Intrabrand competitive analysis in South Africa: "Get the economics right"

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1. Introduction

In perhaps no other area of antitrust law has the force of economic analysis and criticism been felt with the same intensity as in the area of vertical restraints (Halverson, 1983). The value of inter-supply chain competition (in its various forms) has been vigorously debated throughout the past few decades.

Local merger enforcement in respect of a lessening of intrabrand competition has not been aggressive.[2] This can be ascribed to historic international literature and case precedent claiming that interbrand competition, instead of intrabrand competition, is antitrust's primary concern. This paper explores the possibility of intrabrand competition – in itself – requiring more recognition, especially in light of enlightening research since the early 1990s.

If intrabrand competition is indeed essential, more so than the local competition authorities (and practitioners) currently presume, the analytical framework in respect of intrabrand competitive analysis needs to be transformed rather urgently.

In the following section, the findings in respect of the handling of intrabrand competitive effects, as they manifest in the South African large merger Competition Tribunal ("Tribunal") case precedent, are set out. Thereafter, the seminal United States "Sylvania case" is reviewed, as well as efforts by the United States Department of Justice to guide vertical restraints analysis in the country. Following this background, contemporary findings in respect of intrabrand analysis are discussed. I conclude by suggesting that local competition authorities should regard post-1977 literature in effecting much needed policy reform.

2. The context: South African case precedent

2.1 Summary of empirical study

The Tribunal evaluated intrabrand consolidations since its early days. Indeed, the very second merger decided on by the Tribunal in 1999 was the acquisition by Vodacom (Pty) Ltd of two exclusive service providers. Between 1999 and 2001, in the context of two merger cases (one in 1999 and one in 2001), the Tribunal formulated its intrabrand paradigm. Extracts from the following documents formed the basis for the paradigm:

- A report issued by Oftel, the erstwhile telecommunications regulator in the United Kingdom.[3]

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[1] Manager: KPMG Competition Advisory Practice (Johannesburg).
[2] Interbrand competition refers to competition among manufacturers. Intrabrand competition refers to competition among dealers of the same manufacturer.
[3] The Tribunal referred to the Oftel report in Tribunal Case No 10/LM/Nov99. The details of the report were not cited.

- The United States vertical restraints matter involving Continental TV Inc and GTE Sylvania Inc ("Sylvania").[4]

- The United States vertical restraints matter involving Graphic Products Distributors Inc and Itek Corp.[5]

- The 2000 European Commission Guidelines on Vertical Restraints.[6]

Presumably, other literature was also consulted but not cited.[7]

Based on the above guidelines, the Tribunal adopted a paradigm in which it mainly held that interbrand competition is the main concern of antitrust. This paradigm manifested in various axioms borrowed internationally and cited in the local merger cases. In the section below, certain directives regarding intrabrand competitive analysis as advocated by the Tribunal during the past decade, is set out.

2.1.1. Interbrand competition as the main concern of antitrust

In accordance with Sylvania, the Tribunal adopted the philosophy that interbrand competition, and not intrabrand competition, was the main concern of antitrust. This view simplified, even made redundant, the evaluation of intrabrand competition by the Tribunal. Indeed, in ten of the eleven matters reviewed by the Tribunal, the possibility of a lessening of intrabrand competition was refuted with reference to "strong", or "unaffected", or "sufficient" interbrand competition, or by stating that "real competition" existed at manufacturing level.[8]

2.1.2 The correlation between intrabrand and interbrand competition

An important part associated with the analytical framework in respect of intrabrand competition was the correlation between intrabrand and interbrand competition presumed by the Tribunal. The correlation between intrabrand and interbrand competition is important, as it forms the basis for decisions in respect of the lessening of both.

In this regard, inconsistency prevailed. Varying from case to case, the Tribunal presumed negative, neutral or positive correlations between intrabrand and interbrand competition. The different views on correlation were generally not clarified by the Tribunal.

In Tribunal Case No 44/LM/Jul01, a negative correlation between intrabrand and interbrand competition was underwritten. In this regard, the Tribunal quoted Sylvania: *"…the United States Supreme Court recognised that although non-price vertical restrictions reduce intrabrand competition, they promote interbrand competition by allowing manufacturers to achieve certain efficiencies."*

[4] 433 U.S. 36 (1977). This matter was referred to in Tribunal Case No 44/LM/Jul01.
[5] 717 F 2d 1560 (1983). This matter was referred to in Tribunal Case No 44/LM/Jul01.
[6] 2000/C 291/01 paragraph 119. This matter was referred to in Tribunal Case No 44/LM/Jul01.
[7] For example, in the Tribunal said: "What is clear from the *antitrust literature*…"; and "… all *competition authorities around the globe take the view that* any reduction in intrabrand competition can be offset by interbrand competition" (Tribunal Case No 44/LM/Jul01:8 and 19) (emphasis added).
[8] In only one matter (Tribunal Case No 107/LM/Oct08) the relevance of interbrand competition was not articulated, mainly as the Tribunal was unconvinced that intrabrand competition was in fact lessened by the merger.

In addition, a negative correlation was presumed in Tribunal Case No 10/LM/Nov99, based on the notion that the manufacturer knew best how to efficiently distribute its products. Regulatory invention would not be desirable.[9] In this matter, the Tribunal said: *"Even if Vodacom is to wholly integrate its service providers the effect on competition will be negligible. The role of service providers is to provide the networks with a customer base. It the networks think they can do the job more efficiently they should be allowed to do so."*

Secondly, from time to time, the Tribunal acknowledged that a neutral correlation between intrabrand and interbrand competition exists. In certain matters,[10] the Tribunal found that, although intrabrand competition was lessened, interbrand competition remained unaffected.

Lastly, reference to a positive correlation between intrabrand and interbrand competition appeared in the case law.[11] In Tribunal Case No 12/LM/Jan08, the Tribunal said that reduced intrabrand competition could reduce interbrand competition should interbrand competition be weak.[12] Unfortunately, a reduction in intrabrand competition was not found by the Tribunal in this matter, which prevented the Tribunal from elaborating on the potential positive relationship.

