# Investigation into Jamaica Lottery Company Ltd. under Sections 17 and 20 of the Fair Competition Act

***Staff report***

***March 1, 2002***

**Case nos. 3854 & 3893**

PUBLIC VERSION
Confidential information omitted. The omissions are indicated by an endnote or by the symbol [∃]. In other cases, ranges are provided instead of the exact figure.

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# Executive Summary

An investigation was carried out on the conduct of Jamaica Lottery Company (JLC). The investigation was a result of complaints from two JLC dealers. It was carried out in reference to Sections 17 and 20 of the FCA.

Section 17 proscribes agreements that "have or are likely to have the effect of substantially lessening of competition in a market". Under Section 17(4), however, the prohibition may not apply to agreements for which the Commission is satisfied "(a) contributes to the improvement of production or distribution of goods and services; or the promotion of technical or economic progress while allowing consumers a fair share of the resulting benefit; (b) imposes on the enterprises concerned only such restrictions as are indispensible to the attainment of the objectives; or (c) does not afford such enterprises the possibility of eliminating competition in respect of a substantial part of the goods or services concerned".

Section 20(1) of the FCA states that "an enterprise abuses a dominant position if it impedes the maintenance or development of effective competition in a market." Under Section 20(2)(a), "an enterprise shall not be treated as abusing a dominant position if it is shown, [inter alia], that (i) its behaviour was exclusively directed to improving the production or distribution of goods or to promoting technical or economic progress; and (ii) consumers were allowed a fair share of the resulting benefit."

The investigation focused on the following provisions of JLC's retailer agreement:

a) Clause 19 – " During the existence of this Agreement, the Retailer will refrain from engaging in the sale of any tickets or products of any other games of chance without the consent in writing of JLC". This type of arrangement is known as an exclusive dealing or exclusive purchasing.

b) Clause 36 – "Upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination. The retailer acknowledges that its compensation during the term of the agreement is intended to compensate the Agent for this post-termination period and that it believes the restriction reasonable". This type of arrangement is known as a post-term non-compete obligation.

Specifically, the FTC is concerned that the provisions might affect competition in the following ways:—

- they may have or are likely to have the effect of substantially lessening of competition in a market;
- they might impede the maintenance or development of effective competition in the relevant market;


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- they might prevent persons, in particular retailers, from engaging in competitive conduct and expanding their operations in the relevant market.

In conducting the investigation under Sections 17 and 20 of the FCA, the provisions implemented and enforced by JLC are examined within the context of the following four-step approach:

a) *Definition of the relevant market*—this is necessary in order to establish the market power of the supplier and to assess the anti-competitive impact, if any;

b) *Assessment of market power*— Without market power, an enterprise is considered to not be able effect arrangements with substantial anti-competitive effects. Both market share and entry barriers are taken into consideration in assessing whether the firm in question has market power. In most jurisdictions, an enterprise is considered to have "significant market power" so as to be able to affect an arrangement that may substantially lessen competition if it has 25% share of the relevant market. Further, an enterprise with a market share of at least 50% of the relevant market is generally considered to be dominant. We adopt the same percentages in its cases under Sections 17 and 20 of the FCA respectively.

c) *Assessment of anti-competitive effect*—If significant market power and/or dominance are established, then the practices in question should be assessed to determine if they are anti-competitive. Specifically, in accordance with Section 17(1), it should be determined if the arrangement have or are likely to have the effect of substantially lessening competition in a market. In accordance to Section 20(1), it should be determined if the behaviour has impeded "the maintenance or development of effective competition in a market".

d) In the case of Section 20, we consider that dominant suppliers have an onerous special responsibility not to engage in conduct which risks furthering the weak structure of competition remaining in the relevant market by precluding the emergence of new or additional competitors. Furthermore, while the fact that an undertaking which is in a dominant position cannot preclude it from protecting its own commercial interests if they are attacked, conduct that weakens competition is not acceptable under Section 20 of the FCA if its actual purpose is to strengthen this dominant position and abuse it.

e) *Assessment of pro-competitive benefits*—If it is found that the behaviour is anti-competitive, an assessment in accordance with Sections 17(4) and 20(2) shall be carried out, i.e., whether or not the behaviour contributes to, or was exclusively directed to, improving the production or distribution of goods or to promoting technical or economic progress and consumers were allowed a fair share of the resulting benefit. If the provisions are found to be pro-competitive then JLC will not be treated as have substantially lessened competition or abused a dominant position.

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### *Relevant market definition*

The relevant product market defines the product boundaries within which competition meaningfully exists, and includes only those products that are "reasonably interchangeable" by consumers for the same purpose. In this case, it was defined to include only lotteries.

The geographic market is the "area of effective competition" in which the seller operates and to which the purchaser can practicably turn for supplies. In this case the geographic market was defined to cover the entire island.

### *Assessment of market power*

Until recently, JLC was the sole lottery operator in Jamaica. Its annual sales for the year ending December 31, 2000 were $[∃] billion. Supreme Ventures Limited (SVL) started its operations on June 25, 2001. There are no comparable sales figures as yet. Nonetheless, our estimates of SVL's sales suggest that JLC has more than 50% of the market. This market share meets the threshold both for the potential to substantially lessen competition, under Section 17 of the FCA, and for dominance, under Section 20 of the FCA.

There are no close neighbouring industries or markets to the lottery market that would allow a neighbouring supplier to easily and quickly enter into the lottery market at low cost. A new entrant would have to obtain a licence from the Betting, Gaming and Lotteries Commission, set up its distribution network with the requisite equipment and market and advertise the product. All these imply that barriers to entry are not low enough to qualify or overturn the assessment of dominance as indicated by market shares. In other words, a dominant lottery operator's market power would not be diluted in the short run by the threat of entry.

The analysis suggests that JLC currently has more than 50% of the lottery market and there are high barriers to entry. JLC therefore possesses substantial market power and is a dominant player in the market.

### *Assessment of contractual clauses in relation to Sections 17 and 20 of the FCA: Summary*

Each of the two potentially anti-competitive clauses in the JLC agreements was investigated in reference to Sections 17 and 20 of the FCA, in particular, to determine:

- The anti-competitive effects; and if found to be anti-competitive—
- whether it contributed to, or was exclusively directed to, improving the production or distribution of goods or to promoting technical or economic progress and consumers were allowed a fair share of the resulting benefit.


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The following summarizes our findings as they relate to each clause.

The exclusive dealing clause:

Clause 19– "During the existence of this Agreement, the Retailer will refrain from engaging in the sale of any tickets or products of any other games of chance without the consent in writing of JLC".

