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COMPETITION AND TRADE EFFECTS OF VERTICAL RESTRAINTS

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COMPETITION AND TRADE EFFECTS OF VERTICAL RESTRAINTS

I. Introduction

1. Vertical relationships range from transactions between completely independent enterprises to the integration of two or more levels within a single enterprise. Between these two extremes fall contractual arrangements which restrict the freedom of action of one or both of the upstream (generally speaking, a manufacturer) or downstream firm (usually a distributor). Vertical restraints include both price (e.g. minimum or maximum resale price maintenance - RPM) and non-price restraints (e.g. exclusive territorial or customer arrangements, service/support provisions, exclusive dealing, tie-ins, selective distribution, quantity forcing, and two-part tariffs or aggregated rebate schemes). Since such “vertical restraints” could potentially have a significant impact on trade, various Joint Working Party meetings were devoted to examining the theory and practice of such restraints, including how they are generally treated under competition law.[1] Since July 1996, this work has continued in meetings of the Joint Group on Trade and Competition (Joint Group).

2. Joint work on vertical restraints began in 1993 with a roundtable focused on exclusive dealing and exclusive territories agreements. Based on the results of that roundtable, a statement on vertical relationships and market access was included in the 1994 Ministerial report. In February 1996 the Joint Working Party conducted another roundtable discussion this time centred on automobile and auto parts distribution. The Joint Group then embarked on examining a series of real and hypothetical cases:

a. February 1997 - the first hypothetical exclusive dealing case presented by the US delegation (First US Hypothetical);[2]

b. February 1997 - whitegood sales in New Zealand presented by the Australian and New Zealand delegations (New Zealand Whitegoods);[3]

c. June 1997 - exclusive dealing in marmalade presented by the Secretariat (Marmalade I);[4]

d. October 1997 - a return to exclusive dealing in marmalade (Marmalade II);[5]

e. October 1997 - exclusive territories in silicon strips presented by the Secretariat (Silicon Strips);[6] and

f. June 1998 - vertical restraints hypothetical case presented by the US delegation (Second US Hypothetical).[7]

3. Interspersed with these case studies were three Secretariat notes which helped clarify issues relating to the possible impacts of vertical restraints on competition and trade, namely: “Vertical Restraints and Market Access”[8]; “Vertical Restraints - Synthesis of Past Work of the CLP Committee”[9]; and “Synthesis Note of Past Case Discussions”.[10]

4. The present paper seeks to advance the joint work by drawing together some conclusions that both trade and competition delegates can support. It does this in the next two sections: Section II presents the highlights of what was contained in the synthesis of past CLP Committee work on vertical restraints, a synthesis already considered by the Joint Group, while Section III, based on the three pertinent Secretariat notes plus Aides-mémoires of the various case discussions, proposes areas of possible consensus in the work so far. Section IV suggests that areas remain for further discussion.

II. Highlights from synthesis of past CLP Committee work

5. The analysis presented below is simplified by focusing on goods for resale, where upstream firms produce "brands" and distributors provide services in reselling these. The producers are referred to as the "upstream" part of the industry and the distributors as the "downstream". Despite this simplification, it should be apparent that the general arguments carry over to concerns about intermediate production, where the input supplied by an upstream firm is transformed by a downstream producer, as well as situations where producers are subjected to restraints agreed with distributors.

6. It is long standing practice in many jurisdictions to distinguish price restraints, i.e. RPM, from non-price vertical restraints. <u>Minimum</u> RPM is widely prohibited *per se* (except in certain areas, such as books), i.e. treated as illegal regardless of claimed competitive effects. In contrast, maximum RPM and non-price vertical restraints are increasingly subject to a rule of reason, i.e. case by case analysis of pro-competitive and anti-competitive effects. All but one of the examples referred to below concern non-price restraints, and it must be noted at the outset that what is said about market structure and other indicia of market power are not reached where a particular restraint is prohibited *per se* or where price or non-price restraints are employed as part of a collusive scheme to restrict competition.

