

Models of Market Behaviour and Competition Law: Exclusive Dealing

Marilyn MacCrimmon

Asha Sadanand

Follow this and additional works at: <http://digitalcommons.osgoode.yorku.ca/ohlj>
Article

Citation Information

MacCrimmon, Marilyn and Sadanand, Asha. "Models of Market Behaviour and Competition Law: Exclusive Dealing." *Osgoode Hall Law Journal* 27.3 (1989) : 709-768.
<http://digitalcommons.osgoode.yorku.ca/ohlj/vol27/iss3/7>

This Article is brought to you for free and open access by the Journals at Osgoode Digital Commons. It has been accepted for inclusion in Osgoode Hall Law Journal by an authorized editor of Osgoode Digital Commons.

Models of Market Behaviour and Competition Law: Exclusive Dealing

Abstract

The paper arose out of the authors' belief that economic principles should, and probably will, play a larger role in the decisions of the new Competition Tribunal. The objective of the paper is to clarify some of the underlying assumptions and choices implicit in the regulation of competitive behaviour by examining the literature on economic analysis of market behaviour written by both economists and lawyers. The authors are especially concerned with the recent emphasis on strategic behaviour and its contrast to the Chicago school approach which recommends less interference with market behaviour. They examine the differences between the assumptions of both models and then consider the implications for the regulation of exclusive dealing. In particular, the authors examine the requirement that competition must be substantially lessened, by developing two different approaches to a rule-of-reason test.

MODELS OF MARKET BEHAVIOUR AND COMPETITION LAW: EXCLUSIVE DEALING[©]

MARILYN MACCRIMMON* AND ASHA SADANAND**

The paper arose out of the authors' belief that economic principles should, and probably will, play a larger role in the decisions of the new Competition Tribunal. The objective of the paper is to clarify some of the underlying assumptions and choices implicit in the regulation of competitive behaviour by examining the literature on economic analysis of market behaviour written by both economists and lawyers. The authors are especially concerned with the recent emphasis on strategic behaviour and its contrast to the Chicago school approach which recommends less interference with market behaviour. They examine the differences between the assumptions of both models and then consider the implications for the regulation of exclusive dealing. In particular, the authors examine the requirement that competition must be substantially lessened, by developing two different approaches to a rule-of-reason test.

I. OVERVIEW	711
II. LEGISLATION	713
A. <i>Canadian Competition Act</i>	713
B. <i>American Legislation and Department of Justice Merger Guidelines, 1982 and 1984</i>	716
III. MODELS OF MARKET BEHAVIOUR	718
A. <i>Introduction</i>	718

[©] Copyright, 1989, Marilyn MacCrimmon and Asha Sadanand.

* Associate Professor, Faculty of Law, University of British Columbia.

** Assistant Professor, Faculty of Commerce, University of British Columbia. Support from the Social Sciences and Humanities Research Council is gratefully acknowledged. We would like to thank Professor W.T. Stanbury for his suggestions in the early stages of this research.

B. <i>Four Models of Market Behaviour</i>	722
1. Structuralist model	722
2. Deconcentration model	724
3. Consumer welfare model	726
4. Strategic behaviour model	730
C. <i>Competition Act</i>	734
IV. ECONOMIC RATIONALE FOR REGULATING EXCLUSIVE DEALING	735
A. <i>Overview</i>	735
B. <i>Pro-competitive or Ambiguous Effects</i>	736
C. <i>Anti-competitive Effects</i>	738
1. Facilitate collusion	739
2. Foreclosure of rivals	740
V. SUBSTANTIAL LESSENING OF COMPETITION: CONSUMER WELFARE MODEL v. STRATEGIC BEHAVIOUR MODEL	743
A. <i>Introduction</i>	743
B. <i>Consumer Welfare Model</i>	744
C. <i>Raising Rivals Costs Model</i>	745
1. Description	745
2. Criticism	749
D. <i>Comparison of the Two Models and the Conditions Indicating an Anti-competitive Impact</i>	751
1. Assumptions	751
2. Comparison of the consumer welfare model and the RRC model	752
a) <i>Limitation of supply versus raising cost of an input</i>	752
b) <i>Creation of entry barriers</i>	753
c) <i>Market concentration</i>	754
d) <i>Overbuying</i>	754
VI. RECOMMENDED ANALYSIS: SUBSTANTIAL LESSENING OF COMPETITION	754
A. <i>Introduction</i>	754

B. Rule of Reason: An Unreasonableness Test	756
1. Market share	757
2. Are there entry barriers?	759
3. Is there a pro-competitive explanation?	762
C. Rule of Reason: The RRC Model	762
VII. CONCLUSION	766

I. OVERVIEW

This is a period of change for Canadian competition policy. In June 1986, the *Combines Investigation Act* was renamed the *Competition Act* and was extensively amended.¹ In our view, these changes presage a reassessment of the use of economic principles in the regulation of anti-competitive conduct. The *Act* adopts terms that appear to have an economic meaning such as "efficiency,"² "barriers to entry,"³ and "effective competition."⁴ More significantly, the *Act* shifts the regulation of several types of anti-competitive conduct from criminal to civil law and from the courts to an administrative body, the Competition Tribunal. It is to be expected that the Tribunal's broad mandate will give it more opportunity to develop a consistent competition policy based on economic principles.

This paper will focus on the incorporation of economic principles into the legal standards regulating vertical restraints.

¹ *Competition Act*, R.S.C. 1985, c. C-34 as amended. For a review of the amendments, see W. Grover & R. Kwinter, "The New Competition Act" (1987) 66 Can. Bar Rev. 267.

² See, for example, s. 96, which provides that the Tribunal shall not prevent a merger that "...is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition...."

³ Subsection 93(d) provides that in deciding whether a merger should be prevented, the Tribunal may consider, among other factors, whether there are "any barriers to entry into a market."

⁴ See, for example, s. 93(e), providing that in deciding whether to prevent a merger the Tribunal may have regard to, among other factors, "...the extent to which effective competition remains or would remain in a market that is or would be affected by the merger...."

Competition policy on vertical restraints in the United States has undergone an extensive review in recent years, due primarily to a re-evaluation by economists of the impact of vertical restraints on competition. It is our view that this economic and legal literature, which brings into question the traditionally accepted rationale for price and non-price vertical restraints, provides a foundation for the development of specific legal criteria for the regulation of vertical restraints under the Canadian *Competition Act*.

Our purpose is to further this process of adaptation of economic principles by examining the regulation of the vertical restraint of exclusive dealing under section 77 of the *Competition Act*.⁵ This section provides that exclusive dealing is prohibited only if it impedes expansion or entry, and results or is likely to result in a substantial lessening of competition. Economic concepts are not only relevant but fundamental to this inquiry. Examination of the economic literature, however, reveals that there is a conflict over the conditions under which exclusionary vertical restraints have an adverse effect on competition. The following discussion examines this conflict by developing four models of market behaviour and tracing the implications for the interpretation of subsection 77(2) of the *Competition Act*, which regulates exclusive dealing.

Section II of this article briefly describes the Canadian legislation and then surveys the American jurisprudence. Section III describes four models of market behaviour. Section IV examines the economic rationale for regulating exclusive dealing. Section V examines the anti-competitive effects predicted by the consumer welfare model and the strategic behaviour model and compares their underlying assumptions. Section VI, drawing on the previous discussion, sets out conditions under which exclusive dealing results or is likely to result in a "substantial lessening of competition," as required by subsection 77(2) of the *Competition Act*. We conclude that the recent work on strategies to raise rivals' costs provides useful insight into the ways in which exclusionary conduct such as exclusive dealing can foreclose supply and raise rivals' costs, and we adopt some of the underlying assumptions of this approach.

⁵ Section 97 also regulates tied selling. In the interests of clarity we have decided to confine our remarks to exclusive dealing. A paper is forthcoming on tied selling.

However, even if these assumptions are adopted, there is still a decision whether to conduct an inquiry into the circumstances of each case or to rely on presumptions which entail a less costly and time consuming inquiry. We set out one possible structured legal standard that would condemn exclusive dealing by a dominant firm when there are entry barriers with no pro-competitive explanation, and we contrast that standard to the inquiry mandated by a model of strategies to raise rivals' costs.

II. LEGISLATION

A. *Canadian Competition Act*

"Vertical restraint" describes an arrangement between persons or firms in a vertical relationship in the distribution or production process. A supplier may restrict the freedom of a customer to dispose of a product by requiring, for example, that the product be sold at a particular price (resale price maintenance), to certain customers (market restrictions), or from a certain location (exclusive territories). Exclusive dealing arrangements require a customer to deal exclusively in the supplier's product or a supplier to sell exclusively to a customer.⁶ Vertical restraints also include requirements by a supplier that a customer, in order to acquire one product, buy another product from the supplier or its nominee. This last practice is known as tied selling.

Exclusive dealing is regulated under section 77 of the *Competition Act*, which was enacted as part of the Stage I amendments in 1976. Subsection 77(2) provides:

Where, on application by the Director, the Tribunal finds that exclusive dealing or tied selling, because it is engaged in by a major supplier of a product in a market or because it is widespread in a market, is likely to

- (a) impede entry into or expansion of a firm in the market,
- (b) impede introduction of a product into or expansion of sales of a product in the market, or

⁶ It should be noted the definition of exclusive dealing in subsection 77(1) of the *Competition Act* does not include exclusive dealing imposed by a customer on a supplier.

- (c) have any other exclusionary effect in the market, with the result that competition is or is likely to be lessened substantially, the Tribunal may make an order ... prohibiting them from continuing to engage in such [conduct] and containing any other requirement that ... is necessary to overcome the effects thereof ...

Allegations that conduct violates section 77 are adjudicated by the Competition Tribunal upon application by the Director of Investigation and Research.⁷

Exclusive dealing agreements usually take two forms: (1) supply contracts under which a buyer promises to make all or almost all of its purchases from one supplier, and (2) output contracts in which a supplier agrees to sell its entire output of a product to one buyer. Form (2) is known as an exclusive distributorship. If the customer purchases the product for use rather than resale, the arrangement will be referred to as a requirements contract.

The definition of exclusive dealing in subsection 77(1) requires that the exclusive dealing be imposed on the customer by the supplier and therefore covers output contracts.⁸ It does not include an exclusive dealing agreement in which the customer, for example, requires that the supplier sell its entire output. However, the use of exclusive dealing by a dominant firm to pre-

⁷ *Competition Tribunal Act*, S.C. 1986, c.26.

⁸ Subsection 77(1) provides:
"exclusive dealing" means

- (a) any practice whereby a supplier of a product, as a condition of supplying the product to a customer, requires that customer to
 - (i) deal only or primarily in products supplied by or designated by the supplier or his nominee, or
 - (ii) refrain from dealing in a specified class or kind of product except as supplied by the supplier or his nominee, and
- (b) any practice whereby a supplier of a product induces a customer to meet a condition set out in subparagraph (a)(i) or (ii) by offering to supply the product to him on more favourable terms or conditions if the customer agrees to meet the condition set out in either of those subparagraphs.

In contrast, the United States Department of Justice, *Vertical Distribution Restraints Guidelines*, 50 Fed. Reg. 6263 (1985), set out the following definition: "Exclusive dealing arrangements – requirements that a buyer deal only with a particular seller or that a seller deal only with a particular buyer or group of buyers, including exclusive distributorships, sole outlet provisions, and requirements contracts."

empt scarce facilities or resources required by a competitor is regulated by section 78(e) of the *Competition Act*.⁹

The primary targets of the subsection 77(1) definition of "exclusive dealing" are arrangements whereby a supplier requires a dealer who resells the product not to deal in products which compete with those of the supplier. Requirements contracts, whereby a supplier requires a customer to use only or primarily the products of the supplier as a condition of supply, will be caught only if the phrase "deal ... in products supplied by ... the supplier ..." in subsection 77(1) includes using the product as an input in the production of another product.¹⁰

Reciprocal contracts whereby the supplier of product *A* agrees to acquire all of its supply of product *B* from a customer on

⁹ Subsection 78(e) of the *Competition Act* regulates pre-emption of scarce resources by a dominant firm. Subsection 78(f) prohibits overbuying by a dominant firm. Vertical price squeezes by a vertically integrated dominant firm are prohibited by subsection 78(a). See S. Salop & D. Scheffman, "Raising Rivals' Costs" (1983) 73 *Amer. Econ. Rev.* 267.

¹⁰ The issue is whether "deal" is equivalent to the concept of purchasing a product, which connotes a single transaction, or whether "deal" requires a purchase and a subsequent resale by the customer. (It should be noted that a sale is not required by the section. See the definition of "supply" in section 2.) If a purchase is sufficient, then the customer deals in the product when it acquires the product from the supplier. It is irrelevant whether the customer uses the product as an input, consumes it, or resells it. However, the ordinary meaning of "to deal" is to buy and sell a product. Thus it is natural to say that a firm which buys and sells radios, deals in radios. But, a firm which buys transistors and makes radios is not described as dealing in transistors. The ordinary meaning is reinforced by the wording of the section which states that the supplier must require the customer "to deal...in products supplied...by the supplier..." To deal in a product is to buy and sell a product, not merely to buy the product. The phrase "dealing with a supplier" would be more consistent with an interpretation that "deal" refers to the transaction between the supplier and the customer and does not require a subsequent resale by the customer. Section 3 of the *Clayton Act, infra*, note 13, covers requirement contracts and uses the words "on the condition ... that the ... purchaser ... shall not use or deal in the goods ... of a competitor...." Section 77 does not include a reference to using the product. On the other hand, the essence of exclusive dealing is a restriction on purchasing, not resale. The customer must purchase all its requirements from the supplier. In *Empire Volkswagen, Inc. v. World-Wide Volkswagen Corp.*, [1986-1] Trade Cases 66,939 (N.Y. Dist. Ct.) an agreement which required that a dealer sell only volkswagen cars from a certain facility was held not to be an exclusive dealing arrangement because the dealer was free to purchase from other car suppliers as long as it sold the cars from other facilities. (See also *White and White, Inc. v. American Hospital Supply Corp.* 540 F. Supp. 951 (W.D. Mich. 1982), 723 F.2d 495 (6th Cir. 1983)). It is more consistent with the objectives of the section to include requirements contracts within the definition of exclusive dealing, since some may have an anticompetitive effect. Since only those arrangements which are anticompetitive may be subject to an order, there is little reason to eliminate all requirements contracts from its operation.

condition that the customer acquire all of its supply of product *A* from the supplier or its nominee also are covered by section 77. In this case the supplier of *A* is inducing the customer to deal only or primarily in product *A* by offering to buy the customer's product *B*. Market power in the buying side of the market is used to coerce purchases of *A*. The result is that the purchaser of *A* will deal exclusively in product *A*.¹¹

Exclusive dealing may be illustrated by the only decision by the Restrictive Trade Practices Commission (RTPC) on exclusive dealing, *Director of Investigation and Research v. Bombardier Ltd.*¹² Bombardier entered into exclusive dealing arrangements whereby dealers in Bombardier snowmobiles agreed not to carry snowmobiles produced by Bombardier's rivals. Bombardier had 30% of North American sales, 60% in Quebec and the Maritimes, and 40% in Ontario. Percentage of sales in local retail markets varied. The RTPC upheld the legality of the exclusive dealing restrictions on the basis that entry at the retail level was easy and rivals had not been impeded from expanding.