We found that:

- JLC's exclusive dealing clause does not appear to have the effect of foreclosing the horizontal market, and therefore currently does not impede the maintenance or development of effective competition in the supply segment of the relevant market, i.e., from the perspective of competing lottery operators.
- The exclusive dealing clause impedes the maintenance and development of effective competition in the relevant market and in particular prevents and deters retailers from engaging in competitive conduct in that market. The adverse effect is not limited to just the JLC retailers but also extends to the SVL retailers. It was found not to be exclusively directed to improving the production or distribution of goods or to promoting technical or economic progress.

We therefore consider the clause to be in breach of Section 20 of the FCA.

Post-term non-compete obligation

Clause 36 – "Upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination. The retailer acknowledges that its compensation during the term of the agreement is intended to compensate the Agent for this post-termination period and that it believes the restriction reasonable".

We consider Clause 36 to be in breach of Sections 17 and 20 of the FCA.

The Staff of the FTC therefore recommends that both clauses 19 and 36 be removed from the JLC retailer agreements.


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# Table of contents

**1. Introduction and chronology ..... 2**

**2. Scope of investigation ..... 4**
2.1 Application of the FCA ..... 4
2.2 Methodology of investigation ..... 8

**3. Defining the relevant market ..... 11**
3.1 The relevant product market ..... 11
3.2 The relevant geographic market ..... 17
3.3 The relevant market definition: a summary ..... 17

**4. Assessment of market power ..... 18**
4.1 Market shares ..... 19
4.2 Entry barriers ..... 20
4.3 Summary ..... 21

**5. JLC's exclusive dealership arrangements ..... 22**
5.1 Exclusive dealing (clause 19): impact on competition in the horizontal lottery market ..... 22
5.2 Exclusive dealing (clause 19): impact on the ability of retailers to expand their operations ..... 25
5.3 Post-termination non-compete obligation (Clause 36) ..... 32

**6. Conclusions and recommendations ..... 35**

**Appendix A: Vertical restraints and competition policy ..... 36**
A.1 Anti-competitive effects of vertical restraints ..... 37
A.2 When are vertical restraints pro-competitive? ..... 38


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## 1. Introduction and chronology

1. May 24, 2001—The FTC received a letter dated May 21, 2001 from Constant Spring Wholesale Liquor Store (CSWLS) who sought assistance in resolving the following issues. CSWLS is a retailer for JLC. A year ago, the informant was asked by JLC to sign a contract that would impose exclusive dealership arrangements onto CSWLS and prevent it from doing any business with other lottery operators. CSWLS did not sign the contract. On May 11, 2001, after a visit from a JLC sales representative, CSWLS's terminal to JLC's operation was disconnected. On May 14, 2001, CSWLS was informed by JLC that its terminal would be re-connected only if it was willing to do business exclusively for JLC.
2. June 15, 2001—The FTC received a second complaint on the same matter from National Fuels & Lubricants Ltd, by way of letter dated June 14, 2001. The Informant submitted copies of two letters from JLC, both dated June 4, 2001. The first letter stated that "pursuant to our contract and specifically to Clause Nineteen (19), the Jamaica Lottery Company Ltd. (JLC) wishes to advise, that it will take all the steps necessary, to include that of legal, to continue to encourage an exclusive agent network … we further encourage the few agents to desist from allowing the installation of any equipment used for the sale of tickets or products of chance". In the second letter, JLC stated that "pursuant to our contract we regrettably will be suspending your services, if after twenty-four (24) hours, you fail to communicate in writing … your intentions as they relate to the selling of tickets and/or other products of chance".
3. June 6, 2001—the staff of the FTC informed JLC by way of letter of the complaints and requested some information required in researching the complaints. The information was received on June 14, 2001.
4. September 6, 2001—the FTC requested further information from JLC and SVL by way of questionnaires. Both operators where given 21 working days within which to reply. The Betting, Gaming & Lotteries Commission was also contacted to obtain information on the lottery industry.
5. October 12, 2001—SVL provided the requested information.
6. October 22, 2001—the FTC received a letter dated October 16, 2001 from JLC requesting a 14-day extension for providing the information. Further, JLC also stated that, in an earlier letter of June 6, 2001, the FTC advised JLC that it was undertaking some form of "research". JLC was concerned that this "research" was now becoming an "investigation" without their company being duly advised. JLC requested that the project be made clearer to them and specifications as to the future phases that this research/investigation may go through.
7. October 24, 2001—the FTC explained to JLC by letter, that when the Commission receives a complaint, first a preliminary fact-finding exercise is undertaken. This is normally based on, but not restricted to, information provided by the Informant in support of his complaint. Based on this preliminary research, if the Commission is satisfied that there are grounds for concern, a more extensive information-gathering


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exercise is carried out, in order to enable the staff of the Commission to assess whether or not there has been a breach of the Act. At this second stage, the term "investigation" is used. There is no presumption of breach; the investigative process has to be observed.

JLC was also informed that once the staff of the FTC completes the investigation, a report will be sent to JLC, after which a public version of the report and findings will be made available to the public. In this public version, care is taken to omit all confidential material. JLC was also advised that the investigation may reveal no breach of the FCA. If a breach is found, however, recommendations are made to deal with the issue. If the findings and recommendations are not satisfactory to JLC, discussions will be arranged between the Company and the Commission.

8. October 26, 2001—JLC provided the requested information.


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## 2. Scope of investigation

### 2.1 Application of the FCA

9. The JLC is a privately-owned company which is licensed by the Government of Jamaica to conduct lottery games of chance. The Company started operating in the early 1990's with the sale of instant scratch and win games. In November of 1994 the company launched a land-based electronic system and introduced the twice-weekly drawn Lotto game. In 1997 the JLC introduced a 3-daily game called Pick 3. Today, JLC retailers sell over 1.8 million plays each week and have over 508,000 weekly consumer visits.

10. The investigation is carried out in reference to the following provisions of JLC's retailer agreement:

a) Clause 19 – " During the existence of this Agreement, the Retailer will refrain from engaging in the sale of any tickets or products of any other games of chance without the consent in writing of JLC". This type of arrangement is known as an exclusive dealing or exclusive purchasing.

b) Clause 36 – "Upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination. The retailer acknowledges that its compensation during the term of the agreement is intended to compensate the Agent for this post-termination period and that it believes the restriction reasonable". This type of arrangement is known as a post-term non-compete obligation.

11. Specifically, the FTC is concerned that the provisions may have one or more of the following effects:

- they may have or are likely to have the effect of substantially lessening of competition in a market;
- they may impede the maintenance or development of effective competition in the relevant market;
- they may prevent persons, in particular retailers, from engaging in competitive conduct and expanding their operations in the relevant market.