7. The economic effects of vertical restraints can be grouped into two general categories: effects on vertical co-ordination and on market competition. The former is concerned with the benefits which may result from solving problems which might otherwise arise in distribution and supply and detract from aggregate profits. The latter category refers to effects that vertical restraints may have on competition in the market. As will be argued below, one or a set of vertical restraints could have both pro-competitive and anti-competitive effects so that the net effect on competition and on economic efficiency is not obvious *a priori*. Pro-competitive effects could basically arise through improved co-ordination among different levels of the vertical chain leading from raw materials and component parts to finished goods and on through distribution channels to final consumers. Anti-competitive effects could possibly result if vertical restraints either facilitate collusion or exclude/foreclose actual or potential competitors.

Vertical co-ordination and some effects on competition and efficiency

8. Where the supply of goods or services proceeds through successive vertical levels, the complementary nature of such vertical linkages means that co-ordination between them takes on considerable importance. The decisions of this structure, some taken by the upstream firm and some by the downstream firm, determine the nature and quality of the product or service supplied, its cost, and the price and locations at which it is sold; in other words, these decisions determine the economic efficiency with which the product or service is supplied. The terms of an agreement organise the vertical relationship and help co-ordinate what otherwise would be independent, sub-optimal (in terms of total profitability of the firms concerned) decisions.

9. Three categories of co-ordinating provisions or vertical restraints can be distinguished. First, the parties could agree to give the producer direct control over distribution decisions (for example, give

producers the right to specify retail services or prices), or equivalently give the distributor control over supply decisions (e.g. grant distributors the right to specify the inputs and methods used by the producer). Second, vertical restraints could restructure incentives. For example, through using a two-part tariff combining a lump sum fee plus a per unit price set at marginal cost, producers could make distributors feel the full effects of their decisions on aggregate profits. Third, where there are spillover effects among distributors, vertical restraints could reduce or eliminate intrabrand competition, thereby reducing or eliminating "free-riding". For example, consider the situation where distributors are unwilling to supply important in-store information because customers can obtain the information then avoid paying for it by simply crossing the street and buying the same goods at a discounter. This problem can be greatly mitigated by assigning large exclusive territories to each distributor.[11] There can also be free-riding among producers as where one producer engages in extensive informative advertising and other producers choose instead to offer lower prices to distributors. When consumers enter a store to buy the advertised good, the store owner will have an incentive to steer the purchaser to the lower priced competing product (on which he earns a higher profit margin). That kind of free-riding can be eliminated through the use of exclusive dealing (i.e. requiring distributors to carry only a single producer's goods). While exclusive dealing will reduce in-store interbrand competition, it could well improve overall interbrand competition and increase consumer surplus (i.e. the difference between the maximum that consumers would pay for the current quantity consumed and the amount they are actually paying).

10. In addition to situations where vertical restraints reduce intrabrand competition or in-store interbrand competition but may nevertheless increase overall competition and efficiency, there could be circumstances where such restraints help to reduce problems associated with market power. In particular, where both producers and distributors have market power and are earning supra-competitive profits, distributors left to their own devices will only consider the effects on their own profits when deciding whether or not to raise their prices. They would totally ignore the fact that from the perspective of producers, distributor price increases simply reduce the amount sold with no compensating increase in the price received by a producer. As a result, when such distributors increase their prices, not only is consumer surplus reduced, combined manufacturer and distributor profits might fall as well. In this "double margin" situation, manufacturers, distributors and consumers could all potentially be better off if distributors lost their power to set prices.[12]

11. While not denying the potential for vertical restraints to improve consumer welfare, it is also true that the choice of product quality or distribution service that maximises total manufacturer and distributor profits will not necessarily be the choice that maximises economic efficiency, i.e. combined consumer and producer surplus (where producer surplus equals profits above and beyond a normal return on investment). For example, provisions that allow profitable price discrimination may or may not increase efficiency. The greater the competition that the vertical system faces from other suppliers, however, the more its members will be collectively constrained to make choices that increase economic efficiency.