B. *American Legislation and Department of Justice Merger Guidelines, 1982 and 1984*

American experience with the regulation of vertical restraints can provide guidance in the development of Canadian legal standards. The literature contains extensive debates on the application of economic principles in legal decision-making and on whether these principles imply a rule of *per se* illegality, *per se* legality, or a rule of reason. The case law contains examples of the application of various forms of rules regulating vertical restraints.

¹¹ Reciprocal dealing may be used to price discriminate. See D.G. McFetridge, "The Emergence of a Canadian Merger Policy: The ERCO Case" (1974) *Antitrust Bull.* 1.

¹² (1981), 53 C.P.R. (2d) 47 (R.T.P.C.).

Exclusive dealing is regulated by section 3 of the *Clayton Act*¹³ and is evaluated under a rule of reason.

A development in American antitrust law which is a useful source for developing standards under the *Competition Act* is the issuing of the 1982 *Merger Guidelines* by the Department of Justice to replace the merger guidelines issued in 1968.¹⁴ The 1982 *Merger Guidelines* incorporate economic theory on mergers into enforcement policy. The principles of market definition and entry barriers are drawn from economic thinking. The *Guidelines* set threshold concentration levels that must be crossed before a merger will be challenged. They differ from the 1968 *Guidelines* in that the thresholds are higher and the market definition results in wider markets and lower market shares. An additional set of merger guidelines were issued in 1984.¹⁵ The 1984 *Guidelines* expand the concept of market by including foreign production, expand the failing company defence, and replace the threshold numerical standards with a list of factors which are to be weighed. The 1982 *Merger Guidelines* in the vertical merger section provide useful criteria for defining the market and measuring entry barriers, particularly in the case of exclusive dealing which is equivalent on many dimensions to vertical integration.

¹³ Section 3 of the *Clayton Act*, 15 U.S.C.A. Section 14, makes it unlawful for any firm to sell or lease goods to be used, consumed or resold within a federal jurisdiction, or to offer advantageous prices on the product, on the condition that the customer shall not use or deal in the goods of a competitor of the supplier, if the effect of such sales or leases or offers may be to lessen competition substantially in any relevant market. The specific reference to restrictions on the use of goods incorporates requirements contracts. Tying or exclusive dealing is also illegal under section 1 of the *Sherman Act* when there is an agreement between firms.

¹⁴ 47 Fed. Reg. 28,493 (1982). The 1968 Guidelines are reproduced at (1971), 2 Trade Reg. Rep. para. 4500.

¹⁵ 49 Fed. Reg. 26,824 (1984).

III. MODELS OF MARKET BEHAVIOUR

A. Introduction

The *Competition Act* condemns behaviour that "substantially lessens competition." A substantial lessening of competition will in most cases have to be inferred from circumstantial evidence of the conduct of firms and of market conditions rather than direct evidence. Economic theory has developed models which predict the impact of market structure and business behaviour on competition. These models provide the generalizations from which inferences can be drawn from evidence of markets and business practices. They play the same role as conventional wisdom does in everyday life where people draw inferences about behaviour from circumstantial evidence. The generalization that an agreement to fix prices by all the firms in a market will cause prices to rise is analogous to, for example, the generalization that threats of harm cause recipients of threats to feel fear and to commit acts against their will. In both cases there is an inference as to the expected effects of the conduct. The difference is that the first rests on a paradigm of behaviour not generally known and requires expert explanation.

It should be kept in mind that economic theory undergoes a process of simplification in its translation to the legal context. Models implicitly adopted by courts are different from the models applied by economists in that law uses models to classify conduct rather than to analyze it.¹⁶ Courts tend not to check to see if underlying assumptions of models coincide with the facts of the individual case. This is one reason Professor Sullivan has recommended that courts be wary of adopting any particular model but rather rely on traditional legal criteria which are informed by expert economic evidence.¹⁷

¹⁶ R. Schmalensee, "On the Use of Economic Models in Antitrust: The *RealLemon* Case" (1979) 127 U. Pa. L. Rev. 994.

¹⁷ L.A. Sullivan, "Monopolization: Corporate Strategy, the IBM Cases, and the Transformation of the Law" (1982) 60 Tex. L. Rev. 587 at 615.

We recognize the validity of these criticisms and caution the reader to view the following models from that perspective. We do not advocate that any particular model should be assumed to be "correct." On the other hand, economic analysis provides a rich source of information with which to evaluate conduct, and, in our view, knowledge of this literature provides essential guidance for correct classification of conduct as anti-competitive. The law does not require certainty of facts but is content to make decisions on the basis of propositions which fall short of scientific certainty.¹⁸ Economic models provide the initial generalizations – based on extensive analysis – which can be tested against reality. The trier of fact is free to adopt another scenario in the light of the evidence of the particular case.

The market models described below reflect the different and sometimes conflicting goals of competition law. Goals may be classified as either economic or political. Political goals include preserving small businesses, freedom of economic opportunity to compete on the merits, decentralization of power, consumer choice or consumer autonomy, distributional equity, and fairness in the market place. The primary economic goals are allocative and productive efficiency.¹⁹ Productive efficiency is concerned with incurring the lowest costs of production (including opportunity costs) given an array of goods and services that are to be produced. Allocative efficiency requires that the array of goods and services to be produced and the distribution of these goods and services to the consumers be chosen in a manner that maximizes welfare. Ensuring

¹⁸ Alexander, *An Introduction to Logic* (N.Y.: Shocker Books, 1969) at 61. He describes the law as using interpretative arguments. "When a court ascribes responsibility for an action or decides that there was negligence this is not the conclusion of a deductive or an inductive argument. Neither is it a clear statement of fact. It is an interpretation of the facts and it may be controversial."

¹⁹ There is a difference of opinion among advocates of the goal of maximizing consumer welfare whether to adopt a static or a dynamic view. Some advocate a short-run static analysis to determine whether allocative efficiencies exist. Others espouse a dynamic framework which assesses the long-run and short-run tradeoffs involved in determining efficiencies. See A.A. Foer, "The Political-Economic Nature of Antitrust" (1983) 27 *St. Louis Univ. L. J.* 331.

the optimal amount of consumer choice is an aspect of allocative efficiency.²⁰

The general argument underlying the economic goals is that consumers benefit from a competitive market in which rival firms bid down prices as they compete for market share. In the absence of market failure or large economies of scale, intense rivalry among many sellers results in the lowest possible prices for consumers and an efficient quantity of production. The interests of the consumer are often undermined when there are few sellers, because the absence of rivals confers power on the few sellers to maintain higher prices and to obtain greater profits at the expense of the consumer and of efficiency. Thus, market share and its frequent consequence, market power or the ability to affect prices in the market, are important factors in assessing the performance of a market.

Market share alone, however, does not confer market power upon its holder. Market power can be restrained by the presence of potential entrants into the market. Whether potential entrants exist is determined by the size and nature of the barriers to entry in the industry. Examples of barriers to entry are cost advantages to incumbent firms through access to superior technology or exclusive supply of low cost inputs, product differentiation and brand loyalty, economies of large scale, and large initial investment costs.²¹ Although many of these can be short-run barriers, most can be overcome with sufficient financial resources, and they often concern costs which have been paid by existing firms in the industry. Thus, the barriers provide the incumbent firms (which are usually financially healthier than potential entrants) with at least a temporary advantage. Such advantages often translate into larger market shares or greater entrenchment of barriers to entry. In the presence of market power, vertical restraints such as exclusive dealing can sometimes confer further market power or create entry barriers. Therefore, market structure and entry barriers figure

²⁰ The broad areas of location theory and heterogeneous product markets are where economists study this issue.

²¹ We are adopting a broader definition of entry barriers than that advocated by the consumer welfare model. See discussion *infra*, notes 122-26.

prominently in the discussion of the economic effects of vertical restraints.

In the Canadian context, it is particularly important to consider total welfare. With very small markets dispersed over large geographic areas, there is often insufficient demand to support many competitive producers at an efficient scale. The trade-off is between a few large low-cost producers with substantial market power or many small competitive, but inefficient, firms.²² Thus economic efficiency is not always achieved through decentralization. Consumers' interests can sometimes be better served when a few firms (or even one firm) make oligopoly profits. For example, the oligopoly price will be below the price that would be offered by a competitive industry when each firm in the competitive industry operates at such a small scale of production that it is not able to avail itself of substantial economies of scale.

The political goals which may be classified under the rubric of preventing high concentration are generally not taken into account in economic models, although it is feasible to include a component in the objective functions that reflects the political threat of economic power. Similarly while consumer choice is an aspect of allocative efficiency, critics of economic legal standards adopt the preservation of consumer choice as a separate goal of competition law.²³ The deconcentration model described below adopts decentralization and its corollaries of consumer choice and a concern for distributional consequences as a primary goal. It has also been argued that political goals are emphasized when a dynamic view which examines conduct over time is adopted, as in the strategic behaviour model, because such a view recognizes that firms have discretion and that their conduct is not simply a reaction to market forces.²⁴

²² C.E. Williamson, "Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach" (1979) 127 U. Pa. L. Rev. 953.

²³ E.M. Fox, "The Modernization of Antitrust: A New Equilibrium" (1981) 66 Cornell L. Rev. 1140.

²⁴ A firm's decisions affect individuals, communities, and society. Foer argues that it is important "to see the relevance of the political non-efficiency goals of antitrust. Power is going to be exercised, whether by private, public, or a mixture of these forces. To the extent that reliance on the efficiency criteria results in elimination of governmental oversight and intervention, a very significant political decision has been made." Foer, *supra*, note 19 at 337.

B. *Four Models of Market Behaviour*

1. Structuralist model

The objective of the structuralist model is to maximize consumer welfare. The structuralist model assumes that business conduct which harms competition can be identified by examining the type of market structure in which the conduct occurs. It assumes that the higher profit levels experienced in concentrated industries are due to collusion.²⁵ This is the general conclusion of the structure-conduct-performance paradigm which holds that it is ultimately the market structure that affects consumer welfare.²⁶ The casualty runs in the following direction: structure induces conduct that determines performance. For example, a low concentration market structure with many firms induces healthy competition with the lowest possible prices. This causes the maximization of consumer welfare: an efficient amount is supplied without supra-competitive profits. Similarly, it is assumed that high concentration results in restriction of output and raising of prices causing supra-normal profits, supply of less than an efficient quantity, and a reduction in consumer welfare. The goal of the structuralist model, thus, is to control market concentration and to maintain an atomistic market.

The structuralist model leads to concern about the number of firms in an industry. Conduct which forecloses competitors or increases concentration may be classified as illegal without any assessment of the impact on output or price based on the assumption that conduct is determined by structure. For example, the 1968 *Merger Guidelines* of the United States Department of Justice used market share percentages to determine when a merger

²⁵ Werden, "Can the Concentration-Collusion Hypothesis be Refuted Empirically?" (United States Dept. of Justice, Economic Policy Office 84-11, 1984) (Addressing the literature that concludes there is little empirical support for the concentration-collusion hypothesis and concluding that despite this lack of evidence, a restrictive merger policy may be welfare enhancing.)

²⁶ F.M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally, 1980) at 3-6.

would be challenged. Similarly, the 1981 proposals to amend the *Combines Investigation Act* recommended that mergers and joint monopoly should be illegal *per se* if the combined market share was above some threshold level.²⁷ The structuralist model has been described as the "inhospitality tradition"²⁸ because novel market practices such as tied selling or exclusive dealing are assumed to be motivated by anti-competitive purposes, and thus, illegal *per se* without requiring that the practice be shown to be anti-competitive.

The model's underlying assumption that structure determines conduct has been viewed as too simplistic in the light of the failure to find empirical support for a causal connection between concentration and profitability.²⁹ While highly concentrated industries are profitable, the empirical evidence does not show that profitability is necessarily due to collusion.³⁰ High profitability could be caused by economies of scale, innovation, cost reductions, historically lower costs, et cetera.

Canadian competition law has never adopted a pure structural approach, but has required proof that conduct in the particular case has harmed competition. The structuralist approach is more clearly rejected in the recent amendments to the *Competition Act*.³¹ For example, the merger provisions provide that a merger cannot be condemned solely on the basis of evidence of concentration or market share,³² and the provisions create an efficiency defence which would permit a merger where efficiency gains offset the effects of any lessening of competition. The abuse

²⁷ Consumer and Corporate Affairs, *Reform of Competition Policy in Canada: A Consultation Paper*, March, 1985.

²⁸ Williamson, *supra*, note 22 at 989.

²⁹ H. Demsetz, "Industry Structure, Market Rivalry, and Public Policy" (1973) 16 J. Law & Econ. 1; Y. Bozen, "Bain's Concentration and Rates of Return Revisited" (1971) 14 J. Law & Econ. 351.