12. The above provisions will be investigated under Sections 17 and 20 of the FCA.

13. Section 17 reads as follows:

17—(1) This section applies to agreements which contain provisions that have as their purpose the substantial lessening of competition, or have or are likely to have the effect of substantially lessening competition in a market.

(2) Without prejudice to the generality of subsection (1) agreements referred to in that subsection include agreements which contain provisions that—


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a) directly or indirectly fix purchase or selling prices or any other trading conditions;

b) limit or control production, markets, technical development or investment;

c) share markets or sources of supply;

d) affect tenders to be submitted in response to a request for bids;

e) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

f) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts,

being provisions which have or are likely to have the effect referred to in subsection (1).

(3) Subject to subsection (4), no person shall give effect to any provision of an agreement which has the purpose or effect referred to in subsection (1); and no such provision is enforceable."

(4) Subsection (3) does not apply to any agreement or category of agreements the entry into which has been authorized under Part V or which the Commission is satisfied—

(a) contributes to—

(i) the improvement of production or distribution of goods and services; or

(ii) the promotion of technical or economic progress,

while allowing consumers a fair share of the resulting benefit;

(b) imposes on the enterprises concerned only such restrictions as are indispensable to the attainment of the objectives mentioned on paragraph (a); or

(c) does not afford such enterprises the possibility of eliminating competition in respect of a substantial part of the goods or services concerned."

14. Section 20 proscribes the abuse of a dominant position. Section 19 of the FCA defines the existence of dominant position—

    "For the purposes of the Act an enterprise holds a dominant position in a market if by itself or together with an interconnected company, it occupies such a position of economic strength as will enable it to operate in the market without effective constraints from its competitors or potential competitors".

15. Section 20 reads as follows:

    20—(1) An enterprise abuses a dominant provision if it impedes the maintenance or development of effective competition in a market and in particular but without prejudice to the generality of the foregoing, if it—

    g) restricts the entry of any person into that or any other market;


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h) prevents or deters any person from engaging in competitive conduct in that or any other market;

i) eliminates or removes any person from that or any other market;

j) directly or indirectly imposes unfair purchase or selling prices or other uncompetitive practices;

k) limits production of goods or services to the prejudice of consumers;

l) makes the conclusion of agreements subject to acceptance by other parties of supplementary obligations which by their nature, or according to commercial usage, have no connection with the subject of such agreements.

(2) An enterprise shall not be treated as abusing a dominant position—

a) if it is shown that—
  (i) its behavior was exclusively directed to…promoting technical or economic progress; and

  (ii) consumers were allowed a fair share of the resulting benefit;

b) by reason only that the enterprise enforces or seeks to enforce any right under or existing by virtue of any copyright, patent, registered design or trademark.

16. In regard to the above, Section 20(2)(a) shall be interpreted to mean the following:

- the behaviour is essential to improving the production or distribution of goods or to the promotion of technical or economic progress; and
- the behaviour is not any more restrictive than it needs to be for the attainment of these benefits.

17. Sections 17 and 20 are applicable to this case only if the JLC and its retailers are not 'interconnected companies' as Section 2(2) provides for a group of interconnected companies to be treated as a single enterprise. Section 2 of the FCA reads as follows:

(2) For the purposes of this Act—

(a) any two companies are to be treated as interconnected companies if one of them is a company of which the other is a subsidiary or if both of them are subsidiaries of the same company;

(b) a group of interconnected companies shall be treated as a single enterprise.

18. JLC alleges in letter dated June 11, 2001 that the (commercial) relationship between itself and the retailers is one of agency.

19. Defining the relationship between JLC and the retailers is critical because an agency relationship could render JLC interconnected with the retailers, and, by virtue of Section 2(2) of the FCA, both would be liable to "be treated as a single enterprise". The jurisdiction of Sections 17 and 20 of the Act would thereby be effectively ousted. Section 2(2) reads:

(2) For the purposes of this Act—


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(a) any two companies are to be treated as interconnected companies if one of them is a company of which the other is a subsidiary or if both of them are subsidiaries of the same company;
(b) a group of interconnected companies shall be treated as a single enterprise.

20. The Act defines an "enterprise" as any person who carries on business in Jamaica, except for a person who —

    (a) "works under a contract of employment; or

    (b) holds office as director or secretary of a company and in either case is acting in that capacity;"

21. Under the Law of Contract, a genuine commercial agency relationship is determined by the extent to which the financial and commercial risks are borne by one party or the other. In such a relationship the agent does not exercise independent economic control in relation to the activities for which he acts as agent. He is simply an auxiliary of the principal and may be considered to be one with the principal.

22. Similarly, The European Commission's Guidelines on Vertical Restraints state inter alia, that under an agency arrangement:

    - a legal or physical person (the agent) is vested with the power to negotiate and/or conclude contracts on behalf of another person (the principal) either in the agent's own name or in the name of the principal for the:
        - purchase of goods or services by the principal, or
        - sale of goods or services supplied by the principal.
    - the related financial or commercial risks are borne wholly or substantially by the principal.

23. Contractual provisions which relate directly to the purchase of goods and services by the principal or the sale of goods and services supplied by the principal must be necessary for the performance of a genuine commercial agency agreement.

24. It must be noted that for the purposes of this discussion the only goods which would be relevant are lottery chances. In all cases the retailers' enterprises accommodate the lottery business only as a part of their wider business. "Goods" must therefore be limited to the goods in the lottery business, as supplied by JLC.

25. A proper examination of the Agreement establishing the relationship between JLC and its retailers reveals that the fundamental purpose of the relationship is for the sale of the specific goods supplied by JLC. Further it is clear that JLC bears the financial and commercial risk related to these goods; and JLC provides the equipment necessary for the sale of the goods.

26. Accordingly, the provisions that relate directly to that specific activity, and of course, the specific goods, supplied by JLC, would not be amenable to investigation under Sections 17 and 20 of the FCA. Provisions that do not relate to the specific activity and the specific goods would *ipso facto* be amenable to such investigation.

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27. Clauses 19 and 36 of the Agreement do not relate to the sale of goods or services supplied by JLC. Instead, they relate to the sale of goods and services of other suppliers. They are therefore, liable to be examined under Sections 17 and 20 of the FCA.

## 2.2 Methodology of investigation

28. In accordance with Sections 17 and 20 of the FCA, the provisions implemented and enforced by JLC must be examined to determine if they have any anti-competitive impact. If they do not, then they are not in contravention of the relevant sections of the Act. If they do, then an analysis must be carried out to determine if there are any pro-competitive benefits based on the criteria set out in Sections 17(4) and 20(2) of the FCA. If, either of these sets of criteria is not met, then a breach will be determined.