12. The extent of competition from other brands and distributors may though be reduced through the use of vertical arrangements. For example, minimum RPM may help to sustain high prices by making it easier for producers to monitor cheating on a collusive agreement, which in turn increases the incentives to create cartels. Moreover, minimum RPM could be used to support a distributors' cartel, whereby the producer is used as the instrument to set and then monitor a collusive price level. The same could be said of exclusive territories compelled by powerful distributors especially in situations where such restraints are not manifestly necessary to protect distributors' brand specific investments.

13. It is also possible to strategically use vertical restrictions to dampen competition. For example, if exclusive dealing is widely practised, consumers are required to visit other stores to find competing

products and compare their attributes and prices, something consumers may be reluctant to do for low valued items or those required urgently or purchased on impulse. Higher customer search costs could thereby translate into higher average prices and lower consumer surplus. Furthermore, restrictions that decrease intrabrand competition among distributors, e.g. by assigning exclusive territories, may also decrease competition at the upstream level by making producers' price cuts less attractive. That result flows from the fact that reduced competition among distributors means less pressure to pass any producer price cuts on to consumers. If price cuts might simply end up fattening distributor profits, producers will have less incentive to make such cuts.

14. Vertical restraints also may reduce competition in the long run if they can be used to erect significant barriers to entry and if competition is not already substantial. In regard to competition at the producer level, most attention has focused on the role of long-term exclusive dealing arrangements (and provisions which can provide the same effects, e.g. full-line forcing and aggregated rebate schemes) in raising barriers to entry which may have the effect of excluding or foreclosing foreign or domestic competitors. Such arrangements between a producer and its distributors prevent other producers from distributing their brands through these agents. When exclusive dealing or other vertical restraints having similar effects are adopted by a dominant firm or are used by a sufficiently large number of producers, they can effectively raise rivals' costs by requiring them to use alternative less efficient marketing channels. The increased distribution costs may then be sufficiently high to deter entry.

15. On the other hand, it is conceivable that vertical restraints can promote entry and competition. When restraints increase profits without raising entry barriers, either through increased efficiency or increased oligopolist co-ordination, they promote entry. In addition, if restraints increase the returns that can be earned from investments in know-how, they promote investment in know-how, which in turn may lead to entry and both new brands and new distributors.

16. The dynamic effects of vertical restraints on markets take on particular significance from a trade perspective where a restraint such as exclusive dealing may impede or alternatively facilitate market access. For instance, new entry by a foreign firm may be considerably more difficult if non-price vertical restraints tie up existing domestic distribution systems, especially if these are reinforced by laws and regulations or other barriers to entry inhibiting foreign firms from setting up alternative distribution channels. This difficulty is increased if the restraints will run for many years but would be decreased if the market is expanding or alternative distribution systems are being created. On the other hand, new entry might be facilitated by vertical restraints if a new entrant needs to offer an exclusive arrangement to induce a distributor to efficiently promote a new product. Accordingly, the effects of vertical restraints on trade are likely to depend on, amongst other things, the type of restraint, the collective market share of firms practising the restraint, the nature of the market, the duration of the restraint, and whether restraint renewal/expiration dates are staggered or grouped together.

General lessons from economic analysis

17. We have seen that vertical restraints are likely to arise in many different circumstances and could have a variety of effects on competition and economic efficiency. Because these effects depend heavily on the facts and may vary over time, it is difficult to recommend *a priori* that a given vertical restraint should be considered to be either legal or illegal in all situations. *Rather a case-by-case, "rule of reason" approach, one that seeks to balance "pro" and anti-competitive effects, is very much called for.* Moreover, economic analysis provides several other insights of relevance to both competition and trade policy makers.

1. the extent of interbrand competition (including its in-store component) as well as intrabrand competition are crucial factors in the analysis of the effects of vertical restraints

18. Where the vertical structure faces strong competition both from other brands and from other distributors, there is little potential for any type of vertical restraint to reduce economic efficiency.[13]

2. where general market conditions leave open the question of whether a vertical restraint will increase or reduce efficiency, economic analysis provides guidance for identifying those specific circumstances in which a particular restraint may impact on competition or efficiency