Interesting from the above is that mergers in all three categories above occurred in the telecommunications industry. On which basis did the Tribunal decide which theory, and therefore which analytical framework, to apply to matters that were supposedly fairly similar?

Below, I review the Tribunal's analytical framework in respect of intrabrand-interbrand comparisons.

2.1.3 The analytical framework in respect of balancing intrabrand and interbrand competition

Before enquiring into the balancing test, first it is important to note how the Tribunal analysed intrabrand competitive effects. The case law shows that The Tribunal first determined whether intrabrand competition exists in the first place. If so, it determined whether the intrabrand competition would be reduced post-merger. The Tribunal used the criteria below:

- The pre- and post merger intrabrand market shares.[13]
- The prevalence of pre- and post-merger price competition (including discounts).[14]
- The prevalence of pre- and post-merger non-price competition (e.g. service, location and convenience).[15]

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[9] In Tribunal Case 10/LM/Nov99 page 4, the Tribunal quoted from the Oftel report: "*In a fully competitive market, there would be a presumption that if networks did not wish to use independent service providers as a route to market, then it would not be efficient for them to do so and regulatory intervention to require this would not only be inappropriate but would be counter-productive.*"
[10] See e.g. Tribunal Cases No 33/LM/May02 and 87/LM/Oct04.
[11] See Tribunal Cases No 44/LM/Jul01, 33/LM/May02 and 12/LM/Jan08.
[12] In Tribunal Case No 44/LM/Jul01 page 8 the Tribunal said: *"It is generally accepted that where interbrand competition…is strong, the requirement to regulate the vertical relationship between a supplier and his distributor which primarily affects intrabrand competition, is diminished."*
[13] See Tribunal Case No 63/LM/Nov01.
[14] See e.g. Tribunal Cases No 10/LM/Nov99 and 44/LM/Jul01.
[15] Ibid.

- The post-merger requirement for the dealer to engage in sunk cost and the subsequent effect on the relationship with the manufacturer.[16]

- The possibility of the manufacturer monitoring downstream compliance in instances where it is vertically integrated.[17]

- The possibility of removing an effective intrabrand competitor.[18]

In no matter the Tribunal found a *substantial* lessening of intrabrand competition.[19] Among others, according to the Tribunal, in many instances it faced challenges due to insufficient evidence (e.g. prices not being transparent).[20] The Tribunal did not articulate in these instances which evidence it required in order to find a substantial lessening of intrabrand competition.

Regarding the intrabrand-interbrand balancing analysis, Sylvania promoted a "rule of reason" in terms of which the losses in intrabrand competition (as a result of a vertical restraint) had to be "offset" by gains in interbrand competition in order for a restraint to be deemed legal. In particular, it had to be shown that a specific and measurable loss in intrabrand competition prompted specific and measurable gains in interbrand competition. Although the Tribunal claimed to have adopted this approach,[21] in no matter did it seek to methodologically *balance* anti- and pro-competitive outcomes (as intended by Sylvania) in order to determine the net competitive effect realised by the lessening in intrabrand competition. Instead, where relevant, it repeatedly showed that interbrand competition would in general remain unaffected as a result of the merger.[22]

2.1.4 Market definition issues

In light of the Tribunal's interbrand orientation, it goes without saying that, in many cases, downstream product and/or geographic markets were not rigorously defined by the Tribunal. Indeed, in many instances, downstream market definitions remained undecided or assumed.

2.2 Conclusion

The above analysis demonstrates the Tribunal's preference for interbrand vis-à-vis intrabrand competition. The Tribunal's view is based on selected international literature and case precedent. The analysis also shows the uncertainty in respect of (i) analysing the correlation between intrabrand and interbrand competition (and when it would differ); (ii) analysing and finding a *substantial* lessening of intrabrand competition; and (iii) balancing intrabrand and interbrand competition once intrabrand competition has been found to be substantially lessened. One does wonder how the

[16] See Tribunal Case No 33/LM/May02.
[17] Ibid.
[18] See Tribunal Case No 12/LM/Jan08.
[19] Although the Tribunal found a lessening of intrabrand competition in certain instances, in no matter did the Tribunal conclude on substantiality of the reduced competition. See e.g. Tribunal Cases No 44/LM/Jul01, 33/LM/May02 and 68/LM/Dec03.
[20] See e.g. Tribunal Case No. 44/LM/Jul01.
[21] Ibid paragraph 19.
[22] See e.g. Tribunal Case No 33/LM/May02 paragraph 64. The Tribunal said*: "We have thus far approached the mergers by examining the likely negative effect on intrabrand competition. However, as the literature on the subject reflects, a reduction in intrabrand competition is frequently accompanied by an increase in interbrand competition. In the case of these mergers we have no reason to doubt that the same will occur."* However, no balancing exercise has been performed by the Tribunal reflecting that the lessening in intrabrand competition will indeed cause an increase in interbrand competition.

pro-interbrand competition paradigm transpired absent more reliable foundations regarding intrabrand-interbrand relationships.

Naturally, many mergers will not require in-depth analysis of intrabrand competitive affects based on the facts of the matter. However, currently, all matters are approved based on unaffected interbrand markets. Is this methodology correct?

To the end of answering this question, Sylvania and the United States Department of Justice 1985 Vertical Restraints Guidelines are discussed in the next section. These are then contextualised with reference to more recent literature on the topic.

3. Sylvania and its implications

3.1 United States case precedent and literature pre-Sylvania

Between 1960 and 1970, the United States' policy towards non-price vertical restraints ranged from being essentially doubtful (as to the effect of vertical restraints) to creating a rule of *per se* illegality for most restraints (Pitofski, 1997).[23] Aggravated by academic uncertainty as to the value of vertical restraints, courts were not yet persuaded as to their benefits (Popofsky, 1991). During this period, vertical mergers were also frequently challenged by the government. Courts seldom regarded efficiency gains arising from vertical mergers (Pitofski, 1997).

