The Economics of Exclusive Distribution

A. Purpose

1 The issue of exclusive dealing and its economic impacts has received extensive attention in a number of recent cases, including *Australian Competition and Consumer Commission v Universal Music Australia Pty Ltd*[1], *Australian Competition and Consumer Commission v Australian Safeway Stores Pty Limited (No 2)*[2] and *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd.*[3] Moreover, concern about exclusive dealing remains high on the public policy agenda, and is especially significant in respect of small business.

2 The economics of exclusive dealing are complex and have been an area of substantial research in recent years. A specific area of analysis has been that of exclusive distribution – that is, situations in which a manufacturer requires dealers to only distribute products bearing its brand, or products that it approves or specifies. Given the prominence of these issues, it seems timely to seek to summarise and set out in more accessible terms the main findings of that research. That is the objective of this paper.

B. Economic aspects of exclusive distribution

3 In analysing distribution arrangements, economists place considerable weight on the role of market failures. The market failures at issue involve externalities and hold-up problems. The meaning of each of these terms, their implications and relevance to the economics of distribution arrangement are discussed in the paragraphs that follow.

Market failures

4 Market failures are situations where, absent some form of action, decentralised decision-making would lead to outcomes that are inferior, from the point of view of society, than those that could otherwise be secured. An example of a market failure is the 'tragedy of the commons', which is a situation in which each user of an open-access resource, such as an ocean fishery, increases his or her use of that resource beyond the point that would maximise the resource's long term value.

Externalities

5 Externalities are an important source of market failures. Externalities are effects that are not mediated through the price system – that is, they are consequences of an economic action that do not enter directly into the assessment, by the agent deciding to undertake that action, of the action's costs and benefits. Because these consequences are not factored into the decision, the agent's decisions may not be optimal in terms of their overall impacts. As a result, decentralised decision-making may lead to market failure.

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1 [2001] FCA 1800 (14 December 2001); (2002) ATPR ¶41-855.
2 [2001] FCA 1861 (21 December 2001).
3 [2001] HCA 13 (15 March 2001); (2001) ATPR ¶41-805.

6 For example, when a manufacturer advertises its product, it enhances the demand for the services provided by the product's dealers and will, under normal conditions, increase their revenues. Unless the manufacturer can fully claim the expected profits associated with the increased sales, the manufacturer's action will have conferred a net benefit on the dealers. Because that net benefit does not enter into the manufacturer's assessment of the costs and benefits of advertising, the manufacturer may not advertise by an amount that fully reflects the gains that advertising brings.

7 It is useful to distinguish positive from negative externalities. A positive externality arises when one agent confers an unpriced (i.e. uncompensated) **benefit** on another; a negative externality arises when one agent confers an unpriced (i.e. uncompensated) **cost** on another. The benefit a bee grower derives from a neighbour's investment in an orchard is an example of a positive externality; the cost a smoke-emitting factory imposes on a nearby laundry is an example of a negative externality. Generally, in situations characterised by positive externalities, the risk is that the benefit-conferring activity will be *under-produced*, relative to the level that is socially efficient (too few orchards will be planted, as part of the benefit from planting orchards flows to bee growers); conversely, the risk in respect of negative externalities is that there will be *over-production* relative to the efficient level (too much smoke is emitted because part of the costs it causes fall on adjacent laundries).

8 There are two types of positive externality that are especially important in distribution arrangements.

9 The first relates to the relationship between manufacturers and dealers. When dealers increase the effort they devote to selling a manufacturer's products, they generally confer a net benefit on the manufacturer, so long as those products are sold to the dealer at more than marginal cost and the retailer cannot claw back the incremental profits through fixed charges (such as listing fees or shelf space charges). Equally, when a manufacturer undertakes investments that increase dealer revenues (say, by improving product quality) or reduce dealer costs (say, by improving dealers' management of floor space), then, so long as the manufacturer cannot capture all of the incremental profit, a net benefit will have been conferred. In both these cases, "vertical externalities" arise from individual decision-making.