19. For example, it identifies circumstances in which exclusive dealing by either a dominant firm or which is widespread in the market might be used to diminish competition by raising entry barriers, and other circumstances in which reduced in-store interbrand competition might increase over-all interbrand competition by preventing free-riding. Specifically, reduced competition may be expected to result when competition is already limited at both the producer and distributor level and restraints significantly raise rivals' costs. On the other hand, increased competition may be predicted from exclusive dealing required to justify efficient manufacturer advertising which would otherwise be undermined by producer free-riding. More generally, free-riding aspects appear more problematic (and thus provide a stronger efficiency argument) for goods which are complex, technical, expensive, one-off purchases and distributed through non-convenience outlets. This is especially so if consumers have limited product knowledge and have difficulty assessing the product's attributes prior to purchase and consumption, conditions more likely to hold for new rather than established products.

3. it is the degree of competition prevailing in a market that is the key factor in determining the effects of vertical restraints on economic efficiency

20. Analysis should cover the extent of competition in the market from other competing brands and from other distribution systems, rather than being centred on intrabrand competition. Vertical restraints may reduce intrabrand competition without harming economic efficiency. With sufficient competition from other brands and distributors, a producer will be unable to reduce economic efficiency by exercising market power over pricing or the choice of quality in a properly defined market even if intrabrand competition is completely eliminated. However, when interbrand competition is limited, then restrictions on intrabrand competition may take on some importance as they may serve to dampen further interbrand competition.

4. a properly drawn antitrust market must group together what consumers regard as all good substitutes (in both the product and geographic senses)

21. A lack of competition in butter sales in Country X has little significance if a significant, non-transitory price increase in butter prices in Country X would simply cause consumers to substitute margarine or to begin to source butter and margarine supplies from producers located outside the country.

5. as a short hand measure of probable degree of competition, law enforcers should consider market structure in determining when a vertical restraint is acceptable

22. Vertical restraints are very unlikely to harm economic efficiency or reduce competition in a properly defined market with low concentration, negligible barriers to entry, and a rapid rate of technological change.

6. the analysis should consider both long-run (dynamic) and short-run (static) effects of vertical restraints

23. Even if a vertical restraint has a negative or ambiguous effect in the short run, its net long-run effect may be positive because the restraint leads to increased entry or investment in intellectual property. Alternatively, its long run effect may be detrimental if new entry or capacity is inhibited such that competition and incentives to innovate are both reduced.

7. the analysis should consider what is the most likely alternative to a vertical restraint, e.g. operating without the restraint, employing an alternative one, cease trading, or vertically integrating

24. Vertical restraints are one means of integrating decision-making. If a particular restraint is not available, the alternative may be not less integration but a different method of vertical integration, e.g. common ownership, which may be neither more efficient nor more likely to promote interbrand or intrabrand competition, although it is conceivable that closer vertical links involving more mutual agreements may be more desirable than vertical restraints.

25. In addition to the points listed above, it is clear that policy design needs to consider enforcement costs. One way to reduce the enforcement costs of case-by-case analysis is to develop enforcement guidelines, as a number of competition policy authorities already have. Guidelines can increase the predictability of reviews thus generally enhancing compliance as well as reduce the number of cases requiring detailed analysis by including criteria and procedures for identifying those cases where there is a risk of anti-competitive effect and where more detailed analysis may be necessary.

26. Enforcement costs may be further reduced by establishing different rules or enforcement guidelines depending on the state of competition in the market. In this regard it may be appropriate to adopt the following general approaches:

- -- Firms with small market shares in unconcentrated upstream and downstream markets, and new or established firms attempting to enter a new market could have presumptive permission to include vertical restrictions; only the minimal analysis needed to establish competitive market conditions is necessary to determine the economic effects

- -- Vertical systems that are widespread in their market could face a more detailed inquiry into the extent of competition in their market and, if necessary, into the effects of the proposed vertical restraints.

- -- Vertical systems practised by a dominant firm could require a more detailed justification to show that the restraints do not pose substantial risks to product competition, would enhance efficiency, and that comparable benefits cannot be realised with lower risks for product competition.

