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Vertical restraints: why they can be a problem for competition – an Australian perspective

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1. Introduction

1. Vertical agreements are an essential element of a market economy, with firms at different levels of the supply chain dealing with each other. In most cases such agreements do not give rise to competition law concerns. However, in some instances they have an anti-competitive purpose or effect, leading to reduced consumer welfare.

2. The theory of vertical restraints is well-established and understood in Australia. Australian competition law is essentially concerned only with vertical restraints that have the potential to substantially lessen competition, and it recognises that anti-competitive arrangements between businesses can involve efficiency gains or benefits that may, in some cases, offset or outweigh the detrimental effects on competition.

3. As in other jurisdictions, e-commerce and digital technology have given rise to additional challenges. The internet has created new highly efficient distribution and marketing channels for businesses and has increased price transparency and choice for consumers. This has resulted in intensified price competition, making it more difficult for manufacturers and retailers to maintain price differentials between sales channels (bricks-and-mortar and online) as well as against rival products.

4. Growth in online commerce is also breaking down the traditional boundaries within which competition occurs and increasingly exposing Australian manufacturers, suppliers and retailers to competition from overseas online suppliers. This has the potential to disrupt exclusive distribution arrangements organised on a territorial basis, which are prevalent in many markets.

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5. These innovations and greater competition have the potential to deliver significant benefits to consumers. Thus, for example, it is now much easier for consumers to find information about the products and services that they wish to buy, and to compare prices from a far greater range of suppliers than was previously the case.

6. As in traditional markets, whether vertical restraints in online markets are ultimately efficiency enhancing, benign or anti-competitive depends on the facts of a particular case. Many of the issues that arise in relation to online vertical restraints arise equally in an offline context and Australia's competition regime applies equally to online and more traditional business models.

7. However, online markets give rise to some novel issues. Thus, for example, it is not always clear whether traditional efficiency arguments apply in the same way in online markets; for example, it is unclear the extent to which developments in online markets have changed the potential for free-riding on the provision of retail services by offline retailers. On the one hand, the ease and convenience of online shopping could increase the prevalence of free-riding on investments by offline stores in services that enable consumers to experience a product prior to purchase. On the other hand, the ease of searching online and the large quantities of information available online may weaken the potential for free-riding by displacing or reducing the role of traditional retail sales personnel in effectively promoting complex products.

8. Similarly, the ease with which some manufacturers are able to supply direct to consumers may result in retailers and suppliers, which have traditionally operated in a vertical distribution arrangement, coming into direct competition with each other. In these circumstances, vertical restraints between a retailer and a supplier might be used to achieve similar effects to traditional horizontal agreements, and can deter the emergence of low-cost online distribution methods. An interesting example of this in Australia can be seen in the ACCC's *Flight Centre* case, which is discussed below.

9. Given the growth of e-commerce and its related distribution models, and the substantial benefits that developments in the online economy can deliver, it is important to ensure that the potential for such benefits is not undermined by anti-competitive arrangements. In that light, the online economy has, in recent years, been identified as a key priority for the Australia's competition regulator, the Australian Competition and Consumer Commission (ACCC). This is to ensure vibrant competition in online markets, and that the efficiencies, increase in productivity and reduced costs that digital technologies can bring can lead to enhanced consumer welfare.

10. This paper discusses the recent treatment of vertical restraints in Australia. Section 2 considers the framework within which vertical restraints are examined; section 3 analyses recent cases and priorities; and section 4 summarises some recent proposed changes to Australia's competition rules, which will have an impact on the way in which vertical restraints are treated.

2. Australia's competition law framework

11. The Competition and Consumer Act 2010 (the **CCA**) is Australia's national competition and consumer law. The Australian Competition and Consumer Commission (the **ACCC**) is the independent Australian Government agency responsible for enforcing compliance with the CCA.

12. There are prohibitions in the CCA against misuse of market power (unilateral conduct) and against arrangements (horizontal and vertical) that substantially lessen competition (SLC). *Per se* illegality applies to the arrangements that are most likely to cause competitive harm, such as agreements that fix prices, restrict output, rig bids or share markets.

13. Under the Australian model of competition enforcement, the ACCC investigates and prosecutes breaches of the CCA and, where it considers appropriate, prosecutes cases before the Federal Court of Australia for determination of relief, including injunctions, monetary penalties, fines or other orders for compensation or redress for breaches of the law.

14. The ACCC also has the power, where appropriate, to accept formal enforceable undertakings or use less formal administrative resolutions to address issues. In addition, under the authorisation provisions in the CCA, the ACCC is empowered to grant legal protection to potentially anti-competitive conduct, by authorising the conduct, when the public benefit outweighs the public detriment.