However, during the late 1960s, Chicago economics ("Chicago") started to appear in judicial opinions. According to Chicago, vertical restraints almost never restricted competition (unless one of the parties enjoyed a significant degree of market power in the relevant market). In fact, vertical restraints created efficiencies. Distribution costs were reduced and information was supplied to the market (Gerard, 2003). Vertical restraints enabled manufacturers to attract competent distributors and induce them to invest in proper distribution systems (Halverson, 1983). They also induced retailers to promote products and provide the necessary services to the efficient marketing of the manufacturer's product.

Furthermore, according to Chicago, if a vertical restraint was "too harsh", the product would simply be "too expensive" to buy. Consumers would then switch to the brand of another manufacturer. Therefore, interbrand competition disciplined intrabrand market exploitation (Gerard, 2003).

3.2 Sylvania

In light of Chicago, economic efficiency became the "guiding light" of competition policy. For the first time in the history of the United States, in Sylvania, economic theory dominated a vertical restraints decision (Popofsky, 1991).

Among others, the Court said that the impact of vertical restraints was complex: they could simultaneously reduce intrabrand competition and stimulate interbrand competition.[24] Therefore, vertical restraints could not be prohibited *per se;* they had to be evaluated in terms of a "rule of reason" analysis. In terms of the rule if reason, the increase in interbrand competition (created by additional point-of-sale services) had to be measured against the reduction in intrabrand competition (created by the

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[23] For a more comprehensive analysis, see Halverson (1983:50-60).
[24] See Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977) paragraph 51.

territorial restraint) (Easterbrook, 1984).[25] It was the plaintiff's burden to show the unreasonableness of the restraint based on the net competitive effect resulting from the balancing exercise (Popofsky, 1991).

In addition to the above general remarks regarding the rule of reason (and weighing of intrabrand and interbrand effects), the Sylvania Court raised various pro-interbrand competition comments. Relying heavily on Chicago, Sylvania stated the following:

- Interbrand competition, rather than intrabrand competition, is the primary focus of antitrust law.[26]

- Manufacturers will maintain as much intrabrand competition as is consistent with the efficient distribution of their products.[27]

- Interbrand competition provides a significant check on the exploitation of intrabrand market power, as consumers can substitute to a rival product.[28]

- Non-price vertical restraints potentially have "redeeming virtues" (e.g. creating efficiencies by reducing free-rider effects).[29]

3.3 The critique against Sylvania

3.3.1 Pre-occupation with interbrand competition

Sylvania was criticised for averring, as a matter of principle, that interbrand competition was antitrust's first priority (vis-à-vis intrabrand competition) (see the first three bullets above). Interestingly, however, in Sylvania, "… *the Court offered no authority for this broad pronouncement, now frequently repeated as holy writ*" (Grimes, 2002:28).[30]

Regarding the "redeeming virtues" of interbrand competition (see the fourth bullet), the actual purpose of the statement was to argue for the promotion of a rule of reason test instead of a *per se* rule of illegality. (Indeed, Sylvania achieved seminal status for the pivotal change towards rule of reason analysis in non-price vertical restraints.) However, Sylvania did not highlight this nuance. Indeed, the theoretical benefits (or "redeeming virtues") associated with vertical restraints became "economic reality" for most courts. This "reality" required no empirical evidence (the courts did not seek ways to reconcile theory with practice)[31]; but still, the plaintiff had to counter it (often unsuccessfully) (Steuer, 1990a). As a result, limited substantive

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[25] The Chicago School actually argued that *per se* rules of legality, instead of a rule of reason, were more appropriate in respect of all vertical restraints. Rule of reason analyses were superfluous and unnecessary. In fact, it was argued that balancing inter- and intrabrand competition was impossible; they were not commensurable (Easterbrook, 1984). According to Posner (1981), intrabrand competition as such is worthless, the reduction in dealers' rivalry is just the tool the manufacturer uses to induce greater competition in the service dimension.

[26] Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977) note 19.

[27] Ibid paragraph 56.

[28] Ibid note 19.

[29] Ibid paragraph 54 and 55.

[30] According to Grimes (2002), this language is routinely cited as a justification for dismissing a vertical restraints claim.

[31] According to Steiner (1997), the Supreme Court contended itself with reciting dogma like 'price cutting and service cutting usually go hand in hand'. The Court did not seek to determine whether the hypothetical generalities applied. According to Steuer (1990c), in their search for predictability, the courts sought simple rules: *per se* rules of illegality; *per se* rules of legality; mathematical thresholds and indexes; or unifying principles such as "free riding" applicable to every industry.

enquiry under the rule of reason prevailed. Vertical restraints were no longer fiercely challenged (Zwisler, 1999).

3.3.2 Lack of sound analytical framework

The above problem (of presumed legality) was further aggravated as Sylvania failed to provide a meaningful analytical framework for intrabrand and interbrand competitive analysis (Popofsky, 1991).[32] According to Flynn (2006), neither the applicable factors, nor a balancing exercise, were set out in Sylvania. It was predicted that both courts and economists would struggle to balance the competitive effects (Ginsburg, 1991).

It is therefore not surprising that, in 70% of matters decided by the United States courts of appeals between 1977 and 1991, the task of balancing intrabrand and interbrand competition was skilfully avoided.

Instead of engaging in a rule of reason, other methods were used to analyse vertical restraints. For example, the courts employed a “market power screening test”. If a defendant did not have market power, the case was not pursued. Another approach was to accept a “plausible story” that the vertical restraint could theoretically benefit interbrand competition. Such a story would be speculative and based on a court’s general belief that vertical restraints benefited interbrand competition (Ginsburg, 1991:74).

The courts also used an approach in terms of which they asked whether the vertical restraint would pose a threat to interbrand competition. If harm to interbrand competition was unlikely, the analysis was stopped. Another approach saw the courts purporting to balance competitive effects associated with the vertical restraints. Seeing little intrabrand harm – and fairly obvious interbrand competitive benefits (generally based on theory) – the balance was generally resolved in favour of the defendant (Ginsburg, 1991).

The result of the above was that Sylvania’s rule of reason seldom entailed a balancing of intrabrand and interbrand economic effects as intended by the Supreme Court which decided on Sylvania.