29. Specifically, JLC's contractual provisions in question shall be assessed according to the following four-step approach:

a) *Definition of the relevant market*—this is necessary in order to establish the market power of the supplier and to assess the anti-competitive impact, if any;

    (c) *Assessment of market power*— Without market power, an enterprise is considered to not be able effect arrangements with substantial anti-competitive effects. Both market share and entry barriers are taken into consideration in assessing whether the firm in question has market power. In most jurisdictions, an enterprise is considered to have significant market power so as to be able to affect an arrangement that may substantially lessen competition if it has 25% share of the relevant market. Further, an enterprise with a market share of at least 50% of the relevant market is generally considered to be dominant.[1] We adopt the same percentages in its cases under Sections 17 and 20 of the FCA respectively.

b) *Assessment of anti-competitive effects*—If significant market power and/or dominance are established, then the practices in question should be assessed to determine if they are anti-competitive. Specifically, in accordance with Section 17(1), it should be determined if the arrangement have or are likely to have the effect of substantially lessening competition in a market. In accordance to Section 20(1), it should be determined if the behaviour has impeded "the maintenance or development of effective competition in a market".

   In the Hoffman-La Roche case, the European Court of Justice defined the abuse of dominance as follows:[2]

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[1] The European Court, for example, has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%.[1] The Office of Fair Trading in the UK considers it unlikely that an undertaking will be individually dominant if its market share is below 40% (see OFT (1999), *The Competition Act 1998: The Chapter II Prohibition*, March). The Competition Bureau of Canada applies a guideline threshold of 35% market share in its assessment of dominance (see Competition Bureau (2001), *Enforcement Guidelines on the Abuse of Dominance Provisions,* July).

[2] Case 85/76 Hoffman-La Roche v Commission [1979] ECR 461.


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"… The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which … through recourse of methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition".

In the Michelin case, the European Court of Justice stated that:[3]

"a finding that an undertaking has a dominant position is not in itself a recrimination but simply means that, irrespective of the reasons for which it has the position, the undertaking concerned has a *special responsibility* not to allow its conduct to impair genuine undistorted competition on the Common Market". [emphasis added]

In *Hoffmann-La Roche*, the European Court of Justice found:

'An undertaking which is in a dominant position in a market and ties purchasers – even if it does so at their request – by an obligation or promise on their part to obtain all or most of their requirements exclusively from the said undertaking abuses its dominant position within the meaning of Article 86 [now Article 82] of the Treaty, whether the obligation in question is stipulated without further qualification or whether it is undertaken in consideration of the grant of a rebate. The same applies if the said undertaking, without tying the purchasers by a formal obligation, applies, either under the terms of agreements concluded with these purchasers or unilaterally, a system of fidelity rebates, that is to say discounts conditional on the customer's obtaining all or most of its requirements - whether the quantity of its purchases be large or small - from the undertaking in a dominant position.

Obligations of this kind to obtain supplies exclusively from a particular undertaking, whether or not they are in consideration of rebates or the granting of fidelity rebates intended to give the purchaser an incentive to obtain his supplies exclusively from the undertaking in a dominant position, are incompatible with the objective of undistorted competition within the common market, because - unless there are exceptional circumstances which may make an agreement between undertakings in the context of Article 85 [now Article 81] and in particular of paragraph (3) of that article, permissible - they are not based on an economic transaction, which justifies this burden or benefit but are designed to deprive the purchaser of or restrict his possible choices of sources of supply and to deny other producers access to the market…'

According to the principles laid out in the *Hoffmann-La Roche* judgement, it is an abuse for a firm in a dominant position to make exclusivity agreements. They do not suggest or imply that such behaviour becomes abusive only at the point at which it has actually foreclosed some particular proportion of the market.

[3] Case 322/81 NV Nederlandsche Banden Industrie Michelin v Commission [1985] 1 CMLR 282, [1983] ECR 3451.

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We consider that dominant suppliers have an onerous special responsibility not to engage in conduct which risks furthering the weak structure of competition remaining in the relevant market by precluding the emergence of new or additional competitors. Furthermore, while the fact that an undertaking which is in a dominant position cannot preclude it from protecting its own commercial interests if they are attacked, conduct that weakens competition is not acceptable under Section 20 of the FCA if its actual purpose is to strengthen this dominant position and abuse it.

We submit that a finding of abuse of dominance may be made even where the dominant enterprise has entered into exclusive arrangements with some of its customers only, which arrangements do not cover the whole or substantial part of the relevant market. In *Hoffmann-La Roche*, the European Court of Justice said that:

> 'Since the course of conduct under consideration is that of an undertaking occupying a dominant position on a market where for this reason the structure of competition has already been weakened within the field of application of Article 86 [now Article 82] any further weakening of the structure of competition may constitute an abuse of a dominant position.'

(d) *Assessment of pro-competitive benefits*—If it is found that the behaviour impedes the maintenance or development of effective competition in a market, an assessment in accordance with Sections 17(4) and 20(2) shall be carried out, i.e., to determine whether or not the behaviour contributes to, or was exclusively directed to, improving the production or distribution of goods or to promoting technical or economic progress and consumers were allowed a fair share of the resulting benefit. In particular, vertical restraints may be beneficial when there (i) is a free-rider problem; (ii) are significant client-specific investments to be made by either supplier or buyer; or (iii) is transfer of substantial know-how. See Appendix A for a detailed discussion of the anti- and pro-competitive effects of vertical restraints.

If there is no evidence of such benefits, the exclusive arrangement will not be permitted. Of relevance is the position of the European Commission that dominant companies may not impose non-compete obligations on their buyers unless they can objectively justify such commercial practice.[4]

[4] See ¶14 of Commission Notice: Guidelines on Vertical Restraints 2000/C 291/01.


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## 3. Defining the relevant market

30. The first step in any antitrust investigation is to define the relevant market. This is important as it determines the market shares of relevant players that, in turn, heavily influence the assessment of market power. As emphasized by the European Commission:

> "market definition is a tool whose purpose is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market … is to identify those competitors of the undertakings involved that are capable of constraining their behaviour and of preventing them from behaving independently of any effective competitive pressure. It is from this perspective, that market shares may provide meaningful information for the purposes of assessing dominance ..."[5]

This relevant market will have two dimensions - the relevant goods (i.e., the product market); and the geographic extent of the market (the geographic market). Both are discussed below.