III. Shared conclusions

27. In the course of considering the review of previous CLP Committee work on vertical restraints, studying the other two Secretariat papers, and discussing various case examples, trade and competition policy makers have come to agree on a great deal concerning the effects of vertical restraints on their respective domains. The following is an attempt to briefly list these points of agreement, including a few

areas where the two communities have simply come to better appreciate the constraints under which the other works.

(1) Vertical restraints have complex potential pro and anti-competitive effects. They can also enhance or reduce market access by foreign based competitors. Accordingly, vertical restraints call for a careful case by case, "rule of reason" (i.e. balancing) analysis. In markets sufficiently populated by competing firms, vertical restraints cannot be presumed to be anti-competitive simply because they raise rivals' costs, though they should be subject to increased scrutiny the more they potentially exclude new foreign and domestic entrants.

(2) The pro and anti-competitive effects of vertical restraints must be judged in the context of properly defined antitrust markets grouping together products and production locations which consumers consider to be good substitutes. The geographic dimension of such markets could extend beyond a single country, especially if barriers to international trade are low or non-existent.[14] An emphasis on substitutability is central to market definition for competition analysis because the ultimate purpose for making the definition is to provide a context for estimating the existence/extent of market power. There is no market power in situations where consumers could escape harm from anti-competitive pricing by easily substituting other products or geographic sources.[15]

(3) With the exception of vertical restraints being used to facilitate collusion, it is highly improbable that such restraints will have net anti-competitive effects unless there is either: (a) market power on at least one level of a properly defined market; or (b) the restraint, either on its own or in concert with other vertical restraints, has the power to exclude or disadvantage a significant number of competitors (or a uniquely significant competitor or class of competitors) by virtue of its being widely used in the negatively affected market(s). The usual first step in gauging market power is to estimate whether incumbent market shares are high enough to permit unilateral anti-competitive pricing, or to facilitate collusion. Where that is in fact the case, the analysis normally proceeds to examine barriers to entry, i.e. considers whether there is reason to believe that anti-competitive pricing will be unprofitable because it will quickly encourage existing or new firms to increase supply to the market.

(4) Where it is necessary to take a close look at barriers to entry, both competition and trade officials will be especially interested in whether governmental action (or inaction) are contributing to such barriers. Generally speaking, governmentally created or reinforced barriers to entry are among the most durable, hence serious constraints on competition. It follows that the existence of such barriers to entry could greatly increase the chances that competition officials will conclude that significant market power exists and action is warranted against vertical restraints affecting a particular market. Competition and trade officials should work together to reduce unwarranted governmental restrictions on competition and market access.[16] They should also of course co-operate to reduce all types of anti-competitive private restraints that reduce market access.

(5) The primary objective of competition agencies is to promote economic efficiency by enhancing or protecting the competitive process rather than individual competitors. It follows that competition agencies will not necessarily be willing or able to take action against a vertical restraint merely because it harms certain actual or potential competitors, whatever their nationality might happen to be. In addition, extensive market analysis may be

called for to assess anti-competitive effects.[17] At the same time, competition laws applied to promote economic efficiency can, in appropriate cases, also promote market access by for example, simultaneously addressing any anti-competitive exclusion or foreclosure of foreign firms or products.[18]

(6) The primary objectives of trade agencies in cases involving vertical restraints are to determine whether the restraints impede market access, and if so, to encourage or require the concerned government(s) to remedy the situation. Compared with competition agencies, trade officials will attach greater significance to: (a) governmental action that affects the power of vertical restraints to exclude or disadvantage competitors; (b) possible discriminatory or differential effects of vertical restraints on foreign versus domestic competitors; (c) the potential for foreign firms to provide a qualitatively different kind of competition than might be available from domestic firms; and (d) the potential for competition policy analysis to underestimate the potential gains from trade in evaluating whether to intervene in a given vertical restraint case, thus erring on the side of inaction.. Trade officials generally have more power than competition agencies to press for a change in government policy in cases where such policy undergirds a vertical restraint restricting market access or otherwise hindering competition between foreign and domestic firms. This is especially true where the impugned vertical restraint may not have anti-competitive effects under the analysis typically employed by OECD competition agencies. In these circumstances, competition and trade officials should work together to reduce these unwarranted governmental restrictions on competition and market access, bearing in mind that some such restrictions might be fully compatible with WTO obligations.