³⁰ Werden, *supra*, note 25.

³¹ Compare the proposed 1981 amendments to the *Combines Investigation Act*, *supra*, note 27. (Proposed a structural test: mergers and joint monopolies were to be illegal *per se* if combined market share was above some uniform threshold. It did not recognize an efficiency defence.)

³² *Supra*, note 1, s. 92(2).

of dominant position provisions require evidence of a specific intent to exclude or harm a rival.³³

2. Deconcentration model

This model differs from the other models: its goals are to avoid extreme concentrations of economic power in large corporations and protect the consumer from exercises of monopoly power, and to maximize consumer welfare. It is recognized that these two goals may conflict. In some instances increases in concentration may create efficiencies which make the consumer better off than under a less concentrated market structure. In these instances, proponents of this model are willing to trade increases in efficiency for a market structure in which political and economic power is not concentrated in the hands of a few large corporations. There is a fear that excessive concentration will breed anti-democratic political pressures and will reduce individual and business freedom by broadening the range within which private discretion by a few in the economic sphere controls the welfare of all.³⁴ When the goals of consumer welfare and diffusion of political power conflict under this model, consumer welfare is sacrificed to the goal of decentralization of economic and political power. Professor Pitofsky states: "[T]he matter of efficiencies is not dispositive, and ... an occasional loss of efficiency as a result of antitrust enforcement can be tolerated and is to be expected if antitrust is to serve other legitimate values."³⁵ In addition to the political values of deconcentration, Professor Schumpeter has argued that near-atomistic markets encourage innovation.³⁶ For example, it is argued that over time independent suppliers of a tied product would be

³³ *Ibid.*, s. 78.

³⁴ See R. Pitofsky, "The Political Content of Antitrust" (1979) 127 U. Pa. L. Rev. 1051 at 1074.

³⁵ *Ibid.* at 1074.

³⁶ J.A. Schumpeter, *Capitalism, Socialism and Democracy*, 3d ed. (New York: Harper & Row, 1975). (Dynamic efficiency is improved through rapid technological change which is most likely with a structure of loose oligopoly.)

strongly motivated to innovate in order to reduce the power of the tying product monopolist.³⁷

Proponents of a deconcentration model believe that in most cases it will not be necessary to trade efficiency for deconcentration because in their view economies of scale are not substantial.³⁸ In any event, they are skeptical that efficiencies can be quantified. This uncertainty, in combination with a belief that entry barriers are large and easily manipulated and that pricing above marginal costs occurs at relatively low concentration levels, implies that lower concentration levels should be maintained unless efficiencies are clearly shown.³⁹

Proponents of a deconcentration approach also advocate preserving or increasing consumer choice and competitive opportunities. Exclusive dealing is criticized on the ground that it reduces the price/quality options available to consumers.⁴⁰ Similarly, they see the sole role of the rules regulating tied selling to be the protection of a fair opportunity to compete on the merits.⁴¹

An example of the application of the deconcentration model are the National Association of Attorneys General (NAAG) vertical

³⁷ L.A. Sullivan, *Handbook of the Law of Antitrust* (St. Paul, Minn.: West Publishing, 1977) at 447-48. In *Paschall v. Kansas City Star* 695 F.2d 332 (8th Cir.) (reversed on rehearing 727 F.2d 265, cert. denied 105 US 406 (1984)), the court in considering vertical integration of a newspaper publisher into distribution stated that although the integration "might theoretically lead to pro-competitive results...it nevertheless may be beneficial to preserve competition at the retail level because competitors are often more efficient or innovative than monopolists."

³⁸ J.S. Bain, "Economies of Scale, Concentration, and the Condition of Entry in Twenty Manufacturing Industries" (1954) 44 *Amer. Econ. Rev.* 15. See H. Goldschmid, M. Mann & J.F. Weston eds, *Industrial Concentration: The New Learning* (Boston: Little, Brown, 1974). See also Fox, *supra*, note 23.

³⁹ See H. Hovenkamp, "Antitrust Policy after Chicago" (1985) 84 *Mich. L. Rev.* 213 at 218.

⁴⁰ See F.M. Scherer, "The Economics of Vertical Restraints" (1983) 52 *Antitrust L.J.* 687. (Vertical restraint does not necessarily result in increase in output, but may decrease demand and, for example, restrict the set of low price/service choices, or result in smaller outlets.) See W.S. Comanor, "Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy" (1985) 98 *Harv. L. Rev.* 983.

⁴¹ Fox, *supra*, note 23.

restraints guidelines⁴² issued in response to the Department of Justice's *Vertical Restraints Guidelines*. NAAG advocates *per se* illegality for horizontal restraints which they define more broadly than the Department of Justice. High concentration and coverage are not necessary conditions, although they are a factor in the decision. NAAG believes that elimination of intra-brand competition is usually harmful, and that product differentiation can be used as a mechanism to avoid price competition. It does not assume that restraints are efficient and would examine the motivations for a restraint, asking, for example, whether a supplier requires dealers to supply additional services.⁴³

3. Consumer welfare model

The consumer welfare model prohibits only those practices which confer power to reduce output and increase price.⁴⁴ Its primary goal is to maximize consumer welfare by maximizing productive efficiency and confirming the benefits of lower prices for

⁴² National Association of Attorneys General (NAAG), *Vertical Restraints Guidelines* Winter Meeting, Biloxi, Mississippi, December 4, 1985, reproduced in Bureau of National Affairs, 49 Antitrust & Trade Regulation Report 996 (12-5-85).

⁴³ For example, NAAG adopts the American case law which holds that tying is illegal *per se* if a substantial volume of commerce is foreclosed or the supplier has sufficient market power to make forcing probable. It sets out separate factors for assessing tying arrangements which are not *per se* illegal under this standard:

1. The extent of product differentiation of the tied product (inelasticity of demand approaching "market power").
2. Whether the tying arrangement is widely adopted in the tying product industry and whether entry barriers are high.
3. The effect on the number of buyer options.
4. The simultaneous use of an exclusive dealing arrangement for purchase of the tied product.
5. Miscellaneous factors.

⁴⁴ See, for example, R.H. Bork, *Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978); Easterbrook, "On Identifying Exclusionary Conduct" (1986) 61 Notre Dame L. Rev. 972.

consumers.⁴⁵ Practices which make a market more concentrated do not necessarily confer market power since firms in higher concentrated markets often compete fiercely. Increased concentration may also result in efficiencies which benefit consumers in the form of lower prices or better products or services. The goal is to protect competition, not competitors. Therefore increases in market concentration are not condemned *per se*, but the conduct in each case must be analyzed to determine its legality. Furthermore, the model would not prohibit a practice which increases output or lowers price even though industry concentration is increased. It is expected that "[v]igorous competition 'excludes' rivals."⁴⁶ The consumer welfare school would not prohibit a dominant firm from foreclosing competitors from a significant segment of the market unless that foreclosure conferred power on the dominant firm to reduce output and raise prices. There is no objection if all rivals leave the market when entry barriers are low, since competing firms can readily enter the market if the dominant firm raises prices.

The conflict between the structuralist school and the consumer welfare school first arose over the analysis of vertical restraints.⁴⁷ For example, the structuralist model with its "inhospitality tradition" assumed the motivation for tying is to extend market power into a second market, and therefore would classify tying as *per se* illegal. The consumer welfare school examined the motivations more closely and concluded that in most cases tying is ineffective in leveraging monopoly power and is often motivated by other goals which have a pro-competitive or at least a neutral effect on competition. In contrast to the "inhospitality tradition" of antitrust law, the consumer welfare model assumed that vertical restraints are seldom anti-competitive. On the other hand, critics of the consumer welfare school questioned its underlying

⁴⁵ Bork, *ibid.* at 91, defines this goal as "... to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare." It must be noted, however, that with regard to allocative efficiency the emphasis is largely on how different market structures affect allocative efficiency and not on the existence of adequate choice for consumers.

⁴⁶ Easterbrook, *supra*, note 44 at 973.

⁴⁷ R.A. Posner, "The Chicago School of Antitrust Analysis" (1979) 127 U. Pa. L. Rev. 925 at 938-39.

assumption that the private interests of the firms entering into the restrictive agreement and the public interests of the consumer always coincide.⁴⁸ They also pointed out that the consumer welfare model does not give weight to the degree to which consumer choice of price/quality options are reduced.⁴⁹

Advocates of the consumer welfare model concluded that vertical restraints including exclusive dealing should be legal *per se*.⁵⁰ Any anti-competitive effects such as collusion or monopolization should be regulated under legislation explicitly directed at that conduct.

The *Vertical Restraints Guidelines* issued by the United States Department of Justice in January 1985 are an example of the application of the consumer welfare model. Vertical restraints are assumed rarely to have a significant anti-competitive effect and are permitted, even if the initial threshold tests of market share indicate that collusion or exclusion is possible, should the market appear to be functioning competitively or exclusion or collusion is not likely.⁵¹ Efficiencies, while not necessary, indicate that a pro-competitive explanation for the restraint is plausible.⁵² The *Vertical Restraint Guidelines* adopt the underlying assumption of the consumer

⁴⁸ See, for example, E.M. Fox, "Consumer Beware Chicago" (1986) 84 Mich. L. Rev. 1714.

⁴⁹ See Scherer, *supra*, note 40.

⁵⁰ Bork, *supra*, note 44; Posner, "The Next Step in the Antitrust Treatment of Restricted Distribution: *Per Se* Legality" (1981) 40 U. Chi. L. Rev. 6.

⁵¹ United States Dept. of Justice, *Vertical Restraints Guidelines*, 50 Fed. Reg. 6263 (1985), Para. 4.2. The *Guidelines* employ a two-step process to analyze vertical restraints. Step one is the market structure screen which will eliminate vertical restraints by firms with small market shares, restraints by firms in unconcentrated markets, and restraints which do not cover "a substantial percentage of the sales or capacity in the secondary (foreclosed) market." (Para. 4.1.) The *Guidelines* adopt a Vertical Restraints Index (VRI) to measure the market share of the firm employing the restraint (both the supplier and the dealer) and the level of concentration in the same market. They also adopt the concept of a "coverage ratio" which is "the percent of each market involved in a restraint." (Para. 4.1) Restraints which are not eliminated in step one are evaluated under a structured rule of reason analysis to determine if the restraint is likely to have an adverse effect on competition.

⁵² *Ibid.* at para 4.226.

welfare model that manufacturers who impose vertical restraints will generally be acting in the consumer's best interests.⁵³

The debate between the deconcentration school and the consumer welfare school also centers around alternative approaches to efficiency claims. Should such claims be a complete or partial defence and if so, where should the burden of proof lie? Should some conduct be presumed to be efficient under certain conditions? Professor Pitofsky argued that efficiencies could often be achieved by means of contract or internal expansion and do not necessarily result in competitive pressure on rivals. At most, Professor Pitofsky was willing to recognize an exception for evidence of efficiencies "when the likelihood of competitive injuries was slight, the predicted efficiencies were capable of clear demonstration in court, and there was some likelihood that the efficiencies would be converted into significant competitive effects."⁵⁴ The consumer welfare school believes that efficient conduct is probable and argues that efficiencies or at least no anti-competitive effect should be presumed if the conduct does not confer power over price and output.

The debate about the role of efficiency is reflected in the approach taken to the issue of whether existing competition should be protected from the effects of a vertical restraint. Almost all agree that the small inefficient competitor seeking to survive under the price umbrella of a dominant firm should not be protected by competition laws.⁵⁵ There is also general agreement that vertical

⁵³ The validity of this assumption was one of the factors underlying the criticism of the *Vertical Restraints Guidelines* by the United States House of Representatives. On November 21, 1985, the US House of Representatives Committee on the Judiciary approved and recommended passage of House Resolution 303. The Resolution expressed the "sense of the House of Representatives that the antitrust enforcement guidelines entitled "Vertical Restraints Guidelines", published by the Department of Justice on January 23, 1985, do not have the force of law, do not accurately state current antitrust law, and shall not be considered by the courts of the United States as binding or persuasive..."(Report of the House Judiciary Committee, 99th Congress, 1st session, no. 99-399.)

⁵⁴ Pitofsky, *supra*, note 34 at 1075.

⁵⁵ See discussion of Pitofsky, *supra*, note 34, who states he advocates the protection not of "small inefficient competitors", but of competition. Small competitors are only protected against "unfair tactics unrelated to superior skill or efficiency." Protection of competitors conflicts with the goal of equality of opportunity through the limitation of private discretion in that it would confer political power on a minority. Part IV.I originated partly in the

restraints which confer power over price and output should be prohibited. The difficult case is the claim of a competitor that a rival's acts foreclosed it from competing for significant segments of the market although the acts did not confer power over output or prices in the classical sense.⁵⁶ In this case, many proponents of a deconcentration model would dispute the hypothesis of the consumer welfare model that acts which do not increase market power are efficient and would protect the competitor on the reasoning that if the conduct is not shown to be efficient nothing is lost by preserving competitors in the market.

4. Strategic behaviour model

The strategic behaviour model reflects the concerns of those who advocate a more careful analysis of the conditions under which vertical restraints are anti-competitive. Rather than assume as the consumer welfare school does that vertical restraints are efficient or neutral, some commentators have developed models which take into account strategic conduct which has the aim of imposing costs on rivals. While the consumer welfare model assumes costless transactions, these commentators, notably Oliver Williamson and Steven Salop, incorporate transaction costs into their analysis.⁵⁷ Recognizing transaction costs leads to the possibility of strategic behaviour (that is, conduct which puts rivals and potential entrants at a disadvantage). If there are no transaction costs, strategic behaviour is meaningless because it will have no effect.⁵⁸ Professor

Economic Council of Canada's *Interim Report on Competition Policy* (Ottawa: Queen's Printer, 1969). The report recommended that tied selling and exclusive dealing, among other practices, should be scrutinized and prohibited when the practice "was likely to lessen competition to the detriment of final consumers. Not the interest of particular competitors but the interest of ultimate purchasers would be paramount."

