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**Vertical integration and the refusal to supply scarce goods – a legal and economic framework for
analysis of prohibited practices**

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CHAPTER I: INTRODUCTION

1. The economic and welfare benefits of forward integration by a producer are generally accepted to be positive. The efficiencies that arise from vertical integration are numerous and include, inter alia, the elimination of transaction costs and double marginalisation. Furthermore, organic forward integration introduces a new competitor in the downstream market, with the commensurate pro-competitive gains.
2. But what if the forward integration is by a dominant supplier of scarce goods and the forward integration has the effect of foreclosing downstream producers from access to essential inputs? Section 8(d)(ii) of the Competition Act prohibits a dominant firm from refusing to '*supply scarce goods to a competitor when supplying those goods is economically feasible.*'¹ Is there thus an obligation on a dominant firm wishing to vertically integrate to continue supplying essential inputs to competitors in the face of profit-making opportunities in the downstream market?
3. The paper examines the economic theory underpinning efficiencies and foreclosure or exclusionary concerns arising from organic forward integration and assesses how these theories have been viewed by scholars and courts in multiple jurisdictions. The paper then sets out to propose the legal and economic framework for the analysis of refusal to supply as a result of organic forward integration applicable to the South African market and concludes with practical guidance to dominant firms facing these dilemmas.

CHAPTER II: VERTICAL INTEGRATION: THE THEORETICAL FRAMEWORK

4. Vertical integration explained

- 4.1. According to Herbert Hovenkamp ("**Hovenkamp**"), in a March 2010 article published in the *Iowa Law Review*, '*Vertical Integration occurs whenever a... firm does something for itself that it might have otherwise obtained on the market*'². Hovenkamp identifies that vertical integration may occur by means of three different legal devices. In this regard, a firm may vertically integrate by:
 - 4.1.1. Pursuing a course of action *de novo* (or in different parlance, by engaging in organic vertical integration). This involves instances where the firm chooses to do something for itself rather than purchasing an item from or selling an item to the market. An example of *de novo* forward vertical integration may include the case of a plastic producer that, as opposed to selling the raw materials it manufactures to a vuvuzela producer, decides to produce the vuvuzela itself;
 - 4.1.2. By merger, which would entail one firm purchasing a firm in a vertically related market (for example, the plastic producer purchases the vuvuzela manufacturer); and

¹ To this end, this paper contends that the desire of the dominant firm to forward integrate should be based on business reasons other than additional the desire to enhance market power. The actions of the dominant firm should be able to be justified on business grounds other than its intention to decrease and ultimately cease supply to its customers in the downstream market in order to enter this market. To this end, forward integration should be permissible where it is not the dominant firm's intention to eliminate a competitor from the market and where it is commercially feasible for the dominant firm to ultimately use the scarce good it produces to manufacture goods for supply into the downstream market so as to attract additional margin. In the interests of brevity and in keeping with the scope of this paper, we do not consider the issue of what is "economically feasible" much further.

² Herbert Hovenkamp 'The Law of Vertical Integration and The Business Firm: 1880-1960' (2010) *Iowa Law Review* at 865.



4.1.3. Contractual mechanisms i.e. franchising agreements (by way of example, the vuvuzela manufacturer entering into a franchise agreement for the sale of vuvuzelas by a franchisee).³

4.2. It is primarily the first type of vertical integration referred to above, namely organic vertical integration, with which this paper is concerned and in particular with instances where that vertical integration is undertaken by a dominant supplier of scarce goods.

5. The evolution of the economic theory of vertical integration

5.1. Economists have agonised for decades about the incentives, benefits and risks of vertical integration. This section provides an overview of the evolution of the different economic schools of thought and their analysis of vertical integration.

Neoclassical theories of vertical integration

5.2. In the 1940s and 1950s, neoclassical industrial-organization economists such as Joe Bain (“**Bain**”), came to view that the competitive rationales for vertical integration as being rooted only in the technological efficiency brought about by purging a physical step from the process of production of the finished product.

5.3. At the same time, Bain had a heightened fear of "foreclosure" and a belief that the procompetitive rationales for vertical integration tended to diminish as markets became more concentrated. Bain believed that where markets were highly competitive, firms will vertically integrate where it leads to a reduction in costs. However, in markets characterised by oligopolies or by monopolists, Bain theorised that, paradoxically, even uneconomical vertical integration could be profitable. According to Bain, by trading increased costs for increased barriers to entry, the act of vertically integrating made sound commercial sense. In this way, Bain stated that firms with large market shares that sought to vertically integrate were preoccupied with entrenching and increasing their existing market power and raising barriers to entry more than reducing costs.⁴

5.4. Ronald Coase (“**Coase**”) was the first economist to set out the transaction cost theory of the firm in his article, *The Nature of the Firm*⁵. The article offered insight into why firms exist, why they may grow as large as they do and what influences their decision to produce internally when procuring externally from an efficient market place is cheaper.⁶ In contrast to the prevailing popular economic belief of the time, Coase noted that the use of the market can be an expensive exercise. Transaction costs such as, inter alia, search costs, information costs, bargaining costs and the like may render the act of procurement from the market more costly than the good itself. Where this is the case, Coase theorised that firms would tend to vertically integrate producing internally what was more expensive to procure externally. By way of example, Henry Ford was said to have grown his own soybeans for the manufacture of plastic horn buttons.⁷

³ Ibid.

⁴ Joe S. Bain, *Industrial organization* (1959) 168-169, 358-359 as quoted in Hovenkamp op cit note 2 at 872-873.

⁵ Ronald H. Coase 'The Nature of the Firm', 4 (1937) *Economica* as quoted in Hovenkamp op cit note 2 at 869.

⁶ Arguably, transaction cost reasoning became most widely known through Oliver E Williamson's *Transaction Cost Economics*

⁷ Hovenkamp op cit note 2 at 877.



