilds possessed superior influence over the Sovereign. Whether or not these activities responded to the interests of the populace of the time remains open to debate. Later, common law held these activities and the restrictive covenants that sometimes accompanied them to be superior methods of trade which promoted wider distribution. This change reflected the growing popularity of liberalism. More recent common law has scrutinized these vertical restraints more carefully, categorizing resale price maintenance (RPM) as *per se* illegal, while vertical mergers, exclusive dealing, exclusive territories and tying arrangements are subject to a rule of reason.

All Western industrialized countries have enacted policies against restraint of trade. In particular, the Anglo-Saxon tradition attempts to preserve the principles of equity and economic welfare as its primary objectives. Not surprisingly, both economic and legal advisers agree with the priority assigned to these concerns; their conflict has to do with, among other things, the conditions required to challenge vertical contractual control measures. Economists feel that the courts are too quick in their condemnation and prosecution, and that more study is required of the comparative benefits and costs of "pure" market exchanges and those of their contractually-constrained counterparts. Such investigations usually cast doubt on the ability of a purely price-mediated market exchange to maximize economic welfare. Hybrid forms of exchange, incorporating both command and market features, are often superior in vertically-related circumstances.

The purpose of this paper is to go beyond simple price theory to find competitively-motivated explanations in the economics literature for the use of vertical mergers and contractual restraints. This inquiry will identify features that distinguish these cases from anti-competitive ones, and that can thus be used to help the courts in its

task of regulating trade and commerce. The findings should be viewed as complementary to the existing criteria for determining the competitive effects of restrictive covenants, and, it is hoped, will produce more common ground between the two sides on this debate.

HISTORY OF COMPETITION POLICY AND ITS OBJECTIVES

To appreciate this debate, some information on Anglo-Saxon economic history is useful. The evolution of restraint of trade can be divided into three distinct periods: the mercantilist era -- when the medieval regulation of labour and commerce was rampant; the *laissez-faire* era -- when liberalism and free markets were in vogue; and the modern era -- when legislators became active once again. Very approximate dates are provided to demarcate these eras.

A. The Mercantilist Era (1500-1800) - The Medieval Tradition

In medieval times almost all facets of life were regulated either by the church or state. In particular, the medieval guild system enshrined codes of behaviour that restricted competition among suppliers of the same trade by establishing prerequisite training periods for entrants, grading members as apprentices, journeymen or master tradesmen, and regulating labour mobility, outside contracting provisions, post-employment competition, wage scales and prices.

As the secular authority of the church declined throughout the latter part of the medieval period, hastened by Henry VIII's creation of the Anglican church, the English Crown pursued policies of military and economic aggrandizement. Elizabeth I reinforced the guild practices with the enactment of the *Statute of Artificers* (1563), which detailed the enforcement duties of local justices of the peace, aldermen and local administrators. Also, the *Poor Relief Act* (1601) guaranteed a minimum income which was to be paid by the local community to unemployed trade workers. At the national level, monopoly rights given to the favourites and supporters of the Sovereign included those over gunpowder, salt, paper and mineral industries.

Parliament soon began to challenge these special interest privileges in the courts. Common law, as early as 1602 in the case of *Darcy* v. *Allen,* decided that some restrictive covenants violated a basic right of equity. With further conviction, Parliament codified these judgments with the enactment of the *Statute of Monopolies* (1623). This statute effectively abolished royal grants of monopoly, but preserved limited-term patents, customary monopolies of guilds, towns and chartered companies, and new monopolies awarded by Parliament. The first anti-combines legislation was not based entirely on the principles of equity and economic welfare, but in part on the jealousy of Parliament.

In the important common law cases to follow, distinctions were made between voluntary general and voluntary specific restrictions. A general restriction was one that extended throughout the kingdom or indefinitely in time. Specific restrictions were much more limited and often dealt with protection from competition on the sale of a business. The purchaser wanted a guarantee that the seller would not start up a competing firm for a specified period of time after the sale. In *Mitchel* v. *Reynolds* (1711), where Parker C.J. upheld a restraint on the sale of a business, legal distinctions between restraint types were made clear:

> General restraints are all void, whether by bond, covenant or promise, with or without consideration and whether it be of the party's own trade or not. ... Particular constraints ... without consideration are all void by whatever sort of contract created. ... Where a contract for restraint of trade appears to be made upon a good and adequate consideration, so as to make it a proper and useful contract, it is good.(2)

B. The *Laissez-Faire* Era (1800-1890) - The Liberal Tradition

Ultimately, Parliament prevailed over the Sovereign for the right to provide legislation to the Commons. But in the course of the struggle, the enforceability of a sustained monopoly privilege became

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(2) M. J. Trebilcock, "Restrictive Covenants in the Sale of a Business: An Economic Perspective," *International Review of Law and Economics,* Vol. 4, No. 2, December 1984, p. 139.

uncertain and, in turn, the shared profits of monopolists and government waned. Under the democratic decision-making process of Parliament, the costs of lobbying by would-be monopolists increased dramatically; without the parliamentary bureaucracy required to administer and enforce these privileges, government revenue-seeking began to shift away from the proceeds of granting monopolies towards commodity taxes and, later, income taxes.

The Industrial Revolution that began in the latter half of the eighteenth century can be distinguished from earlier periods by its new, mass-production technology and its large urban labour force. The period's unprecedented growth of industrial output and demographic changes brought new social, economic and political philosophies. Born in this upheaval was liberalism - a philosophy that maintained moral and political freedom as a social imperative. The notions of "unrestrained competition" and "free trade" as espoused by Adam Smith and David Ricardo would become the means for enhancing moral and political freedom, as well as the economic wealth of the nation. Moreover, the proponents of this philosophy clearly recognized the financial implications for the community of the Poor Relief Laws in the wake of mass-migration to urban centres.

Liberalism carried over to the courts as well. The *laissez-faire* era marked a significant change in the courts' attitude towards restrictive covenants. Conventional thinking now held the right of one's freedom to contract above that of any adequacy of consideration test applied in earlier court decisions. Jessel M.R., in *Printing and Numerical Registering Co.* v. *Sampson* (1875), proclaimed:

> If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by the courts of justice. Therefore you have this paramount public policy to consider in that you are not lightly to interfere with this freedom of contract.(3)

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(3) M. J. Trebilcock, *The Common Law of Restraint of Trade - A Legal and Economic Analysis,* The Carswell Company Limited, Toronto, 1986, p. 18.

This logic was also typical of the few vertical contractual restraint cases that appeared about that time. Exclusive dealing practices (where one party to an agreement requires the other to handle its merchandise exclusively) were few, and usually involved railroads that required right of way services. The courts upheld these restraints, and knew full well that the practice was an alternative to vertical integration since many railroads integrated forward into these services themselves.

The early cases of a tying arrangement (where one product could be obtained only with the purchase of a second, different product) involved the practice of "full-line forcing." Ale houses were leased or sold by brewers with the stipulation that the lessee or purchaser buy all his beer from that brewery. In *Catt* v. *Tourle* (1869) this practice was upheld, despite the recognition that it "restricted the publicans in their choice of brewers."(4)

Finally, RPM (where the manufacturer sets both its own and the retailer's price of a product) was practised and upheld by the court at about this time; but it appears that exclusive territory arrangements were not challenged in the courts until well into the twentieth century.