Written undertakings and administrative resolutions

15. Section 87B of the CCA gives the ACCC the power to accept voluntary enforceable undertakings in connection with a matter in relation to which it has a power or function under the CCA. Undertakings accepted pursuant to section 87B are binding and can be enforced in the Federal Court of Australia. The ACCC may also resolve a matter in a less formal way, through an administrative resolution. These are not generally court-enforceable.

Authorisation and notification regimes

16. Australian competition law recognises that anti-competitive arrangements between businesses can give rise to efficiency gains that may offset or outweigh the detrimental effects on competition. In other words, in certain circumstances, arrangements that restrict competition can nevertheless generate net benefits (efficiencies). In that light, the CCA contains provisions that allow parties to such arrangements to apply for protection from legal action where the public benefits outweigh any public detriment. Parties can do this through two procedures: authorisation and notification.[2]

Authorisation

17. The CCA allows businesses to apply for authorisation from the ACCC to engage in certain anti-competitive conduct. Broadly, the ACCC may authorise businesses to engage in such conduct where it is satisfied that the public benefit outweighs any public detriment. In assessing the public benefits and detriments of an application for authorisation, the ACCC undertakes a public consultation process.

[2] The ACCC maintains a public register for authorisations and notifications: http://registers.accc.gov.au/content/index.phtml/itemId/6031.

Decisions by the ACCC as to whether or not to grant authorisation are subject to review by the Australian Competition Tribunal and appeal to the Federal Court of Australia.

Notification

18. Under the notification regime, the CCA allows parties to obtain statutory protection from legal action in relation to:

a. exclusive dealing

b. certain collective bargaining arrangements, and

c. private disclosure to competitors of price information.

19. As with authorisations, notified conduct is subject to a public benefit test, and the nature of this test depends on the type of conduct for which protection is sought. Thus, for example, the ACCC can object to third line forcing if it considers that the likely public benefit will not outweigh the likely public detriment resulting from the conduct. For other types of exclusive dealing, the ACCC can revoke a notification if it is satisfied that the notified conduct is likely to result in a substantial lessening of competition and the likely benefit resulting from the conduct will not outweigh the likely detriment to the public. Decisions by the ACCC to revoke the protection granted by notifying conduct are subject to reviewed by the Australian Competition Tribunal.

Provisions expressly dealing with vertical restraints

20. Vertical restrictions can potentially be challenged under a number of provisions in the CCA, including the provisions that prohibit anti-competitive contracts, arrangements or understandings (section 45) and those relating to misuse of market power (section 46). There are, in addition, two sections of the CCA that deal specifically with particular types of anti-competitive vertical arrangements: section 47, which deals with exclusive dealing; and section 48, which deals with resale price maintenance (RPM).

Section 47- exclusive dealing

21. Section 47 of the CCA prohibits exclusive dealing that has the purpose, effect or likely effect of substantially lessening competition. Some forms of exclusive dealing are considered to breach the CCA *per se*, that is, irrespective of the purpose or effect of the conduct. An example of this is third line forcing, which involves the supply of goods or services on condition that the purchaser buys goods or services from a particular third party, or a refusal to supply because the purchaser refuses to agree to such a condition. As described above, third line forcing can be exempted through notification to the ACCC, and, in practice, the vast majority of third line forcing notified to the ACCC is permitted.

22. Exclusive distribution agreements between manufacturers and distributors are a common form of exclusive dealing arrangement. Many such agreements do not substantially lessen competition and are often therefore not of concern under the CCA. Indeed, many such arrangements are pro-competitive. However, the growth of online trade and in particular the breakdown and expansion of traditional geographic boundaries is making it harder for suppliers and distributors to enforce exclusive distribution arrangements in a number of industries. This raises the possibility that parties to these arrangements will use potentially anticompetitive means to protect their exclusive territories, by for example, seeking to exclude overseas online competitors or by fixing the price at which online competitors supply Australian consumers.

Section 48 – Resale Price Maintenance

23. Section 48 of the CCA deems RPM, where a supplier requires a third party to on-sell its items at a minimum price, to be a *per se* breach of the CCA. In other words, there is no requirement to show that the conduct in question has any effect on competition. However, as described above, RPM may be authorised by the ACCC if a manufacturer can demonstrate that the imposition of RPM results in such a benefit to the public that it should be allowed.

24. In the recent *Tooltechnic* case, the ACCC dealt with the first application for authorisation of RPM since the CCA (then the Trade Practices Act 1974) was

amended in 1995 to allow the ACCC to authorise such conduct.[3] This case is discussed below.