### 3.1 The relevant product market

31. The relevant product market defines the product boundaries within which competition meaningfully exists, and includes only those products that are "reasonably interchangeable" by consumers for the same purpose. The US Supreme Court has explained what it means to be "reasonably interchangeable:"

> "For every product, substitutes exist. But a relevant market cannot meaningfully encompass that infinite range. The circle must be drawn narrowly to exclude any other product to which, within reasonable variations in price, only a limited number of buyers will turn; in technical terms, products whose 'cross-elasticities of demand' are small." [6]

32. The boundaries of the market are, therefore, determined by taking the products relevant to the investigation and looking at the closest substitute products, those products which consumers would switch to if prices of the relevant products rose. These substitute products are included in the market if substitution by consumers and suppliers would prevent prices of the products relevant to the investigation from rising above competitive levels. The alternative products do not need to be perfect substitutes, but alternatives that would fill a role similar to that filled by the goods in question, and to which consumers would switch in the event of a price increase. Essentially any similar goods that would prevent price-setting above competitive levels should be included in the definition of the relevant product market.

33. In addition to this substitution by customers (so-called "demand substitution"), prices can also be constrained by the potential behavior of suppliers producing other products ("supply substitution"). Businesses that are not currently supplying a

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[5] Notice on the Definition of Relevant Market for the Purposes of Community Competition Law [1998] 4 C.M.L.R. 177; [1997] O.J. C372/5 (E.C. Commission) (97/C 372/03), Para. 2.

[6] Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 612


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particular product might switch some of their existing facilities to supplying that product (or close substitutes) if prices rose significantly. There can also be importation of close substitutes.

An example of supply substitution may be found in the paper industry. Although low quality paper is often not considered to be a substitute for high quality paper, from a consumer's point of view, the different grades of paper are almost perfect substitutes from the producer's point of view. This is because the production methods are identical across all grades of paper where only the input (pulp) has to be changed in order to change the output from low to high quality paper. In this example, even though there is no demand substitutability, a rise in the price of high quality paper is likely to see paper manufacturers switching from low quality paper towards producing more high quality material. In other words, a similar product should be included in the same relevant market as the product in question as long as either demand or supply substitution applies.

34. One common way of defining the market is to apply the conceptual framework of a hypothetical monopolist. This framework assumes an undertaking that was the only supplier of the products (or group of products) to be at the center of the investigation and asks the question if it could maximize its profits by consistently charging higher prices than it would if it faced competition.[7]

    Based on the concept of the hypothetical monopolist, a test that is commonly applied is the so-called "SSNIP test", where SSNIP stands for "small but significant non-transitory increase in price" which is normally interpreted as a 5 – 10% price increase.[8] Further, as a rule of thumb, the Office of Fair Trading (OFT) in the UK interprets "non-transitory" to mean more than one year. In other words, if substitution took longer than one year, the products would not be included in the same market.

    The question posed is, can the hypothetical monopolist effect an SSNIP? If consumers will switch to substitutes such that the hypothetical monopolist *cannot* effect an SSNIP, then these substitutes will be added to the market definition. The test is repeated and wider circles of substitutes added to the market definition until the hypothetical monopolist can effect an SSNIP. This implies that there is limited substitutability between goods included in the market definition and those excluded. At this point, the boundaries of the relevant market are drawn. Both demand and supply substitution are taken into account when applying this test.

35. There are many forms of gambling and betting games, both legal and illegal. Legal games offered in Jamaica currently include the following:

    - Betting on horse races – on track and off-track;

[7] The SSNIP concept is applied by the EU Competition Commission, the Office of Fair Trading in the UK as well as the Department of Justice and the Federal Trade Commission in the US.

[8] Competition agencies that apply the SSNIP test include the Office of Fair Trading (OFT) in the UK (see OFT (1999), *The Competition Act 1998: Market Definition*); the Department of Justice and the Federal Trade Commission in the US (see DOJ and FTC (1992, amended 1997) *Horizontal Merger Guidelines*); The Canadian Competition Bureau (see Competition Bureau (1997), *Merger Enforcement Guidelines*); and the European Commission (see European Commission (1997), *Notice on the Definition of Relevant Market for the Purposes of Competition Law*).


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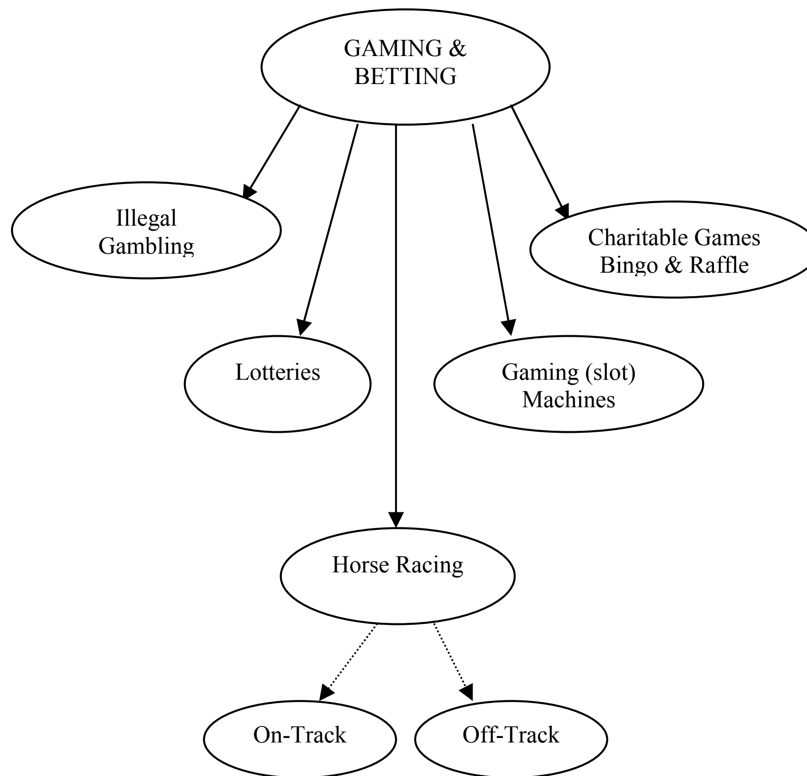
- Gaming (slot) machines;
- Lotteries, including price competitions, national lotto, Pick 3, Scratch and Win, Drop Pan, Cash Lotto.

36. The Betting, Gaming and Lotteries Commission regulates all legal forms of gambling in Jamaica. There are also charitable games such as raffles and bingo parties. Finally, there are also various forms of illegal gambling that are offered in the country. Figure 1 indicates the different categories of gambling and betting games.

**Figure 1: Different categories of gambling and betting games**




37. Lottery games are sold in shops that have an alternative primary function, for example, petrol stations, grocery stores and other corner shops. In other words, the sale of lottery games is an incremental service provided by a retailer. Horse race bets can be bought either on-track or off-track. On-track betting entails going to the races while off-track bets are made in stand-alone outlets specific to off-track betting. Gaming machines are often located either in bars or in hotels. The latter, however, cater predominantly to the tourist market.