3.3.3 Market power as significant screening test

Another factor leading to the neglect of the rule of reason was the presumption that only firms with market power could engage in anti-competitive vertical restraints (Gerard, 2003). This view was based on Chicago, and based on the premise that, if a brand did not exert sufficient market power to influence the prices of other brands in the market (or to exclude other brands from the market altogether), as a matter of law it was irrelevant as to whether distributors of the brand were subject to vertical restraints (Steuer, 1990b).

Because of the market power presumption, courts have generally limited the rule of reason enquiry by requiring the plaintiff to prove the defendant’s market power in a relevant market. If the plaintiff succeeded in establishing market power, the plaintiff was then required to balance the competitive effects. As expected, in the few matters that indeed reached this stage, plaintiffs had a very difficult time proving that anti-competitive intrabrand effects outweigh the interbrand benefits.

[32] According to Grimes (2002), the Sylvania rule could be applied devoid of its policy justification and limits. It could easily become an end in itself. This could lead to either over- or under-enforcement.

3.3.4 Chicago as unrealistic foundation

As indicated above, Sylvania drew on Chicago for "modern economic thought" (Zwisler, 1999:328). However, Chicago followed neo-classical economics, which is static and fails to address real-world challenges in many respects. For example, it ignores important dynamic indicators like initial wealth distribution, innovation efficiencies, transaction costs, information asymmetries and macro-economic consequences of micro-economic decisions. Moreover, it presumes perfect rationality (Flynn, 2006).

3.4 The 1985 Guidelines on Vertical Restraints and its discontent

In the midst of much debate on the implications of Sylvania, the United States Department of Justice issued Vertical Restraints Guidelines in 1985. The Guidelines sought to advance predictability; to provide a "coherent intellectual framework" in respect of the rule of reason. Among others, the Department set out a "two-step approach" for evaluating vertical restraints (Rule, 1985).[33]

Although well intended, the Guidelines were widely unpopular. They attracted criticism from both scholars and practitioners in the antitrust field. Some of these concerns are set out below:[34]

- In numerous respects the Guidelines ignored, misinterpreted or contradicted existing case law.

- No empirical evidence seemed to underlie the views promoted in terms of the Guidelines.

- The analytical framework offered by the Guidelines was not easy to apply.

- Guidance in respect of market definitions did not allow for dynamic factors to be taken into account.

- The Guidelines assumed pro-competitive explanations for all vertical restraints (the Guidelines seemed to argue for a rule of *per se* legality). These assumptions were based on Chicago. It was the plaintiff's task to rebut all the justifications that the Department of Justice found in favour of vertical restraints.[35]

- Related to this, the Guidelines seemed to protect interbrand competition and not intrabrand competition. It assumed that the manufacturer always knew best how to distribute its products. (This was claimed regardless of the Guidelines acknowledging that dealers may be in a far better position to observe shortcomings in the current method of distribution.)

- The Guidelines presumed aligned interests between manufacturers and retailers.

[33] Under the first test, the Guidelines set out a "market structure screen" in order to eliminate the instances of restraints that, in all likelihood, did not have anti-competitive effects. Under the second test, the Guidelines set out a structured rule of reason analysis applicable to those vertical restraints that did not pass muster under the first step (Rule, 1985).

[34] This section draws on Freeman and Ettinger (1985) and Rosch *et al* (1985) except where indicated otherwise.

[35] According to L.A. Freeman Jr as quoted in Rosch *et al* (1985: 345), "…*the Guidelines argue that even if the manufacturer cannot dream up a rationale for imposing a vertical restraint, the court should try to supply one for him, or the Department of Justice will intervene as an amicus to supply one for him*."

- The Guidelines did not give adequate recognition to the way in which vertical restraints facilitated oligopoly pricing and collusion among manufacturers.

- The Guidelines failed to differentiate among types of products and vertical relationships. In effect, the Guidelines only applied to situations where dealers were already closely associated with the manufacturer, and did not distribute more than one manufacturer's product.

It is clear that the Vertical Restraints Guidelines were controversial. In light of their general inapplicability, the Department of Justice withdrew the Guidelines in 1993 (Grimes, 1995).

4. Contemporary thought on the analysis of intrabrand competition

4.1 Single stage economics: an old approach

Arguably, the debates in respect of Sylvania and the 1985 Guidelines sparked deliberations regarding inter-supply chain considerations. The debates prompted a serious question: does Chicago (and therefore, much of Sylvania) suffice for purposes of analysing intrabrand-interbrand matters? Chicago depicts retail markets as static and perfectly competitive (unless it is cartelised or monopolised). It assumes that, in the distribution process, manufacturing costs and competitive conditions are passed through unaltered. A change in the cost of manufacturing will fully reflect in the retail price. Was this the world we live in?

Steiner (1978) dubbed Chicago's simplistic supply chain model as a "single stage" model. "Single stage" referred to the model in terms of which only one stage, i.e. the manufacturer-retailer relationship, was depicted. The following logic applied to it: A manufacturer employs a vertical restraint and thereby raises the price of its retail brand. (Of course) the firm has a pro-competitive, output-increasing motive for the vertical restraint, such a curing a free-rider problem (if not, the higher retail price will reduce sales). (Of course) the vertical restraints are also uniformly welfare-enhancing (Steiner, 1997).

4.2 Dual stage economics: the new learning on intrabrand competition

Steiner (1991c:41) said: "*If we are to embrace the economic approach to antitrust, we must first get the economics right."* To this end, based on the complexity of the value chain, Steiner argued for a "dual-stage" recognition of supply chain economics. In terms of this model, both the relationship between the manufacturer and retailer, on the one hand, and the relationship between the retailer and consumer, on the other hand, had to be recognised and studied.

Moreover, more often than not, both the first-stage manufacturer-retailer markets and the second stage retailer-consumer markets are imperfectly competitive. For example, manufacturers may not necessarily sell their products to a fiercely competitive retail sector (Steiner, 1997). Therefore, the consequences of vertical restraints could in fact significantly differ from those depicted in Sylvania. Indeed, it could benefit manufacturers to increase retailers' margins, and in so doing, reduce welfare (Massey 1998).