C. The Modern Era (Post 1890) - The Consumer Interest Tradition

One of the most important institutional developments of the nineteenth century was the aggrandizement of private capital in the form of the joint-stock company, from which grew the modern corporation. This organizational form benefited from limitations on personal liability and ease of ownership divisibility and transferability which fostered large-scale operation. However, towards the end of the nineteenth century, the virtues of free competition, in face of increasing corporate scale and concentration, began to fade in the minds of the public. Pressure mounted for the legislative regulation of corporations.

In 1889, Canada adopted its first anti-combines legislation; this made illegal the activities of corporations that conspire, combine or

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(4) J. E. Fortenberry, "A History of the Antitrust Law of Vertical Practices," in *Research in Law and Economics,* JAI Press Inc., Greenwich, Conn., Vol. II, notes 141 and 155, p. 206 and 208.

agree to lessen competition unduly. Canada's lead was followed in the next year by the United States with the *Sherman Act,* and before the end of the century by Australia and New Zealand. In England, legislation took the form of the *Monopolies and Restrictive Practices Act* of 1948.

The proponents of the anti-combines law knew that some combines were not harmful to competition, but that action was required to protect consumers and small business:

> ... certain combinations of persons engaged in the same lines of trade and business are necessary and proper ... [but some combines] not only ... regulate the prices at which the manufacturers shall sell, but also the prices at which the dealers are bound to sell.(5)

> ... there is necessity in my judgment for intervention to protect the consumers of the country. We have seen in the last few years gigantic institutions and corporations forming combinations to enhance the cost of the necessaries of life, and I see very little distinction between what is called in the criminal law, larceny, and the result of an arrangement which obliges the unfortunate consumer to transfer from his pocket to that of the wealthy producer an unnecessary amount of money in order that he may maintain life.(6)

From these statements we can infer that the equity principle had been rejuvenated in decisions of restraint of trade. Mercantilist competition law was motivated in the interests of preserving the individual's right to work and decided on the basis of adequacy of consideration. Contemporary law, however, maintains one's freedom to contract as was established in the *laissez-faire* era, but refutes contracts on the basis of inequality of bargaining power.

The principle of economic welfare has also been expanded from the mercantilist era. Modern common law better understands the trade-offs between allocative, production and dynamic efficiencies. As in

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(5) Wallace, *House of Commons Debates,* 29 February 1888, p. 28, in P.K. Gorecki and W. J. Stanbury, *The Objectives of Canadian Competition Policy 1888-1983,* The Institute for Research on Public Policy, Montreal, 1984, p. 15.

(6) Mulock, *House of Commons Debates,* 22 April 1889, p. 1440, *Ibid.,* p. 17.

the mercantilist era, the law gives priority to the economic benefits of time-limited patents over the social costs of monopoly. Contemporary law, however, recognizes the social benefits of economies of scale in production (probably not very apparent in the mercantilist era) and other possible economic benefits associated with horizontal and vertical mergers.

In 1986, Canada reformed its competition statute with the enactment of the *Competition Act* and the *Competition Tribunal Act.* Under these Acts, adjudication of mergers and abuse of dominant position are conducted under civil rather than criminal law. Civil law affords an interpretation of whether competition is lessened substantially "on the balance of probabilities" rather than "beyond a reasonable doubt." The reduced burden of proof improves the effectiveness of successfully challenging a merger. When combined with the added powers bestowed upon the Director of Investigation and Research (Director) to apply to the Competition Tribunal for a consent order and to issue advance ruling certificates, the focus of reviewable trade practices shifts from litigation to negotiation. In effect, the *Competition Act* empowers the Director to regulate trade and commerce.

It is interesting to note that while the possible inequity considerations of RPM were recognized, the practice was not made illegal in Canada until 1952. Subsequent legal treatment, including section 61 of the *Competition Act,* does not consider any possible distributional efficiencies that might arise from the vertical restraint. RPM is *prima facie* illegal. An exception is made when the dealer uses the manufacturer's product as a loss-leader for promotional purposes (sells the product at a loss to induce sales of other products).

Vertical mergers are reviewable, non-criminal practices (section 92 of the Act), whose legal status is to be determined on the balance of probabilities of factors that include: whether vertical integration is so extensive that potential entrants must enter at both manufacturing (upstream) and retailing (downstream) levels -- the so-called market foreclosure argument; the extent of any barriers preventing new competition from entering the market; the likelihood that one of the merging firms will fail in the absence of the merger; the amount of foreign competition; any efficiency gains; and other relevant factors.

Tying arrangements are covered under section 77 and, like the practices of exclusive dealing and market restriction, are prohibited where they would result in a substantial lessening of competition, including market foreclosure. An exception is made for the use of exclusive dealing and market restriction when they are engaged in for a reasonable period of time to facilitate entry of a new supplier or product into the market. Tied selling is allowed when there is a technological relationship between products, such as between computer hardware and software, or when it is engaged in by a person in the business of lending money to secure loans.

ECONOMIC THEORIES OF VERTICAL INTEGRATION

Vertical integration, by definition, replaces a market exchange by an internal transfer. The allocation process of both types of exchange is governed at the aggregate level by demand and supply conditions. However, vertically-integrated trade tends to dominate market trade in which there are significant transaction costs. Generally, transaction costs refer to resource expenditures consumed in the process of allocation. They are costs-related, directly, to the degree of uncertainty implied in lengthy and complex contracts that may promote inequity through pre-commitment and so increase the costs of non-performance to either party. Transaction costs are costs-related inversely with the decline in number of potential trading parties that may come about with the renewal of existing contracts where there are firm-specific investments in capital or learning-by-doing benefits.

Both situations lend themselves to opportunistic behaviour that can be better controlled by the firm than by contract law. This is because of the firm's rights of ownership over the joint residual profits generated by the assets in question and because more discretion is given to an employer to control unspecified individual actions within an employer-employee relationship than is given to a contractor.

Vertical integration may also yield cost savings by facilitating the flow of information between vertically-related markets, by

avoiding price distortions due to monopoly power in vertically-related markets, by increasing the amount of point-of-sales information provided to customers, and by shifting risks to or away from the acquiring firm in a merger. However, vertical integration can have anti-competitive effects by raising entry barriers or facilitating oligopolistic collusion.

A. Competitive Motivations

Automotive companies, such as General Motors and Ford, will vertically integrate backward into the production of automotive component parts when their manufacturing processes, broadly defined, generate specialized, non-patentable expertise and when there would be significant costs associated with switching suppliers. In such cases, the assembler is exposed to the possibility of opportunistic recontracting because the supplier could obtain a first-mover advantage over otherwise potential rivals from cooperative pre-production development with the automotive company. Thus, automotive component parts that require extensive engineering design will generally be manufactured in-house, while other parts are obtained from independent suppliers.