38. The question therefore is, should the relevant market be defined as including only lottery games or as also including gaming machines and/or horse race betting. As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discussed above, this depends on the demand and supply substitutability between the different types of games. Each is discussed below.

### 3.1.1 Product market definition: demand substitution

39. Demand substitutability can be inferred by looking at several indicators including prices, the skill required to play, the location of the games and other entertainment provided at the location and the risk levels involved in the games. Each is discussed in the following:

***(i) Prices***

40. If products were close substitutes to each other and markets were competitive, non-transient significant price differences could not be sustained. Consumers would switch from the more expensive product to the cheaper product until the supplier of the more expensive product lowers the price. This process would lead to a convergence of prices of goods in the same market (this lies behind the hypothetical monopolist test discussed above). Therefore, significant and non-transient differences in price levels between products would suggest that the products are in different markets.
41. Table 1 compares the price of each wager under different betting games. As can be seen, a lottery ticket and each turn at the gaming machine are within a similar price range. However, it would be rare for a gaming machine player to have only one go at the machine, while consumers may buy single, or at most a few, lottery tickets each time. Therefore, while the unit cost is similar, the total cost of each gaming 'experience' would often be much higher for gaming machines than for lottery tickets. The cost of horse-race betting is unlimited and players could end up with very costly wagers. In sum, price and cost comparisons suggest that playing the lottery is generally much cheaper than playing gaming machines and horse-race betting.

**Table 1: Price comparisons of different betting games in Jamaica**

| Games | Price per wager |
|---|---|
| *Jamaica Lottery Company* | |
| Lotto ticket (JLC) | $20 |
| Pick 3 (JLC) | $10 |
| Scratchers tickets | $10 - $40 |
| *Supreme Ventures* | |
| Lucky 5 | $20 |
| Cash Pot | $10 |
| Gaming (slot) machines | Approximately $20 |
| Horse race betting | No limits |


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### *(ii) Skill required*

42. Different gambling games require different skill levels. In the case of horse race betting, for example, experience in horse races would increase one's chances of winning. Gaming machines and lottery, on the other hand, are 'non-skill' games in that they depend purely on chance and there is nothing that a player may do to increase his chances at winning.

### *(iii) Location and the 'entertainment bundle'*

43. The location where the games are played may also be an indication of their substitutability. Different locations, for example, may offer different 'bundles' of entertainment. Buying a lottery ticket from the corner grocery store, for example, is quite different from a day at the races or a few hours spent on a gaming machine in a bar. In this regard, time spent on a gaming machine may be secondary entertainment to, and a consequence of, going to a bar. In other words, the attraction to a gaming machine may be the bar and not the gaming machine per se. In this way, the purchase of a lottery bet is likely to result in a different type of entertainment as compared with other games.

### *(iv) Risk levels*

44. Different games have different risk levels. In other words, they offer different probabilities of winning and different amounts in each winning. In general, high-risk games are characterized by low probabilities of winning but high winning levels, if the player wins. In contrast, low-risk games would tend to have smaller betting units, low potential winnings and higher probabilities of winning.

    Different games therefore offer different trade-offs between probabilities and amounts of winning and cater to different tastes between players. Consequently, players who are 'risk-loving' would choose games that have a low probability of winning but offer higher winnings over those that have higher probability of winning but offer lower winnings.

45. The risk in horse-race betting may, to some extent, be controlled by the consumer as he/she may choose the horse with the corresponding odds against it. Risk in both lottery and gaming machines is, on the other hand, fixed by the game operator and cannot be influenced by the player.

### *(v) Demand substitutability: A summary*

46. The comparison of lottery to other betting games in respect of the various factors discussed above is summarized in Table 2.

    Taking into account the factors discussed above, it appears that on- and off-track horse betting are not likely to be close substitutes to lottery from the consumers' point of view. Although gaming machines share some similarities to lottery, in terms of risk


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and skill level involved, the other entertainment that can be found with gaming machines in bars make it a different product bundle from lottery machines. Further, the nature of gaming machines is such that the total cost of each ‘betting session’ is likely to be significantly higher than for lottery. Therefore, the relevant market is defined to include only lottery games.

**Table 2: A comparison of the characteristics of different betting games**

| Feature | Lottery | Gaming machines | Off-track betting | On-track betting |
|---|---|---|---|---|
| *Price/cost* | Low | Total cost could be high | Unlimited | Unlimited |
| *Location and entertainment bundle* | Corner-shops, no additional ‘entertainment’ provided | In bars with additional ‘entertainment’ | Stand-along outlets with no additional ‘entertainment’ provided | On-track with additional ‘entertainment’ |
| *Skill level* | Low | Low | High | High |
| *Risk* | | | Unlimited | Unlimited |

### 3.1.2 Product market definition: supply substitution

47. All gambling and betting operations require a licence from the Betting, Gaming and Lotteries Commission (the Commission). Until recently, JLC was the sole licensed lottery operator. Recently, however, the Commission has awarded licences to two other operators:

- SVL, which was granted a ten-year licence, effective as of January 11, 2001, to conduct three games, namely Drop Pan, Cash Lotto and Keno; and
- Telefun International Ltd., which was granted a five-year licence, effective as of the February 1, 2001, to operate a lottery game via telephone, named ‘Audiotex Tello’.

SVL started operations as of June 25, 2001. Telefun has yet to start operations.

48. In selecting a lottery operator licensee, the Commission uses the following criteria:

- The satisfactory evaluation of the integrity of the applicant;
- If the applicant is a company—
  - The amount of its shareholding must be at a level which can support the proposed lottery activity;
  - It must submit copies of its Certificate of Incorporation and its Memorandum and Articles of Association to the Commission;
- A detailed description of the proposed lottery activity must be submitted;
- A business plan including a statement of income and expenditure and cash flow projections must be submitted.


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Given the licence requirements to start lottery operations, the supply substitutability between lottery and other gaming operations is low. An operator with a licence for horse-race betting or gaming machines, for example, cannot start lottery operations without applying for a new licence. In other words, the supply substitution possibilities between different gambling and betting games are low and support the view that the other gaming operations are not in the same market as lottery.

## 3.2 The relevant geographic market

49. The geographic market is the "area of effective competition" in which the seller operates and to which the purchaser can practicably turn for supplies. Therefore, the geographic market will sometimes be the area supplied by the parties to the conduct concerned. However, consideration should also be given to whether customers could easily obtain similar products from suppliers in other areas on reasonable terms. If so, those other areas may form part of the geographic market.