10 These externalities can lead to under-investment in the activity that creates the net benefit. For example, to the extent to which dealers cannot capture the incremental profit associated with their investment in promotional effort, they may invest less in promotional effort than would be optimal from the point of view of dealers and manufacturers viewed as a whole. Equally, if a manufacturer cannot capture the incremental profit associated with its investment in enhancing dealer revenues or reducing dealer costs, it may invest less in these activities than would be jointly desirable.

11 A second type of positive externality relates to the interaction between dealers. When dealers provide services for which they cannot or do not separately charge, part of the benefit associated with the supply of these services may 'spill over' from one dealer to another. For example, if one dealer displays a full range of products, and does not charge potential consumers directly for examining those products, then that dealer may be carrying a cost (in the form of the holding cost of the full range) that benefits those dealers which do not display a full range. This happens because consumers can examine the product range at the dealer in question, while then purchasing the product from its lower-cost rivals. The costlier dealer confers a 'horizontal externality' on its competitors.

12 This externality too can lead to under-provision. Each dealer would rather not bear the costs associated with generating the ‘spill-overs’ from which other dealers can benefit. Services that are valued by consumers, and hence generate incremental profits to the manufacturer, are consequently not supplied to optimal levels.

13 Consolidation provides an obvious way of correcting these market failures. Thus, vertical integration between the manufacturer and the dealer would eliminate the vertical externalities associated with their investment in sales promotion. Equally, horizontal integration between all the dealers that might benefit from spill-overs would eliminate the externality that arises when one dealer’s actions benefit another dealer.[4]

14 However, consolidation is rarely optimal, even from a strictly private point of view. Vertical integration into dealership is often inefficient, as manufacturers are poorly placed to monitor and give the proper incentives to managers of manufacturer-owned dealerships. Equally, complete horizontal integration, even if lawful, could run into obvious diseconomies of scale.

15 As a result, contractual means are more frequently used to control the adverse effects that externalities, if left uncorrected, would have. The various forms of exclusive dealing are particularly important in this respect.

16 This is mainly because exclusive dealing can mitigate, though not eliminate, the vertical externality that arises when a manufacturer invests in enhancing dealer revenue or reducing dealer costs. In these instances, absent exclusive dealing, the benefit to the manufacturer would be reduced by the extent to which the dealer could secure the benefits (of enhanced revenues or lower costs) while promoting a rival brand. For example, a dealer could obtain direct or indirect advertising support from a manufacturer but then direct customers, once they visited the show-room, to a competing brand which – because it had not engaged the same level of promotional outlays – could offer the dealer a higher dealer margin. By eliminating spill-overs of this type, exclusive dealing can yield a better alignment of incentives between dealers and manufacturers, and hence induce a level of investment in marketing effort that is closer to being jointly efficient.

17 Exclusive dealing can also have an impact in reducing, though rarely completely eliminating, the horizontal externalities associated with dealer investments in market development. Because exclusive dealing will generally be associated with a smaller number of dealers carrying a particular brand, and those dealers being more distant from each other, it will limit the spill-overs that would otherwise arise when one dealer sought to more actively promote that brand. Exclusive dealing, in other words, creates some degree of territorial division, which in turn induces dealers to invest more in promotion than they otherwise would.

18 There are also some negative externalities that affect the operation of dealer networks.

19 To begin with, dealers compete. When dealers in differentiated products (including products that involve some transport costs for search or carriage) locate close to each other, they reduce each others’ margins and hence ability to cover fixed costs. As a result, left to their own devices, dealers may locate either too close – jeopardising fixed cost coverage – or too far (which causes consumer costs to rise by more than would be desirable from the standpoint of dealers and manufacturers combined).

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[4] Technically, integration would not eliminate the externality, but internalise it, thus removing its direct distorting effect.