⁵⁶ See E.M. Fox, "Monopolization and Dominance in the United States and the European Community: Efficiency, Opportunity, and Fairness" (1986) 61 *Notre Dame L. Rev.* 981 at 1020.

⁵⁷ Williamson, *supra*, note 22 at 962; S. Salop, "Strategic Entry Deterrence" (1979) *Am. Econ. Rev.* 335; S. Salop & D. Scheffman, "Cost-Raising Strategies" (F.T.C. Working Paper No. 146, July, 1986). See also Scherer, *supra*, note 40.

⁵⁸ Williamson, *ibid.* at 990.

Williamson defines strategic behaviour as "efforts by established firms to take up advance positions and respond contingently to rivalry in ways that discipline actual and discourage potential competition."⁵⁹

Strategic behaviour is, in fact, no different from the usual optimization behaviour in modern economic models. The only difference is that the strategic behaviour models allow the existence of more complex information conditions and more realistic assumptions about costs. This difference often results in optimization behaviour by a firm that is disadvantageous for rivals. In particular, it is assumed that the environment in which firms operate is uncertain, often with asymmetric information among firms. In addition, bounded rationality or at least costs of learning are assumed. Professor Williamson refers to all such factors as transaction costs. The existence of transaction costs provides a further complication in identifying the conditions under which actions based on self-interest serve the public interest.

Transaction costs analysis both attacks and supports vertical restraints. A supplier who contracts with a view to reducing its own transaction costs is acting efficiently. A supplier may, however, impose a vertical restraint with a view to increasing a rival's costs and causing anti-competitive effects.

In vertical restraints arrangements, transaction costs arise from human asset and capital market restrictions. It is possible to impede entry by "differential cost bearing consequences."⁶⁰ Thus, the timing of the imposition of costs can put rivals at a disadvantage by imposing costs on them that are not incurred by the incumbent firm. For example, if learning by doing is an important factor, a firm which enters later will require time to learn by doing if it cannot bid employees from the incumbent. The incumbent will be able to charge lower prices if prices closely track costs. Capital costs will be an impediment to entry if investors demand a premium to invest in a new enterprise because of the uncertainty of success

⁵⁹ O.E. Williamson, "Antitrust Enforcement: Where It's Been, Where It's Going" (1983) 27 St. Louis U. L.J. 289; Hovenkamp, *supra*, note 39 at 260 defines strategic behaviour as "...conduct designed by the actor to reduce the attractiveness of the offers against which it must compete."

⁶⁰ Williamson, *supra*, note 22.

and the possibility of opportunistic behaviour.⁶¹ This is in contrast to the emphasis of the consumer welfare model on long-run behaviour which leads it to assume that assets are freely transferable from one firm to another.⁶² Thus the strategic behaviour model expands the definition of entry barriers to include impediments to entry.

Transaction costs analysis supports the imposition of vertical restraints by providing explanations which are pro-competitive or at least neutral. For example, if the transaction costs of a scheme whereby all suppliers distribute their products through all dealers are very high due to transportation or negotiation costs, exclusive dealing may be efficient and, thus, pro-competitive.

The strategic behaviour model has the same goal as the consumer welfare model: the maximization of consumer welfare. Neither model values deconcentration or increases in consumer choice for its own sake, as the deconcentration model does. The principal question is still whether vertical restraints confer market power with the result that total output is reduced and price is raised. The strategic behaviour model, however, does elaborate the conditions under which market power is enhanced by examining strategic purpose and effect, and is less willing than the consumer welfare model to assume that vertical restraints are pro-competitive. Therefore, the application of the strategic behaviour model may result in less concentrated markets. Incorporating strategic behaviour increases the complexity of the analysis and makes it more difficult to classify behaviour as unequivocally efficient. For this reason, advocates of the consumer welfare model such as William Baxter have argued that even if strategic behaviour does occur, the courts are not equipped to understand it and therefore it should be ignored.⁶³

⁶¹ Williamson, *supra*, note 22 defines opportunistic behaviour as acting in your self-interest with guile. For example, an entrant may misrepresent the risks of the investment. Discovery of the misrepresentation will be unlikely if there are few competitors for the investment funds.

⁶² Hovenkamp, *supra*, note 39 at 264.

⁶³ W.F. Baxter, "Reflections Upon Professor Williamson's Comments" (1983) 27 St. Louis U. L. Rev. 315.

Advocates of the deconcentration model acknowledge the usefulness of the strategic behaviour model in providing support for the traditional legal insight that exclusionary conduct directed at rivals can be a realistic threat⁶⁴. In their view, however, the strategic behaviour model is not so much a "new" model as it is an elaboration of the consumer welfare model in that its primary concern is also whether firms have gained the ability to limit total output.⁶⁵ They argue that antitrust legislation is not directed towards the solitary goal of productive efficiency but is also concerned with consumer choice, diversity, freedom to compete, and innovation which are elements of allocative efficiency.⁶⁶

To summarize, the strategic behaviour model sets the interaction among firms in a realistic environment where there is uncertainty and asymmetric information. It is concerned with the dynamic effects of firms' actions. Thus an action by a firm resulting in a short-run advantage may in the long run be a permanent setback for its rivals. Moreover, it abandons the classical assumption that assets are costlessly malleable and that markets are complete in favour of the more realistic notion that there are transaction costs associated with divesting specific-use assets. Finally, in the world of very complex transactions, decision-makers have bounded rationality and this permits opportunistic behaviour on the part of firms that have some sort of advantage.

The raising rivals' costs model which is described below is an example of a model which incorporates strategic conduct into an assessment of the anti-competitive effects of vertical restraints. Under this model, strategic behaviour by a dominant firm or group of firms can impose relatively higher costs on rivals, resulting in higher profits for the dominant firm(s).

⁶⁴ Sullivan, *supra*, note 17 at 622.

⁶⁵ *Ibid.*

⁶⁶ Fox, *supra*, note 23.

C. *Competition Act*

The recently enacted *Competition Act* amendments do not fit easily into the structuralist, deconcentration or consumer welfare model. They reject a structuralist approach by, for example, providing that a merger may not be condemned solely on the basis of increase in concentration or market share.⁶⁷ As between the deconcentration and consumer welfare models, classification depends on the views of the Competition Tribunal on the conditions necessary for efficiency gains, entry barriers, and monopoly pricing. The *Act* requires a balancing of gains from efficiency against losses from decreases in competition. For example, the *Act* would permit a substantial lessening of competition brought about by a merger if the Competition Tribunal finds that the merger has brought about or is likely to bring about "gains in efficiency that will be greater than, and will offset, the effects of any preventing or lessening of competition" and the gains would not exist if merger did not occur.⁶⁸ If the Tribunal assumes that economies of scale are a likely result of a merger or that pricing above marginal cost is unlikely at low concentration levels, it will be leaning toward the consumer welfare model. On the other hand, it could be skeptical about the existence of efficiencies and the efficacy of potential competition in preventing price rises.

There is some support in the *Competition Act* for the deconcentration model. Concerns about deconcentration are evident in the 1986 amendments which state that one of the purposes of the *Act* is to "maintain and encourage competition ... in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy."⁶⁹ Small businesses are not to be protected for their own sake. The *Guide*

⁶⁷ Section 92(2) provides that the Tribunal shall not find that a merger lessened competition substantially "solely on the basis of evidence of concentration or market share."

⁶⁸ The *Act* appears to adopt a modification of the approach of Williamson: "The Welfare Tradeoffs" (1968) 58 Am. Econ. Rev. 18. The literature on tradeoffs between efficiency and dead weight welfare losses is criticized in A.A. Fisher & R.H. Lande, "Efficiency Considerations in Merger Enforcement" (1983) 71 Cal. L. Rev. 1580.

⁶⁹ *Supra*, note 1, s. 1.1.

to the *Competition Act* amendments states that "if competitors fall from the market because a dominant competitor is more effective in meeting consumers' needs, this is not an abuse of market power, but rather a natural consequence of the competitive process."⁷⁰ The value of consumer choice is also recognized in the statement of purpose, which states that one aim in encouraging competition is "to provide consumers with competitive prices and product choices." However, in our view the *Act* is more consistent with economic models of behaviour because of its emphasis on the trade-off between competition and efficiency, its concern for innovation,⁷¹ and its prohibition of conduct which creates entry barriers.

Section 77 which regulates exclusive dealing may be viewed in this context. By rejecting a *per se* illegality rule for exclusive dealing, the section departs from the tradition of inhospitality to the novel business behaviour of the structuralist model. By requiring that the practice substantially lessen competition, the *Act* recognizes that the impact of the restraint may be pro or anti-competitive in contrast to the consumer welfare model which advocated a *per se* legal rule. In our view the section when read within the context of the *Act* as a whole is most consistent with the strategic behaviour model, which emphasizes the effect of the restraint in the real world.

IV. ECONOMIC RATIONALE FOR REGULATING EXCLUSIVE DEALING

A. Overview

If exclusive dealing always had an anti-competitive effect, it should be prohibited in every case. Economic analysis has shown, however, that in many cases exclusive dealing has a neutral or even a pro-competitive effect. The pro-competitive effects from vertical

⁷⁰ Ministry of Consumer and Corporate Affairs, Guide at 22-23. It should be noted that the centralist model does not protect small competitors for their own sake or advocate inefficient outcomes. See Fox, *supra*, note 23.

⁷¹ *Supra*, note 1, s. 93(g).

restraints are usually due to a reduction of transaction costs or the elimination of externalities. Because of these decreases in costs, the firm is better able to compete with its rivals, and this results in efficiency gains. The behaviour of the firm exercising the vertical restraint is kept in check whenever there are rivals not engaged in the vertical restraint. If consumers are unhappy with the vertical policy of a firm (because their choice is limited), they are free to purchase from the rivals. Thus, a firm implementing vertical restraints in the presence of competitors must experience costs savings that are sufficiently large to offset any consumer dissatisfaction. Anti-competitive effects occur when there are few (or no) rivals. Without many rivals, the firm has greater control over its price since the consumer's alternatives are limited.

The *Competition Act* which requires a showing that the practice substantially lessens competition is consistent with this general analysis of vertical restraints. Developing a standard requires an understanding of the pro- and anti-competitive effects of the practice.

B. *Pro-competitive or Ambiguous Effects*

Exclusive dealing may reduce inter-brand free-riding on the promotional efforts of the supplier. The supplier may be motivated to spend more on promotion because exclusive dealing prevents free-riding on suppliers' advertising and services. Professor Marvel gives the example of large life insurance companies that advertise widely and maintain a large sales force to signal the existence of insurance to the consumer, who goes to an agent to purchase the insurance.⁷² If the agent represented both informing firms and non-informing firms, the non-informing firms could underprice the informing firms and thus free-ride on the efforts of the informing firms. Similarly, exclusive dealing by car manufacturers which requires that car dealers carry the parts of the manufacturer may

⁷² H. Marvel, "Exclusive Dealing" (1982) 25 J. Law & Econ. 1.

prevent free-riding on the brand name of the manufacturer.⁷³ Dealers may be motivated to promote the product because their own success is tied to the success of the only brand it carries. A dealer which carries more than one brand will be indifferent as to which brand is sold as long as the margins are the same.

Requirements contracts, by allocating risks among the parties, may minimize costs and make projects feasible. For example, an agreement by a supplier to provide continuous supply over a long period of time protects the customer against short-term shortages. The supplier may charge for this service by extracting a higher price or by requiring that the customer purchase all of its requirements from the supplier. The most efficient option, in many cases, may be the requirements contract.⁷⁴

Exclusive dealing may result in lower wholesale prices. Since suppliers must compete for retailers through wholesale contracts which may or may not require exclusive dealing, the supplier will have to lower the wholesale price to induce the dealer to deal exclusively in the products of the supplier. Exclusive dealing which results in a higher margin between wholesale and resale price may motivate dealers to expend more effort on promotion, carry larger inventories, and provide maintenance and repair service. Professors Mathewson and Winter frame the question as whether "any reduction in wholesale prices to capture existing retailers generate[s] sufficient benefits to outweigh the reduction in product choice [by the consumer]."⁷⁵ They conclude that retail prices may be lower if potential competition indicated by the number of substitutes (for example) is high.

Exclusive dealing may protect trade secrets. For instance, in the absence of exclusive dealing, a distributor could use the market strategies of one supplier to benefit another.

⁷³ P. Mathewson & Winter, "The Economics of Vertical Restrictions" (Working paper, Law and Economic Programme, U. of Toronto, 1984) at 72.

⁷⁴ P. Areeda, *Antitrust Analysis, Problems, Text, Cases*, 3d ed. (Toronto: Little, Brown, 1981) at 811. It should be noted requirements contracts imposed by the customer are not caught by s. 77.

⁷⁵ Mathewson & Winter, *supra*, note 73 at 81.

Exclusive dealing may facilitate the entry of a new producer into a market. A new producer may be able to recover its initial developmental costs through exclusive dealing. Exclusive dealing may permit a small, entering supplier to obtain the services of dealers and help build its reputation. Subsection 77(4)(a) provides a defence for exclusive dealing or market restriction which is used to facilitate the new entry of a product or firm into a market.

C. *Anti-competitive Effects*

There are two anti-competitive affects of exclusive dealing: facilitation of collusion and foreclosure of rivals. Section 49 regulates both exclusive dealing and tied selling. This is consistent with economic theory because the two practices are similar in their effects on the consumer and other firms in the market. Exclusive dealing is essentially a special type of tied selling where the consumer can purchase the product of a particular manufacturer only in connection with the services of a dealer that is authorized by the manufacturer. In effect, there is a bundling of product and dealer which is a type of tied selling.