Chicago school theories of vertical integration

5.5. The Chicago school evaluation of the competitive effects of vertical integration has traditionally been based on two models, namely the (i) monopoly leverage model (also known as the single monopoly profit theorem) and (ii) the successive monopoly model (or the theory of double marginalisation). The implication of both of these models is that vertical integration is welfare enhancing.

5.6. Monopoly leverage model

5.6.1. The monopoly leverage model contends that a firm with a legitimate unregulated monopoly in one product would not have the economic incentive to try to leverage that monopoly into the creation of a second monopoly in an adjacent market. According to this model, the monopolist can extract all of the monopoly profits available in the first market without integrating (either explicitly or by contract) into a second market. On account of the fact that there is no anticompetitive incentive for leverage, it is argued that a monopolist's decision to integrate into the second market must be motivated by pro-competitive efficiency gains.

5.6.2. However, Post-Chicago economic analysis has suggested that there are a number of assumptions required for the monopoly leverage model to apply. These include, inter alia situations when the first monopoly is regulated, when markets are characterised by economies of scale and scope, or when markets have multiple types of buyers. Moreover, in some cases, the monopolist may utilise vertical integration or exclusive contracts with suppliers or customers to raise barriers to competition that can preserve or enhance its monopoly power in the first product.

5.7. The successive monopoly model

5.7.1. The successive monopoly model considers the effect of integration between an upstream monopolist and a downstream monopolist.⁸ It shows that the effect of the vertical merger is welfare improving because it eliminates double marginalisation. Double marginalisation (as first theorised by Lerner in 1934⁹) is defined as *the 'exercise of market power at successive vertical layers in a supply chain, resulting in an impetus to mark up the product's price above marginal cost'*. The sequence of mark-ups *'leads to a higher retail price and lower combined profit for the supply chain than would arise if the firms were vertically integrated'*¹⁰.

5.7.2. In these circumstances vertical integration makes both consumers and the vertically integrated firm better off. Under vertical integration the downstream business division faces the true marginal cost of production for the upstream input. The decrease in the marginal cost downstream due to vertical integration provides the firm with a profit incentive to expand output and lower prices, making consumers better off. Equivalently, the vertical integration internalises the vertical pricing

⁸ OECD Round Table 'Vertical Mergers 2007' at 21.

⁹ Procurement Insights 'Double Marginalization and the Decentralized Supply Chain' at <http://procureinsights.wordpress.com/2007/08/09/double-marginalization-and-the-decentralized-supply-chain/>.

¹⁰ Ibid.



externality; that is to say that the integrated firm in considering the lost profits from a price increase will internalise the lost margins both up and downstream. Hence the integrated firm has an incentive to charge lower prices since the cost to it of raising its price is greater.

- 5.7.3. The internalisation of double marginalisation is an important *potential* source of efficiency associated with any vertical integration where there is market power both up and downstream pre-integration. The successive monopoly model allows for a very simple exposition of the gains from eliminating double marginalisation. However, it is based on the assumptions that (i) the upstream firm has all of the bargaining power in the upstream and downstream markets and (ii) that the monopolist upstream uses uniform pricing and not nonlinear pricing.

The Post-Chicago and modern theories of vertical integration

- 5.8. Whilst recognising the potential benefits and efficiencies of vertical integration, the Post-Chicago theories of anticompetitive harm arising from vertical integration focus on how foreclosure either raises rivals' costs or reduces rivals' revenues and how these negative effects on rivals result in anticompetitive harm, i.e., harm to consumers or a reduction in efficiency (total welfare). The focus of the theories is on the effect and incentives for input and customer foreclosure. Input foreclosure occurs when the vertically integrated firm no longer sells, or sells at a higher price to downstream rivals. Customer foreclosure occurs when the vertically integrated firm no longer buys from upstream rivals.
- 5.9. The modern theories of input and customer foreclosure provide a template for antitrust enforcement to vertical integration. Those theories demonstrate that the indirect link from vertical integration to an increase in market power and anticompetitive harm involves determining:
- (i) The incentive for foreclosure;
 - (ii) The effect of foreclosure on rivals and, in turn, how it affects their ability to compete;
 - (iii) How the change in rivals' ability to compete impacts competition;
 - (iv) How the vertical integration changes the incentives of the integrated firm in the downstream market; and
 - (v) The impact on the welfare of consumers, or efficiency, from the change in competition and the change in behaviour of the vertically integrated firm.

Summary: Economic theory of vertical integration

- 5.10. In summary, it is clear that vertical integration is an enduring topic for economics and economists. The literature has abundant studies that show both the beneficial and potential detrimental impacts of vertical integration.
- 5.11. In this regard, vertical integration is somewhat of a double-edged sword. For whilst vertical integration has the potential, in certain circumstances, to lead to an increase in market concentration and allow dominant firms to leverage their market power in a vertically related market; the efficiencies that arise from vertical integration are numerous and include, inter alia, elimination of transaction costs and double marginalisation.



- 5.12. Against this background, the next section outlines the specific benefits and risks of vertical integration and concludes by setting out the potential competition law risks of organic forward integration by a dominant firm.

CHAPTER III: ORGANIC FORWARD INTEGRATION: BEAUTY OR BEAST?

6. The Benefits of organic forward integration

- 6.1. Vertical integration can be objectively necessary to achieve certain commercially legitimate goals such as the preservation of limited economic resources¹¹ and increased profits.
- 6.2. Much of the controversy associated with vertical integration enforcement arises from the widely held view that anticompetitive harm from such integration is unlikely and that the motivation for vertical integration is not to enhance or preserve market power, but to realise efficiencies.
- 6.3. In particular, competition authorities worldwide have recognised that vertical integration can lead to the following efficiencies:¹²
- 6.3.1. Avoiding the need for negotiation and execution of contracts and minimises the risk and uncertainty (according to the transaction cost theory);
 - 6.3.2. Enabling the internalisation of externalities, particularly the elimination of double marginalisation leading to a higher amount of delivered goods due to lower prices and / or innovation;
 - 6.3.3. Economies of scale and scope;
 - 6.3.4. Savings that would increase production and / or distribution and increased output;
 - 6.3.5. Technical improvements in the quality of goods;
 - 6.3.6. Streamlining the co-ordination of design, and distribution of goods; and
 - 6.3.7. Dynamic efficiencies in the form of innovation.¹³
- 6.4. In addition to the above, organic forward (and backward) integration (unlike other types of vertical integration) introduces a new competitor in the downstream (or upstream) market, with the commensurate pro-competitive gains.
- 6.5. The next section explores the potential undesirable side-effects of vertical integration.