20 Exclusive dealing arrangements can help secure a locational distribution of dealers that better matches joint profit maximisation. It does this first, because it reduces the extent to which each dealer competes directly with other dealers (as closely located dealers are likely to be offering separate brands) and hence leads to a denser dealer network for the product as a whole than would otherwise occur. At the same time, it somewhat spaces out dealers in each brand, and hence helps ensure that they can cover fixed costs.

21 A second negative externality arises from the fact that each dealer in a brand can affect that brand's reputation. When a dealer shades on the service associated with a particular brand, or otherwise takes advantage of that brand's customers in ways that are difficult for the manufacturer to detect and prevent, the brand suffers. If that dealer handles multiple brands, then the dealer itself may experience few costs from the degradation in brand reputation. Additionally, if there are many dealers in that brand closely located, then some part of the cost of any individual dealer's harmful conduct will fall on other dealers. As a result, dealers will have too few incentives to maintain brand reputation.

22 Exclusive dealing again ameliorates this externality. By forcing the dealing to only carry a particular brand, it ensures that the dealer's own good-will is tied up with the brand; this reduces the incentives for otherwise difficult to monitor quality degradation. At the same time, by spacing out dealers, it reduces the degree to which the costs of any individual dealer's quality degradation fall on other dealers in that brand. The combined effect is to better ensure that dealers have an incentive to invest in brand reputation.

23 Overall, the economics of dealership networks are significantly influenced by externalities that, left unchecked, would lead to market failures. These externalities are especially great when the products being handled are technically complex or for other reasons require significant dealer input – where there is, in other words, a close complementarity between the physical product and dealer input in determining the quality and ultimate competitiveness of the product. Exclusive distribution arrangements are relatively common in respect of these products, as they provide a way of better aligning incentives along the vertical chain.

Hold-up

24 As well as market failures associated with externalities, dealership arrangements can lead to sup-optimal outcomes from the point of view of the parties because of hold-up risks.

25 In economics, hold-ups are situation where parties develop *ex post* power relative to each other that they lacked prior to entering into a transaction. The essence of these situations is that one party must, as a result of the transaction, incur a cost that (1) once incurred is sunk and (2) will only yield a return if the relationship between the parties continues.

26 For example, a manufacturer may invest in training a dealer over an extended period of time in skills that are not entirely specific to its brand. Once that investment has been made, the dealer could, absent any contractual ties, threaten to move to another brand. Should that move occur, it would (1) deprive the manufacturer of the return it would otherwise have secured on the investment and (2) force it to duplicate the investment cost. Faced with these possible outcomes, the manufacturer would likely allow the dealer a higher margin so as to not completely lose out on the now-sunk investment. The dealer could, in other words, extract a rent from the manufacturer.

27 Equally, thanks to long association with a brand, and to cumulative investment by the manufacturer in the brand, a dealer may develop an extensive list of actual and potential

customers. That list is actually a joint asset to it and the manufacturer. However, it is held by the dealer and would be costly for the manufacturer to monitor or if necessary duplicate. If the dealer can use that list to distribute an alternative product, which has not had to bear the sunk costs involved in securing the local knowledge, it can take for itself part of the income stream that would otherwise have compensated the original manufacturer for its investment.

28 The threat of hold-ups in dealer networks is most acute when dealers, as a result of association with a brand, acquire some degree of local market power. A dealer that has developed a strong local position, and can to some extent auction access to its dealer services among competing manufacturers, will maximise the gains it makes for itself from past shared investments.

29 The knowledge that hold-up can occur will, all other things being equal, deter investments that might thus be placed at risk. In the example above, the manufacturer, knowing that the dealer may act opportunistically, will invest less in transferable skills than would otherwise be optimal.