Iron ore producers mine and beneficiate ores that are contained in parent rocks with varying depositional characteristics. Variable rock consolidation, overburden-to-ore ratios and ore grades contained in the host rock will produce variable ore mining and beneficiation costs. These random conditions will likely vary by mine as well as within an open pit, and are often better predicted by the resource extraction firm than the downstream product manufacturer. Consequently, an independent steel company that buys iron ore under long-term, take-or-pay contracts will experience considerable variation in its iron input cost, and subsequently its steel ingot cost. A vertically-integrated steel company, on the other hand, effectively acquires better predictive information beforehand. Subsequently it can mitigate variable iron unit costs by substituting steel scrap in its steel furnace for iron units obtained from the reduction of iron ore, thereby lowering the costs of producing steel ingots.

The Aluminum Company of America in the first half of this century had significant monopolistic power in the production and sale of

aluminum ingots and milled products in the United States. The company chose to integrate forward into the production of aluminum cookware utensils with its acquisition of Aluminum Cooking Utensils Company and Aluminum Goods Manufacturing Company, whose trademark names were Wear-Ever and Mirro respectively. These acquisitions prevented the two cookware manufacturers, which controlled about 75% of cookware sales before World War II, from substituting cast iron, stainless steel, copper and copper clad stainless steel for aluminum in the production of a skillet, and from substituting glass, ceramics, enamel and tinware for aluminum in the production of pots. In such cases, vertical integration provides a production efficiency to the firm by prohibiting the substitution of competitively-priced inputs for the monopolistically-priced input.

Retailers provide an array of services to their customers, some of which are product specific. These might include technical information about the product, such as performance attributes of an automobile, high-fidelity acoustic attributes of various stereo components, and so on. These services can have an appreciable affect on the demand for the manufacturer's product. Other services are not product specific. They include convenient hours of operation, location, parking, credit card services, and the like. Their impact may be marginal at best. Vertical integration can ensure that an adequate amount of these product-specific services are provided by all retail outlets. Otherwise, discount stores might attempt to lure away clients of full service stores by offering lower prices, and whenever such free-riding is successful, the provision of product-specific services is likely to be unprofitable.

Vertical integration allows risk to be borne by the firm that has the least aversion to risk. Where two vertically-related firms value risk differently, their merger provides a hybrid form of insurance and lowers the overall cost of capital.

B. Anti-Competitive Motivations

Vertical integration can raise entry barriers that can successfully block entry of potential competitors. An entry barrier is created when technological or economic conditions raise the cost to

potential entrant firms above that of incumbent firms such that it is unprofitable for the potential competitor to enter the market while incumbent firms are profitable. Vertical integration, in circumstances where a potential competitor must enter at both levels of production, at one of which there is market power, can raise entry barriers when there are: (a) differential rates of efficiency; (b) differential minimum efficient scales; (c) capital market problems; or (d) product differentiation problems.

Vertical integration may facilitate collusion by oligopolistic firms that attempt to instill market discipline and price squeezes or exclude potential rivals. For example, if there is market power at the production stage and there are increasing numbers of firms at the wholesale and retail levels, then a product manufacturer that is party to a collusive agreement can integrate forward to the wholesale stage and thus better detect cheaters and discounters. The fewer the number at the wholesale stage, the greater the risk of detection and the more likely it is that a collusive agreement will survive.

C. Contractual Alternatives and Economic Welfare

The reasons for failure of the market to provide the proper incentive structures, information channels or cost control measures that give rise to some vertical integration situations are not always readily apparent. Some contractual restraint practices can achieve the same efficiencies. For example: consignment sales can shift market risk from downstream sellers to upstream producers; long-term quantity-contingent contracts can mitigate variable input costs; tying arrangements can control to some degree downstream manufacturers' use of a substitute for a monopolized input; RPM, coupled with a policy of refusing to deal with discount retailers, can reward full-service retailers for their point-of-sales services.

These contractual alternatives do not suffer from the managerial dis-economies of scale that arise with internal transfer arrangements. They also stop the firm from incurring increased capital costs by borrowing capital offered at interest rates that rise with the size of the borrowings.

Finally, there is an important caveat concerning the social welfare implications of vertical integration. While the welfare effects of the preceding anti-competitive motivations are obviously negative, not all competitively-motivated restraint practices are positive. The competitive motivations of facilitating the flow of information to reduce uncertainty and the shifting of market risk vertically improve social welfare. On the other hand, when the motivation for vertical integration is to increase point-of-sales services, consumers to whom the added informational service may be worthless, and those who shop more intensively before buying, may be adversely affected. Their losses may outweigh the benefits of others. Similarly, when an input monopolist integrates forward to prevent a competitive downstream sector from substituting for its input, the adverse effects of monopolization of the sector on the price of the downstream product may outweigh gains in production efficiency.

ECONOMIC THEORIES OF VERTICAL CONTRACTUAL CONTROL

A. Resale Price Maintenance (RPM)

The practice of RPM can have both competitive and anti-competitive effects. Its motivation may be to increase the quantities of point-of-sales services, to induce retailers to carry out activities that protect the quality of brand-name products, to coordinate collusive agreements of oligopolistic manufacturers, or to coordinate a retailer cartel's attempt to fix prices and restrict entry.

When the demand for a good is positively correlated with the amount of product-specific promotion or point-of-sales information provided by retailers, RPM can protect the retail margins of full-service retailers from discount retailers who would attempt to attract these newly-informed consumers with low prices. Without this protection, full-service stores might vanish and sales plummet. These conditions are often thought to exist for goods with a high degree of complexity and for new products or existing products with new features - such as automobiles, boats, snowmobiles and stereos.

When a product, such as beer, has a limited shelf life, RPM can induce retailers to undertake costly activities, such as stock rotation, to preserve the quality of the product. Because this activity is unseen by the consumer, and thus cannot be monitored, a manufacturer's policy to refuse to supply will succeed with retailers who would otherwise attempt to degrade the brand-name quality established by the brewer. Therefore, RPM and refusal-to-supply policies prohibit retailers from free-riding the brand-name quality of perishable products. This logic can easily be extended to include non-perishable products, provided that the retailer's activities to preserve brand-name quality can be monitored better by manufacturers than by consumers.

Finally, RPM can help a retailer cartel coordinate a price-fixing agreement when there are sunk entry costs at the retailer level. An RPM strategy can also assist in the preservation of a manufacturers' cartel by facilitating monitoring of cartel members. This might enable the conspirators to detect cheaters from within the cartel, and thus sustain an agreement that might otherwise be unsustainable.

B. Exclusive Dealing

Exclusive dealing contracts may be an efficient mechanism for protecting the profitability of investments made by manufacturers to enhance the demand for their products. For example, exclusive dealing prohibits insurance agents from offering cheaper, unadvertised insurance policies of other insurance companies to clients who have contacted the agent as a result of the advertising campaign financed by the original insurance company. Also, a fashion designer will sell retailers many fashion lines, only a few of which will be successful. Exclusive dealing agreements can protect the profitability of clothes designers when some retailers are likely to free-ride their fashion suppliers by holding copycat merchandise that sells more cheaply.