Steiner and Grimes, together with other like-minded economists, significantly contributed to the new learning on distribution economics. They provided prominent insights, which are (to some extent) related. Their main insights included:

- Vigorous interbrand competition does not, in itself, discipline the exercise of intrabrand market power.
- Intrabrand competition *promotes* interbrand competition in instances where it matters most.
- Competition across the value chain, including intrabrand competition, matters.
- Inter-supply chain "power struggles" significantly affects competition between levels of the supply chain.
- A possible inverse relationship exists between the levels of intrabrand competition and interbrand competition, respectively.
- Absolute market power and absolute market shares are not reliable case screeners.

Each of these insights is discussed below.

4.2.1 The first insight: vigorous interbrand competition does not, in itself, discipline the exercise of intrabrand market power

Steiner pointed out that, in addition to "competition among rival manufacturing firms" (as stated in Sylvania[36]), other forms of supply chain competition existed. At the manufacturing level, competition existed *among* firms, but also *within* firms. At retail level, competition existed *among* retailers, but also *within* retailers (Steiner, 1991c) (emphasis added).

According to Steiner (1991c), it is competition *between* rival firms and not *within* firms that primarily disciplines their margins. Put differently, it is not the internal competition between two brands manufactured by the same manufacturer that determines the margins reaped by the manufacturer, but how the brands of the manufacturer compete with the brands of other manufacturers in the market.

The same applies to retailers. It is competition *between* retailers that best discipline the exercise of retail market power.[37]

Based on the notion that interstore competition is important, Steiner said that no amount of interbrand competition on the shelves of a monopolist retailer can prevent the retailer from taking super mark-ups over factory invoice costs or charging high prices to his captive clientele (i.e. the end consumer). Rather, the retailer's margin depends, to a large extent, on the level of competition faced from other retailers (i.e. intrabrand competition). Vigorous the interstore competition led to the retailer's average demand being more elastic. In the end, it is the combination of inter- and intrabrand competition in the market that will determine the net economic effect of a vertical restraint (Steiner, 1991c).

[36] Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977) note 19.
[37] A practical example of this logic appears in Steiner (1991c:50-55).

In summary, vigorous interbrand competition does not, in itself, discipline the exercise of intrabrand market power. Simply put, intrabrand competition best disciplines the exercise of intrabrand market power.

4.2.2 The second insight: intrabrand competition promotes interbrand competition in instances where it matters most

This modern view contradicts Sylvania, in which interbrand competition was labelled as the "main concern of antitrust". Indeed, intrabrand competition was generally seen as a "stepchild of antitrust"; a form of competition that could be stifled in the interest of promoting interbrand competition.[38] During the past few decades, the inferiority of intrabrand competition has been assimilated into case law and commentary across various jurisdictions (Grimes, 1995).

Although the Court rightly found that vertical restraints can promote a producer brand, its assertion that interbrand competition provides a significant check on the exploitation of intrabrand market power[39] fails to recognise that the brand promotion associated with vertical restraints tends to increase brand differentiation. Increased brand differentiation means lower demand elasticity and therefore greater market power. To put it differently, the more effective a vertical restraint is in differentiating a brand, the greater the reduction in interbrand competition (Grimes, 1995).

Increased brand differentiation leads to the benefits of interbrand competition dissipating. The greater the success of the vertical restraint in promoting brand differentiation, the greater the discipline imposed by intrabrand competition (Grimes, 1995). For example, where intrabrand competition has reduced the resale price of a brand, the interbrand competition at the retail level will act to force competing dealers to reduce the margins and prices on competing goods. In this sequence, interbrand competition in retailing is activated by a surge in the level of intrabrand competition (Steiner, 1991c).

In the long run, without strong intrabrand competition among retail firms, dealer margins will tend to remain high (irrespective of the strength of interbrand competition). In addition, less efficient types of retailers will survive. Intrabrand competition is a downstream market response to upstream market power.

4.2.3 The third insight: competition across the value chain, including intrabrand competition, matters

The elimination of intrabrand competition does not concern some scholars because they believe that the intrabrand arrangements between a manufacturer and its dealer do not operate directly to increase market share beyond the level already held by the manufacturer of a particular brand (Halverson, 1983). However, during the past 25 years, many economists have revisited and strengthened the case for maintaining

[38] Recall that, in terms of Chicago, intrabrand competition played a secondary role because the competitive process is driven by interbrand competition amongst producers.

[39] The full text of the relevant passage is as follows: *"The degree of intrabrand competition is wholly independent of the level of interbrand competition confronting the manufacturer. Thus, there may be fierce intrabrand competition among the distributors of a product produced by a monopolist and no intrabrand competition among the distributors of a product produced by a firm in a highly competitive industry. But when interbrand competition exists, as it does among television manufacturers, it provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product"*.

competition at all distribution levels (see e.g. Steiner, 1991b and Steiner, 1993).[40] According to Grimes (1995 and 2002), intrabrand competition serves antitrust goals in a number of ways:

- First, intrabrand competition has an arbitrage function. It involves taking products once sold at a relatively high price and reselling them under unshackled competitive conditions that adjust to conditions of supply and demand (Grimes, 1995). In the context of the *per se* rule in respect of vertical price fixing, Professor Fox noted that "…*markets work better when the individuals closest to the pulse of the market transaction have the flexibility to determine the price*" (Fox, 1981).

- Secondly, intrabrand competition contributes to efficient allocation among retailers. Efficient retailers who can sell the desired brand more cheaply will be rewarded with more business. The less efficient retailers will tend to be replaced.

- Thirdly, active downstream intrabrand competition may foster upstream competitive discipline. For example, the arbitrage features of downstream intrabrand competition will make it difficult for producers exercising market power to discriminate in pricing. Vigorous downstream intrabrand competition will lead to producers having to compete for distribution outlets through low prices or through brand loyalty won through advertising or other information exchange.

- Fourthly, intrabrand competition reduces the risk of dealer promotions that exploits information asymmetries. Intrabrand competition tends to equalise retailer margins on popular brands, lessening the risk that a multi-brand retailer will have a hidden incentive to push one brand over another.

- Lastly, intrabrand competition adds value and innovation to the distribution process.