A difference between the two, often observed in practice, is that tying usually occurs between two products of an integrated firm while exclusive dealing is between unintegrated firms, although contractual obligations regarding matters such as financing and training may result in cooperation between unintegrated firms that is similar to vertical integration.⁷⁶

It has been argued that a vertical restraint arising from the unilateral action of one integrated firm is likely to cause more harm to the public than bilateral exclusive dealing agreements, which are open to periodic renegotiation. The contention is that the competition between dealers for suppliers and between manufacturers for dealers ensures that the public interest is being served. While in our view it cannot be assumed that competition for exclusionary rights will always lead to efficient arrangements, such bilateral agreements resulting from mutual accommodation are

⁷⁶ It should also be noted that subsection 77(4) exempts exclusive dealing and tied selling among affiliated firms.

likely to be more benign than tying arrangements, which in many cases are all-or-nothing offers imposed by suppliers with market power.⁷⁷

1. Facilitate collusion

Exclusive dealing may be used to facilitate collusion among dealers of different suppliers. Widespread practice of exclusive dealing among suppliers may limit the number of dealers, which makes collusion easier because of the fewer numbers. Such practice will also make it difficult for the members of a dealer cartel to hide price cutting, and thus will strengthen the cartel. By foreclosing the market to entering suppliers, widespread exclusive dealing may also protect dealers from the threat of outside competition sparked by supra-competitive prices.⁷⁸

Exclusive dealing may also facilitate intra-brand cartels. There is disagreement whether the effect of a cartel among dealers of the same brand is to lessen competition. The US *Vertical Restraints Guidelines* state that intra-brand cartels will not be treated as horizontal agreements because "[s]uch restraints can have no effect that could not also be obtained through the unilateral action of the manufacturer of the particular brands in question."⁷⁹

Exclusive dealing may also be used to facilitate collusion among suppliers. Exclusive dealing facilitates the enforcement of a cartel agreement by making it more difficult for suppliers to cheat. Any change in a dealer's price can be traced to a specific supplier. A supplier cartel is not likely to occur unless the suppliers' market is concentrated. If the market is not concentrated, a supplier cartel is unlikely to be able to coordinate prices without an express agreement. Exclusive dealing could facilitate an agreement by

⁷⁷ M.E. Porter, *Interbrand Choice, Strategy, and Bilateral Market* (Cambridge, Mass.: Harvard University Press, 1976).

⁷⁸ The US *Vertical Restraints Guidelines*, *supra*, note 50 will classify such agreements as horizontal agreements and thus illegal *per se*. This includes agreements to refuse to deal with a seller at the same level of distribution.

⁷⁹ *Supra*, note 51 at 7. See also W. Liebler, "Intrabrand 'Cartels' Under *GTE Sylvania*" (1982) 30 UCLA L. Rev. 1.

suppliers to divide the market geographically if dealers were assigned non-overlapping territories.⁸⁰

In the inquiry into *Restraints on Competition in the Canadian Petroleum Industry*, the Director of Investigation and Research argued before the RTPC that exclusive dealing restrictions on dealers facilitated price rises at the wholesale level by "dominating motor fuel marketing at retail." This is because "[a] small number of refiners can more easily raise prices if they control the setting of prices at a sufficient number of retail outlets than if they were to sell only at wholesale to numerous independently owned-and-operated distributors."⁸¹ The Commission found no evidence of collusion in any sector of the industry,⁸² but it highlighted as a concern, minimum quantity requirements contracts which required independents to purchase a minimum amount from a specific retailer. Although the Commission found that the contracts were not enforced, it was concerned that enforcement in the future would lessen competition among refiners.⁸³

2. Foreclosure of rivals

Foreclosure of existing and potential rivals in the supplier or dealer market is another anti-competitive motivation for exclusive dealing. The difficulty encountered here is that the existence of foreclosure does not necessarily allow us to conclude that welfare is reduced. Foreclosure can be the result of inefficient firms losing ground to efficient ones. It is also conceivable that given the existing concentration of market power in the economy, vertical restraints leading to foreclosure may be welfare enhancing.

⁸⁰ Schwartz & Eisenstadt, "Vertical Restraint" (U.S. Department of Justice: Economic Policy Office Paper No. 82-8, Dec. 2, 1982) at 92.

⁸¹ Reply Remedies Argument of the Director of Investigation and Research submitted to the RTPC (22 August 1984) at M-4.

⁸² RTPC, *Competition in the Canadian Petroleum Industry* (Hull, Que.: Supply & Services Canada, 1986) at 461.

⁸³ *Ibid.* at 285.

One theory developed to determine when foreclosure is detrimental is the leverage theory which assumes that leverage of market power from one market to another is highly probable. This theory underlies the adoption in the United States of a *per se* rule of illegality for tied selling.⁸⁴ The theory has been criticized by economists on the basis that there are conditions under which monopoly power cannot be extended into a second market.⁸⁵ This conclusion, however, should not divert attention from the possibility of using exclusionary rights to create market power among firms operating in an oligopolistic or even competitive market. The purchase of an exclusionary right such as exclusive dealing can confer power over output and price on suppliers "who absent these rights would be selling inputs as competitors or oligopolists, not as monopolists."⁸⁶ Exclusionary rights can restrict supply to rivals or

⁸⁴ *Standard Oil Co of Calif. v. U.S.*, 337 U.S. 293 (1949) at 305-06. The United States Supreme Court in 1949 concluded that "tying agreements serve hardly any purpose beyond the suppression of competition." Tying arrangements were prohibited if the tying producer had dominant market power and the arrangement accounted for a substantial quantity of commerce in the tied good. Market dominance could be shown by evidence that (1) the supplier makes a large number of tied sales and there is no buyer advantage in purchasing the tied package, or (2) the supplier's tying product is unique because of its physical characteristics, a legally conferred monopoly or an economic advantage possessed by the seller. See also *Betaseed, Inc. v. U. & I, Inc.* 681 F.2d 1203 (9th Cir. 1982).

⁸⁵ It is generally accepted that under certain conditions "there is only one monopoly profit to be made in a chain of production." The following conditions are necessary for the statement that there is only one monopoly profit to be made in two vertically adjacent markets: (1) all inputs must be used in fixed proportions, (2) the restraining firm and its rivals must face equal costs and have constant marginal costs of production, and (3) the restraining firm and its rivals must be vertically integrated to the same degree. W.S. Bowman, "Tying Arrangements and the Leverage Problem" (1957) 67 Yale L.J. 19. R.A. Posner, *Antitrust Law* (Chicago: University of Chicago Press, 1976). This conclusion was adopted by O'Connor J. in the decision of the United States Supreme Court in *Jefferson Parish Hospital v. Hyde*, 466 U.S. 2, 104 S.Ct. 1551 (1984) at 27-28:

The existence of a tied product normally does not increase the profit that the seller with market power can extract from sales of the tying product. A seller with a monopoly on flour, for example, cannot increase the profit it can extract from flour consumers simply by forcing them to buy sugar along with their flour. Counterintuitive though that assertion may seem, it is easily demonstrated and widely accepted.

If the products are sold in variable proportions, the tying producer may be able to increase its monopoly profits through price discrimination.

⁸⁶ T.G. Krattenmaker & S.C. Salop, "Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price" (1986) 96 Yale L.J. 209 at 248.

facilitate coordination among competing suppliers. In addition, restraints by monopolist suppliers should not be ignored. There are conditions under which a monopolist would agree to limit supply to rivals of a purchaser.⁸⁷

In our view, the approach of the critics of the leverage theory who focus on the question of whether monopoly power has been extended into a second market is too narrow in that it fails to investigate the effect on welfare. This failure obscures the fact that welfare effects of an extension of a monopoly are ambiguous. Retaining the leverage theory does not necessarily imply that efficient explanations for the conduct must be ignored; nor does rejecting the leverage theory necessarily imply that the conduct should be presumed to be efficient. Under either view, the emphasis should be on setting out the conditions under which these arrangements have a detrimental effect on welfare.⁸⁸ The leverage theory has not proven to be very useful since its emphasis is on the creation of another monopoly, rather than on the welfare effects of vertical restraints.

The consumer welfare model studies vertical restraints with the view that they are detrimental only when they result in greater market power in a market that is concentrated. The strategic behaviour model examines the assumptions underlying the bilateral monopoly model,⁸⁹ and points out that in the real world conduct directed at excluding rivals may be effective. These two current models are compared and contrasted in the next section. The general conclusion is that each theory is valid under different sets of assumptions. The practical challenge is to determine which theory is most generally applicable to a world where verifying the validity of a set of assumptions may not be feasible.

⁸⁷ *Ibid.* at 249, footnote 125.

⁸⁸ Compare L. Kaplow, "Extension of Monopoly Power Through Leverage" (1985) 85 *Colum. L. Rev.* 515, who argues that the alternative explanations for vertical restraints are not convincing and would at the very least require that the firm be consciously pursuing an efficient objective on the reasoning that many of the alternative explanations require conscious pursuit if the result is to be efficient.

⁸⁹ See *supra*, note 85 for the conditions under which it is impossible to extend monopoly power from one market to another.

V. SUBSTANTIAL LESSENING OF COMPETITION: CONSUMER WELFARE MODEL v. STRATEGIC BEHAVIOUR MODEL

A. Introduction

The foregoing discussion of models of economic behaviour demonstrates the conflict between the goals of deconcentration and economic efficiency; that is, deconcentrated markets may not be the most efficient markets. The models also illustrate the importance of the underlying assumptions about the effects of vertical restraints. The consumer welfare model assumes the effects are almost always efficient, while the other models are skeptical and assume that little harm will be done by prohibiting restraints which have not been shown in the particular case to be efficient or at least to have a pro-competitive purpose.

Two approaches to the assessment of the anti-competitive effects of exclusive dealing will be analyzed: the consumer welfare school and the strategic behaviour school. The deconcentration theory is not discussed because there is no established formal model behind the theory that lends itself to analysis.

The following discussion first examines the anti-competitive effects predicted by the consumer welfare model and sets out the sufficient conditions for harm. The strategic behaviour model, however, indicates that these conditions may not be necessary or, at least, are not sufficiently developed. The consumer welfare model does not develop fully the conditions under which rivals are disadvantaged by vertical restraints and adopts a narrow definition of entry barriers.⁹⁰ The next section describes a type of strategic behaviour model — that of raising rivals' costs — which analyzes the conditions that show harm to the firms remaining in the post-

⁹⁰ Many advocates of the consumer welfare model adopt a narrow definition of entry barriers. For example, it is argued that costs of capital to enter a market are not entry barriers because the possession of capital by the established firm is "like its advantage in having a functioning management team, knowledge, commercial contacts, and so on." Bork, *supra*, note 44 at 324. Compare Williamson, *supra*, note 22 at 963 who argues that the capital costs of entering one stage will be less than those of firms entering two stages because, among other things, the firms entering at two levels will be penalized for lack of experience.

restraint market and that confer market power on the excluding firm. We do not repeat our discussion of the collusive aspects of vertical restraints (see IV.B.1.) since all models are in agreement that these exist and are detrimental.

B. *Consumer Welfare Model*

The principal anti-competitive effect predicted by the consumer welfare model is the use of vertical restraints to reinforce or extend market power. A firm may impose the restraint in the market in which it has the largest share, by creating entry barriers in that market. Exclusive dealing will foreclose competition in the supplier market if the exclusive arrangement limits the supply of dealers to such an extent that rival suppliers are forced to enter the dealer market, and entry into the dealer market is difficult. With difficult entry into the dealer market rival suppliers are eventually forced to exit or, at least, to participate at a reduced level. This enhances the original supplier's dominant position in the supplier market.

The consumer welfare model, unlike the strategic behaviour model, is not concerned if the restraint results in the creation of another dominant firm in the dealer market — unless the effect is to reinforce market power in the supplier market through the creation of entry barriers into that market. The first order effects of firms being forced to leave the dealer market are of concern to the consumer welfare model only if entrants into the supplier market are consequently forced to enter both the supplier and dealer markets. In the view of the consumer welfare school, even if there are few independent dealers, exclusive dealing will not increase the costs of rival suppliers if entry into the dealer market is easy:⁹¹ rivals will be able to depend on new entrants or create new dealers in response to the new demand generated by the rival to increase the supply. Although competition has been lessened in the dealer market in the sense that dealers have been foreclosed, it also must be shown that there are barriers to entry in that market. "Even if

⁹¹ See Schwartz & Eisenstadt, *supra*, note 80 at 78.

independents are largely eliminated, little is gained if the cost of establishing new facilities is not significantly higher than the cost of using existing ones, that is, if entry into the [dealer] market is easy."⁹²

Under the consumer welfare model, in order for exclusive dealing to have the effect of creating entry barriers such that rivals in the supplier market are excluded, the following conditions must be present:

1. The exclusive supplier must have a high market share in the supply market, or exclusive dealing must be widespread. There must be insufficient independent dealers remaining; otherwise, a rival in the supplier market will have adequate supplies of the product.
2. Entry barriers to the dealer market must be high, or entry must require more than a specified period of time. This inquiry focuses on the difficulties of a rival supplier in entering the dealer market.

C. *Raising Rivals Costs Model*

1. Description

The analysis of the consumer welfare model can be criticized on the basis that it ignores the competitive conditions in the dealer market and focuses on the effect on rivals in the supplier market. The consumer welfare model assumes that complete elimination of independent rival suppliers should be permitted if entry barriers are low or entry is possible in a "relatively short time."⁹³ It is assumed that potential entrants will exert sufficient pressure on prices to prevent the remaining firms from raising prices. In contrast, the strategic behaviour model would shift the focus away from potential rival suppliers to an examination of the competitive conditions in

⁹² *Ibid.* at 80.

⁹³ *Vertical Restraints Guidelines, supra*, note 51 at para. 4.21.

the markets and propose that under certain conditions a pool of firms should be maintained.

Recent work by economists Steven Salop and David Scheffman and by law professor Thomas Krattenmaker has analyzed exclusionary behaviour of dominant firms designed to raise rivals' costs.⁹⁴ The raising-rivals'-costs (RRC) model focuses on the impact of the exclusionary conduct on the costs of rivals in the market. Practices such as exclusive dealing, tied selling, and refusals to supply may be used to restrict the supply of a product to rivals, thus raising their costs and lowering their output. When this occurs under certain conditions, the firm imposing the restraint may be able to raise prices above the pre-restraint level.