In contrast, exclusive dealing can foreclose a retail market to a competitive manufacturer. This can be accomplished if there are two types of consumers - one who values the incumbent's product at a premium and one that values the incumbent's products and those of entrant firms as

perfect substitutes and when there are economies of scope at the retail level.(7) Exclusive dealing can, therefore, raise the limit price that forecloses entry of the second manufacturer, because the scope economies of retailers go unrealized. The greater demand for the incumbent's product will sustain these additional costs, but not the entrant's.

C. Tying Arrangements

Tied selling or leasing when there is a complementary relationship between products (such as that between computers and punchcards), and when consumers place different values on the tying good (computer) that are positively correlated with the quantity used of the tied good (punchcards), permits the manufacturer to make more profit from various consumers, depending on their use of the product. By setting a price of the tying good equal to its cost of production and pricing the tied good above its cost of production, the manufacturer can earn differing levels of profit, based on tied good usage, on total sales to each consumer.

When two or more films are viewed as substitutes by consumers, and are sold in a bundle to movie theatre companies, a subtle form of price discrimination between theatre companies can be achieved by the film distributor. Provided that the values the theatre company assigns to these films are inversely correlated with one another, bundling the films is likely to attract a greater number of buyers. Thus, by exploiting the cross-price elasticities of two or more films, a distributor can earn greater profit from bundling films than from pricing and selling them separately.

Where consumers value two somewhat related products or services differently, such as audit and managerial advisory services, but where these values are positively correlated with one another, the strategic bundling of the two services can have anti-competitive effects.

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(7) Economies of scope are defined as factors that make it cheaper to produce a range of related products than to produce any of the individual products on their own. Economies of scope at the retail level provide a base for product diversification.

If large, oligopolistic accounting firms tie their auditing services to their managerial advisory services, they can price the bundle at a relatively high price and sell only to those consumers who place a high value on both services. Smaller, more competitively organized auditing firms are then left to split the remaining market, which is highly populated with consumers who place little value on their services. This market separation technique may very well lead some firms to leave the market or possibly bar entry to potential auditing firms.

D. Exclusive Territories

Territorial restrictions involve assigning consumers in certain geographic areas to specified retailers. In general, this in itself is not considered to lead to monopoly power but may be used as an efficient means of capturing monopoly profits for a manufacturers' cartel when transportation costs are significant.

Territorial restrictions can have competitive effects as well. They may be used to better secure the profits of a retailer who has incurred sunk costs in the establishment of services related to the manufacturer's product. In this case, territorial restrictions prevent the manufacturer from later establishing a retail outlet nearby that could free-ride the brand-name capital that the retailer had helped build.

ECONOMIC ANALYSIS OF VERTICAL MERGERS AND CONTRACTUAL RESTRAINTS LAW

From the preceding analysis, it would appear that the courts should apply a rule of reason when considering the competitive effects of vertical mergers and their contractual equivalents. But such a conclusion would be premature. A rule of reason entails considerable costs relating to the uncertainty about the adjudicative competence of courts and tribunals, and to the length of proceedings. Thus contesting parties are subjected to more costs than would be caused by a *per se* legal or a *per se* illegal rule. Consequently, a conclusive assessment of the appropriate legal status of vertical mergers and vertical contractual restraints can be

made only when theoretical grounds are complemented by exhaustive analyses of case studies.

Obviously, both *per se* rules and rules of reason are subject to error. But when competent jurisprudence carefully weighs opposing economic theories and evidence, a prudently-crafted competition law should be able to minimize the magnitudes of such errors. When it cannot, complementary approaches, such as fiscal policies promoting industry entry, regulation, public ownership, or a free trade policy, should be considered.

On this last point, there has been much debate on the effectiveness of the country's *Competition Act,* particularly as it concerns mergers. Here, the facts are straightforward. Since the adoption of the *Combines Investigation Act* in 1910, there has not been one successful conviction in eight contested merger cases. In one case, the defendants pleaded guilty. In another, a prohibition order was obtained that prevented the acquiring firm from obtaining an interest in one of its rivals. The obvious weakness of the merger provisions of Canada's second competition legislation is probably the dominant reason why only eight merger cases were brought to court in 75 years.

These few contested cases stand in stark contrast to the number of mergers. For example, in 1960 there were over 203 reported mergers, while in 1985 there were 712. In the 1960s, the annual number of mergers averaged 253; in the 1970s it averaged 382, and finally, in the first six years of the 1980s it averaged 577.(8)

These grim prospects for contesting a merger have a significant bearing on the effectiveness of the Act in curtailing anti-competitive vertical contractual restraints. Clearly, when transaction costs are not prohibitive and when the business community does not fear the consequence of a legal inquiry into a merger, manufacturing firms will choose to merge with their suppliers and/or distributors to avoid the more punitive repercussions of the Act as it pertains to vertical contractual restraints. In effect, the business community, in its continuing quest for greater profit,

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(8) Director of Investigation and Research, *Annual Report 1989,* Consumer and Corporate Affairs Canada, p. 47.

will change its preferred practices in order to circumvent the stronger provisions of the Act.

This also suggests that court cases that deal with RPM, exclusive dealing, tied selling and restrictive territories will most probably be few, and may also be mostly competitively motivated and not deserving of inquiry. Only when transaction costs are high will anti-competitive cases arise in this context. Given weak merger provisions, a *per se* legal status of vertical contractual restraints begins to look appealing.

Reform of Canada's original competition law and its amendments was debated for more than three decades before the new law came into effect in 1986. At this time, five years after the adoption of the *Competition Act,* it is appropriate to evaluate the Act on normative and positive economic grounds.

An overview of the Bureau of Competition Policy's record in dealing with vertical contractual constraints will follow. Also, five contractual restraint cases will be discussed: one dealing with exclusive dealing, two with tied selling, and two with RPM. Three of them were conducted under the *Competition Act* of 1986.

Excluding RPM, these cases represent a substantial portion of the jurisprudence on vertical contractual restraints in Canada. There have been in all only three Canadian cases of exclusive dealing. In addition to the one studied here, there was an inquiry into the oil industry that involved many anti-competitive charges beyond the scope of this study, and there was a case against Bombardier Ltd. which the Director lost on grounds of ease of entry at the retail level. One recent notable case of tied selling involving Chrysler Canada (1988) is not studied here but is similar, both in terms of the issues raised and the decision taken, to the Xerox case, which is reviewed below. Restrictive territories practices on their own have not played any significant role in Canadian competition law.

On the other hand, there are numerous cases dealing with RPM and Refusal to Deal on the grounds of not complying with an RPM practice. There were 83 convictions of 108 RPM cases brought to trial between 1952

and 1983.(9) Between 1986 and 1989, there were 24 convictions out of 47 cases decided.

A. The Bureau of Competition Policy and Vertical Mergers

The merger provisions of the new *Competition Act* better reflect Parliament's original concerns about combines. Inherently, mergers are neither good nor bad. Their adjudication is now conducted under the civil jurisdiction of the Competition Tribunal, which considers their likely impact on competition. The Tribunal has a myriad of remedies to choose from when considering a potentially harmful merger; these include divestiture of assets and shares, modification of the proposed merger, or an outright prohibition of the merger.

