

James Hardie Pty Ltd's Exclusive Dealing Notification (23 December 2005): Comments and Issues

A Report on behalf of Gilbert & Tobin

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The analysis here represents the views of CoRE Research Pty Ltd (ACN 096 869 760) and should not be construed as those of Gilbert & Tobin or their clients CSR.

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1 Background

James Hardie Australia (JHA) notified the ACCC (on 23rd December 2005) of its intention to engage in exclusive dealing with respect to its fibre cement building products. Specifically, JHA will prevent retailers of its products from (a) on-selling to fibre cement competitors of JHA and (b) acquiring fibre cement products from other suppliers if they purchase JHA's 'new technology differentiated products.'

Gilbert & Tobin have asked me to comment on JHA's submission and identify issues of economic and competitive concern. In so doing, I rely upon information in JHA's submission and also the letter by Gilbert & Tobin to the ACCC of 6th February, 2006.

The report here proceeds as follows. First, I outline the basic economics of exclusive dealing and when this might raise an anti-competitive concern. I also outline potential public benefits that might also arise from exclusive dealing. Then (in Section 3) I consider these in relation to the fibre cement market and find that JHA's proposed conduct does not appear to be consistent with pro-competitive outcomes and raises significant anti-competitive concerns.

2 The Economics of Exclusive Dealing

At a wholesale level, exclusive dealing arises when a retailer agrees with a supplier not to purchase or sell the products of any other supplier. It is this type of exclusive dealing that is most relevant to this case. However, it is useful to note that exclusive dealing could also arise when a supplier agrees with a retailer not to supply its product to any other retailer or when a supplier and a retailer agree not to supply or sell the products of any other.

Exclusive dealing is a form of 'vertical restriction' that puts requirements on a retailer beyond simply paying the supply price for the product in the wholesale market. Economists recognise that there can be benefits (or efficiencies) from exclusive dealing. However, at its heart, when imposed by a firm with some degree of market power, exclusive dealing can have a baseline anti-competitive effect.

2.1 Anti-Competitive Effects

If a retailer and a supplier agree to an exclusive arrangement, this has an immediate effect of foreclosing on other suppliers. If the supplier and retailer do not have any market power, this foreclosure may not lead to a significant reduction in competition as other suppliers will still be able to supply their products through other retailers.

However, if either the retailer or the supplier has a sufficient degree of market power, such alternatives may not exist for other suppliers. In this case, those suppliers may be forced into a smaller market position (unable to realise scale and scope economies should they exist)¹ or they might be forced to exit entirely.²

Many of the economic issues with regard to the potential anti-competitive harm from exclusive dealing concern the incentives for retailers and suppliers to enter into such arrangements. After all, if an exclusive deal with a supplier reduces the number of suppliers, this may harm the retailer in the long-run. The retailer would have to be compensated for this and such compensation may not be worthwhile.

Here, however, we are not considering the incentive to engage in exclusive dealing. JHA's intention to do so is already a fact. Thus, the potential anti-competitive effect need only relate to the effect of such a deal on the ability of other suppliers to compete. This will be significant if JHA has a sufficient degree of market power such that if it were to tie conditions to retailers it would be too costly for retailers to reject those conditions as they would not be able to secure substitutable supply from elsewhere.

¹ This possibility is explored by Joshua Gans and Stephen King, "Exclusionary Contracts and Competition for Large Buyers," *International Journal of Industrial Organization*, 20, 2002, pp.1363-1381.

² See, for example, Philippe Aghion and Patrick Bolton, "Contracts as a Barrier to Entry," *American Economic Review*, 77 (3), 1987, pp.388-401. This is a well-established argument for anti-competitive exclusive dealing by a monopoly supplier. See, for example, Oliver Hart and Jean Tirole, "Vertical Integration and Market Foreclosure," *Brookings Papers on Economic Activity, Microeconomics*, 1990, pp.205-285; and Preston McAfee and Marius Schwartz, "Opportunism in Multilateral Vertical Contracting: Nondiscrimination, Exclusivity and Uniformity." *American Economic Review*, Vol.84, 1994, pp.210-230.

2.2 Potential Benefits

It is widely acknowledged that in competitive and monopolistic markets alike, vertical restrictions such as exclusive dealing can result in efficiencies.

Just as vertical integration is often the efficient organizational form because it reduces transactions costs, the same can be said in favor of exclusive dealing. Benefits may include lower selling expenses by the supplier and lower search costs by the dealer. Also, the supplier may find it worthwhile to invest in developing the skills of the dealers if he knows that the dealers will be devoting all their efforts to selling his products. Another factor is that the supplier may find it worthwhile to promote the products nationally if he knows that the dealers will not substitute a lower-priced nonadvertised brand when consumers flock to their stores.³

The basic idea is that in a competitive market, exclusive dealing can lead to retailers focusing sales effort on the suppliers' products and the supplier in turn making investments that assist the retailer in marketing and promotion. In this respect, by creating a closer sales-distribution network, the degree of non-price competition against other suppliers can be enhanced.