3. Recent cases and priorities

25. The vertical restrictions of most concern to the ACCC in recent years have related, in particular, to online sales: RPM and RPM-facilitating arrangements and platform parity agreements. The pro-competitive justification for such conduct is typically the need to address free-riding on retailers' promotional efforts (including pre- and post-sales services) in order to ensure that the right amount of promotional effort is supplied.

26. The competition implications of RPM can be significant in relation to online sales: in particular, RPM may be a way for manufacturers and distributors to shield higher cost retail channels, such as bricks-and-mortar outlets, from price competition from lower-cost online retailers.

27. As regards platform parity agreements, which seek to ensure that prices are comparable across different distribution platforms, the concern is that such arrangements may restrict price competition and raise barriers to entry for online suppliers. Such agreements seem to be particularly prevalent in relation to online travel agencies, both in Australia and elsewhere.

28. Some recent examples of cases dealing with vertical restrictions are considered below.

The Narta case

29. In the recent *Narta International Pty Ltd* (Narta) case,[4] the ACCC denied authorisation to Narta for proposed arrangements that would enable it to set a minimum advertising price (MAP) on a wide range of electrical goods. Narta is a

[3] http://registers.accc.gov.au/content/index.phtml/itemId/1179445/fromItemId/401858.

[4] http://registers.accc.gov.au/content/index.phtml/itemId/1080397/fromItemId/401858/display/acccDecision. Other online RPM cases include: Eternal Beauty Products Pty Ltd [----]; *ACCC v Dermalogica Pty Ltd* [2005] FCA 152; (2005) 215 ALR 482; *ACCC v IGC Dorel Pty Ltd* [2010] FCA 1303 (10 December 2010); *ACCC v Jurlique International Pty Ltd* [2007] FCA 79 (8 February 2007); *ACCC v Navman Australia Pty Ltd* [2007] FCA 2061.

buying group of around 30 electrical goods retailers, including bricks-and-mortar and online suppliers. The proposed conduct would have ensured that all of its members advertised the same price for particular products. Narta argued that application of a MAP was necessary for it to be able to obtain exclusive access to the products at issue and thus to enable its members to compete more effectively with members of other chains and franchises.

30. However, the ACCC was concerned that the imposition of a MAP on a broad range of electrical goods could reduce competition between retailers and result in higher prices. This would have a particular impact on online retailers of electrical goods which generally do not negotiate their selling price below advertised prices like bricks-and-mortar retailers often do. This would result in a reduction in intra-brand competition and in particular a lessening of the competitive constraint that online retailers could impose on bricks-and-mortar Narta retailers. In addition, given the likelihood of high advertising prices, and hence selling prices, there was likely to be less pressure on other brands to compete on price with the products at issue, thus reducing inter-brand competition.

Online Travel Agents

31. In the latter half of 2015, the ACCC issued a public consultation on the online accommodation booking sector in Australia in the context of investigations into whether the use of price parity clauses and last room availability clauses by online travel agents in their dealings with accommodation providers raised any competition concerns under the CCA.[5]

32. After reviewing over 500 responses and speaking with industry participants, the ACCC identified the key issues of concern as the use of broad price parity and room availability parity clauses by online travel sites. The parity clauses stopped consumers from getting different prices from competing online sites.

33. Following the investigation, in September 2016 Expedia and Booking.com each reached agreements with the ACCC to amend price and availability parity clauses in

[5] https://consultation.accc.gov.au/communications/online-accommodation-booking-sector/consult_view.

their contracts with Australian hotels and accommodation providers. From 1 September 2016, Expedia (which includes Wotif.com) and Booking.com removed contractual requirements for Australian accommodation providers to:

- offer room rates that are equal to or lower than those offered on any other online travel agent
- offer room rates that are equal to or lower than those offered on an accommodation provider's offline channels
- make all remaining room inventory available
- offer the same number and same type of rooms offered to any other online travel agent.

34. The agreements extended to the largest online travel sites used in Australia for Australian accommodation including Booking.com, Wotif.com, Hotels.com, and Expedia.com and removed barriers to price competition between major online travel sites for hotel bookings.

35. Parity clauses generally require accommodation providers to offer best price and availability to online travel sites. This guarantees the online travel site the accommodation provider's lowest rate and prevents competitors and consumers from negotiating better deals directly with the provider.

36. Following this outcome, Australian accommodation providers can tailor their offers to better meet the needs of their customers and their own businesses requirements. They can offer lower rates through telephone bookings and walk-ins, offer special rates and deals to customer loyalty groups, in addition to offering deals via Expedia and Booking.com.