In March 1991, the Director released Canada's Merger Enforcement Guidelines. In terms of vertical mergers, the guidelines indicate that concerns about competition will be raised in two circumstances: (a) when a vertical merger would eliminate an independent upstream source of supply or downstream distribution outlet and leave only a small amount of unintegrated capacity at either of the stages at which the acquirer or the acquiree operates; and (b) when upstream interdependence is facilitated by forward integration into retail.

In the first circumstance, the Director is concerned about a merger that would be likely to increase barriers to entry. In general, this happens when the small percentage of unintegrated capacity at one stage makes it necessary for a potential competitor at one stage to enter at an other stage as well. Where such simultaneous entry would involve greater sunk costs than entry to one market alone, barriers to entry may be raised. From an operational point of view, for the Director to let a merger proceed, he or she must be satisfied that: (a) the resulting need to enter the secondary market simultaneously would not render unlikely entry into the primary market on a scale sufficient to eliminate a material price increase within two years; and (b) the exercise of market power in

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(9) Gorecki and Stanbury (1984), Appendix B, Table 4B, p. 213.

the primary market is not likely to be facilitated by the merger in the absence of such entry.

In the second circumstance, the Director is concerned about a merger that results in, or increases, an existing high degree of vertical integration between an upstream market and a downstream retail market whereby firms in the upstream market can more easily monitor rivals' prices at that level and thus act more interdependently. From an operational point of view, the Director is to consider the merger benign to competition unless: (a) the prices at which transactions are actually made at the retail level are more visible than prices at which upstream transactions are actually made; (b) conditions in the upstream market are otherwise conducive to the interdependent exercise of market power; and (c) the percentage of upstream output that is sold through unintegrated firms is so low that post-merger sales to firms on concealable terms would not likely result in preventing a material price increase from being imposed and maintained for two years.

When any of these circumstances exist, the inquiry will expand to consider factors such as market shares or concentration, the existence of foreign competition, the likelihood of business failure, the availability of substitutes, barriers to entry, the effective remaining competition, and, probably the most important, efficiency gains.

Table 1 illustrates the pronounced increase in the activity level and effectiveness of the *Competition Act* compared to its predecessor Act. Taking the year 1989 as an example, the Bureau of Competition Policy investigated about 18% of reported mergers, of which 90% of of those concluded were determined to pose no threat to competition under the Act. The Bureau of Competition Policy restructured four of these mergers, referred another four to the Tribunal and continues to monitor 10. Another two mergers were abandoned by the proponents as a result of the position taken by the Director. Since the Act came into force, the Director has thwarted seven mergers and restructured eight others. Thus far, the Director has had an impact on 3% of the 710 mergers investigated and concluded, and continues to have an impact on another 6% of these cases through its ability to monitor post-merger developments.

TABLE 1

MERGER ACTIVITY UNDER THE *COMPETITION ACT*
STATISTICAL SUMMARY

	1986-87[1]	1987-88	1988-89	1989-90	1990-91[2]
Reported Mergers[3]	938	1,082	1,053	1,091	n.a.
Examinations Commenced[4]	40	146	191	219	144
Examinations Concluded:					
- Posed No Issue Under Act	17	120	166	204	134
- Monitoring Only	5	7	10	13	10
- Pre-Closing Restructuring	-	2	1	-	-
- Post-Closing Restructuring	1	2	3	1	-
- Consent Order	-	-	-	3	-
- Parties Abandoned Merger	3	2	2	2	2
- Examinations Concluded	26	133	182	223	146
- Examinations Ongoing	14	25	32	31	40
Applications Before Tribunal					
- Concluded[5]	1	-	2	3	-
- Ongoing	-	2	2	1	2
- Intent to File	-	-	2	-	-

[1] period beginning June 19, 1986;

[2] period ending December 20, 1990;

[3] published reports of acquisitions that appear in financial and daily press and trade publications in the calender year;

[4] more than two days review;

[5] included in examinations concluded.

Source: *Canadian Competition Policy Record,* Vol. 11, No. 4, December 1990, p. 10.

A review of the mergers currently being monitored by the Bureau of Competition Policy or those that were either restructured or abandoned makes it apparent that they were all horizontal mergers, so that the Director would seem to have had no direct impact on vertical mergers.

According to the Director's annual reports since 1986, the Director mentioned only one vertical merger. This involved the acquisition of Gormley Aggregates Limited (GAL) by Lake Ontario Cement Limited (LOCL). LOCL operates a cement plant in Picton, Ontario, and numerous ready-mix concrete-related construction products facilities in the major population centres of Ontario. LOCL also operates a major construction aggregates facility in Wingham, Ontario, and holds a minority position in United Aggregates Limited near Brampton, Ontario. The target company, GAL, operates a number of stone quarries and sand and gravel aggregate pits located northeast of Toronto, Ontario.

The Director concluded that there was no evidence to suggest that LOCL was likely to withhold aggregate from independent concrete producers. The Director was also satisfied that a new entrant into the Ontario cement market would not have to integrate into aggregate production in order to compete with its incumbent cement producers. Therefore, the Director allowed the merger to proceed as planned.

Because reported mergers do not indicate whether a merger is horizontal or vertical, the Director's vigilance in preserving and enhancing competition when it comes to vertical mergers cannot be established. But one inference is possible. The new Act is a better tool to regulate commerce, particularly with regard to mergers. The powers given to the Director and the subsequent jurisprudence indicate that the *Competition Act* has corrected the previously noted deficiency of its predecessor and that, consequently, the Director does indirectly influence vertical merger behaviour.

The *Combines Investigation Act* of 1910 provided the business community the opportunity to circumvent the provisions dealing with vertical restraint covenants. Because of the changes introduced with the *Competition Act,* vertical contractual restraint cases are likely to be more prevalent, with the bulk of the increase being anti-competitive cases. The

only question remaining is: does the Bureau of Competition Policy have the necessary resources, and has it put into place effective enforcement procedures to deal with the increased workload?

B. *The Director of Investigation and Research* v. *The NutraSweet Company* (1991)

The Director filed a notice of application under sections 79 (abuse of dominant position) and 77 (exclusive dealing and tied selling) of the *Competition Act* to prohibit The NutraSweet Company (NutraSweet) from using certain business practices alleged to be contrary to these sections. The business practice discussed in this paper is exclusive dealing.

NutraSweet is a major producer of the high-intensity sweetener aspartame, which is marketed under the brand-name of NutraSweet. The company operates two plants in the United States with a combined annual capacity of 5,400 tonnes, and also obtains supplies from two other manufacturers to bridge the shortfall of its capacity to sales until its third plant comes on-stream in 1992. NutraSweet's Canadian and United Kingdom patents expired in 1987, but are not due to expire in the United States and Australia until late 1992.