(7) Both anti-competitive effect and negative impact on access by foreign producers are more likely to be associated with vertical restraints the longer their terms. The pro-competitive effects could also be stronger the longer the vertical restraints' terms. Claims that some vertical restraints have pro-competitive efficiency effects and a potential to either assist or restrict market access are more likely to be credible and significant the more technically sophisticated, expensive and infrequently purchased is a product.

(8) Competition agencies should continue to improve information sharing and enforcement assistance co-operation so as to more effectively address vertical restraint cases which cross borders.

IV. Further reflection

28. The above points represent a significant body of shared learning which has been fostered by the Joint Group and its predecessor Joint Working Party. Though much has been accomplished, there remain some important questions meriting continued exploration.[19, 20, 21]

NOTES AND REFERENCES

1. Periodic meetings between the Working Party of the Trade Committee and the Competition Law and Policy Committee's Working Party 1 are here referred to as Joint Working Party Meetings.

2. See COM/TD/DAFFE/CLP/RD(96)101.

3. See COM/DAFFE/CLP/TD(97)22.

4. See COM/DAFFE/CLP/TD(97)52.

5. See COM/DAFFE/CLP/TD(97)94.

6. See COM/TD/DAFFE/CLP(97)49.

7. See COM/DAFFE/CLP/TD(98)46.

8. COM/TD/DAFFE/CLP(97)48/REV1.

9. COM/DAFFE/CLP/TD(97)50.

10. COM/DAFFE/CLP/TD(98)21.

11. Setting minimum permitted resale prices, i.e. (minimum) RPM, where legally permitted is another way of doing the same thing.

12. This could justify, in appropriate cases, the use of (maximum) RPM whereby a manufacturer sets the maximum resale price a distributor can charge. Essentially the same result could be obtained by requiring distributors to achieve and sustain minimum unit sales levels.

13. The reader is reminded that virtually all OECD countries make a distinction between price and non-price vertical restraints, and treat at least minimum RPM as illegal *per se*. Under such laws, the extents of interbrand and intrabrand competition have no significance so would not need to be determined in pertinent cases.

14. There is nothing contradictory about a competition agency stating that it is empowered to protect only domestic interests, yet recognising that the market for a particular good is international in size. Consumers could be just as well protected by the prospect that higher domestic prices would attract increased imports as by the possibility that higher prices would cause domestic producers to increase their outputs.

15. Marmalade I and II provided ample scope to explore market definition, and to note its importance in competition and trade cases. See the Aides-mémoires of the discussions - COM/TD/DAFFE/CLP/M(97)82/ADD2, pages 4-6, and COM/TD/DAFFE/CLP/M(97)117/ADD2, pages 6-8.

16. Discussion of the Marmalade I and Silicon Strips cases illustrated competition and trade officials' concerns about how government regulations might affect the anti-competitive potential of vertical restraints. See the Aides-mémoires of the discussions - COM/TD/DAFFE/CLP/M(97)82/ADD2, and COM/TD/DAFFE/CLP/M(97)117/ADD2, pages 4-5. Another area that has several times been discussed in joint meetings is the question of parallel imports. Under current laws, copyright holders are able to licence their intellectual property in a way which segments national markets, reduces trade, and preserves international price discrimination that could potentially be anti-competitive.

17. The New Zealand Whitegoods case provided a good illustration of these important points. New Zealand competition law requires much more than merely showing that Australian whitegoods manufacturers found it difficult to enter the New Zealand market because of exclusive dealing practised by a domestic producer accounting for some 80% of sales in New Zealand. To obtain relief under New Zealand competition law, the Australian firms would have had to demonstrate that the New Zealand firm benefiting from exclusive dealing had a dominant position in a properly drawn antitrust market and that it was using its market power in an unreasonable way. Establishing either of those points would require probing actual market conditions and would be a very fact intensive exercise. See the Aide-mémoire of the discussion - COM/TD/DAFFE/CLP/M(97)36/ADD1 at pages 8-10.