An alternative possibility is that exclusive dealing allows a supplier to 'capture more rents' in the industry and this may produce incentives for beneficial investment. A similar argument is often made in relation to horizontal or vertical mergers. The 'rent capture' idea is that the exclusive deal gives the suppliers and the retailers who are party to the arrangement a greater share of industry profits. In so doing, the supplier has more incentive to invest in things – such as R&D – that require more 'rent capture.' This may benefit the industry in the long-run.

Note that, in contrast the first set of benefits from exclusive dealing, this benefit explicitly relies on the exclusivity arrangement (or set of arrangements) having an anti-competitive effect. One supplier's rent capture is another supplier's rent loss.⁴ Such redistribution can only occur if the first supplier has some degree of market power.

³ W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr, *Economics of Regulation and Antitrust*, 2nd Edition, MIT Press: Cambridge (MA), 1995, p.246.

⁴ See Ilya Segal and Michael Whinston, "Exclusive Contracts and Protection of Investments," *RAND Journal of Economics*, 31, 2000, pp.603-33.

Moreover, this also means that any incentives other suppliers' may have to engage in value creating investments will be diminished. For example, the exclusive supplier's R&D expenditures might rise but other of other suppliers will fall. It is unclear that the net effect will be beneficial.

3 Evaluating JHA's Proposed Conduct

3.1 Market Definition Issues

The fibre cement products that JHA sell appear to fall into two classes. The A-class consists of its 'technologically differentiated products' including Linea Weatherboard, Linea Trim, Aqua Tec Wet Area Flooring, Eclipsa Eaves Lining and Ezi-Grid Tile Underlay. There is some acknowledgement that some of these products are distinct and no close functional substitutes are sold by other fibre cement product suppliers.

The B-class products are the rest of JHA's fibre cement lines. These are products for which CSR and BCG have close substitutes. I note, however, the JHA has the largest market share in these products regardless of their specific function (external and internal lining, flooring, columns and special applications). In general these market shares exceed 50% suggesting that JHA has brand name or other competitive advantages above those of its nearest competitors.

At present, CSR and (perhaps) BCG can compete in distributing fibre cement products by supplying their own B-class products with JHA's A-class products bought at a retail level and at retail prices by CSR and BCG. This suggests that, in supplying a full line, CSR and BCG must make up negative margins on A-class products with margins earned on B-class products. Thus, the B-class market would be accurately described as imperfectly competitive.

In addition, there are other broader substitutes for fibre cement products. It is my understanding that competition for these products comes at the 'design' stage of a building project and that considerations other than price are the driving force of decisions to utilise fibre cement as opposed to other building materials. In that respect, it is reasonable to consider the product dimension of the relevant market as including suppliers of fibre cement products alone.

3.2 The Proposed Conduct

JHA proposes (a) to prevent retailers who are supplied with its A-class products from on-selling those products to JHA's competitors in B-class products. This would have the effect of either (i) reducing the number of retailers supplying A-class products as part of their range or (ii) making it impossible for CSR and BCG to compete by offering a full line of fibre cement products. Current behaviour suggests that customers do value full line supply (which is why CSR and BCG sacrifice margins to achieve this) and hence, that the effect of this conduct would be to reduce customers options in this regard.

The second part of JHA's proposed conduct is to (b) require any retailer who sells its A-class products to acquire all of their B-class products from JHA and none from others. This would have the effect of either (i) reducing the number of retailers supply JHA's products and/or (ii) foreclosing on CSR and BCG's ability to supply retailers also selling JHA's A-class products.

3.3 Potential Anti-Competitive Effect

The information available to me is insufficient to detail what the precise competitive effects from this proposed conduct are. However, the current market position of JHA in fibre cement products plus their status as the only supplier of A-class products, suggest that they have the requisite degree of market power such that exclusive dealing – of they type proposed – may give rise to an anti-competitive effect. This is because their market position may leave a significant number of retailers with little choice but to accept the vertical restrictions proposed; especially in situations where stocking A-class products is important to their own competitive position. The conduct effectively forecloses on other sources of A-class products from suppliers other than JHA. This coupled with JHA's market leadership position in fibre cement overall may leave retailers with little alternative choice when faced with JHA's new exclusive dealing policy.

The end result of this conduct may be (a) to foreclose from contestability a significant volume of the retailer market for other fibre cement suppliers; (b) to give JHA a future potential to raise price as its A-class products become more established and/or (c) cause potential exit of existing suppliers (particularly, smaller suppliers), cause other larger suppliers to adopt niche market positions and/or raise barriers to entry to new fibre cement suppliers. Each of these is a manifestation of potential anti-competitive

consequence flowing from the proposed conduct. It is only where a significant number of retailers would not adopt the policy that this effect could be minimised. However, at present, the information at hand does not suggest that this is a likely outcome.