¹¹ Tu Thanh iNguyen 'Price squeezing: Linkline in the United States - no link to the European Union' (2010) *International Review of Intellectual Property and Competition Law* at 319.

¹² To be considered such an efficiency, it is required that the efficiency must (i) arise directly as a result of the vertical integration; (ii) should be demonstrable; and (iii) must be likely that the benefit will be passed on to consumers.

¹³ Miguel Mendes Pereira 'Vertical and horizontal integration in the media sector and EU competition law: The ICT and Media Sectors within the EU Policy Framework' 7 April 2003 at 5 and 7, OECD Round Table 'Vertical Mergers 2007' at 132.



7. The undesirable side-effects of vertical integration

- 7.1. Broadly, there are two potential concerns with vertical integration, namely the extension of market power from one stage of production to another and the facilitation of co-ordination in the relevant markets.

The extension of market power from one stage of production to another

- 7.2. Vertical integration can lead to the extension of market power from one stage of production to another through foreclosure by –
- 7.2.1. pre-empting competition through discriminatory, limited (or the total refusal of) access to an essential input; and
 - 7.2.2. by access to commercially sensitive information on its downstream rivals.
- 7.3. As was enunciated in merger cases such as the seminal United States Brown Shoe case¹⁴, vertical integration raises concerns of market foreclosure. After all, the *'multiplication of the presence of a company throughout a number of markets along the value chain of the product concomitantly multiplies the possibilities for such a company to foreclose one or more of the corresponding markets where the company possesses market power. In these circumstances, vertical integration may in itself raise barriers to entry'*¹⁵.
- 7.4. As indicated earlier, the Post-Chicago theories of anticompetitive harm from vertical integration focus on how foreclosure either raises rivals' costs or reduces rivals' revenues (thus raising the barriers to enter into or expand in the relevant market) and how these negative effects on rivals result in anticompetitive harm, i.e. harm to consumers or a reduction in efficiency (total welfare).
- 7.5. Market foreclosure is generally apparent in one of two forms – either in the form of input foreclosure or in the form of customer foreclosure. Input foreclosure occurs where the vertically integrated firm no longer sells, or sells the inputs it produces at higher prices to equally efficient downstream rivals (with which it now competes), thereby resulting in higher input prices (and hence higher prices of the finished good).
- 7.6. Customer foreclosure occurs where the vertically integrated firm no longer buys from upstream rivals, resulting in a reduction in sales volume and an increase in the average variable or marginal cost of upstream competitors¹⁶.
- 7.7. Generally speaking, there is a greater chance that the impact of such foreclosure is likely to be substantial in the event that the integrating firm is a dominant player in the relevant upstream or downstream market.

¹⁴ 370 U.S. 294, (1962) at 325.

¹⁵ Pereira op cit note 13 at 5.

¹⁶ Ibid at 17.



Co-ordinated effects

- 7.8. Vertical integration can also lead to the facilitation of co-ordinated effects, when it assists firms in the market in implicitly or explicitly co-ordinating their pricing, output or related commercial decisions. For example, the integrated firm may either obtain access or utilise its previous access to confidential or commercially sensitive information about the activities of its competitors, for its own gain. The exchange of this information may result in the tacit co-ordination of prices and other trading conditions.
- 7.9. Furthermore, vertical integration may be facilitative of co-ordinated effects by simply reducing the number of firms among which to co-ordinate, by removing or weakening competitive constraints or by altering certain market conditions that make co-ordination more likely.

8. Conclusion

- 8.1. The economic and welfare benefits of vertical integration by a producer are generally accepted to be positive. The efficiencies that arise from vertical integration are numerous and include, inter alia, elimination of transaction costs and double marginalisation. Furthermore, organic forward integration introduces a new competitor in the downstream market, with the commensurate pro-competitive gains.
- 8.2. However, it is clear from the above that vertical integration can result in an anticompetitive effect - harm to consumers or a reduction in efficiency - if it leads to the extension of market power from one stage of production to another and / or by facilitating co-ordination in the relevant markets.
- 8.3. In particular, if the vertical integration is by a dominant supplier of scarce goods (even if such forward integration is organic, and introduces a new competitor in the downstream market) the vertical integration could potentially have the effect of foreclosing downstream producers from access to essential inputs.
- 8.4. Section 8(d)(ii) of the Competition Act prohibits a dominant firm to refuse to ‘*supply scarce goods to a competitor when supplying those goods is economically feasible.*’ The question that arises in this regard is whether there is an obligation on a dominant firm wishing to organically forward integrate to continue supplying essential inputs to competitors in the face of profit-making opportunities in the downstream market?
- 8.5. Ultimately, as in most areas of competition, the “*devil will lie in the details*” and the circumstances surrounding each instance of a desire to organically forward integrate. A flexible approach within a guided legal and economic analytical framework is required, and we attempt to develop such framework below.

CHAPTER IV: VERTICAL INTEGRATION: THE LEGAL FRAMEWORK

9. Introduction – An outline of the relevant law

- 9.1. In providing upstream dominant firms which seek to organically forward integrate with guidelines on how to do so, it is critical to understand in what circumstances such firm may be forced to supply parties in the downstream market. The reality is that when dominant firms vertically integrate, supply to the downstream market will inevitably be reduced on account of the dominant firm now needing to self-supply. Particularly when that dominant firm is a supplier of scarce goods required by downstream players to compete in the downstream market, careful regard must be



had to the manner in which the dominant firm conducts itself in relation to such downstream players. Ultimately though, it is important to bear in mind that each scenario will be different based on its own unique facts.