Rivals' costs are raised when a purchaser of a restraint restricts inputs to its rivals by making an agreement with suppliers in the input market not to supply rivals. Either the upstream or downstream market may be the input market. For example, in an exclusive dealing arrangement, dealerships can be viewed as either an input or an output. Dealerships are an input from the viewpoint of the manufacturer whose objective is to distribute its product. From the viewpoint of the dealer, the input market is that of the manufactured product. The conduct that is regulated is restriction by a purchaser of the supply of inputs to its rivals. Thus a manufacturer may enter into exclusive dealing arrangements with 90% of the dealers and severely limit the supply of dealerships to some or all of its rival manufacturers. Or a dealer may enter into an exclusive dealing arrangement with a manufacturer and cut off supply of that manufacturer's product to rival dealers; this conduct does not come within the definition of exclusive dealing in the *Competition Act*.⁹⁵

The RRC model postulates four ways in which exclusive arrangements that restrict inputs can raise costs for rivals of the exclusive purchaser. As background, it is important to note that an

⁹⁴ The following discussion summarizes the argument of Krattenmaker & Salop, *supra*, note 86. See also Salop & Scheffman, "Cost-Raising Strategies" (Federal Trade Commission, Working Paper No. 146, July, 1986).

⁹⁵ Definition of exclusive dealing does not include exclusive dealing imposed by buyers on suppliers. It is limited to restrictions imposed by suppliers on buyers. There is no economic justification for the distinction.

exclusive supply contract in and of itself does not restrict supply; it simply reorganizes the chains of supply. Thus an agreement by dealer *A* to carry the entire product of supplier *X* exclusively does not necessarily raise the costs of *A*'s rivals, because the exclusive arrangement will free up supply from the rivals of *X* which had been purchased by *A*. Rivals of *A* cut off from supplier *X* are able to fulfill their needs from *X*'s rivals.

The costs of *A*'s rivals will rise, however, if *A* captures a unique input with the result that rivals are forced to shift to higher cost substitutes. The RRC model refers to this as a "bottleneck." In this case the purchaser has captured the input market's lowest cost suppliers where "those suppliers determine the input's market price."⁹⁶ This case is referred to in antitrust literature as the "essential facilities doctrine" or the bottleneck.⁹⁷ It is illustrated by the facts in *Terminal Railroad Association*,⁹⁸ in which a group of railroad operators gained control of the only railway bridges across the Mississippi River, and also obtained a promise that the bridge would only be made available to other railroads on discriminatory terms. The Restrictive Trade Practices Commission in the Petroleum Inquiry concluded that in the Canadian petroleum industry, refineries and large terminals are essential facilities. The Commission adopted measures to assure continuing supply to efficient independents and potential entrants.⁹⁹

Second, costs to *A*'s rivals will also rise if there is insufficient non-foreclosed supply to satisfy the needs of rivals at the competitive price. Demand for the limited supply will drive the price of the input up. *A* may limit supply of the input by overbuying or by obtaining an agreement from suppliers not to supply rivals, referred to in antitrust law as a "supply squeeze." The RRC model classifies this as "real foreclosure" because *A* gains

⁹⁶ Krattenmaker & Salop, *supra*, note 86 at 234. In the absence of the exclusive dealing agreement, the lowest cost suppliers would have sufficient capacity to keep the price at the competitive level.

⁹⁷ See D.E. Troy, "Unclogging the Bottleneck: A New Essential Facility Doctrine" (1983) 83 Colum. L. Rev. 441.

⁹⁸ 224 U.S. 383 (1912).

⁹⁹ Restrictive Trade Practices Commission, *supra*, note 82 at 453.

control of the input with the ability to restrict supply and raise the price. It should be noted that a bottleneck is a special case of real foreclosure. The concept of foreclosure is illustrated by *R. v. British Columbia Fruit Growers Association*,¹⁰⁰ in which an association of fruit growers gained exclusive rights to the services of all the full storage and packing facilities in British Columbia.

Third, costs to *A*'s rivals may rise because *A* is using the exclusive arrangement to orchestrate a cartel agreement among input suppliers such as retail dealers.¹⁰¹ For instance, in *Interstate Circuit*,¹⁰² the operators of motion picture theaters obtained a promise from a group of distributors that they would in effect raise the cost of exhibiting films to rivals by requiring second run theaters to raise their ticket prices. The RRC model refers to this strategy as "cartel ringmaster."

Fourth, costs to *A*'s rivals may rise because the remaining unrestrained input suppliers are able to fix prices. For example, if only one unrestrained retailer remains, that retailer has market power over *A*'s rivals (assuming there are entry barriers). The RRC model refers to this strategy as "Frankenstein monster."

These strategies may be illustrated by the facts of *Bombardier*.¹⁰³ Bombardier, a producer of snowmobiles, entered into exclusive dealing arrangements with its Canadian dealers. The RTPC held that the exclusive dealing did not violate section 77. Applying the RRC model's analysis, the practice would have raised

¹⁰⁰ (1985) 11 C.P.R. (3d) 183 (B.C.C.A.). It should be noted that this conduct should be classified as horizontal, not vertical, because of the horizontal agreement among members of the association. The Association was charged under former s. 32(1)(a) (now 45(1)(a)) for conspiring to limit storage facilities. The verdict of not guilty was based on the court's findings that although independent fruit producers were foreclosed from full service packing houses, entry into the packing house market was easy, and that independent producers continued to market fruit despite the foreclosure.

¹⁰¹ It should be noted that cartel agreements can be attacked directly under section 45 as a conspiracy which substantially lessens competition. Exclusionary acts by monopolies that limit supply are regulated by sections 78 and 79 of the *Competition Act*, *supra*, note 1. For example, the following anti-competitive acts are listed: s. 78(e) pre-emption of scarce resources; s. 78(f) overbuying; s. 78(h) requiring or inducing a supplier to sell only to certain customers.

¹⁰² 306 U.S. 207 (1959).

¹⁰³ *Supra*, note 12.

Bombardier's rivals' costs of distribution if (1) non-foreclosed dealers did not have sufficient capacity to meet rivals' needs, (2) non-foreclosed dealers of snowmobiles were less efficient than the foreclosed dealers, (3) Bombardier induced dealers not to deal with rivals or to charge high prices, or (4) the non-foreclosed dealers were so concentrated that they were able to charge supra-competitive prices to rivals. Requirement (1) does not affect rivals' costs if entry into the dealer market is easy, as the Commission found to be the case. Requirement (2) was argued in *Bombardier* but not discussed by the Commission. Any advantage to Bombardier from possessing the "best" dealers was implicitly rejected as an important factor by the Commission's finding of high turnover of Bombardier dealers and vigorous recruitment of Bombardier dealers by rivals. There was no evidence of requirement (3). Regarding requirement (4), the Commission found that entry into the dealer market was easy and therefore dealers possessed no special market power.

2. Criticism

There has been some opposition to the RRC model. One criticism is that the model is redundant because existing monopolization and conspiracy provisions would prohibit conduct identified as anti-competitive by the RRC model. The argument is that in order to raise rivals' costs, control over the input market is necessary. This market power should be caught as monopolization of the input market without worrying about the second-order considerations of what a firm with such control in the input market can do in the forward market. While this argument is theoretically appealing, there are a number of reasons why competition policy may fail to catch concentrations of power in the input market. For example, although the act of monopolization is illegal,¹⁰⁴ simply having a large market share is not. Thus, a firm that acquired market power in the past through means not prohibited by the *Competition Act* or not detected by enforcement authorities could

¹⁰⁴ *Supra*, note 1, s. 50.

later choose to exercise that power without violating the monopolization section, if it does not intend to exclude rivals or impede entry. The effect of the RRC model is to discourage the formation of monopolies.

In addition, for the purposes of the monopolization section, the RRC model's definition of the input market may be narrower than the market definition.¹⁰⁵ For example, Alcoa, a supplier of aluminium, monopolized the supply of electricity to rival aluminium suppliers; it did not monopolize the market for electricity.¹⁰⁶ A court considering an allegation of monopolization may not recognize this narrowly defined input market, while the RRC analysis highlights the anti-competitive effect of Alcoa's conduct by explicating the possible anti-competitive motives and effects.

Some other criticisms of the RRC model are at a more practical level. Since the model results in more complex legal rules, it is feared that firms will be uncertain about what conduct is legal. This uncertainty may lead them to avoid legally marginal but efficient conduct.¹⁰⁷ Moreover, the complexity may result in courts not being able to recognize the conditions set out by the RRC model tests. This uncertainty about how courts will interpret the conditions will lead to further conservative behaviour on the part of firms, resulting in greater inefficiency. We reject these concerns because we feel that while there are many conditions under the RRC model tests that give the illusion of complexity, each condition is straightforward and can be verified as easily as the conditions of any other of the competing tests. Thus, we think that neither the firms nor the courts will be any more baffled by this set of conditions than they are by other possible sets of conditions.

Finally, the model has been rejected by the advocates of the consumer welfare model for fear that a recognition of strategic behaviour will lead to a revival of the antitrust doctrines of vertical

¹⁰⁵ Brennan, "Understanding 'Raising Rivals' Costs" United States Department of Justice Economic Analysis Group, EAG 86-16, September 26, 1986.

¹⁰⁶ *Ibid.* at 28.

¹⁰⁷ Brennan, *supra*, note 105.

foreclosure and predation,¹⁰⁸ doctrines that are in their view obsolete. We conclude that this fear is exaggerated and, in any event, is irrelevant in the face of legislation that prohibits predatory conduct.

D. Comparison of the Two Models and the Conditions Indicating an Anti-competitive Impact

Although both the RRC model and the consumer welfare model derive from economic reasoning, their policy prescriptions are very dissimilar. The differences stem from the objectives adopted in each model and the assumptions being made. The RRC model differs from the consumer welfare model in that under the RRC model an anti-competitive impact is possible even if supply in the input market is sufficient or the restraint does not create entry barriers in the output market. In addition, the RRC model examines the possibility of collusion by the unrestrained suppliers or by all suppliers of the input, and whether overbuying has been used to increase rivals' costs.

1. Assumptions

The two models differ on two crucial assumptions: (1) the likelihood that firms will be able to purchase exclusionary rights that do not reflect their full value to the purchaser, and (2) the likelihood of entry barriers.

The consumer welfare model argues that a rational seller of an exclusionary right would not agree to confer a benefit on the purchaser of the right without receiving full compensation. Thus, it is doubtful that sellers of a unique input such as a raw material would sell it exclusively to one purchaser for a price less than that of substitutes so that the purchaser's costs would be lower than those of its rivals.

We reject this argument because it assumes that the bidding process for exclusionary rights is perfect, while in the real world

¹⁰⁸ Baxter, *supra*, note 63.

bidding is subject to the imperfections of asymmetric information and uncertainty. Even if bidding were perfect, it cannot be assumed that a competitive market for exclusionary restraints "will lead to competitive product markets."¹⁰⁹ In addition, the problem of a bidding process depriving the excluding firms of any benefit does not arise in the case of tied selling by an integrated firm.

The consumer welfare model defines entry barriers as long-run costs incurred by an entrant that are not incurred by firms already in the industry.¹¹⁰ But the strategic behaviour model defines them as whatever makes entry more difficult and permits an established firm to charge supra-competitive prices without attracting new entry. We agree that entry barriers should include the case in which a firm entering the market has higher costs than existing firms.

2. Comparison of the consumer welfare model and the RRC model

a) *Limitation of supply versus raising cost of an input*

The consumer welfare model is primarily concerned with the degree of foreclosure to rivals of the firm imposing the restraint. In the absence of entry barriers, it would permit tied selling even if all producers of the tied product were eliminated as a result. The consumer welfare model is only concerned with increases in concentration that confer market power in the classical sense: a few firms remain in a market where they are free from competitive pressure on price and there are no potential entrants. For example, it focuses on the degree of foreclosure in the supplier market of

¹⁰⁹ Krattenmaker & Salop, *supra*, note 86 at 277. See P. Mathewson and Winter, "The Competitive Effects of Vertical Agreements: Comment" (1987) *Amer. Econ. Rev.* 1057 at 1062. They adopt a middle ground between the *per se* legality approach of Bork and proposals that exclusive dealing should be prohibited when rivals are excluded and there are no concerns about free-riders. "Our model thus speaks against a *per se* approach to exclusive dealing. The rule suggested by Thomas Krattenmaker and Steven Salop, that an exclusionary practice should be prohibited when it allows a firm to raise its price is supported as a conservative rule of reason or *ex post* test of legality."

¹¹⁰ G.J. Stigler, *The Organization of Industry* (Homewood, Ill.: R.D. Irwin, 1968).

rivals seeking to expand or enter, who must enter two levels at the same time because inadequate supplies are available.

The strategic behaviour model, in contrast, argues that the purchaser of exclusionary rights can gain some control over price by raising rivals' costs even in a perfectly competitive market, if the increase in rivals' marginal costs results in a higher competitive market price. All that is necessary is the restraint of output by rivals and the existence of entry barriers.¹¹¹ It assumes that costs are raised not only by being deprived of an input and therefore being forced to enter at two levels, but also by conduct which raises the cost of an input above the cost to rivals. The RRC model, for example, would prohibit a restraint which raised concentration in the input market to such a level that collusion is likely. In this case rivals of the excluding firm will not be able to obtain the input at a competitive price and the restraining firm will be able to raise prices. In contrast, the consumer welfare model is satisfied if there is sufficient capacity in the input market remaining to supply an entering rival. The RRC model will condemn a restraint if the restraint has caused the price to rise significantly, even if there is sufficient capacity remaining to supply rivals. (Entry barriers are implicitly assumed since in their absence, pressure from potential entrants would keep the price down).

b) *Creation of entry barriers*

The RRC model does not require that the restraint create an entry barrier which forces entry at both levels.¹¹² It is objectionable if the restraint raises the costs of rivals and the restraining firm is able to raise prices because entry barriers which existed before the imposition of the restraint forced the rivals to depend on established firms for their supplies of the restricted input. A model which examines the position of existing firms is consistent with the wording

¹¹¹ See Krattenmaker & Salop, *supra*, note 86 at 251, footnotes 131-32 and at 265, footnote 179. They give the example of a market for taxi rides. If bus service is greatly reduced and no new taxis enter the market, taxi owners collectively will likely earn more although no single taxi driver has power over price.