3.4 Potential Public Benefits

JHA argue that several potential public benefits might flow from the proposed conduct. I will review each of these in turn but note here that, in each case, the benefit relies on JHA being able to appropriate more rents in the industry at a first order. Therefore, as noted earlier, each relies on anti-competitive effects being realised.

3.4.1 Dynamic Efficiency and Innovation

JHA argue that its incentives to develop new products will be higher with than without the proposed conduct. I note that this argument is consistent with economic theory. However, it is difficult to measure the extent of the gains from such innovation and determine whether these will offset the losses from anti-competitive detriments.

However, qualitatively, there is a strong reason why an economist would expect the improvement in incentives arising from the future with and without the proposed conduct to be relatively low. JHA earn the majority of their fibre cement revenues from overseas sales. For example, its sales are \$2.1 billion per annum as compared with CSR's \$61 million. Thus, their incentives to innovate depend critically on the profits they expect to earn with products in the global market and not domestically.

Interestingly, I note that JHA suggests that this will also drive competitors to introduce new products. However, there is a dramatic logical inconsistency in this argument. JHA need a reduction in competition in order to have an incentive to generate new products while its competitors need an increase in competition to do so! More likely is that its more domestically oriented rivals will have their innovation incentives diminished further by this conduct. Indeed, JHA's global position already means that it considerably outspends its rivals in R&D in this area.

3.4.2 Preventing Cherry Picking

JHA argue that when its rivals re-sell its A-class products, they are able to 'cherry pick' those products and sell to rivals. However, it is

unclear that this is a problem for efficiency. After all, on every single sale that CSR and BCG make of those A-class products, JHA earns as much revenue as it would have earned had its retailers sold directly to final customers. As such, the behaviour of CSR and BCG contributes to JHA's overall demand.

It is my understanding that JHA's products remain clearly labeled and that JHA does have the ability to raise wholesale prices should demand rise. As such, there appears to be no harm in efficiency arising from this although as noted earlier it does allow others to compete with JHA as full line sellers. But this is pro-competitive and likely to result in benefits to consumers.

3.4.3 Free-riding

JHA suggest that by re-selling its A-class products, its competitors will free ride on its sunk R&D expenditures. However, these products are not being 'stolen' nor do they suffer from weak intellectual property protection. Instead, they are being sold at retail prices to competitors. Indeed, it could be argued that this is itself anti-competitive and competitive neutrality could be achieved if those products were sold to competitors at the wholesale prices retailers are able to purchase them for.

Thus, the supposed free riding that occurs here is the same as the benefits any consumer receives from new products. Even a monopolist cannot hope to capture all consumer surplus and in this case JHA are not losing out because of the re-selling actions of its rivals.

3.4.4 Other considerations

JHA also argue that the proposed conduct will allow them to reduce their costs. This will be done by achieving economies of scale on their B-class products. However, it is unclear that these even if achieved will be passed on to consumers as JHA's gain in scale economies will be CSR and BCG's loss. Hence, they will face reduced price pressure.

Even aside from this, it can be argued that JHA has the ability to realise scale economies through greater sales by discounting the price of its B-class products. Thus, this alone cannot be the goal of this proposed conduct.

Finally, JHA argue that by denying re-sale of its A-class products, JHA will be able to respond to the current lower prices of its competitors (as might be achieved by bundled discounts). Surely, the

best way for JHA to respond in this way given its market leadership position would be to discount its own prices. This suggests that the proposed conduct is a way of JHA to gain market share without engaging in directly competitive actions. Affording a firm the ability to refrain from competition can hardly be considered a public benefit.

It is my understanding that the level of vertical integration by other suppliers in this market is relatively low and does not represent a barrier to JHA in accessing customers. This is indicated by its large market share.

3.5 Summary

JHA's market power as a supplier of A-class products and its large market share in fibre cement products suggests that it may have the requisite degree of market power such that the proposed conduct is likely to result in an anti-competitive effect – resulting in a reduction in competitor strength, exit and raised entry barriers.

This is reinforced by JHA's own proposed public benefits that rely on anti-competitive effects in order to have economic weight. Nonetheless, I find that those potential benefits are not convincingly large or are based on logical inconsistencies so much so that no significant public benefit from this conduct has been identified.

As such, on the information available to me, I conclude that there is a prima facie case that JHA's proposed conduct will result in a lessening of competition in the fibre cement market throughout Australia. There are no identified benefits likely to outweigh the negative effect on consumers and on welfare from the potential detriments that may arise.