- 9.2. What remains constant however, are the provisions of the Competition Act which apply to dominant firms.
- 9.3. In terms of section 7 of the Competition Act, a firm is dominant in a given market if –
 - 9.3.1. it has at least 45% of that market;
 - 9.3.2. it has at least 35% but less than 45% of that market unless it can show that it does not have *market power*; or
 - 9.3.3. it has less than 35% of that market but has *market power*.
- 9.4. ‘*Market power*’ is defined in the Competition Act as ‘*the power of a firm to control prices, or to exclude competition or to behave to an appreciable extent independently of its competitors, customers or suppliers*’.
- 9.5. What is important to realise is that being dominant in and of itself is not problematic or automatically tantamount to a breach of competition law. However, where a dominant entity abuses its market position in a manner which offends the Competition Act, such abuse will prompt the competition authorities to intervene. Although William Shakespeare could never have foreseen the advent of competition law in South Africa, he nevertheless made a pertinent observation when he said that ‘*O, it is excellent To have a giant's strength, but it is tyrannous To use it like a giant.*’¹⁷. In this way, dominant firms have an additional responsibility in terms of the Competition Act in that they have to ensure that their activities do not fall within the type of conduct considered to be abuses of dominance.
- 9.6. Section 8(d) of the Competition Act sets out specific prohibited exclusionary acts. To this end, when a firm engages in organic forward vertical integration into a downstream market, it ceases to merely be a producer / supplier or manufacturer of a good, and becomes a competitor of its customers for that good in the downstream market as well. As such, section 8(d)(ii) of the Competition Act - which states that it is prohibited for a dominant firm to refuse to supply scarce goods to a competitor when supplying those goods is economically feasible, unless it can be shown that technological, efficiency or other pro-competitive gains outweigh the anti-competitive effect of this conduct - becomes especially relevant.
- 9.7. It is owing to provisions such as those contained in section 8(d)(ii), that to an appreciable degree, the freedom of a dominant firm to enter into or resile from contracts as unreservedly as if it did not enjoy a dominant position in the market may be limited. In this way, a dominant firm may in fact have a duty to deal with its customers and may be lawfully enjoined not to reduce or completely cease supplying such customers. Whether this duty extends to new customers is less clear. Whether this duty exists and in what circumstances it arises, would however be fact dependent.
- 9.8. In addition, over and above section 8(d)(ii), section 8(c) functions as something of a catch-all provision. On the basis of section 8(c), is prohibited for a dominant firm to

¹⁷ William Shakespeare *Measure for Measure (Isabella at II, ii)* as quoted in the judgment handed down in *Harmony Gold Mining Company Ltd / Durban Roodepoort Deep and Mittal Steel South Africa Ltd / Macsteel International* Case No: 13/CR/FEB04 at para 127.



engage in an exclusionary act (conduct which impedes or prevents a firm from entering into or expanding within a market), if the anti-competitive effect of that act outweighs its technological, efficiencies or any other pro-competitive gains. By refusing to supply a party with a scarce good by virtue of its own vertical integration, a dominant firm may be said to have prevented such firm from being able to enter into or expand within the particular relevant downstream market.

- 9.9. Theoretically at least, a firm should be able not to contract with parties with which it ceases to have no dealings¹⁸. South African common law supports the principle that contracts are constituted by agreement. The basis for this principle is the concept of individual autonomy which stipulates that the individual must be free to decide ‘whether, with whom, and on what terms to contract’¹⁹. However, this principle of being able freely to contract (or not to contract, as the case may be) is not necessarily absolute. As Sutherland and Kemp point out, South African law (unlike that in Europe and America) does not necessarily allow parties to freely choose their trading partners and refuse to supply their competitors where such firm falls to be classified as dominant²⁰. In the USA, a refusal to supply may be condemned where it constitutes a desire to sacrifice profits to achieve anti-competitive outcomes, whereas in Europe, a refusal to supply ‘is treated as a broad abuse that includes the refusal to grant access to an essential facility and refusal to supply scarce goods to a competitor’. This approach has been rejected by the Competition Appeal Court, which has stated that the contravention of section 8(d)(ii) allows a respondent to raise an efficiency defence whereas an essential facilities prohibition does not²¹.

10. Relevant South African case precedent

- 10.1. In *Competition Commission / SAA Pty (LTD)*²², the Competition Tribunal (the “Tribunal”) set out the approach to be taken to the analysis of exclusionary acts. In this regard, it stated that

*‘In summary, we find that the Competition Act sets out the following approach to exclusionary practices. In the first place we examine whether the conduct in question is exclusionary in nature. In terms of section 8(c) that would be conduct that fits the definition in the Act for what constitutes an exclusionary act. In terms of 8(d) it is conduct that meets the definitions set out in the sub-paragraphs of that section. If the conduct meets the requirements of the definition, we then enquire whether the exclusionary act has an anti-competitive effect. This question will be answered in the affirmative if there is **(i) evidence of actual harm to consumer welfare or (ii) if the exclusionary act is substantial or significant in terms of its effect in foreclosing the market to rivals** (our emphasis). This latter conclusion is partly factual and partly based on reasonable inferences drawn from proven facts. If the answer to that question is yes, we conclude that the*

¹⁸ Romano Subiotto and Robert O'Donoghue ‘Defining the scope of the duty of dominant firms to deal with existing customers under Article 82 EC’ (2003) European Competition Law Review at 683.

¹⁹ Schalk Van der Merwe et al *Contract General Principles* 2 ed (2003) at 10.

²⁰ Philip Sutherland and Katharine Kemp *Competition Law of South Africa* October 2009 at 7-84.