¹¹² Krattenmaker & Salop, *ibid.* at 285.

of section 77 which refers to impediments to expansion as well as entry. The output of a firm whose costs have increased and which is forced to raise its price will in most cases fall.

c) *Market concentration*

Third, the RRC model permits the inference of power over price and output from measures of market concentration. This approach examines the ability of the nonexclusive firms (that is, firms which are not a party to the exclusive agreement) to constrain price increases by the exclusive firm after the restriction is in place. The basic question is whether the restraint raises the costs of the nonexclusive firms and if so, whether this cost increase confers power on the restraining firm to raise prices.

d) *Overbuying*

Lastly, the RRC model demonstrates that overbuying of inputs or highly complementary products through exclusive dealing or other vertical restraints can be a profitable strategy in combatting rivals. This has been shown even in the case of a tying of two products in fixed proportions which is the classical case in which critics of the leverage theory argue that a monopolist cannot increase monopoly profits.¹¹³

VI. RECOMMENDED ANALYSIS: SUBSTANTIAL LESSENING OF COMPETITION

A. *Introduction*

The above analysis points out the different underlying assumptions of the two models. We agree with the RRC model that the possibility of firms being able to purchase exclusionary rights is

¹¹³ K.K. Wollenberg, "An Economic Analysis of Tie-In Sales: Re-examining the Leverage Theory" (1987) 39 *Stan. L. Rev.* 737.

a real one, and we adopt the assumption that the limitation of supply through the acquisition of exclusionary rights is likely. We also adopt the RRC model's definition of entry barrier. In this section, in the light of these assumptions, we take exclusive dealing as an example and discuss the conditions necessary for these arrangements to have an anti-competitive effect.

Section 77 prohibits exclusive dealing when undertaken by a major supplier, or when exclusive dealing is widespread in the market and is likely to impede entry or expansion with the result that competition is or is likely to be substantially lessened. The two conditions, (1) impediment to entry or expansion and (2) a substantial lessening of competition, can be defined using the foregoing discussion of the anti-competitive effects of exclusionary conduct, which draws primarily on those conditions suggested by the RRC model.

The conditions in subsection 77(2) of impediments to entry or expansion and a substantial lessening of competition were encapsulated into one inquiry by the Restrictive Trade Practices Commission in *Bombardier*. The Commission stated, "[W]hether exclusive dealing by a supplier impedes expansion or entry of competitors in the market is most easily and meaningfully considered as part of the determination of whether there is or is likely to be a substantial lessening of competition as a result of the practice."¹¹⁴ The legislative debates indicate that merely impeding entry is not sufficient, but that the question is "whether entry is impeded to such an extent that competition is likely to be lessened substantially."¹¹⁵ The section mandates a rule-of-reason analysis which assesses the impact on competition in each case.

This rule of reason analysis can be compared to a *per se* rule which is a conclusive presumption. Under a *per se* rule, conduct is presumed to have an anti-competitive effect once it is shown to come within certain classes which the courts have determined are highly likely to have a pernicious effect on competition. The

¹¹⁴ *Supra*, note 12 at 37.

¹¹⁵ House of Commons Standing Committee on Finance, Trade, and Economic Affairs, May 29, 1975 at 52:15.

defendant cannot escape liability by showing that the conduct in reality has a pro-competitive or neutral effect on competition.

Under a rule of reason, the effect of conduct on competition is assessed in each case. It is a misconception, however, to assume that this inquiry must be begun anew each time. Any such wide-ranging inquiry involves implicit evidentiary burdens based on the logical effect of the evidence. Courts have traditionally been prepared to develop evidentiary presumptions from recurring factual situations based on generalizations about behaviour. For example, based on the generalization that a person in possession of stolen goods is probably the real offender, evidence that an accused was found in possession of recently stolen goods is sufficient to identify the accused as the thief, in the absence of an explanation from the accused. This is not a matter of substantive law, in contrast to the *per se* rule which in effect redefines the elements of the illegal conduct but is a matter of common sense and experience. The inference that the person in possession is the perpetrator of the theft flows from the logical effect of the facts based on our assumptions about behaviour. Logical inferences from the evidence place an evidentiary burden on defendants to explain their conduct.

B. *Rule of Reason: An Unreasonableness Test*

Models of market behaviour provide the basis for generalizations about vertical restraints and the structure for a rule-of-reason analysis. The level of evidence sufficient to show a substantial lessening of competition is a matter of logical inferences based on generalizations from the economic models discussed. Once the existence of an exclusive dealing arrangement has been established, one possible test is to infer a substantial lessening of competition if (1) the defendant has a large market share and (2) entry barriers exist in the market in which supply has allegedly been cut off or limited,¹¹⁶ unless (3) the defendant has a reasonable pro-

¹¹⁶ The reasoning here is as follows: If a firm or a set of firms with a dominant position are using exclusive dealing to the detriment of their rivals by limiting supply, then such an action can have an effect on the rivals only if there are barriers to entry in the dealer market. Otherwise, such an action will cause no harm, since the dealer market will attract more

competitive explanation for the practice. This inference is based on the assumptions that exclusive dealing is likely to limit supply, a pro-competitive effect is unlikely unless this was the defendant's objective, and the class of conduct which is difficult or impossible to identify as anti- or pro-competitive should be assumed to be anti-competitive unless the defendant reasonably intended it to have a pro-competitive effect. (If there is no pro-competitive intention and there is no information about the conduct, the test assumes it is equally likely to have a good or bad effect, and the burden is placed on the defendant to show a good effect.) This approach is consistent with the history and goals of the legislation which gives weight to consumer choice and an "equitable" opportunity to compete.¹¹⁷ This test will be referred to as the unreasonableness test because the default assumption is that when the first two conditions are met, the restraint is unreasonable unless the defendant provides an explanation.

1. Market share

A necessary but not sufficient condition for a vertical restraint to cause an anti-competitive effect is foreclosure of supply. Foreclosure of supply in combination with entry barriers indicates that expansion or entry has been impeded as required by section 77 of the *Competition Act*. Foreclosure of supply through exclusive dealing arrangements may be inferred from market share and entry barriers. Exclusive dealing by a monopolist cuts off supply of the monopolist's product from unrestrained dealers. If a monopolist engages in exclusive dealing, entry barriers exist in the supplier market, and a pro-competitive explanation is absent, then the exclusive dealing will be prohibited under the unreasonableness test. Exclusive dealing which impedes expansion of independent firms in

dealers (who can clearly enter in the absence of entry barriers), who would then serve the rivals. Similarly, when there is a dominant dealer, there must be barriers to entry in the supplier market, so that exclusive dealing between the suppliers and the dominant dealer will hurt other dealers. Thus, the entry barriers must be in the market in which the supply has been cut off or limited.

¹¹⁷ *Supra*, note 1, s. 1.1.

the dealer market because of inaccessibility to the product of the monopolist will be sufficient.

The unreasonableness test may be compared to the standards adopted in other sections of the *Competition Act* to control foreclosure of supply. A monopolist supplier can avoid application of subsection 77(2) because a monopolist, *A*, does not need to impose exclusive dealing in order to achieve the effect of exclusive dealing with *B*. It merely needs to choose to supply *B* exclusively. No commitment by *B* to deal only with *A* is necessary since by definition *A* is the only firm in the *A* market. When there is no exclusive dealing arrangement, the conduct can be assessed under the rules on a refusal to deal under section 75 and abuse of dominant position by a monopolist under section 77.¹¹⁸

Section 75 requires that a person be substantially affected in its business by the refusal, and that the inability to obtain supplies be due to insufficient competition among suppliers. This imposes a higher standard for prohibiting the conduct than our proposed test for section 77. First, it requires the firm which was refused supply to show substantial effect on its business and not merely a foreclosure of supply. Second, the section also requires that the inability to obtain supply be "because of insufficient competition among suppliers of the product." It is an open question whether refusals directed at the secondary level of distribution by a monopolist will be presumed to be caused by insufficient competition unless the supplier shows a legitimate business reason for the refusal. The duty of a monopolist to supply is consistent with the "especially strict standards of conduct ... required [of a monopolist]"¹¹⁹ Section 75, however, does not require proof of entry barriers. In our view there is no inconsistency between an unreasonableness standard under section 77 and refusal to supply

¹¹⁸ Section 78, *ibid.*, regulates among other conduct (a) vertical price squeezes, (e) pre-emption of scarce facilities or resources, (f) buying up of products to prevent the erosion of existing price levels, (h) requiring a supplier to sell only or primarily to certain customers, or to refrain from selling to a competitor.

¹¹⁹ *R. v. Electric Reduction of Canada Ltd.* (1970), 61 C.P.R. 235 (Ont. H.C.). The R.T.P.C. in its report on the petroleum industry, *supra*, note 82, vol. III at 67, recommended that "suppliers who hold high degrees of market power should be entitled to refuse supply to others except to the extent that they can establish sufficient reason for refusing supply."

under section 75, because of their different objectives. Section 75 provides a remedy when individual firms are harmed and no barriers to entry exist. Section 77 is designed to prevent substantial harm to competition.

The section 78 provision on abuse of dominant position does not catch all limitations of supply by a dominant firm. It is primarily directed at the pre-emption of supply from other sources. For example, the section would cover buying up products for the purpose of preventing the erosion of existing price levels,¹²⁰ or pre-empting scarce facilities or resources for the purpose of limiting supply.¹²¹ A refusal to supply a product produced by the dominant firm, often referred to as a "supply squeeze," is not listed among the anti-competitive acts in section 78. It would appear therefore that a monopolist could choose to supply one dealer exclusively as long as the arrangement was not contrary to section 75, covering refusal to deal.

Unlike the RRC model, the unreasonableness test does not require a detailed investigation into the effect of the practice on supply or costs. It assumes that foreclosure of supply exists when both exclusive dealing by a dominant firm in an oligopoly and entry barriers to the relevant market are established. There is no inquiry as to whether the reduction in supply can be remedied by alternative sources, on the assumption that other sources are unlikely given the entry barriers. The RRC model, in contrast, assesses alternative sources of supply by measuring, among other factors, the net foreclosure rate: that is, the percentage of the supplier's capacity available to rivals before the restraint but that is no longer available as a result of the agreement.

2. Are there entry barriers?

Rivals will not be affected by interruption in the supply of inputs or by increased costs of inputs unless there are barriers to entry. Without barriers, other firms can quickly enter the input

¹²⁰ *Supra*, note 1 at s. 78(f).

¹²¹ *Ibid.* at s. 78(e).

market to satisfy the needs of rival firms. Evidence of barriers to entry in the input market is needed to demonstrate harm to rivals. A detailed discussion of entry barriers is outside our terms of reference, but there is a straight-forward condition for the existence of barriers to entry. The costs, fixed or marginal, of a firm entering in the short run are greater than those for an efficient existing firm. It is sufficient that costs be even slightly higher, because this implies that rivals' costs will be increased in two ways. First, because of the higher costs, fewer firms will enter the supply market than otherwise, which means that there is still a supply shortfall. Second, when higher costs are even partially passed on in price, the rivals will be facing higher costs for their inputs. Moreover, it is sufficient for the barriers to be short-run, since with such disadvantages, the rivals cannot compete in the short run. The firm imposing the restraint will then be able to expand market share during the rivals' temporary set-back.

One approach is to require that the post-restraint input market be fully contestable in the sense that market pressures will push price down to costs, thus passing savings on to the consumers of the product. This broad definition of entry barriers would further the goal of deconcentration and would make it more likely that savings be passed on to consumers. Under this approach it is not sufficient for savings to be passed on to consumers in the aggregate. In contrast, the consumer welfare model is unconcerned about distributional effects and treats consumers as a group.¹²² It assumes that they are better off as a group even if savings go to producers and are not passed on to the specific consumers of the restrained product, because producers will be able to invest in other products which consumers want. Requiring that the market be fully contestable is more consistent with the view of European Economic Community competition law, which requires that benefits from combinations that distort competition be passed on to consumers of

¹²² See Bork, *supra*, note 44.

the relevant product.¹²³ This possibility has also been pointed out in American antitrust commentary.¹²⁴

One way to increase the degree of contestability is to adopt a narrow definition of potential entrants. Firms that are now in the market, but have the potential to enter if market prices rise, exert a downward pressure on price. Potential entrants could be confined to those firms which already produce the product but distribute in another geographical market, or those firms able to produce the product with few changes in their existing production process.¹²⁵

We would include as a barrier to entry proof that a firm must enter at both levels in order to expand. The RTPC in *BBM* appeared to hold that when this is shown, no further barriers to entry need be proven.¹²⁶ In this case, competition is substantially lessened when supply of an input is completely cut off from a rival, and the cut-off firm's demand cannot be met by its own rivals. In this case the restraint has not merely redistributed supply, it has reduced supply.

¹²³ See Fox, *supra*, note 56 at 1019; *infra*, note 137, and s. 85(3) of the *Treaty of Rome* in relation to combinations to restrain competition.

¹²⁴ See Fisher & Lande, *supra*, note 68 at 1631-34.

¹²⁵ Posner, *supra*, note 85 at 124 concludes that "[o]n the basis of present knowledge it would seem best simply to ignore potential competitors who cannot be regarded as equivalent to the firms already in the market." Alternatively, Professor Sullivan has recommended that a variety of market definitions be employed in each case, a process described as "peeling the onion." Sullivan, *supra*, note 17 at 609-12. Sullivan describes the expert testimony of Dr. Alan McAdams provided market data on groupings of related products and then successively stripped products out of the group figures to show "the quantitative significance of multiple product groupings and to infer the significance of these data for analyzing IBM's market power." This would enable the Court to look at the problem from a variety of angles and avoid the danger of adopting a simplistic rule that ignores the reality of the situation. Sullivan suggests the question on monopolization might be stated as: "Whether, given all the evidence, including alternative expert appraisal of the data, the market is one in which sufficient power exists to make predation by the defendant a significant risk."