50. Lottery is played island wide in Jamaica. Further, the prices of the games are identical throughout the island. As the identical products are offered throughout Jamaica under homogenous competitive conditions, the geographic market should be defined to cover the entire island.

## 3.3 The relevant market definition: a summary

51. In sum, the market relevant to this investigation is defined to include the full range of lottery products offered throughout Jamaica.


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## 4. Assessment of market power

52. Market power is usually determined by consideration of market share of the enterprise and barriers to entry into the relevant market. Both are discussed in the following.

- *Market shares*—a (combined) market share of 20 – 25% is commonly used by competition authorities as a guideline threshold to determine "significant market power", i.e., the ability of the enterprise(s) to substantially lessen competition by its arrangements and practices. The Office of Fair Trading (OFT) in the UK considers it unlikely that an agreement will generally have no appreciable effect on competition if the parties' combined share of the relevant market (in the case of an agreement between competitors) does not exceed 25%.[9] The EC considers that agreements will not appreciably restrict competition if:

  – The aggregate market share held by the parties to the agreement does not exceed 10% of the relevant market, where the agreements between competitors; or

  – The market share held by each parties to the agreement does not exceed 15% on any of the relevant markets affected by the agreement, where the agreement is between non-competitors.

  A market share of between 40 – 50% is commonly used by competition authorities as a guideline threshold for dominance. The European Court, for example, has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%.[10] The OFT in the UK considers it unlikely that an undertaking will be individually dominant if its market share is below 40%.[11]

- *Barriers to entry*—the ability of an undertaking to exercise market power is constrained to the extent that new entrants may easily enter the market. If barriers to entry are low, any action by an enterprise to increase prices, for example, would attract new entrants who would put competitive pressures onto the undertaking, forcing it to reduce prices again. In this case, the firm would not be considered to have market power. On the other hand, if barriers to entry are high,

[9] OFT (1999), *The Competition Act 1998: The Chapter I Prohibition*, March.
[10] See Case C62/86, *AKZO Chemie BV v Commission* [1993] 5 CMLR 215
[11] OFT (1999), *The Competition Act 1998: The Chapter II Prohibition*, March. These are, however, guideline thresholds that are not set in stone. Dominance could be established even below the 40% threshold if other relevant factors, such as weak position of competitors in that market provided strong evidence of dominance, for example, if the largest player in the market has 30% market share and many other small firms, none possessing more than 3% of the market, sharing the remainder of the market. In this scenario, 30% market share could be sufficient to meet the dominance test. Consider another scenario in which a market is equally shared between two players, each accounting for 50% of the market. In this case, collusive behavior aside, neither of them can be said to be truly dominant, as neither is likely to be able to act independently of the other. Actions of one player are likely to be met by equally forceful reactions from the competitor who himself commands a similar degree of market power. In this case, a competition authority may see it appropriate to raise the dominance threshold level to between 70 – 80% market share.

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entry is unlikely even if the market is highly profitable. In this case, an enterprise will be able to sustain high prices and profitability and can therefore be said to have market power. High barriers to entry could exist for various reasons including licensing and regulatory requirements for entry (including patent rights) and high sunk costs.[12] Factors that would constitute barriers to entry would differ according to the case and circumstance.

53. In accordance with precedence from other established jurisdictions, we consider that an agreement between two non-competitors (e.g., an exclusive dealing agreement) would have the potential to substantially lessen competition as stipulated under Section 17 of the FCA if any of the parties to the agreement has 20 – 25% market share and there are barriers to entry. Further, if a firm has a market share of more than 40% and there are high barriers to entry, we consider it to be dominant under Section 20 of the FCA.

## 4.1 Market shares

54. Until recently, JLC was the sole lottery operator in Jamaica. Its annual sales for the year ending December 31, 2000 were $[∃] billion. SVL started its operations on June 25, 2001. There are no comparable sales figures as yet.

55. We estimate SVL's sales using two different approaches.

a) The first approach is based on SVL's own projection of weekly sales presented in court when it was sued by JLC in relation to the alleged trademark infringement by SVL. SVL's affidavit states that because of the delay in the start-up of operations resulting from the legal battle, it has lost:

> "all revenue for the two week period of June 11, 2001 to June 25, 2001 which was projected at $[∃] million for each week …" [emphasis added]

These estimates would give a projection of annual sales of approximately $1.7 billion. Adding up SVL's estimated sales of $1.7 billion and JLC's annual sales of $[∃] billion in 2000, the size of the Jamaican lottery market can be estimated to be worth approximately $[∃] billion annually. This implies that JLC has approximately [50-60]% of the market.

b) The second approach is to estimate *future* sales of SVL based on two pieces of information that it has submitted to the Commission:

- The minimum sales stipulated in its contract with retailers, which is currently set at $[∃]per week; and
- The number of retailers it has signed up, which currently stands at [∃].

[12] Sunk costs refer to the investments that have to be made to enable production of a good or service. These costs are incurred even before a single unit of good or service is produced. An example of sunk costs can be found in telecommunications where the cable network has to be put in place – at a high cost – before any voice or data transmission can be made.

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If the number of retailers does not change and all meet the minimum sales, this would give projected annual sales of approximately $[∃] billion.[13] A similar figure is calculated for JLC. Given that it now has [∃] retailers (figure provided by JLC in June 2001), stipulated minimum sales of $[∃] per settlement and two settlements per week, this would provide an estimate of approximately $[∃] billion in sales annually.[14].

This implies that, *if* all of SVL's retailers are able to meet their minimum sales requirements, SVL operations may soon grow to equal or even exceed JLC's. This however, is based on several assumptions that may not hold, especially when the third operator, Telefun International Ltd. begins its operations. It also assumes that the increase in SVL's sales is completely due to an increase in market size and therefore do not come at the cost of reduced sales by JLC.

56. Table 3 shows the estimated market shares under two scenarios – present and future projections. For the purposes of the investigation, current estimates should and will be used. This results in JLC having an estimated [50-60]% of the market, which is above the guideline market share threshold for determining dominance.

**Table 3: Estimated market shares: present and future**

| Scenario | Annual sales (J$ billion) | Market share |
|---|---|---|
| ***Scenario 1*** | | |
| *JLC's sales (2000)* | *[∃]* | *[50-50]%* |
| *SV estimated present sales* | *[∃]* | *[40-50]%* |
| Total lottery market | *[∃]* | 100% |
| ***Scenario 2*** | | |
| *JLC's estimated future sales* | *[∃]* | *[40-50]%* |
| *SV estimated future sales* | *[∃]* | *[50-60]%* |
| Total lottery market | *[∃]* | 100% |

## 4.2 Entry barriers

57. Barriers to entry would be considered to be low if there are potential suppliers or production substitutors that could switch easily and quickly to supply the relevant market. We consider entry to be easy if it could be done without significant new capital investments and within one year after the decision to enter is made. As such, entry would be most likely from neighbouring industries or markets with a similar production technology; or from firms which produce the relevant product in other geographical markets.