4.2.4 The fourth insight: Inter-supply chain "power struggles" significantly affects competition between levels of the supply chain

Seemingly, the criteria developed for purposes of vertical restraint analysis do not distinguish between instances where the manufacturer and retailer have different levels of power vis-à-vis each other (De la Cruz, 1997 and Massey, 1998). As said, Steiner sought to replace the single stage model with a dual stage model in order to appropriately account for imperfect markets in the form of "vertical competition" (i.e. competition between players at subsequent levels of the supply chain). Firms were regarded as "vertical competitors" if they were able to steal sales, or margins, or market shares, from each other (Steiner, 1991a).

Steiner's "vertical competition" theory prompted an emerging body of economic literature stating that vertical restraints could harm competition if either the manufacturer, *or the retailer*, possessed market power. This is in stark contrast to laws (and analytical frameworks) which have developed to only cater for settings in which the manufacturer, and not the retailer, has market power (De la Cruz, 1997). In line with this awareness, both the sources of retail buyer power and the implications of retailer-imposed restraints on manufacturers have been studied (Dobson and Waterson, 1996).

[40] See e.g. Business Elecs. Corp. v. Sharp Elecs. Corp., 485 U.S. 717, 748, (1998) in which Justice Stevens said: "*What is most troubling about [current law], is its failure to attach any weight to the value of intrabrand competition."*

According to Dobson (2005a), three primary sources of retail power exists. These power may be found in their (many times combined) roles as customers, competitors and suppliers for producers. Retailers act as customers when they buy the products for resale to ultimate consumers. They act as competitors when they sell proprietary products in competition with producer branded goods.[41] They act as suppliers when they sell shelf space, either directly through listing fees, or indirectly through requiring lower prices from producers as conditions of stocking. These roles in (whichever) combination may potentially endow the retailer with substantial bargaining power over the supplier (Foer, 2007).

Understanding the nature of the different powers in a vertical relationship, as well as the occasional holder of the powers in a vertical relationship, is critical. Upstream and/or downstream market power could easily spark anti-competitive risks associated with a reduction in intrabrand competition (Grimes, 2002). Although a seller traditionally required a fairly high market share in order to be viewed as powerful, on the buying side it is considerably less, perhaps as little as 8% (empirical data on this question is limited) (Foer, 2007). Therefore, fairly low levels of buying power could trigger anti-competitive vertical restraints.[42] It is important to be attentive to instances of buyer power in order to maintain as much intrabrand competition as possible in order to prevent a buyer from disrupting the competitive process (Grimes, 2002).

To complicate matters, among many issues, the power struggle between manufacturers and retailers is a function of the prevailing level of intrabrand- and interbrand competition in their supply chain. Manufacturers of strong brands are able to command a relatively high price for the product. They do not need to offer many promotional allowances and other concessions to retailers. The reason is that the manufacturers are fully aware that retailers must stock their brands and resell them at a thin margin. If the retailer charges too much for the product, or do not stock it at all, it may risk losing a customer to another retailer (i.e. an intrabrand competitor). On the other hand, manufacturers of weak brands must “beg the retailer” to stock the product by offering a lower invoice price and more allowances and concessions. With weak brands, the retailer may wish to experiment with a high margin on the product, not concerned about losing a customer to another store, as the customer would simply switch to a similar product in the same store (Steiner, 2000). It is important to consider this dynamic when evaluating inter-supply chain power struggles.

Note that the rights and interests of manufacturers, wholesalers, brokers, retailers and consumers seldom coincide. Each successive participant in the value chain seeks to maximise its self-interest. This creates a myriad of opportunities for vertical restraints to be harmful to consumers (Harbour, 2007). Antitrust economists must be aware of these struggles.[43]

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[41] The judicial and administrative decisions on vertical restraints do not seem to contemplate scenarios where manufacturers and retailers share roles within the supply chain (De la Cruz, 1997).

[42] Note that vertical restraints need not necessary be explicit. Instead of having e.g. exclusive dealing arrangements with retailers, the retailers could merely impose strict profitability targets which give the supplier no other choice as to stock via the specific retailer. This effect is known as the “waterbed effect”. Its challenges for purposes of vertical restraints are set out in Dobson (2005b).

[43] In this light, it is unfortunate that the Antitrust Modernisation Commission chose not to address buyer power as a topic (Foer, 2007).

4.2.5 The fifth insight: a possible inverse relationship exists between the levels of intrabrand competition and interbrand competition, respectively

To its credit, the Sylvania Court in note 19 envisioned fierce intrabrand competition among resellers of a monopolist brand. But in contrast with the Courts' view that it proved a "wholly independent" relationship between competition at manufacturer level and at retail level, respectively, Steiner has since argued that a negative correlation exists between competition in the manufacturing market and competition in the retail market (Steiner, 1991c).[44]

Steiner argues that, if the functions of different firms along the vertical channel were fully complementary (as the common economic view holds), the manufacturing and retail margins would not be inversely related. Empirical evidence of an inverse association appears to refute the notion that vertical relationships are purely complementary. Therefore, vertical competition may be real.

Regarding the intrabrand-interbrand interplay, a negative correlation could underline the theory that fierce upstream competition would not protect retail margins (as suggested in Sylvania) as the retailer's negotiating power in respect of competitive brands would be too strong. Weak interbrand competition (e.g. comprising of a monopoly) would discipline retail markets (more so than competitive interbrand markets) as the manufacturer's negotiation power vis-à-vis the retailers would be significant.

Certain economists highlighted other potential explanations for inverse relationships between the margins of manufacturers and retailers. According to Harbour (2004), counter-explanations for inverse relationships highlight the need for further scholarship and analysis before reaching final conclusions.

4.2.6 The sixth insight: Absolute market power and absolute market shares are not reliable case screeners

As indicated, Sylvania offered little guidance on how to conduct a rule of reason (Gavil, 2004). In response, to concretise analyses, many courts imposed "market share screening tests". Under this test, the plaintiff had to show that a seller met the threshold (otherwise the claim would be dismissed) (Grimes, 2002). This test spread widely. Not only have certain regulators officiated market share thresholds;[45] but some commentators have actually promoted higher thresholds in order to emphasise that only dominant firms could impose anti-competitive vertical restraints (Gerard, 2003).