18. For example, in the case of the First U.S. Hypothetical, at least one Member's competition law might have found that the manufacturers enjoyed collective dominance and could have been prohibited from using threats of refusal to deal plus practices of progressive rebates to maintain an exclusive dealing system that appeared to inhibit market access. See the Aide-mémoire of the discussion - COM/TD/DAFFE/CLP/M(97)36/ADD1, at pages 8-9.

19 Consider for example a case where Country A's competition authority concerns itself solely with national or domestic welfare (the normal case), and also evaluates vertical restraints under a total economic surplus instead of the more common consumer surplus standard. Suppose there is a particular exclusive dealing restraint which happens to raise prices in Country A, hence reduces consumer surplus in that country. Suppose further that the exclusive dealing also increases producer/distributor surplus by more than enough to offset the reduction in consumer surplus. The exclusive dealing might therefore be permitted, but only if enough of the increase in the producer/distributor profits accrues to enterprises owned by the country's nationals because increased profits accruing to foreign owners would not be counted as offsetting harm to Country A's consumers. A variant of this example would be a situation where competition officials are willing to include producer/distribution surplus in the balance provided the producers/distributors are located in their jurisdiction (i.e. the competition authority applies a domestic welfare standard). In that case there is a potential for discrimination according to location rather than ownership of the firms involved.

20. To illustrate one possibility, let us turn to another hypothetical exclusive dealing example. Suppose that such restraints in a particular market are very widespread in Country A, but older established, mostly domestically owned/based producers have no particular problems distributing their goods. In addition, let us assume that the incumbent producers have satisfied Country A's competition officials that the exclusive dealing arrangements benefit consumers through enhanced interbrand competition based on improved manufacturer supplied information, and in any case, there is no evidence that incumbents are either inefficient or earning supra-competitive profits.

Despite all the preceding assumed "facts", suppose producers in Country B establish that all that stops them from selling to Country A consumers are the exclusive dealing practices of existing sellers. In particular they demonstrate that:

a. barriers to entry into distribution prevent them from setting up new parallel distribution systems in Country A;
b. they offer a product significantly different (but still within the same antitrust market) from what is currently on offer in Country A; and
c. they are profitably selling their products in other countries having the same product array they would have to compete against in Country A, but lacking the exclusive dealing arrangements found in Country A's market.

Faced with the above situation, Country B's trade policy officials might understandably try to persuade Country A's competition officials to prohibit the market access inhibiting exclusive dealing arrangements. They might also receive help from Country B's competition officials assuming they are mandated to advance Country B's producers' interests. Despite such interventions, Country A's competition officials would naturally be reluctant to prohibit exclusive dealing which they believe benefits Country A's consumers. Moreover, they would likely be quick to point out that they would be just as reluctant to help any Country A producers who might similarly complain about their inability to sell to Country A consumers.

It is worth noting that the above example has some similarity to the Second US Hypothetical presented by the US delegation to the Joint Group's 7th meeting - see COM/DAFFE/CLP/TD(98)46

21. The Second US Hypothetical begins by noting that:

> In some cases, foreign goods embody different perspectives on production methods, different product design and development ideas, and other physical or non-physical factors that are either unknown or unavailable in the importing country. Exposing domestic firms to these factors can lead to product and technological advancement that would not be possible with domestic perspectives and ideas alone. (2)

The hypothetical concedes that such gains from trade cannot always easily be estimated at the time an initial decision must be made concerning whether or not to permit one or a series of vertical restraints. It explores what trade and competition officials could and should do if a set of vertical restraints which, focusing solely on existing domestic products, offers a net improvement in consumer welfare despite an associated severe foreclosure effect. Two possible situations are proposed. Under the first, nothing is known about potential foreign competition at the time the vertical restraints are being considered for approval. Under the second, foreign potential entrants oppose permitting the restraints. In the context of the initial assumption that foreign enterprises may be able to offer especially valuable competition, the hypothetical seeks to explore whether or not competition agencies should make a special effort to assess the effects of foreclosure on foreign firms, and what informational hurdles would have to be surmounted to make that possible. The hypothetical urges greater co-operation among trade and competition agencies both within and across countries.