30 Exclusive distribution arrangements help reduce the distortions that hold-up threats would otherwise create. This is because exclusive distribution causes dealers to incur some costs that are themselves relationship-specific. More particularly, a dealer that is bound by an exclusive distribution arrangement is less likely to act opportunistically as to do so would force the dealer to incur the costs of shifting away from its current brand. In general terms, exclusive distribution reduces the transferability of the dealer's good will and hence increases the cost to the dealer of seeking to secure for itself income streams that merely compensate the manufacturer for previously incurred sunk costs.

31 For example, where manufacturers invest in dealers' potentially transferable skills, exclusive distribution reduces the risk of that transfer occurring, as it would have more of an 'all or nothing' quality. As a result, exclusive distribution arrangements are common in situations where manufacturers have to make investments in dealer skills and in other potentially transferable assets.

C. Exclusive distribution and competition

32 The impact of exclusive distribution on competition has been the subject of a great deal of academic research, which has highlighted a number of complexities this impact involves.

33 A case where distribution arrangements plainly have no impact on competition overall (though they may well affect efficiency) is when one or more layers in a vertical chain is an unassailable monopoly. Equally, distribution arrangements are likely irrelevant when all layers in a vertical chain are intensely competitive – for example, when there are many suppliers of a product and many dealers in that product in each geographical market.

34 When markets are less than intensely competitive, but not monopolised, there are ways in which exclusive distribution can reduce competitive pressures. Broadly, these ways involve: unilateral effects; effects through concerted conduct; and effects through the height of entry and expansion barriers.

Unilateral effects

35 "Unilateral effects" is a term that refers to the impact of conduct on each firm's assessment of the gains and costs to it of adopting more or less aggressive pricing behaviour. Conduct such as exclusive dealing is said to have a unilateral effect when it alters the extent to which each firm, acting independently, faces an incentive to reduce price to (or keep it at) the competitive level.

36 Exclusive distribution arrangements can reduce the price-cutting incentives facing each manufacturer adopting such a policy, or operating in a market where such a policy is widespread. The basic reason this occurs is the 'distancing' impact that exclusive distribution has on the dealership structure (see paragraph 20 above). Greater distance between otherwise identical dealers gives each dealer a degree of market power (which may be small, but is potentially greater than it would otherwise be); this means each dealer does not pass on fully any reduction in its associated manufacturer's wholesale prices. As a result, each manufacturer can face somewhat less elastic demand and hence select a higher mark-up.

37 There are many concrete forms this effect may take. For example, when dealers are more distant than they would otherwise be, consumers will incur somewhat higher search costs. As a result, they will be less well-informed, and hence each manufacturer will be able to maintain prices at a somewhat higher level than would prevail were dealers more closely located.

38 Whether this effect occurs, and its extent if it does, is by no means certain. To begin with, exclusive distribution should increase the return each manufacturer obtains on promoting its product, and hence may well increase the overall aggressiveness of competition. Indeed, in many economic models, all manufacturers would rather adhere to a policy of common agency (that is, of allowing dealers to carry multiple brands) if such a policy could be enforced collectively. However, such a policy cannot be enforced collectively, and once any one manufacturer selects exclusive dealing, others follow, even though in aggregate, each acts more aggressively than it otherwise would and hence overall profits fall. The greater the extent to which the product is amenable to differentiation through manufacturer effort or by the addition of dealer services (or more generally through dealer input), the more likely it is that this 'prisoner's dilemma' will occur.

39 Additionally, even if exclusive dealing did have some effect on the residual demand elasticity facing the manufacturer, the extent of that effect would obviously depend on market circumstances. For example, if the product is a significant input into the purchaser's consumption, and hence search costs are low relative to the potential gains from search, consumers are unlikely to be much influenced in practice by small changes in distance between dealers.

Concerted conduct

40 "Concerted conduct" is a term that refers to the manner in which economic agents perceive and respond to their interdependence. Concerted conduct is conduct that embodies this interdependence. The most obvious form this takes is tacit coordination of price-setting.