²¹ *Glaxo Wellcome (Pty) Ltd v National Association of Pharmaceutical Wholesalers* Case No. 15/CAC/Feb02 paras 50–52 and 56. Philip Sutherland and Katharine Kemp *Competition Law of South Africa* October 2009 at 7-84.

²² Case No. 18/CR/Mar01 [2001] ZACT 44, at 31–32.



conduct will have an anti-competitive effect. Whichever species of anti-competitive effect we have, consumer welfare or likely foreclosure, we have evidence of a quantitative nature and hence we can return to the scales with a concept capable of being measured against the alleged efficiency gain.'

10.2. The Tribunal further stated that:

'In terms of section 8(d) the burden of proof now shifts to the respondent who must prove that the efficiency justification outweighs the anticompetitive effect. If the respondent does not, then the conduct will be found to be an abuse.'

10.3. Furthermore, in *The Bulb Man (SA) (Pty) Ltd v Hadecco (Pty) Ltd*²³ (the "**Bulb Man decision**"), the Tribunal set out the approach to be taken in the analysis of section 8(d)(ii), i.e. a refusal to deal. The following extract from the Bulb Man decision is instructive:

'The crucial question here is: Does the respondent's refusal to deal advantage its alleged market power? In York Timbers Limited v SA Forestry Company Limited, we cited the following page from Areeda and Hovenkamp's Treatise, which we suggest is apposite:

"An arbitrary refusal to deal by a monopolist cannot be unlawful unless it extends, preserves or creates, or threatens to create significant market power in some market, which could be either the primary market in which the monopoly firm sells or a vertically related or even collateral market. Refusals that do not accomplish at least one of these results do not violate section 2 of the Sherman Act, no matter how much they may harm the person or class of persons declined service. Nor are such refusals an "abuse" of monopoly power in the sense of using power in one market as "leverage" to increase one's advantage in another market".

*We can look at the anticompetitive effect from another perspective. Why is the dominant firm refusing to deal? As **the authorities show, even dominant firms are entitled to refuse to deal. However, if the dominant firm lacked a proper explanation for its conduct, this might shift the probabilities in favour of the applicant** (our emphasis).*

Faul and Nickpay observe in relation to European jurisprudence that:

"A refusal to deal by a dominant undertaking will not be considered an abuse under Article 82 of the EC Treaty if it is objectively justified. This will be the case if the refusal can be justified on business grounds other than the intention to eliminate a competitor from the market."²⁴

10.4. Thus, in order for a contravention of either sections 8(c) and / or 8(d)(ii) to occur, the following must be proved:

10.4.1. That dominant's intention to decrease and ultimately cease supply to its customers in the downstream market for the production of the

²³ Case No. 81/IR/Apr06 [2006] ZACT 86.

²⁴ Ibid 55-56.



downstream good itself impedes or prevents a firm from entering into, or expanding within a market and, in the case of section 8(d)(ii), that such action leads to a refusal to supply scarce goods to a competitor when supplying those goods is economically feasible, and that such refusal can be justified on business grounds other than the intention to eliminate a competitor from the market.

10.4.2. That there is anti-competitive effect. Such anti-competitive effect could be manifested in two forms: either there is direct evidence of an adverse effect on consumer welfare or evidence that the exclusionary act is substantial or significant in terms of its effect in foreclosing the market to rivals.

10.5. If both of the above factors are confirmed in the affirmative, the next step to be taken is to ascertain whether it can be shown that any technological, efficiency or other pro-competitive, gain resulting from that agreement outweighs that effect. In terms of section 8(d)(ii), the onus of proving that any technological, efficiency or other pro-competitive, gain resulting from that agreement outweighs that effect will be on the dominant firm.

11. Relevant European case precedent

11.1. A dominant firm is perfectly entitled to maximise its profit and become as commercially successful as possible – provided it does so within the ambit of the law. The question which must be asked though is to what degree it will be legitimate to limit business relationships with third parties in the pursuit of the aforementioned goals. What requires assessment is whether the refusal to supply in question is tantamount to an abuse of dominance. In the case of organic forward vertical integration, the South African competition law authorities have not yet had the opportunity to properly tackle the issue of whether and to what degree an upstream dominant firm may reduce or cease supplying downstream players (with which it now competes by virtue of it having vertically integrated).

11.2. Despite the differences between South African and European law as highlighted by Sutherland and Kemp, Subiotto and O'Donoghue²⁵ provide useful insights into in what circumstances, a dominant firm's refusal to supply may be problematic. The authors raise a number of notable points, the most pertinent of which are summarised briefly below:

11.2.1. A simple refusal to supply – even where total – is prohibited only if it constitutes an abuse. It would be absurd to expect a dominant supplier of scarce goods to supply every customer in the market for those goods (this accords with what is set out in the Bulb Man decision).

11.2.2. As already alluded to, a dominant firm must be able to pursue profit-maximising strategies including determining if it wishes to sell to third parties and what quantities it is prepared to sell to such parties. As the European Court of Justice ("ECJ") held in *United Brands*, 'the fact that an undertaking is in a dominant position cannot disentitle it from protecting its own commercial interests if they are attacked, and that

²⁵ Subiotto and O'Donoghue op cit note 18.



such an undertaking must be conceded the right to take such reasonable steps as it deems appropriate to protect its said interests²⁶.

11.3. As is the *ad nauseam* recited mantra of competition law, competition law is there to protect consumers and competition and not competitors; unless in exceptional circumstances where interfering with contractual freedom would be warranted.