Aspartame production involves several steps. Each (or several combined, depending on the technology) is subject to patents held by different firms. Evidence provided and confirmed by NutraSweet indicates that there are significant economies of scale and sunk costs required for production. Although there had been more in the past, in 1989 there was only one other producer of aspartame remaining to compete with NutraSweet in European and Canadian markets. This was the Holland Sweetener Company, which operates a 500-tonnes per annum plant in Holland.

Worldwide sales of aspartame in 1989 were about 7,500 tonnes, with the United States accounting for 75%, Europe, 15%, Canada, 5%, and Australia accounting for most of the remaining 5%. NutraSweet, the sole firm with sales in the United States and Australia, holds market shares of sales in Canada and Europe of 95% and 80%, respectively. Sweetener consumption is divided between table-top and industrial use. Household and restaurants make up the former group, and in 1988 accounted

for 3% and 29% of aspartame and overall sweetener sales in North America, respectively. The latter group is primarily composed of soft drink producers and accounts for 85% of industrial demand in North America.

From a taste point of view, aspartame is considered to be the closest substitute for sugar. However, it loses sweetness when heated. On the other hand, saccharin is the least expensive sweetener by far, on a sweetness equivalency basis, but has an unpleasant bitter aftertaste and is considered to pose some potential health risks. Because of aspartame's loss in sweetness with the storage of soft drinks, fountain drink producers prefer to blend both sweeteners in their diet products. This also provides synergistic increases in perceived sweetness. Furthermore, blending more than one high-intensity sweetener provides users with the opportunity to reduce their costs.

No formal proof of the potential health risk posed by saccharin was offered the Tribunal. However, officials from both Coca-Cola Ltd. (Coke) and Pepsi-Cola Ltd. (Pepsi) expressed a reluctance to remove NutraSweet's logo from their diet products. NutraSweet offered "fidelity rebates" to customers that displayed its swirl logo. Estimates suggest that these and other promotion rebates that are conditional on exclusive use of NutraSweet aspartame were at times equivalent to 40% of its list price. Both officials stated that NutraSweet-conducted research showed that some diet consumers feel that the logo indicates a safer product.

In fact, the history of the adoption of NutraSweet's logo sheds light on fountain drink producers' insistence on maintaining that logo. When aspartame was approved for use in carbonated drinks in the United States in 1983, Coke initially chose to use a mixture of aspartame and saccharin, while Pepsi opted to use aspartame alone and to display the NutraSweet logo on its containers. Within months Coke followed.

The Tribunal concluded that:

> ... there are very serious barriers to the entry of new manufacturers of aspartame other than NSC [NutraSweet]. Entry is difficult because would-be entrants who hope to obtain production costs comparable to those of NSC face barriers in the form of patent portfolios of existing producers, significant economies of scale

> relative to existing world demand for aspartame and sunk costs that increase the risk of entry. ... NSC has induced exclusive dealing with its aspartame customers through its financial incentives or fidelity rebates, and its exclusivity clauses. These inducements amounted to a practice. NSC is a major supplier and this exclusive dealing has lessened, and is likely to lessen, competition substantially.(10)

While the Tribunal concluded that the aspartame production portfolios formed a barrier to entry, an alternative conclusion could have been drawn. Since NutraSweet was required to obtain these patent licences before it began production, there appears to be little evidence to suggest that a barrier to entry was so formed (see definition provided earlier).

An alternative market foreclosure explanation was suggested previously. Clearly, there are two types of consumers of diet soft drinks. Some value a diet cola with aspartame alone more than a cola that contains blends of sweeteners that include saccharin; other consumers are indifferent to the matter. Whether or not aspartame is safer than saccharin is not the critical issue. Rather, it is the customer's perception of these substitutes that matters most to Coke and Pepsi. The fact that Coke officials removed saccharin from their product and put the NutraSweet logo on its containers (and not the other way around) is evidence of this.

Economies of scope do exist at the soft drink production stage, as is suggested by the perceived sweeter taste of diet soft drinks in which aspartame is blended with the cheaper sweetener saccharin. An exclusive dealing arrangement executed through the trademark logo of NutraSweet can raise the limit price of NutraSweet aspartame so as to impede entry of potential aspartame producers and saccharin producers into the market. Potential economies of scope go unrealized - something NutraSweet aspartame can sustain, but others cannot.

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(10) *Canada (Director of Investigation and Research)* v. *The NutraSweet Co.* (1991), 32 C.P.R. (3d) 1.

C. *The Director of Investigation and Research* v. *BBM Bureau of Measurement* (1981)

The Director brought an application under section 31.4 of the *Combines Investigation Act* to prohibit BBM Bureau of Measurement (BBM) from engaging in tied selling of radio and television audience measurement services. The Director alleged that the pure bundling strategy offered to advertisers and the mixed bundling strategy offered to station representatives, which conferred a substantial discount for the purchase of a second report, constituted two tying arrangements which had the effect of lessening competition substantially because they raised entry barriers to newcomers in the business of broadcast audience measurement. The Director also alleged that these tie-ins impeded the expansion of sales of BBM's sole competitor in this business in Canada, A.C. Nielsen Company of Canada Limited (Nielsen).

BBM had been the sole supplier of local and national radio audience data on a regular basis in all provinces of Canada since 1963. It also provides television audience data in all provinces. BBM is a non-profit association of members which comprises three types of consumers. The consumer cooperative is managed by a Board of Directors consisting of 28 members; they and the executive officers serve without pay. Members pay an annual membership fee based on their combined billings or expenditures for radio and television advertising of the previous year.

The three consumer types are advertisers, station representatives and advertising agencies. An advertiser whose 1980 expenditures on radio and television advertising combined were $5-6 million paid $6,420 in 1981 for both reports. A station representative in the $6-8 million category received either radio or television reports for a membership fee of $2,730 and reports of both for $3,370.

Evidence indicates that Nielsen had experienced growing losses from operations throughout the 1970s. BBM has a monopoly in radio data, but shared the market with Nielsen in television data. More specifically, of the 113 agencies purchasing television audience measurement reports, 88 purchased from BBM only, 13 purchased from Nielsen only, and 12 purchased from both. Of the top ten agencies that purchased from BBM, one

purchased from Nielsen. Of the top 20 agencies that purchased from BBM, nine purchased from Nielsen. The products of the two companies were slightly different, although each claimed to be superior.

The Restrictive Trade Practices Commission (the Tribunal's predecessor) found that BBM was engaged in the practice of tied selling within the meaning of section 31.4 of the Act. The Commission prohibited BBM from engaging in tied selling of radio and television audience measurement services and from engaging in 11 specifically enumerated practices.

Obviously, the Commission realized from the outset that the claim that BBM was a consumer cooperative, which has no incentive to gouge its own members, was a "smoke screen." Because these types of services have a high fixed cost component, marketing policies that attract wider membership will reduce average costs and thus membership fees to existing members. There is nothing anti-competitive or inequitable about adopting marketing strategies to overcome these problems. The central question is: did the tying of television audience measurement reports to the monopolized radio audience measurement reports adversely affect the competitive performance of the television audience measurement industry? The answer is yes. The tying arrangement had the potential to reduce the duopoly to a monopoly. Those consumers who preferred to buy the differentiated television audience reports offered by Nielsen were adversely affected.