The first problem with a seller's market share screening test is that vertical market power, i.e. the different forms of power possessed by different players in the supply chain, as well as the combined effect of such powers, are not considered for purposes of the analysis. Secondly, market shares are not good proxies of market power (at either level of the supply chain) in light of the market definition challenges associated with e.g. product differentiation, after-markets and downstream geographic delineations. Downstream market power could manifest in many forms,

[44] See e.g. the prescription drug business example described by Steiner (1991c:52): *"Retail gross margins have been recorded relatively low in instances where the products have been manufactured by monopolies. The retail gross margins have been recorded relatively high (sometimes twice the manufacturing price) in instances where competition has existed at manufacturing level".*

[45] See e.g. the EU Commission Notice on Vertical Restraints (2000). The South African Tribunal underwrites the philosophy that intrabrand competition will only be lessened should interbrand competition be weak.

least of all, significant downstream market shares. Clearly, analysts need to be aware of the danger of market share screening tests.

According to Grimes (2002:27), the third problem with the test is its “wholly unresponsiveness” to the importance of maintaining effective intrabrand competition. If no firm meets the threshold, all vertical restraints employed in the supply chain (regardless of their harm) will run undetected. Indeed, if five firms of 20% market share each impose anti-competitive restraints, no claim will succeed should the market share threshold be e.g. 30% (Grimes, 2002).

The market share screening test could also produce perverse results should only one firm in the industry exceed the threshold market share. The remainder of the firms could then engage in vertical restraints; stifling intrabrand competition in the market and provide a price umbrella under which even the leading firm could raise prices to supra-competitive levels (Grimes, 2002).

4.3 Conclusion

The economics of product distribution is a continually evolving area of antitrust policy and legal doctrine. According to Steiner, there is far too much that we still don’t know about the real-world effects of supply chain economics. It is therefore imperative that more evidence is gathered (Harbour, 2007).

In the meantime, it is important for South Africa to consider – and co-formulate – the new learning. Local challenges may indeed require new thinking on supply chain mechanics.

5. South African policy considerations

5.1 International momentum (or not?)

5.1.1 United States

Today, scholars in the field of antitrust economics actively pursue challenges in respect of vertical restraints issues. They develop real-world theoretical frameworks[46] as well as workable analytical frameworks (comprising valid rule of reason guidelines).[47]

In addition, the United States antitrust agencies have upped their concern for vertical mergers and joint ventures (and have indeed challenged several vertical mergers). This is (in part) due to more careful economic analysis in respect of vertical mergers and restraints. According to Pitofski (1997), in these cases, the agencies have not revived the simpler approaches of a generation ago that found violations simply because of significant foreclosure in the market. Rather, they have focused on the actual impact of that foreclosure on competition in the market.

On the enforcement side, however, although striking inadequacies to the Sylvania paradigm have been pointed out, little change emerged from the United States jurisprudence and regulatory rhetoric. With the exception of one or two judges,

[46] See e.g. Steiner (2004), which sets out applications in respect of dual-stage thinking; and Steiner (date unknown), which set out a unified theoretical framework to estimate market power in consumer goods industries with differentiated products.
[47] See e.g. a test proposed by Grimes (1995:119-124).

currently, there are no clear champions of post-Chicago thinking in the courts. The federal agencies also host no clear winners of post-Chicago thinking in prominent positions (Grimes, 2006).

The failure of post-Chicago learning to make headway into the courts (and federal agencies) has many causes. One of the reasons is the quality of input required for judicial or agency decisions. Careful lawyering and input from economists are required in order to correctly lay out the anti-competitive effects of vertical restraints in courts. Although input is no assurance of success, a lack of it will obviously not persuade courts to depart from the now venerable Chicago paradigm (Grimes, 2006).

5.1.2 Europe

In Europe, the role of economic analysis in the application of Article 81 of the Treaty of Rome has not been a constant one over the years. Especially in recent years, debates evolved rapidly. The main drivers for the debate were major public policy debates around the world (De la Cruz, 1997) and the publication of the Green Paper of the European Commission concerning Vertical Agreements in 1997. An important reason for drafting the Green Paper was to explore whether the European Commission's policy sufficiently distinguished between competition-enhancing and competition-restricting effects of vertical agreements. This question has been raised amidst growing criticism regarding insufficient economic rigour associated with the European Commission's antitrust policy.[48]

Since the publication of the Green Paper, European competition policy regarding vertical restraints underwent some reform. The European Commission adopted a detailed set of interpretive guidelines on the assessment of vertical restraints, and has issued new regulations on the application of Article 81 in this field.[49] Broadly speaking, the policy allowed for a more impact-based assessment of vertical agreements (Verouden, 2003).

As is evident from the enactment of the Motor Vehicle Block Exemption, the European Commission values the development of intermediaries in the car distribution sector. The European Commission has been adamant to improve the functioning of the internal market through the promotion of intrabrand competition; thereby enabling consumers to derive their fair share of benefits from the system (Gerard, 2003).[50] The measures will also facilitate economically beneficial relationships between producers, suppliers and distributors (Kellaway, 1997).

5.2 Local imperatives

How is local policy formulation affected by the developments in analysis of intrabrand competitive effects? See the following suggestions:

[48] The historic treatment of intrabrand competition in European had not been discussed in this paper. For a comprehensive overview of the development of the intrabrand analysis in Europe, see e.g. De la Cruz (1997), Gerard (2003), Verouden (2003) and Fredenberg *et al* (2008). In short, where the United States erred on the side of focusing on interbrand competition, the European Commission erred on the side of legal formalism (i.e. placing too much emphasis on the legal form of vertical contracts, especially on the mere presence or absence of specific clauses) and placing too little emphasis on the likely economic impact of the agreements. Today, the European Commission is aware of the important role that economics plays in assessing vertical restraints. However, certain assumptions, e.g. the market share threshold as screening test, still prevails, which may be indicative of the still prevailing Chicago school paradigm.