11.4. The earliest European case dealing with a dominant firm's duty to supply is *Commercial Solvents*²⁷. The ECJ held that Commercial Solvents had abused its dominant position by refusing to continue to supply essential raw materials to a customer, namely Zoja. The basis for the refusal to supply was that Commercial Solvents was planning to vertically integrate into competition with Zoja in the downstream market for the supply of the product derived from the raw materials. The action in question was thus intended to exclude Zoja from the downstream market by cutting off essential raw materials. It was noted that the raw materials in question has been supplied by Commercial Solvents to Zoja for some years and the supplies were only terminated when the latter decided to compete with the former. In the circumstances, the ECJ held that there was an abuse. As was stated:

*'It follows that an undertaking which has a dominant position in the market in raw materials and which, with the object of reserving such raw material for manufacturing its own derivatives, refuses to supply a customer, which is itself a manufacturer of these derivatives, and therefore risks eliminating all competition on the part of this customer, is abusing its dominant position ...'*²⁸

11.5. Therefore where an instance of forward integration is premised by an anticompetitive rationale and effect, the European competition authorities are likely to intervene.

12. **The analysis of vertical integration and the refusal to supply scarce goods - learnings from economic theory and case precedent**

12.1. The following learnings as regards the circumstances in which a dominant firm's refusal to supply may be problematic can be drawn from economic theory and South African and international case precedent:

12.1.1. The economic and welfare benefits of vertical integration by a producer are generally accepted to be positive. The efficiencies that arise from vertical integration are numerous and include, inter alia, elimination of transaction costs and double marginalisation. Furthermore, organic forward integration introduces a new competitor in the downstream market, with the commensurate pro-competitive gains.

12.1.2. However, even organic forward integration can lead to anticompetitive effect. To this end, if the forward integration is by a dominant supplier of scarce goods, the forward integration could potentially have the effect of foreclosing downstream producers from access to essential inputs.

²⁶ *United Brands v Commission* Case 27/76 [1978] E.C.R. 207, 189. As quoted in Subiotto and O'Donoghue op cit note 18 **Error! Bookmark not defined.** at 683.

²⁷ Joined Cases 6/73 and 7/73 [1974] E.C.R. 223.

²⁸ As quoted in Subiotto and O'Donoghue op cit note 18 at 684.



- 12.1.3. Owing to provisions such as those contained in sections 8(c) and 8(d)(ii) of the Competition Act, that to an appreciable degree, the freedom of a dominant firm to enter into or resile from contracts as freely as if they did not enjoy a dominant position in the market may be limited. In this way, a dominant firm may in fact have a duty to deal with its customers and may be lawfully enjoined not to reduce or completely cease supplying such customers.
- 12.2. South African case precedent outlines the test to determine whether such conduct is unlawful and states that where:
- 12.2.1. a dominant firm's intention to decrease and ultimately cease supply to its customers in the downstream market for the production of the downstream good itself impedes or prevents a firm from entering into, or expanding within a market and, in the case of section 8(d)(ii), where such action leads to a refusal to supply scarce goods to a competitor when supplying those goods is economically feasible, and that such refusal can be justified on business grounds other than the intention to eliminate a competitor from the market; and
- 12.2.2. there is anti-competitive effect²⁹,
- such action may be unlawful. Thus if both of the above factors are confirmed in the affirmative, the next step to be taken is to ascertain whether it can be shown that any technological, efficiency or other pro-competitive, gain resulting from that agreement outweighs that effect. In terms of section 8(d)(ii), the onus of proving that any technological, efficiency or other pro-competitive, gain resulting from that agreement outweighs that effect will be on the dominant firm.
- 12.3. Furthermore, the following main themes arise:
- 12.3.1. A simple refusal to supply – even where total – is prohibited only if it constitutes an abuse.
- 12.3.2. A dominant firm must be able to pursue profit-maximising strategies including determining if it wishes to sell to third parties and what quantities it is prepared to sell to such parties.
- 12.4. Lastly in providing a consolidated and coherent view of what is expressed above, there should be *'no general obligation on a dominant firm to subsidise competition to itself and it is entitled to rely on legitimately-acquired advantages for its own use even if the effect of excluding competitors' access to them means that they can compete less effectively or even not at all. This is, after all, what competition involves*³⁰. However in terms of the Competition Act, where the input concerns constitutes an essential element in the good(s) produced downstream, without which the manufactures of such goods will be unable to compete, as per section 8(d)(i) the case is markedly different. However this does mean that the dominant firm is entirely precluded from vertically integrating.

²⁹ Such anti-competitive effect could be manifested in two forms: either there is direct evidence of an adverse effect on consumer welfare or evidence that the exclusionary act is substantial or significant in terms of its effect in foreclosing the market to rivals.

³⁰ Subiotto and O'Donoghue op cit note 18 at 687.



- 12.5. In terms of reducing supply of the scarce good to already existing customers, the dominant firm needs to have particular regard to its contractual obligations to such customers. In *Commercial Solvents*, the refusal to deal was sudden and absolute. In such instance the dominant firm should give the affected customer sufficient notice so as to allow the customer to establish relations with alternative sources of supply³¹. In such instances, a phased approach of a reduction in supply is the most favoured approach to be followed.
- 12.6. In a paper prepared by the International Competition Network pursuant to a conference on the subject held in Turkey in 2010³², it was indicated by the participants in the conference that a prior supply relationship between a firm and its customer is required to establish liability in the case of a refusal to deal. Therefore, a refusal to deal may be found to be anti-competitive both when it concerns the cut-off of supplies to an existing customer and the refusal to deal with a new customer. According to the European Commission, it is sufficient to show that 'there is demand from potential purchasers and that a potential market for the input at stake can be identified.' However, many agencies present at the conference consider a history of dealing between trading partners to be potentially relevant to evaluating refusals. Prior dealing may serve as evidence that supplying a particular customer is economically and technically feasible.
- 12.7. However, where a supplier can justify discontinuing an existing supply arrangement or rejecting a new customer for efficiency reasons, where for example continued supply affects the firm's incentives to invest, this may be permissible i.e. if the supplier supplies everyone no-one will be able to effectively compete. However, the European Commission indicated that if the supplier refuses to sell to its main competitor, but at the same time is willing to deal with a smaller competitive fringe or sell inputs in other markets in which it is not present, efficiency arguments may be more difficult to support.³³