More specifically, BBM established two different types of tie-in selling policies, a pure bundle and a mixed bundle, which were based on consumer types. Also, the prices charged for these different services were graduated according to the advertiser's ability to pay. From a social welfare point of view, neither policy is objectionable. They are both merely a subtle form of price discrimination which, in most circumstances, is likely to promote, rather than stifle, competition.

However, in this case the evidence indicates that consumers' demand for either radio or television audience report services is positively correlated to demand for the other. Therefore, it is likely that BBM's tie-in sale would have prevented Nielsen from gaining enough market share to make a profit. The tie-in policy would effectively skim off most of the high-paying customers for television audience measurement services,

leaving a small number of potential consumers willing to pay only low prices for Nielsen's services. Ultimately, this had the potential to ruin Nielsen so that the market would eventually have been reduced to a monopoly. Consumers who would have preferred to receive Nielsen's report services would have been forced to acquire BBM's report services.

D. *The Director of Investigation and Research* v. *Xerox Canada Inc.* (1991)

The Director brought an application seeking an order to require Xerox Canada Inc. (Xerox) to accept Exdos Corporation (Exdos) as a customer for the supply of Xerox copier parts under section 75 (refusal to supply) of the *Competition Act.* This application was in response to a policy begun in August 1988 by Xerox, but originating with Xerox Corp. (U.S.), to curtail its supply of parts to independent service organizations (ISOs) for the second-hand market in Xerox copiers.

In 1983, Exdos entered into a one-year contract with Xerox, extended indefinitely, to purchase exclusively from Xerox certain photocopiers (all types prior to its 10-series) and photocopier parts at specified list prices. Previously, it had been Xerox's policy either to scrap such machines or to refurbish them to an "as new" condition for resale.

Almost from the beginning, Exdos began purchasing second-hand copiers from other sources (chiefly finance companies). At this time, other ISOs entered the market as well. Xerox clearly recognized that this uncontrollable source of second-hand Xerox copiers adversely affected the sale of its newer models, but knew it could do nothing about it.

To further separate the markets for new photocopiers, Xerox adopted three maintenance and service agreements with those that bought or leased its products: (1) a full service maintenance agreement, where an annual lump-sum is paid plus an amount per copy produced by the machine; (2) a time and materials service agreement; and (3) a parts agreement where an employee of the customer is trained by Xerox to service its machines. Ninety-five percent of customers chose the first option. Evidence provided

to the Competition Tribunal demonstrated that Xerox parts were priced 198% to 951%, with the median 389%, more than parts from two equivalent copiers. Despite this, in 1989 Xerox dominated the high-volume end of the market with a 90% share; it held 50% and 33% market shares of medium- and low-volume copier models but did not compete in the personal copier market.

By 1988, Xerox 10-series and its newer 9000 models were available to ISOs in the second-hand market. Canadian ISOs' service contracts easily undercut Xerox's service agreements in both Canada and the United States. In 1988, Xerox put in place a policy that would have Xerox parts supplied only to end-users of its 10-series and 9000 copier models, but left parts for its pre-1983 models available for supply to ISOs. This policy was enforced regardless of whether the end-user or the ISO owned the copier.

In considering this application, the Tribunal had no problem establishing that the parts in question were in adequate supply, that Exdos was willing to abide by the usual trade terms, that Exdos was unable to obtain adequate supply, and that Exdos' business was substantially affected. The final competition issue under section 75 was that of market definition. Should the relevant market be narrowly defined to include only Xerox copier parts, thereby establishing Xerox as a monopolist, or should it be broadly defined to include products and services of Xerox's competitors in a vertically-integrated market of copiers and parts and services?

The Tribunal chose the former definition. Subsequently, the Tribunal ordered Xerox to accept Exdos as a customer for all but its newest 50-series copiers and any new models not yet introduced.

Questions can be raised about the validity of this decision. This case reflects the situation where a firm was employing a tying arrangement as a subtle form of price discrimination, which enhances competition. Xerox was pricing its photocopiers according to its economic cost, and was charging monopolistic prices for its parts and service, as the evidence indicated. Therefore, Xerox was earning differential rates of profit on total sales to different consumers and somewhat according to the number of photocopies made.

The product market that is relevant for section 75 purposes should be determined by reference to the market in which Xerox competes, as was clearly stated by Xerox's economic expert:

> ... the relevant competition is not that for Xerox proprietary parts, but among the providers of photocopying services, of which there are many. ... To argue that the market is Xerox ignores the manner in which consumers make decisions. ... End-users (those who want photocopying services) are not indifferent to the prices of Xerox parts since ultimately that price, whether explicit or implicit, is a component of the cost per copy. Competition among providers of photocopying services in the cost per copy provides discipline in the market for parts.(11)

By choosing to supply parts to end-users alone, and by by-passing ISOs, Xerox was vertically integrating its parts through its own service technicians by way of contract. The benefit of a vertically-integrated structure for Xerox was in the form of added revenues to defray research and development costs. In this way, an efficient distribution system is consistent with production efficiency, as well as dynamic efficiency. The suppression of competition and choice in the copier service market succeeds at expanding competition and choice in the photocopier equipment market. In the long run, consumers benefit from lower unit photocopy costs and a wider choice of high quality photocopiers.

E. *Regina* v. *Epson (Canada) Ltd.* (1987)

The accused was charged, pleaded guilty and was convicted of 10 counts of violating section 38.1 of the *Combines Investigation Act* relating to issuing threats to refuse supply to distributors that did not maintain the suggested retail price on its advertised products, in particular its QX-10 computer and its matrix dot printer.

The company's computer printer was a leader in the industry. It was one of the first on the market with a high degree of reliability and accounted for almost all of Epson sales, which in 1984 and 1985

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(11) *Canada (Director of Investigation and Research* v. *Xerox Canada Inc.*, (1991), 33 C.P.R. 3(d) 83.

were $26 million and $40 million, respectively. The printer is estimated to account for one-third of industry sales in Canada. Competitive manufacturers were few and sales of the second largest were half of Epson's.

The company decided to introduce the QX-10 computer to its existing dealers, but wished to ensure that these provided the public with adequate pre-sales advice and assistance, because the product was both new and complicated. Epson required dealers to sign a certified dealership agreement containing the following sentence: "Dealer agrees not to advertise the QX-10 for sale at a price lower than the Supplier's suggested Retail Price."(12) Forty dealers signed this contract, which was in force for some six to seven months. A similar agreement was in force for four months between Epson and the 222 distributors of its printer. Finally, Epson found that some of its distributors were advertising at below the suggested retail price. Epson threatened either to cancel the authorized dealership or to refuse supply in periods of high demand.

Plainly, the Court did not recognize the point-of-sales information argument for RPM as a legitimate defence. As the summary below indicates the Court continued to rely on simple price theory to explain what is competitive and what is not.