41 Exclusive dealing can facilitate this tacit coordination. This is for two reasons. First, when each dealer sells only a single brand, it has less scope to direct customers as between competing brands. As a result, when a manufacturer cuts its price, there is less of a dealer and hence market response. This reduces the gain each manufacturer obtains by price

cutting and therefore makes the tacit coordination more stable than it might otherwise have been. Second, with exclusive dealing, each manufacturer may be able to more readily observe its rivals' prices, which facilitates monitoring of tacit coordination and hence favours price stability.

42 Again, whether this effect occurs, and its extent if it does, is uncertain, in that it depends on market circumstances. To begin with, as already noted above, to the extent to which exclusive dealing increases the return each firm obtains on promoting its product, it may induce competition that is, on balance, more rather than less aggressive – though obviously, it may be that the intensified competition is mainly non-price in form. Additionally, there are market structures in which tacit collusion is highly unlikely to occur and persist: most notably, where products are extensively differentiated, pricing is complex, and buyers solicit competing bids and secure discounts off list prices (for example, through trade-ins). In these cases, it is not realistic to think that distribution arrangements by themselves can materially alter price dynamics. Finally, if the market itself is relatively unconcentrated, then sellers will not generally be able to durably coordinate their pricing. Often, it suffices for there to be four or more suppliers, each with relatively substitutable products, for price coordination to be unlikely.

Entry barriers

43 Exclusive dealing may reduce competition to the extent to which it increases the entry barriers that would confront a potential competitor, or creates barriers to expansion (often referred to as 'mobility barriers') for existing competitors.

44 The way in which this occurs is mainly by foreclosing entrants' access to dealer networks. As a result of this foreclosure, the entrant must commit to entry at two levels simultaneously – manufacturing and distribution. This can entail higher sunk costs than a manufacturing entrant would otherwise need to incur. Entry is consequently more risky and hence generally less likely and in any event slower.

45 Whether there is any such foreclosure obviously depends on the share of dealer outlets that are subject to exclusive distribution. If a reasonable number of dealers are not subject to exclusive distribution, and of those that are, a reasonable number could be freed up in any period, then it is difficult to see how any foreclosure could occur. A 'reasonable number' in this context means a number sufficient to ensure that an efficient entrant could cover the fixed costs involved in product distribution.

46 Where many dealers are subject to exclusive distribution, the extent of the effect on entry costs will depend largely on the economies of scale and scope in dealership. If (1) there are high fixed costs to dealership relative to the variable costs dealers incur, and (2) economies of scope, or at least no diseconomies of scope, in dealership (so that dealers would not in any event choose to distribute a single brand over the longer term), then exclusive distribution can act as an entry barrier.

47 Where products are technically complex and dealers and their staff require brand-specific training, there are likely to be diseconomies of scope in dealership, as carrying multiple brands will, over the longer term, require some degree of duplication of essentially fixed training costs. Diseconomies can also arise when products are durable and require ongoing maintenance; in that case, the wider the product range, the greater is the likely carrying cost of spares (assuming parts are not interchangeable). To the extent to which these diseconomies of scope are significant, the exclusive distribution policy in itself does not alter the investments entrants need to make.

48 Additionally, it needs to be noted that exclusive distribution can also reduce entry barriers. In particular, entrants may opt for exclusive distribution (1) as a signal of commitment to the market and (2) as a way of more securely appropriating the gains from any differential advantages their products possess, and especially, from anticipated market success. Particularly for durable, technically complex products (for which maintenance and after sales service are significant), the more efficient an entrant (and hence the greater the social gain from the competition it brings), the more likely it is to itself adopt a policy of exclusive distribution.

49 This needs to be kept in mind not only *ex ante* but also *ex post*. Today's incumbents are yesterday's entrants. If exclusive distribution assisted these incumbents' original entry and expansion, requiring them to give it up may make current entrants uncertain as to their ability to obtain and retain the fruits of successful entry. This will increase the risks entry involves and hence reduce competition.