37. The ACCC continues to monitor and review the operation of the arrangements between online travel agents and accommodation providers.

Flight Centre Limited[6]

38. Flight Centre is Australia's largest travel agent. Flight Centre obtains its revenue from commission from airlines for its travel arrangement services in a vertical relationship. However, airlines have increasingly been recognising the benefits and opportunities of direct online sales to consumers, which can bring an airline into competition with its traditional distributors. Flight Centre had a "price beat" policy under which it would beat cheaper airfares (for the same flight, date and class of travel) offered by its competitors. As a result of that policy, Flight Centre was obliged to match cheaper web fares offered by airlines direct to customers. This resulted in Flight Centre having to forego its commission from airlines in some cases.

39. In March 2012, the ACCC brought proceedings against Flight Centre in the Federal Court of Australia for breach of section 45 of the CCA. It alleged that Flight Centre had attempted to induce competitors to enter into price fixing arrangements with it by agreeing to stop offering their international airfares directly (including over the internet) to the public at prices lower than those offered by Flight Centre. In some cases, Flight Centre accompanied those attempts with the threat of no longer offering flights operated by the airline in question if it refused to agree to the arrangement.

40. In December 2013, the Federal Court found, in agreement with the ACCC, that Flight Centre competed with international airlines for the retail or distribution margin on the sale of international air fares. Flight Centre was thus in a horizontal relationship with airlines as well as operating in a vertical relationship (through the provision of distribution services to the airlines). The Court also found that on six occasions between 2005 and 2009 Fight Centre had attempted to enter into arrangements with airlines which sought to eliminate differences in airfares so as to fix control of or maintain Flight Centre's retail or distribution margin. A crucial fact was Flight Centre's promotion of its corporate pricing policy which operated throughout the period, known as its "Price Beat Guarantee". Despite these representations, Flight Centre had engaged in concerted efforts to remove other

[6] *ACCC v Flight Centre Limited (No 2)* [2013] FCA 1313 (6 December 2013) (trial judgment); *ACCC v Flight Centre Limited (No 3)* [2014] FCA 292 (penalty judgment).

cheaper airfares from being made available to consumers. The Court held that Flight Centre's conduct infringed section 45 of the CCA and imposed a penalty of AUD 11 million.

41. Flight Centre appealed the Federal Court's ruling (before the full court of the Federal Court), and the ACCC cross-appealed on the quantum of penalty, contending that the penalty imposed did not provide adequate deterrent effect. In July 2015, the Full Court found in favour of Flight Centre, holding that Flight Centre was not in competition with the airlines in the market for the supply of international passenger air travel, but rather acted as their agent in that market.[7]

42. The ACCC was granted special leave to appeal the full Federal Court judgment to the High Court, Australia's highest appeal court, and hearings took place on 27 July 2016.[8]

43. The Australian Competition and Consumer Commission has won the High Court appeal in relation to Flight Centre's attempt to induce three international airlines to enter into price-fixing arrangements between 2005 and 2009 in relation to air fares offered online by the airlines that were cheaper than those offered by Flight Centre.

44. The High Court found the relevant market is for the sale of international airline tickets, and importantly also found that Flight Centre and the airlines competed in that market. This was found to be the case notwithstanding that Flight Centre was an agent for each of the airlines.

45. The ACCC pursued this matter because we were concerned that Flight Centre's conduct in this case affected the competitive process. At the core of the matter was the question of whether Flight Centre and the airlines are legally considered competitors.

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[7] *Flight Centre Limited v ACCC* [2015] FCAFC 104. See: http://www.accc.gov.au/media-release/accc-granted-special-leave-to-appeal-to-the-high-court-from-the-full-federal-court-flight-centre-judgment.

[8] *ACCC v Flight Centre Travel Group Limited* [2016] HCATrans 59 (11 March 2016).

46. This decision will provide important guidance for the future application of competition laws in Australia to other situations where competing offers are made directly to consumers by both agents and their principals. It is likely to be particularly relevant when businesses make online sales in competition with their agents.

Visa Worldwide Pte Ltd[9]

47. This was a case involving international payment card transactions at point of sale (POS) and at ATMs in Australia. For international travellers to Australia wishing to use their Visa cards to make purchases at point of sale, Visa has always supplied the currency conversion services necessary to allow the Australian merchant to be paid in $AUD and the purchases to be billed to the cardholder in their home currency. Visa earns substantial revenue from the provision of these services, both in the form of foreign currency trading revenue and fees.