> The company dominated the printer market and dealers clamoured to be authorized to sell the company's product. To take advantage of that situation by bullying the dealers into agreeing not to engage in competitive advertising is obviously contrary to the public interest.(13)

F. *Regina* v. *Shell Canada Products Ltd.* (1989)

The accused was charged with influencing upward the price of gasoline at a gas bar/car wash in contravention of the RPM section of the *Competition Act*. The Jet Car Wash (JCW) was acquired by Regatta Investments Limited in 1985 and obtained its gasoline products on consignment

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(12) *Regina* v. *Epson (Canada) Ltd.*, (1987), 19 C.P.R.(3d) 195, p. 196 (Ont. Dist. Ct.).

(13) *Ibid.*, p. 199.

from Shell Canada Products Ltd. (Shell). At that time, JCW leased its premises to Shell and priced its gasoline at the pumps under the direction of Shell.

By April 1986, Shell changed its pricing system from consignment to rack pricing. The effect of this change was to require JCW to pay $30,000 for the fill-up of its storage tanks upon delivery. Shell did offer JCW the necessary financing, and subsequently JCW was free to set its retail price for gasoline. Shell had also stated on several occasions that it would ensure a consistent retail margin, proportional to the final retail price, to all its retail outlets in the event of a price war. Shell insisted that its retail outlets should not and would not start a price war.

JCW was a full-service station located some distance off Portage Avenue in Winnipeg, Manitoba. Shell had erected a sign advertising JWC's gasoline price to Portage Avenue motorists, but, because of its inconvenient location, JCW did not attract many of these customers. JCW relied primarily on its car wash clients to fill up at its station. This dependence, however, made the gas station susceptible to reduced demand on rainy days. Accordingly, with its newly-acquired discretionary power to set its price of gasoline, JCW management chose to reduce prices on such days.

Approximately one hour after reducing this price for the first time a representative of Shell phoned JCW to inquire about its retail price and made a second phone call later that same day, telling JCW's manager that Shell felt that the price reduction would likely initiate a price war, which apparently could have involved 30 independent retail outlets in the immediate area. The Shell representative instructed JCW to raise its price by 5 p.m. that day. JCW's manager, without permission from its owner, raised its advertised price from 43.4 cents a litre to 45.4 cents, the same price charged by its full-service competitor station across the street. The following Monday, JCW was told to raise its price to 45.8 cents. The manager complied, and the owner eventually complained to the Bureau of Competition Policy.

Shell corporate documents provided by the Crown also confirmed that the rack pricing system was a corporate policy enabling Shell, in part, to establish RPM in the event of a price war as evidenced by:

> ... in order to administer the current price support system in automotive, we have found it necessary to rely upon dealers' assessment of competitive pricing. At the same time, the dealers have relatively fixed unit margins and stand to gain by dropping pump prices. This obvious conflict of interests has undoubtedly resulted from time to time in dealer initiated price wars in which the only casualty is the supplier - Shell.(14)

The Court concluded that the conduct of the Shell representative constituted intimidation that could, in the mind of the JCW manager, be followed by a revocation of its lease. It was proved that this further constituted an attempt to influence upward the retail price of gasoline.

In determining whether RPM promoted or stifled competition in this case, one must first consider how the interests of JCW conflicted with those of its competitive retailers and those of Shell. In most circumstances, retailers gain only for a short time in a price war. Over the long run they all lose. This fact, more than any other, prevents retailers from initiating a price war. Under these conditions, the interests of JCW, competitive retailers, and Shell are the same.

In some circumstances, however, this similarity of interest may not exist. For example, retailers facing different demand conditions may benefit from initiating a price war; JCW is one such case. Because of the complementary relationship between car washes and gas sales, it was optimal for JCW to set two prices for its gasoline, depending on the weather. Regardless of whether JCW's competitors matched these price reductions on rainy days, JCW would gain market share. By lowering prices on rainy days, Portage Street motorists would shift their preferred gas fill-up times from good-weather days to rainy days. Consequently, JCW

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(14) *Regina* v. *Shell Canada Products Ltd.* (1989), 24 C.P.R.(3d) 501, p. 508 (Man. Q.B.).

would attract greater sales and profits over the year from "rainy day price wars," while its competitors would lose.

What is not clear from this case is how long the price war would have lasted had Shell not snuffed it out in its infancy. Had it taken considerable time for prices to re-order themselves to their previous rainy daily levels, it might have appeared that consumers were benefiting from this war. However, a lower retail margin for all full-service stations caught in a price war would eventually have forced them to reduce service levels or, in the alternative, forced some to install self-serve gas facilities or to leave the market entirely. In this eventuality, some consumers would have lost.

In defence of its profits, Shell could choose from three types of vertical structure. It could merge with JCW; it could return to its consignment selling relationship with JCW; or it could institute an RPM marketing strategy. Anyone of these three actions could eliminate these "rainy day price wars." From society's point of view, the strategy involving the lowest transaction costs is the optimal choice, and, in this regard, the interests of society and Shell are the same. Therefore, Shell's choice to invoke an RPM strategy promotes competition. Again, restraining intra-brand competition promotes inter-brand competition.

CONCLUSIONS

The evolution of competition policy provides interesting insights into the economic content of the law, and the assumptions of legal practitioners. One clear message from such studies is that competition policy is not static, it adapts to human conditions. Not surprisingly, however, the speed of this adaptation is slow. Contemporary competition policy embodies a fair understanding of price theory and industrial organizational issues of entry barriers, sunk costs, and predatory and conspiratory behaviour; however, it trails economic theory most notably in terms of the vertical organizational relationships of firms and markets.

The changes to competition policy introduced in 1986 were an important step in reducing the gap between economic theories of mergers and

pragmatic competition enforcement. Unfortunately, legislators did not seize the opportunity to modify the Act's reviewable, non-criminal provisions relating to vertical contractual restraints. This is likely to result in a proliferation of vertical contractual restraint cases as the business community realigns its practices from ownership towards spot and long-term contracts. A casualty of this realignment will be vertical restraint measures that promote competition. They will likely be lumped together with anti-competitive cases by the Director and Tribunal and categorized as pernicious to competition because the law does not incorporate criteria that can distinguish between the two.

This paper offers an alternative explanation for the anti-competitive use of an exclusive contract arrangement. In this regard, the Tribunal's working definition of a barrier to entry would be helpful. Also, suggested is a competitive explanation for the use of a tying arrangement. The conflict between interpretations rests on the proper definition of the term "relevant market." In its deliberations, the Tribunal should understand fully the conditions in which consumers make their product and service choices, and should also endeavour to ascertain how and in what circumstance competition will discipline the market. Industry concentration statistics tell us nothing about motivations, and thus can be misleading.

Finally, this paper also suggests that legislators might consider a change in the legal status of RPM. The appropriate legal standard appears to be a rule of reason, although further investigation beyond the two cases of RPM discussed here is required to verify the frequency of competitively motivated cases. In the two cases studied here, measures were invoked to ensure the consumer received greater service, in one case informational, in the other complementary. It would be appropriate for the rules guiding adjudication to permit RPM when a product is new or has new features, or when important complementary services would enhance the brand-name quality of the product. Consumers who desire these services at point-of-sale will be likely to outnumber those who do not and thus competition and economic welfare would be enhanced.

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