Conclusions on impacts on competition

50 Exclusive distribution can reduce competition through its impact on unilateral market power, concerted conduct and entry barriers. However, whether it does so is highly sensitive to market circumstances. And in any overall assessment, account must also be taken of the ways in which it facilitate and encourages investment by manufacturers and dealers in competitive effort.

51 Exclusive dealing is most likely to increase manufacturers' unilateral market power when it shelters individual dealers from competitive constraint. To the extent to which consumers can substitute between brands, face a range of reasonably widely distributed brands and have incentives to search for 'good deals', the competition-strengthening impacts of addressing the market failures discussed above are likely to outweigh any unilateral effects.

52 Exclusive dealing may facilitate concerted conduct, most notably in the form of tacit price coordination. However, for it to do so, market conditions must be conducive to tacit price coordination in the first place. As a general matter, this requires that there be a small number of competing suppliers, that their products not be highly differentiated and that prices be observable. Where there are several (say, four or more) competing brands, products are highly differentiated and prices often involve difficult to observe discounts, price coordination is not likely to occur, regardless of distribution arrangements.

53 Exclusive dealing can increase entry and mobility barriers by increasing the sunk costs, and hence risks, involved in entry. Whether this occurs depends on the share of potential dealers that are covered by exclusive distribution arrangements and the costs involved in convincing dealers to shift. Where there are numerous unaffiliated dealers, covering areas sufficient to allow an efficient entrant to defray its fixed costs, no such foreclosure can occur. Nor can it occur if the fixed costs involved in dealership are low, or alternatively, if there are diseconomies of scope to distribution. Finally, exclusive dealing can reduce entry barriers as well as increasing them, so any claims on this score need to be treated with caution.

D. Conclusions

54 Exclusive distribution provides a potentially efficient way of handling issues associated with externalities and with hold-up risks in situations where vertical integration is not an efficient option. Whether these benefits outweigh the costs exclusive distribution can create depends on the circumstances.

55 Concerns about exclusive distribution typically arise most acutely in two sets of circumstances.

56 A first is when a dealer is terminated. There are circumstances in which this can have anti-competitive effects – for example, when it forms part of a strategy of retail price maintenance that sustains tacit or explicit price coordination either at the wholesale or the retail stage. At the same time, making it unduly difficult for manufacturers to terminate dealers, when that termination is not plainly anti-competitive, can impose high costs. In particular, it can result in manufacturers only accepting dealers who are highly 'trustworthy', so that the risk of termination is minimised. This, in turn, can impose costs for three reasons: because it limits the number of dealers; because it allows 'trustworthy' dealers to secure a greater rent not only on their relative scarcity but also on their reputational capital; and because it creates an asymmetry between established manufacturers, who have built up a stock of trustworthy dealers, and entrants, who have not.

57 A second set of circumstances in which exclusive dealing typically becomes controversial is when an entrant faces one or more incumbents who, over a period of time, have developed exclusive distribution channels. It is obviously the case that the entrant could gain, perhaps materially, from access to the incumbent's dealership network. It is also obviously true that if it obtained such access, in the short term, existing dealers might secure a lower priced product which was a very close (indeed, virtually perfect) substitute for their existing product range. Some part of the fall in wholesale price would likely be passed on. There would therefore be some immediate gain to consumers.

58 However, these effects seem entirely short term, and hence do not sit well with an emphasis on competition as a dynamic, longer term phenomenon.

59 Rather, the long run implications of forcing the incumbent to provide access to its dealership network are likely largely adverse. More specifically, were such compulsory third party access policy enforced, it would be impossible for a manufacturer to retain an exclusive distribution policy that proved successful. Given that exclusive distribution, at least in some cases, seems to enhance rather than reduce competition over the longer term, thus precluding it would be contrary to the economic goal of protecting competitive activity and contrary to the policy of the Trade Practices Act. It might advantage a particular competitor, but would not benefit competition.

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