¹²⁶ While the RTPC does emphasize the exclusionary effect of forcing Nielsen to enter at two levels, the decision does not state clearly whether it is sufficient if a firm is forced to enter at both levels or whether there must be entry barriers to the second market. The RTPC does appear to have found that entry into either market was difficult. It stated that "[p]roducing broadcast data involves high fixed costs," and it noted the lack of entry in the last 18 years and the absence of any current threat to enter.

3. Is there a pro-competitive explanation?

Pro-competitive explanations would be taken into account in deciding if there is a substantial lessening of competition. The Tribunal would inquire whether there is evidence supporting a pro-competitive explanation for the practice, such as encouraging innovation or reducing transaction costs. While the absence of an explanation is ambiguous because managers may not understand the impact on competition, the existence of a pro-competitive explanation helps to explain the conduct.¹²⁷ The absence of pro-competitive purpose does make it less likely the restraint is pro-competitive, since most of the projected efficient outcomes are more probable if the firm has a conscious purpose to achieve them.¹²⁸ Similarly, while the section does not require that the defendant intend its actions to have an adverse effect on competition, evidence of an anti-competitive purpose may indicate the actual effects of the practice.

C. *Rule of Reason: The RRC Model*

The principal difference between an unreasonableness test and the RRC model is that the unreasonableness test would prohibit a restraint that foreclosed supply, without requiring proof of "actual or probable competitive injury"¹²⁹ in the form of higher rivals' costs. Competitive injury is inferred from market share and entry barriers. In contrast, the RRC model would not prohibit overbuying, for example, unless it was shown that the overbuying was "significantly in excess of what the defendant really needed or, perhaps that the input purchasers were so large that significantly inefficient resource use would occur."¹³⁰ Under an unreasonableness test, an exclusive dealing arrangement which reduced the retailing capacity to rivals

¹²⁷ See *U.S. Vertical Guidelines*, *supra*, note 8 at para. 4.226.

¹²⁸ See Kaplow, *supra*, note 88 at 543.

¹²⁹ Krattenmaker & Salop, *supra*, note 86 at 282.

¹³⁰ *Ibid.* at 282, note 228.

would be prohibited if the conditions of dominant firm, entry barriers, and absence of pro-competitive explanation were not met.

Application of the RRC model would require an inquiry into whether rivals' costs were actually raised in the individual case. Beginning with an assumption that the restraining firm is a major supplier or that the practice of exclusive dealing is widespread, the following measures indicate whether rivals' costs have increased:

- Has there been a reduction in the supply of dealers which is not remedied by alternative sources of supply? At the same time has the share of the restraining firm increased?

Evidence of changes in market shares must be carefully evaluated. In many cases it will be misleading. In *Bombardier*, the RTPC held that there was no substantial lessening of competition because entry was easy and the market shares of Bombardier's competitors had increased. The market share data, however, was ambiguous. Any increase may not have been due to the recruitment of new dealers. Takach points out that the increase might have been caused by increases in advertising or other means.¹³¹ An increase in market share by the supplier does not necessarily imply a decrease in consumer welfare; it may simply mean that the supplier has captured market share from departing rivals. A decrease in the market share of the supplier does not necessarily mean that the supplier lacks market power. In fact, an increase in price and a concomitant decrease in market share may in some circumstances be evidence of market power.¹³²

- What is the net foreclosure rate – that is, the percentage of the suppliers' capacity available to rivals before the restraint but that is no longer available as a result of the agreement.¹³³

¹³¹ Takach, "Case Comment on *Bombardier*" (1983-84), 8 Can. Bus. L. J. 226.

¹³² See *Berkey Photo Inc. v. Eastman Kodak Co.*, 603 F.2d 263 (2d Cir. 1979), cert. denied 444 U.S. 1093 (1980). See also *U.S. v. Dairymen Inc.*, [1985] Trade Cases 66,638 (6th Cir).

¹³³ For example, if a manufacturer with 20% of the sales of a product enters into an exclusive dealing arrangement with dealers which account for 30% of the retailing capacity, the net foreclosure rate is 12.5%. Before the agreement, 80% of the retailing capacity was available to rivals. The manufacturer has foreclosed 10% of that capacity. The net foreclosure rate is 10% divided by 80% or 12.5%. If the manufacturer had 10% of the sales

- What is the market share of the unrestrained dealers?
Does the restraint order confer market power on the unrestrained dealers which enables them to raise prices to rivals of the firm imposing the restraint?

Standards adopted to assess the impact of mergers can be employed in the above analysis.¹³⁴ For example, in assessing the impact on the market power of unrestrained firms, the Herfindahl-Hirschman Index (HHI) for the dealer market before the restraint could be compared to the HHI of a hypothetical market consisting only of the unrestrained dealers using the standard for mergers.¹³⁵ If the increase in concentration is more than that permitted for pre- and post-merger markets and there are entry barriers, the restraint should be prohibited. Should horizontal merger thresholds be applied to exclusionary vertical restraints? In our view, the differences between exclusionary restraints balance the similarities. On the one hand, a restraint does not confer complete control and is a more costly device than simply cutting output in a merged firm. On the other hand, excluded rivals may have more incentive to collude, causing more social waste than a simple output restriction in vertical relationships.¹³⁶

of the product, the net foreclosure rate would be 22%. See Krattenmaker & Salop, *supra*, note 86 at 260.

¹³⁴ A straight application of the *Merger Guidelines 1982* would measure the power of the purchaser to control price by assuming that the purchaser of an exclusionary right has merged with all the excluded firms (those firms whose costs have been raised significantly). The question is the same as that in the *Merger Guidelines*: does the absence of the excluded firms as a constraint permit the purchasing firm, either unilaterally or collusively, to raise price? This measure must be modified, however, because the restraint does not confer complete control over rivals. Rivals may continue non-price competition, sharing of supra-competitive profits is not as easy as in the case of a merged firm, and raising rivals' costs is a less efficient method of cutting output than ordering a subsidiary to cut its output. See Krattenmaker & Salop, *ibid.* at 263.

¹³⁵ The Herfindahl-Hirschman Index of market concentration is calculated by squaring the market shares of each firm in the relevant market and summing the values. The HHI for a market with one firm is 100 squared or 10,000. The HHI for a market with five firms with 20% market share each would be $20^2 + 20^2 + 20^2 + 20^2 + 20^2 = 2,000$. The *Merger Guidelines 1982* recommend challenging mergers when the post-merger HHI is between 1000 and 1800 and the HHI increase due to the merger is more than 100, or where the post merger HHI is over 1800, and the merger increases HHI by more than 50. See Weinstock, "Using the Herfindahl Index to Measure Concentration" (1982) *Antitrust Bull.* 285.

¹³⁶ See Krattenmaker & Salop, *supra*, note 86 at 266.

An alternative approach is the same measure proposed in the American *Merger Guidelines 1984* on vertical mergers: are post-merger sales (purchases) by unintegrated firms in the secondary (supplier) market sufficient to service two minimum-efficient-scale plants in the primary (purchaser) market?¹³⁷ It is submitted that measures of the increase in concentration are preferable. With regard to exclusive dealing, the question should be whether sufficient number of unrestrained dealers remain to exert a downward pressure on price. Increases in concentration are an accepted measure of this power, while in contrast, the two-efficient-firms standard is unrelated to theory and appears arbitrary.¹³⁸

— Are the remaining nonexclusive firms able to produce an efficient level of output?

If these firms are able to produce output for sale at the competitive price, rivals' costs will not rise.

— Has total output gone down?

It is argued that consumers cannot be hurt if industry output rises and prices fall. The difficulty is that first, industry output is difficult to measure if, for example, the market is growing or costs change. Second, the test is often misapplied by asking whether the output of the restraining firm rose rather than looking at the industry as a whole.¹³⁹ This is misleading since, as explained above, it may merely mean that the restraining firm has gained 100 percent of the market. In addition, under certain conditions when products are differentiated, consumer welfare can fall when output rises.¹⁴⁰

Third, a static model measures effects on output and price assuming that a market is unaffected by external events, while in the real world there are many explanations for changes in output. A static model requires a comparison of the output after exclusionary activity with the output in a hypothetical market that is identical to the monopolized market in all respects except for the

¹³⁷ *Supra*, note 15 at para. 4.211.

¹³⁸ Krattenmaker & Salop, *supra*, note 86 at 285.

¹³⁹ See *ibid.* at 283-84, who point out that Judge Easterbrook has made this error.

¹⁴⁰ W.S. Comanor, "Vertical Price Fixing, Vertical Market Restrictions, and the New Antitrust Policy" (1985) 98 Harv. L. Rev. 983.

existence of the monopoly.¹⁴¹ These difficulties may be resolved by means of a dynamic model using standard statistical techniques that take into account any exogenous factors affecting output. Such a model can predict expected output after the exclusionary activity. However, this is not an easy task.

In contrast to these measures of impact on costs and supply in the individual case, an unreasonableness test infers foreclosure of supply and its consequent impeding expansion from the proof of an exclusive dealing arrangement, market share and entry barriers. Rival suppliers will be cut off from the dealers who agree to deal exclusively with the firm imposing the restraint. Unrestrained dealers will be cut off from the dominant supplier. When there are entry barriers, the rivals will be impeded from setting up new dealers to compensate for the reduction in supply of dealers, and existing dealers cannot expect new firms to enter the supply market. While it may be that the supply of the remaining dealers in the market is sufficient to satisfy the needs of the rivals, or that the remaining unrestrained suppliers will produce sufficient quantities for the unrestrained dealers, the unreasonableness test assumes these possibilities are too remote to be worth the cost of a detailed investigation when the exclusive dealing is imposed by a dominant firm. It is open to the defendant to show that the exclusive dealing did not reduce the retailing capacity available to rival firms.

VII. CONCLUSION

Examination of the premises underlying various models of market behaviour clarifies the choice of a legal standard. We have set out four models of market behaviour based on the legal and economic literature on anti-competitive conduct. Comparison of these four models illuminates the underlying assumptions. The structuralist model assumes that there is a causal connection between concentration and collusion. Empirical studies have failed to support the validity of this assumption and, in addition, the *Competition Act* appears to reject a structuralist approach. Our

¹⁴¹ See Hovenkamp, *supra*, note 39 at 256 (discussion of the static market fallacy).

discussion highlighted a disagreement over the definition of entry barrier, the consumer welfare model adopting a narrower definition than the strategic behaviour model. There are also different assumptions about the probability that the interests of manufacturers and consumers will coincide. The consumer welfare model assumes that this is highly probable, while the strategic behaviour model highlights the instances when there is a conflict of interest. In relation to the vertical restraint of exclusive dealing, there is disagreement over whether competition at the wholesale level will result in monopolist dealers in local markets charging lower prices.¹⁴² Also in relation to vertical restraints generally, there is disagreement over whether firms will be able to purchase exclusionary rights that do not reflect their full value to the purchaser. The strategic behaviour model assumes these agreements are probable in the real world with its asymmetric information and uncertainty, while the consumer welfare model assumes such agreements are unlikely.

In addition to empirical assumptions about the likelihood and effect of market conduct, there are also assumptions about the ability of adjudicators to understand and evaluate the information, the interaction between various legal standards, and the administrative costs of obtaining information. For example, advocates of the consumer welfare model reject the RRC analysis partly because they are skeptical of the ability of adjudicators to apply the analysis, and they fear that it will revive antitrust doctrines of predation and vertical foreclosure.

Assumptions about the benefit of obtaining information with which to assess the impact on competition in the particular case differ among the models. No model recommends measuring all effects on welfare – an unfeasible inquiry even when conducted by economists. The models have responded to this difficulty by making different assumptions about the probable effects of conduct on welfare. The literature indicates that vertical restraints have three possible general effects. First, there are the possible pro-competitive effects that were outlined earlier. Second, vertical restraints can result in the extension of market power from one

¹⁴² Compare Bork, *supra*, note 44 at 306-09 with Mathewson & Winter, *supra*, note 109.

market to another. This has an ambiguous effect on welfare since the creation of another monopoly (or highly concentrated market) when one already exists may or may not reduce welfare. Finally, there are effects which are unambiguously welfare-reducing, such as the widespread use of vertical restraints to create entry barriers that enhance industry market power, or the use of tying or exclusive dealing to capture efficient producers or suppliers, thereby disadvantaging rivals and gaining market share at their expense.

All models agree that conduct that is unambiguously welfare-reducing should be prohibited. Similarly when restraints are unequivocally pro-competitive, there is little disagreement about permitting them. It is the ambiguous middle category that causes disagreement. The consumer welfare model classifies ambiguous effects as having a neutral or pro-competitive effect, and therefore does not analyze the effects of the conduct. The RRC model does not make this assumption but would examine the facts of the particular case to determine if the restraint reduces welfare. The unreasonableness test proposed above assumes that a restraint is likely to be anti-competitive where the firm imposing the restraint has a large market share, entry barriers exist, and the firm does not have a pro-competitive explanation. As is the case under the consumer welfare model, the unreasonableness test does not require proof of anti-competitive effects as does the RRC model.

The choice between the models is ultimately a decision on whether a detailed inquiry into the cases with ambiguous effects is worth the administrative costs. Estimates of the size of this class depend partly on the assumption about the likelihood of exclusionary restraints limiting supply. If limitation of supply is unlikely, any error caused by not assessing each individual case will be minimal and the analysis of the consumer welfare model is indicated. Recognition that strategic behaviour is likely still does not necessarily imply an inquiry such as that proposed by the RRC model. The inquiry may be considered to be too burdensome, and an unreasonableness test may be preferred although it increases the probability of prohibiting conduct that has a neutral or pro-competitive effect. In our view the inquiry indicated by the RRC model is a feasible one and one that takes account of the real world by recognizing the existence of transaction costs.