CHAPTER V: DEVELOPING AN ANALYTICAL FRAMEWORK

13. The crux of the issue has to be whether by organically forward integrating, self-supplying and shorting the market the dominant firm can be said to:
- 13.1. In the case of section 8(c), be impeding or preventing a firm from entering into, or expanding within a market; and,
- 13.2. In the case of section 8(d)(ii), have perpetrated an abuse of dominance by refusing to supply supply scarce goods to a competitor when supplying those goods is economically feasible.
14. As noted, in terms of section 8(c) of the Competition Act, it is prohibited for a dominant firm to engage in an act that impedes or prevents a firm from entering into, or expanding within a market (i.e. the so-called *exclusionary act*), if the anticompetitive effect of that act outweighs the technological, efficiency or other pro-competitive gains arising there from. It may be argued that by vertically integrating, self-supplying and shorting the market either completely or partially that a dominant firm has engaged in an exclusionary act in that its

³¹ Ibid at 687-688.

³² International Competition Network 'Report on the Analysis of Refusal to Deal with a Rival Under Unilateral Conduct Laws' April 2010.

³³ Ibid.



conduct will potentially hinder incumbents and new entrants from participating in the downstream market.

15. In terms of section 8(d)(ii), what needs to be assessed is what the intention of the dominant firm is. To this end, to the extent that the dominant firm is desirous of eliminating competitors from the downstream market, its actions will be regarded with heightened suspicion and in all likelihood competition law condemnation.
16. However, the innate problem with a purely intention based test is separating commercial truth from commercial fiction, a task which is certainly not easy to perform. Rather, intention should be one factor of the analysis with the real question being whether or not the refusal to supply leads to any anti-competitive effect. Thus, an action must be characterised as an abuse of dominance before it can actually be deemed (and condemned) as such.
17. As already noted, the Tribunal in the SAA matter found that the anti-competitive effect could be manifested in two forms:
 - 17.1. When there is direct evidence of an adverse effect on consumer welfare; or
 - 17.2. When there is evidence that the exclusionary act is substantial or significant in terms of its effect in foreclosing the market to rivals.
18. The above means that an adverse effect on consumer welfare does not have to be proven, but rather that the exclusionary act is substantial or significant in terms of its effect in foreclosing the market to equally efficient rivals.
19. When analysing whether conduct (when such conduct has been found to be exclusionary) has an adverse effect on consumer welfare and / or is substantial or significant in terms of its effect of foreclosing the market to rivals that are equally efficient rivals, will broadly depend on the following factors, including:
 - 19.1. The effected portion of the market that is foreclosed. In this regard, the larger the effected portion of the market that is foreclosed, the higher the likelihood that such conduct will be substantial in terms of its effect in foreclosing the market to equally efficient rivals;
 - 19.2. The level of competitiveness in the relevant markets. To this end, when the level of competitiveness in the relevant markets is high, the impact of foreclosure on the competitive conditions in the market is likely to be lower, and significant consumer harm is unlikely. The level of competitiveness in the relevant markets can be measured by the number of competitors, the alternative channels to consumers and the barriers to enter or expand in the markets.
20. **The effected portion of the market that is foreclosed**
 - 20.1. We do not have benchmarks on foreclosure percentages in South Africa.
 - 20.2. As regards international case precedent, in the complaint of *RJ Reynolds, Lorillard Tobacco and Brown and Williamson Tobacco vs. Philip Morris in the United States*³⁴ where the plaintiffs complained that the promotional programs of Philip Morris foreclosed them from the: '*market for effective retail merchandising opportunities*', the following is stated regarding benchmarks in the US (p. 62): '*Courts have not*

³⁴ In the US District Court for the Middle District of North Carolina, May 1, 2002.



established a firm percentage of market foreclosure that constitutes substantial foreclosure. Professor Hovenkamp suggests 20% as an appropriate minimum foreclosure percentage and 50% as a level at which courts routinely condemn foreclosure. See XI Herbert Hovenkamp Antitrust Law 1821c (1998)'.

- 20.3. In addition, an article by Wright & Anderson (2006)³⁵ argues that contracts that foreclose less than 40% of distribution are unlikely to deprive rivals of the ability to achieve minimum efficient scale.
- 20.4. Another example of an international case where foreclosure percentages were calculated is that of Heineken beer in the Netherlands (Dutch Competition authority (“NMa”) 2002). Heineken supplied more than 50% of the draught pilsner market in the Netherlands. Heineken provides financial support to outlets in exchange for exclusivity in supplying its draught pilsner. The NMa ruled that despite Heineken’s large market share in the total market, their exclusive supply agreements did not give rise to market foreclosure. There were over 45 000 beer on-premise outlets, and almost half of these, representing over 40% of on-premise beer sale volume, had no ties with any brewer. Consequently there were plenty of retail outlets available to rival suppliers.
- 20.5. In an Irish case³⁶, an ice cream manufacturer Van den Bergh supplied ice-cream freezers to retailers subject to an obligation to stock them exclusively with Van den Bergh ice-cream. It had a market share of up to 89% in single-wrapped impulse ice cream in Ireland; more than 40% of all retail outlets selling this ice cream had a freezer supplied by Van den Bergh subject to exclusivity. However, when considering the total market that was covered by such agreements, the court found that only 17% of outlets had freezers that belonged to the retailer and not to an ice cream supplier. In sum, the practices of Van de Bergh and other ice cream manufacturers combined foreclosed 83% of the total market.