[49] These include the Guidelines on Vertical Restraints (2000), The Block Exemption Regulation (2003) and Regulation 1/2003 (replacing Regulation 17).

[50] Refer to Gerard (2003:527-532) for an outlay of the details on the key modifications.

First, it is advisable that the South African competition authorities set aside the belief that interbrand competition is the main concern of antitrust. Note that this view was never supported by empirical evidence. Supply chain economics, multi-faceted and complex, is based on the interplay between horizontal and vertical competition. Competitive analyses must incorporate notions associated with both forms of competition.

Secondly, it is a great temptation to use as screening test the manufacturer's upstream market share in order to decide whether a vertical restraint (or arrangement in terms of which intrabrand competition will be lessened) may potentially be anti-competitive. This temptation should be avoided. Market power is not necessarily reflected in market shares (in fact, differentiated products or branded products may have fairly low market shares). The market power associated with differentiated brands may be significant, and may require as much intrabrand competition as possible in order to be restrained from exercising market power.

Regarding downstream market shares, retailers may have buying or selling power based on factors completely unrelated to size. Recall that vertical competition exists when firms are able to steal sales, margins, or market shares from each other (Steiner, 1991a). A retailer may therefore have "power" based on the fact that it frequently and significantly undercuts its supplier's vertically integrated downstream retailer. Will we be inclined to clear a merger between the supplier and the maverick distributor should the supplier decide that the mavericks' undercutting must stop? During the past decade, we have done so many times regardless of evidence of higher prices post-merger.[51]

A good starting point when analysing intrabrand competitive effects is to test the intension of the acquirer for entering into the merger (or introducing the restraint). Does the firm intend to secure margin? Does it intend to remove a competitive quote? Is the target competing the price away? There is no obligation to approve a merger if the quote to be removed is significant (regardless of the size of the retailer under acquisition). Note that the removal of the intrabrand competitor may have chain reactions in light of existing vertical restraints or related power struggles in the industry.

Thirdly, care must be taken when defining downstream retail markets. Especially downstream *geographic* markets need to be carefully defined. Retail end customers may often be constrained in terms of their ability to approach alternative intrabrand competitors (or interbrand competitors) situated in other areas (sometimes even

[51] In Tribunal Case No 44/LM/Jul01, the acquiring party said*: "…what is happening at the moment is a kind of dealing with vehicles dealing with specs and destroying prices and whatever…"* In this matter, one reason for the transaction was: *"To realise greater profit opportunities from high retail margins and revenues, as well as the promise of greater return on investment."* Furthermore*: "What did cause some concern were remarks made in the marketing documents and in Mr Hiller's comment that dealers were competing the price away. That might indicate that the merger could be utilised to inhibit price competition amongst dealers as it might make more credible a threat to terminate franchises if dealers were seen to be undercutting the normal price offered in the market."* In Tribunal Case No 33/LM/May02 the Tribunal quoted the rationale for the transaction from the sound bites of the acquirer's presentation package: *"Inter-dealer rivalry rather than the competition"; or "Minimise and hopefully eliminate the negative effects of current discount practice"*. In Tribunal Case No 12/LM/Jan08 the Tribunal referred to the acquiring party's proposal document: *"The average retail rate offered by GTSA is 22% across their post-paid subscriber base, compared to Vodacom levels closer to 15%, and Vodacom will have effectively removed the competitive quote scenario in the market with the acquisition. Future profit growth will be enhanced by reducing these discount rates."* All of the matters were approved unconditionally.

“close by”). The number of effective competitors in the geographic market may in fact be quite low. This may necessitate the preserving of intrabrand competition in the geographic market.

Regarding downstream product markets, the authorities must consider the effect of service markets (or “after-markets”) as customers are usually not able to substitute to interbrand competitors for the rendering of brand-specific services. Indeed, in many international matters, after-markets have been defined as monopolies based on this constraint. An erroneously defined product market could lead to valuable intrabrand competition being foregone.[52]

Fourthly, the days of postulating theories as basis for arguments may indeed be over. Real market factors and effects must be used as basis for determining intrabrand and interbrand competitive effects. No theory should be used unless it had been thoroughly contemplated and tested against real-world market phenomena.

Lastly, to quote Steiner, the local competition authorities “must get the economics right”. Economists must rise to the challenge and question the old school assumptions. The new learning urges us to think critically about our premises and methods (including correlations and methods of analyses). It requires us to develop sound analytical frameworks to account for intrabrand-interbrand analyses.

In this regard, resources must be made available to study, among others, the relevant chain reactions in respect of intrabrand and interbrand competition (which can be quite complex). For example, in Tribunal Case No 33/LM/02, it was argued that the development of the brand centres will increase brand awareness (as a result of the vertical restraint), which will lead to improved interbrand competition. In fact, it is more likely that branding will *reduce* interbrand competition as the brand becomes more shielded from competitors (refer to the relevant section above). Many other complicated links prevail, e.g. the relationship between horizontal competition and the effect of negotiation power in the supply chain.

Recall that Grimes (2006) has remarked that careful lawyering and input from economists are required in order to correctly lay out the anti-competitive effects of vertical restraints in courts. All parties wishing to oppose vertical restraints (including the Competition Commission) should therefore take responsibility for employing sound economic analyses to the end of persuasively arguing their case.

Unfortunately, the Competition Commission does not publish its decisions. It would have been beneficial to understand the Commission’s approach towards intrabrand competitive analysis. Suffice to say, the pending matter against the food retailers – which may very well address issues in relation to vertical and intrabrand competition – may require sophisticated thinking on supply chain interrelationships. It is hoped that the Commission is well equipped to analyse these cases with reference to sound economic theory, and thereby attaching sufficient weight to behavioural factors.

[52] In Tribunal Case No 33/LM/May 02, the Tribunal contended itself with monopoly service markets regardless of the effect on pricing post-merger. The argument was that although monopoly prices will prevail post-merger, at least they will be transparent. The Tribunal also said that customers could in fact approach non-branded dealers for services. This view disregards the nature of after-markets – which rules out the possibility for substitution – as the services to be rendered are to be most reliably rendered by the brand itself.

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