48. Dynamic Currency Conversion (DCC) is a service which competes with Visa's currency conversion services and gives international cardholders a choice to complete a transaction in their home currency rather than in the local currency of the merchant. If a cardholder chooses DCC, the exchange rate is locked in and disclosed to the cardholder at the time of making a transaction. This provides cardholders with certainty about the exchange rate applied and reduces the risk to cardholders from subsequent changes in exchange rates.

49. During the period 1 May 2010 to 6 October 2010, Visa Worldwide made changes to its rules which prohibited further expansion of the supply of DCC services on POS transactions on the Visa network by Visa's rival suppliers of currency conversion services. This effectively meant that retail stores, hotels and restaurants that were not already offering DCC services to their customers as at 30 April 2010 could not offer those services, effectively freezing the pool of merchants who could offer DCC services during the period of the prohibition.

50. The ACCC commenced proceedings against Visa in February 2013 in the Federal Court of Australia. It was concerned that Visa's conduct was likely to stop

[9] *ACCC v Visa Inc and others* [2015] FCA 1020; see also, http://www.accc.gov.au/media-release/visa-ordered-to-pay-18-million-penalty-for-anti-competitive-conduct-following-accc-action.

the growth of currency conversion services which competed with its own currency conversion services and, as a result, limit the choices available to consumers. It alleged that Visa's conduct amounted to: (i) a misuse of its market power pursuant to section 46 of the CCA in preventing the expansion of DCC services to new merchant outlets in Australia and preventing businesses in Australia from supplying DCC services on ATMs in competition with Visa's own currency conversion service; and (ii) exclusive dealing contrary to section 47 of the CCA to the extent that Visa granted access to its payment network to Australian banks and merchants on the condition that they did not acquire competing DCC services.

51. During the course of the proceedings, Visa admitted that its conduct involved exclusive dealing contrary to section 47 of the CCA. As part of the terms of settlement, the parties agreed to orders from the Court that all other claims against Visa be dismissed, including allegations relating to section 46.[10] Following a short hearing, the Federal Court declared that Visa's conduct infringed section 47 of the CCA and imposed a pecuniary penalty of AUD 18 million.

4. Proposed reform of treatment of vertical restraints in Australia

52. A comprehensive independent review of Australia's competition laws and policy has recently been completed – "Competition Policy Review".[11] The Review, which concluded in 2015, recommended a number of changes to Australia's competition regime, including in relation to the treatment of vertical restraints.

53. The main recommended changes in that regard include repealing, or at least simplifying, the specific provisions on exclusive dealing (section 47) and dealing with such conduct under the provisions prohibiting anti-competitive agreements (section 45) and misuse of market power (section 46). In addition, the Review recommended that:

[10] The ACCC has an obligation to resolve proceedings wherever appropriate and practicable, and given Visa's admission in this case of a serious contravention of section 47 the ACCC did not further press allegations in relation to section 46. One reason for this is the significant legal hurdle and complexity presented by proceedings under section 46 of the CCA.

[11] Competition Policy Review, Final Report, March 2015, http://competitionpolicyreview.gov.au/.

a. Third-line forcing (Sections 47(6) and (7) of the CCA) should only be prohibited where it has the purpose, effect or likely effect of substantially lessening competition (it is currently a *per se* offence).

b. The prohibition on RPM in section 48 of the CCA should be retained in its current form as a *per se* prohibition, but notification should be available for RPM.

54. The Australian Government supports the Review's recommendations in relation to third-line forcing and RPM.[12] It also agrees that section 47 on exclusive dealing should be simplified.

5. Conclusion

55. Vertical restraints will continue to be scrutinised by the ACCC because of their potential adverse effect on consumer welfare. There will be a focus on online restrictions, and in particular platform parity agreements in the travel sector and other parity arrangements in digital markets, given the potential for such agreements to achieve, through vertical restraints, similar effects to horizontal agreements. The Australian competition regime generally applies to online markets in the same way as other markets.

56. The International Competition Network (ICN) Special Project Report on online vertical restraints, prepared by the ACCC in 2015,[13] considered many of these issues and concluded that further guidance on the economic assessment of certain online vertical restraints would be beneficial. The issues identified as being of main concern were: (i) RPM, (ii) RPM-facilitating conduct, (iii) platform parity agreements, and (iv) online sales bans or limitations. Further work on vertical restraints is likely to be carried out by the ICN in the near future.

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[12] Australian Government response to the Competition Policy Review: http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Government%20response%20to%20the%20Competition%20Policy%20Review/Downloads/PDF/Govt_response_CPR.ashx

[13] http://www.internationalcompetitionnetwork.org/uploads/library/doc1070.pdf.