21. The level of competitiveness in the affected market

- 21.1. This analysis requires an assessment of competition in the upstream market and the affected or downstream market. Where competition is rife in such markets and barriers to enter into this market are relatively low, such markets are likely to be competitive. In particular where ultimate customers have significant bargaining power, the ability of the vertically integrated entity to wield any market power, is further curtailed.
- 21.2. The determination to be made then is whether a refusal to supply – as an exclusionary act which will potentially hinder incumbents and new entrants from participating in a downstream market on account of a dominant upstream firm shorting such players therein or not supplying them at all, is substantial or significant in terms of its effect in foreclosing the market to equally efficient rivals or potential rivals. Where the portion of the market that is foreclosed to competitors is low, and the impact of foreclosure on the competitive conditions in the market is likely to be low, an abuse of dominance is unlikely to occur.
- 21.3. Critically, even where such abuse is seen to occur, section 8(d)(ii) makes provision for an efficiency defence. In this regard, potential gains to be considered in the downstream market are innovation, technological progress, a decrease in

³⁵ Yale Journal on Regulation, 4/24/2006.

³⁶ The judgment of the Appeal Court in the case of *Unilever Bestfoods (Ireland) Ltd (formerly Van der Bergh Foods Ltd) v Commission of the European Communities, Masterfoods Ltd, and Richmond Ice Cream Ltd* (2006).



production costs, barriers to entry overcome and higher volumes produced. Where these gains are directly as a result of the offensive conduct and are, the net effect of the conduct on the economy is positive, no abuse of dominance will occur.

- 21.4. In this regard, the entry of the dominant firm into the downstream market may be regarded as pro-competitive where it, for example, provides incumbent strong players stiff competition and where it can be proven that the pro-competitive gains outweigh any anti-competitive effects resulting from the conduct.

CHAPTER VI: GUIDELINES

22. The economic literature and competition authorities worldwide recognise the significant and elaborate efficiencies that can result from vertical integration, and particularly organic forward integration that introduces a new competitor in the downstream market. However, as alluded to above, forward integration can lead to anticompetitive effect.
23. Naturally, a one size fits all approach is not appropriate in the context of forward integration. As such each instance warrants assessment on the basis of its unique merits and demerits. It is suggested that the mechanism of assessment employed in cases for forward integration is one which embraces a structured rule of reason analysis.
24. However, based on the economic theory and South African and international case precedent set out earlier, dominant firms wishing to organically forward integrate that operate in markets that are characterised by the following factors could potentially attract scrutiny by the competition authorities when:
 - 24.1. the market in which the dominant firm operates is characterised by high and non-transitory barriers to entry, which will prevent entry into the market;
 - 24.2. the product supplied by the dominant upstream supplier is considered to be a scarce good. Scarce goods are generally referred to as products that are considered to be a key input in the production of the downstream product for which no viable substitutes (including imports) exists and where that product makes up a significant portion of the production costs of the downstream product;³⁷
 - 24.3. a significant portion of the downstream market will be foreclosed; and
 - 24.4. the downstream market is concentrated and characterised by high barriers to entry, of which access to the scarce good may be one such barrier.
25. Under such circumstances, forward integration by a dominant firm is likely to lead to input foreclosure that may have substantial anticompetitive effects and unless it can be illustrated that the efficiencies arising from the conduct will outweigh such anticompetitive effects, the conduct of such a dominant firm is likely to fall foul of the provisions of the Competition Act.
26. Dominant firms wishing to organically forward integrate under the circumstances outlined above must therefore be particularly mindful and perhaps conservative in the way and terms on which they supply their downstream competitors once they enter into the downstream market.

³⁷ Such substitutes would need to be substitutable by both price and function. Possible avenues to be considered are the availability of imports or the imminent entry into the upstream market of new players.



27. But, even these firms will be safe if they are able to demonstrate that their conduct does not lead to a substantial anticompetitive effect in the relevant market(s) in which they operate, and a subsequent negative impact on consumers.
28. Where conduct is likely to lead to a substantial anticompetitive effect, we would suggest that the dominant firm reduces the requirements of all usual purchasers of the input in question (including to itself) on a pro-rata basis such that all such users (including itself) feel equal pain. On this basis, a complainant would be hard-pressed to make out a case of anti-competitive conduct if the vertically integrated firm is also receiving less than it requires on a pro-rata, equal-pain basis.

CHAPTER VII: CONCLUSION

29. The economic and welfare benefits of forward integration by a producer are generally accepted to be positive by competition authorities worldwide. The efficiencies that arise from vertical integration are numerous and include, *inter alia*, the elimination of transaction costs and double marginalisation. Furthermore, organic forward integration introduces a new competitor in the downstream market, with the commensurate pro-competitive gains.
30. However, even organic forward integration can lead to anticompetitive effect. To this end, if the forward integration is by a dominant supplier of scarce goods, the forward integration could potentially have the effect of foreclosing downstream producers from access to essential inputs, possibly in contravention of sections 8(c) and 8(d)(ii) of the Competition Act.
31. However, learnings from economic theory and South African and international case precedents shows that a simple refusal to supply – even where it is the dominant firm’s intention to decrease and ultimately cease supply to its customers– is prohibited only if it can be proven that the conduct leads to substantial anticompetitive effect.
32. Whether such conduct leads to substantial anticompetitive effect is analysed on a case by case basis and will depend on the particular facts and circumstances of each case. In general, concentrated industries with high barriers to entry (both upstream and downstream) are usually more susceptible to substantial anticompetitive effects.
33. Therefore, dominant firms operating in such industries that supply “scarce” products to their customers³⁸ are therefore particularly vulnerable to scrutiny by the competition authorities when they wish to forward integrate and must therefore be particularly mindful and perhaps conservative in the way and terms on which they supply their downstream competitors once they enter into the downstream market.
34. But, even these firms will be safe if they are able to demonstrate that their conduct does not lead to a substantial anticompetitive effect in the relevant market(s) in which they operate and a subsequent negative impact on consumers.

³⁸ Scarce products are generally referred to as products that are considered to be a key input in the production of the downstream product for which no viable substitutes (including imports) exists and where that product makes up a significant portion of the production costs of the downstream product. Such substitutes would need to be substitutable by both price and function. Possible avenues to be considered are the availability of imports or the imminent entry into the upstream market of new players.



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