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TESTIMONY AT THE PUBLIC HEARINGS ON EXCLUSIVE DEALING BEFORE THE U.S. DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION

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The following is testimony given by the author on November 15, 2006 before the U.S. Department of Justice and Federal Trade Commission at the Public Hearing on Single-Firm Conduct and Antitrust Law.

Exclusive dealing contracts have been the focus of a substantial amount of recent antitrust litigation. A number of these cases allege that slotting contracts, payments from manufacturers to retailers for promotional shelf space, impair rivals and ultimately harm competition. A theme in these cases, such as *McCormick*, *Conwood*, and *Gruma*, appears to be that some form of exclusivity term explicitly limiting rivals' access to shelf space appears to be a necessary condition for antitrust liability. My testimony examines antitrust analysis of exclusive shelf space arrangements.

The economic point that is most fundamental to understanding the these arrangements is that the manufacturer will generally desire more promotional shelf space than the retailer is willing to provide left to its own independent interests when promotion does not induce significant inter-retailer quantity effects. Manufacturer and retailer incentives are not aligned with respect to the supply of promotional shelf space because

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the supply of additional shelf space induces highly profitable promotional sales for the manufacturer while the retailer earns a much smaller margin on these sales. Therefore, competition between retailers will not lead to the desired quantity of promotional services. Manufacturers and retailers contract to solve this incentive incompatibility problem with a spectrum of compensation arrangements designed to increase retailer supply of promotional shelf space.

It is important to recognize that manufacturer contracting for shelf space with retailers is the outcome of a competitive contracting process and is “competition on the merits.” However, the fact that the manufacturer and retailer have come to an agreement does not mean that the retailer will necessarily perform. Retailers paid for the additional supply of promotional shelf space have the incentive to violate the contract and “free-ride” on the manufacturer’s compensation arrangement in any number of ways, including taking the manufacturer’s payments and failing to supply the contracted-for shelf space.

Predictably, manufacturers and retailers economize on the costs associated with free-riding by including terms that facilitate performance. Full exclusivity is one method to facilitate performance by reducing the retailer’s incentive for non-performance. Exclusivity thus allows the retailer to commit its valuable shelf space, and promotional sales, to a single manufacturer. This competition for valuable shelf space is a boon to consumers since these payments are passed on in the form of lower prices and increased retail amenities.

More commonly, we do not observe full exclusives in supermarkets where some consumers are likely to have strong brand preferences for a number of brands within a product category. Under these conditions, the efficient shelf space contract is likely to involve some form of "limited exclusive" where the retailer commits to supply a specific percentage of shelf space to the manufacturer's featured brand while allocating sufficient space to satisfy consumers with significant demand for rival brands who might switch retailers if a highly demanded product is not offered.

Category management, another shelf space arrangement recently subject to antitrust scrutiny, is properly analyzed as a form of limited exclusive. Category management is a business practice whereby a retailer designates a manufacturer as a category manager or captain and gives the designated manufacturer authority concerning retail shelf space allocation within a product category. The implicit contractual understanding is that the category manager will be supplied the promotional shelf space but will manage the category space in a manner that satisfies consumers with strong loyalties to rival brands. The economics of category management are not fundamentally different from exclusive shelf space contracts -- control over the shelf space allocation decision is merely shifted from the retailer to a manufacturer with the manufacturer becoming the transactor that can violate the implicit contract and the retailer becoming the policer of the contract. However, mistaken reasoning regarding fiduciary-like obligations imposed on the category manager in *Conwood*, as well as the notion that these contracts should be analyzed as horizontal rather than vertical contracts, has led to the perverse result that category managers may face stricter scrutiny than monopolists adopting more restrictive full exclusives.

This analysis of the economics of shelf space competition suggests several lessons for antitrust policy:

1. Full or limited exclusive terms are commonly an efficient element of shelf space contracts because they facilitate contract performance by reducing the retailer's incentive to violate the terms of the implicit understanding regarding the supply of promotion.
2. Category management contracts are a form of limited exclusive adopted when some consumers have high demand for rival brands which retailers want satisfied, and therefore, performance is much more difficult to define. These contracts are inherently less restrictive than full exclusives.
3. Exclusive shelf space contracts solve a broader array of retailer free-riding problems than suggested by the standard antitrust analysis, and thereby increase the value of its shelf space it can commit to manufacturers. This function is pro-competitive because manufacturer payments for shelf space are passed on to consumers. Antitrust standards for single firm conduct must be careful to protect this form of competition for contract.
4. Exclusive contracts may generate anticompetitive effects in some cases. Standard antitrust analysis under the rule of reason suggests that plaintiffs bear the burden of demonstrating the likelihood of anticompetitive effects before the defendant must proffer a pro-competitive justification for its exclusive contract. The key policy lesson for exclusive contracts is that this requirement must be taken seriously and defined precisely. Courts may be tempted to conclude that the presence of an exclusive contract,

especially in the absence of an obvious pro-competitive justification or in cases involving conduct which is clearly not competition on the merits, is a sufficient condition to shift the burden to defendants without any genuine analysis of the likelihood of anticompetitive effects. *Conwood* and *Microsoft* appear consistent with this form of analysis, which ignores the possibility of yet to be understood pro-competitive explanations for conduct and thus threaten to deter a significant amount of pro-competitive conduct.