58. There are no close neighbouring industries or markets to the lottery market that would allow a neighbouring supplier to easily and quickly enter into the lottery market at

[13] $120,000 x 52 x 523 = $3.26 billion.
[14] $40,000 x 2 x 52 x 655 = $2.7 billion.


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low cost. A new entrant would have to obtain a licence from the Betting, Gaming and Lotteries Commission, set up its distribution network with the requisite equipment and market and advertise the product. All these imply that barriers to entry are not low enough to qualify or overturn the assessment of dominance as indicated by market shares. In other words, a dominant lottery operator's market power would not be diluted in the short run by the threat of entry.

## 4.3 Summary

59. The analysis suggests that JLC currently has more than 50% of the lottery market and there are high barriers to entry. JLC is therefore considered to:

- have significant market power under Section 17 of the FCA; and
- be a dominant player in the market under Section 20 of the FCA.


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## 5. JLC's exclusive dealership arrangements

60. The provisions in the JLC retailer agreement which might contravene the FCA and which are being investigated are as follows:

- Clause 19 – " During the existence of this Agreement, the Retailer will refrain from engaging in the sale of any tickets or products of any other games of chance without the consent in writing of JLC".

- Clause 36 – "Upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination. The retailer acknowledges that its compensation during the term of the agreement is intended to compensate the Agent for this post-termination period and that it believes the restriction reasonable".

61. The potentially anti-competitive provisions are investigated in accordance with the Sections 17 and 20 of the FCA as laid out in Section 2 of this paper. Specifically, The following sections analyze each provision with reference to:

a) its anti-competitive effects; and, if found to have anti-competitive effects—

b) its pro-competitive benefits, as stipulated under Sections 17(4) and 20(2) respectively.

62. Note that potentially Clause 19 might affect competition in one or more of the following ways:—

- they may have or are likely to have the effect of substantially lessening of competition in a market;
- it might prevent or restrict the ability of competing lottery operators to expand in the market, therefore, leading to a lessening of competition in the lottery market;
- it might prevent retailers from engaging in competitive conduct and expanding their operations in the lottery market.

### 5.1 Exclusive dealing (clause 19): impact on competition in the horizontal lottery market

#### 5.1.1 Assessment of anti-competitive effect

63. The key competition objection to exclusive dealing is its tendency to foreclose existing competitors or new entrants from competition in the market. In examining whether there is foreclosure, authorities look to see whether the exclusive dealing agreement increases the entry costs of a new competitor or prevents an existing competitor from expanding its enterprise.

64. In examining whether there is foreclosure in the lottery market it is therefore important that three alternative forms of distribution for competitors be assessed. First, existing retailers, who were not previously distributing lottery tickets, may

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expand their operations and enter the lottery distribution market. Second, "new retailers" may be willing to enter the market if there are sufficient profit opportunities. "New retailers" refers to potential retailers who were not previously involved in the (re)sale of any products. Third, existing retailers who are already lottery distributors may be able to switch to new suppliers in a relatively limited period of time or they may be able to open new outlets in favour of competing brands.

65. Whether or not the exclusive arrangement forecloses markets to competitors depends on the following questions—

- Are competitors able to contract retailers for their operations to the same degree as JLC is?
- Is the 'quality' of the retailers available to competitors equal to those of JLC?

***Are competitors able contract retailers for their operations as easily as did JLC?***

66. In its response to a questionnaire (dated June 6, 2001) administered by the Staff the JLC places the total number of its retailers at [∃]. In response to a similar questionnaire SVL places the total number of its retailers at [∃]. Since both lottery marketing companies have similar selection criteria for their retail outlets (e.g. location accessibility and high traffic flow) the fact that SVL's total number of retailers, in its third month of operation, represents [70-80]% of JLC's total number of retailers (JLC is six (6) years old) indicates that there are existing and potential alternative channels of distribution to those employed by JLC. This finding is further supported by the list of currently activated retail outlets for both marketing companies, which includes a similar mix of outlets. For example, gas stations, grocery stores, bars and restaurants appear on both lists.

***Is the 'quality' of the retailers available to competitors equal to those of JLC?***

67. Another issue that has to be examined in the analysis of market foreclosure is whether the entrant, once he is in the market, will be able to compete effectively. That is, is the entrant being forced to employ a channel of distribution that is "inferior" to the one employed by the incumbent? Inferiority here refers to the suitability of the outlet in relation to lottery sales only and does not speak to other characteristics of the outlet. The suitability of an outlet depends on various characteristics set out by both lottery companies in their criteria for selection of outlets. It is noted that both companies use similar criteria.

    JLC, for example, uses the following criteria:

- *Location*—outlets must be accessible to the player base, secure, have easy access from the major thoroughfares, safe and have the ability to handle crowds at the location;
- *Population*—the JLC attempts to evenly distribute terminals throughout the island based on per capita population;
- *Credit-worthiness*;


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- *Customer service*—potential retailers must exhibit a readiness to perform in a "fast-based technological environment' and be receptive to further training that would allow them to maintain a high standard of service.

SVL's criteria are as follows:

- The retailer must already be an established and operating retail business;
- The outlet must be situated on the ground floor of the premises and be easily accessible;
- The outlet must be situated at a point of relative visibility and high traffic flow.

68. Further, both companies stipulate minimum sales levels that must be met by their outlets in their respective sub-agency contracts. For JLC the minimum level of expected sales is $[∃] per "settlement". With "settlement" occurring twice a week, the weekly level of expected sales is $[∃]. On the other hand, SVL minimum level of expected sales is $[∃] per week. It is reasonable to expect that, before activating its retail outlets, the marketing companies would already have a sense of whether the contracted outlets are likely to meet the required sales target.

69. In sum, SVL's distribution channel does not appear to be inferior to that of JLC, for the following reasons:

    - SVL applies criteria in its outlet selection process that are similar to those used by JLC; and
    - SVL has a higher minimum weekly sales requirement than JLC

70. SVL's successful entry into the market can be attributed to the profile of lottery retail outlets that allows dealers from other industries to expand into the lottery retail market. All lottery retail outlets are incremental arms of other types of businesses. Further, a wide range of existing businesses, from grocery stores to petrol stations to photo-shops, are suitable for becoming sub-agencies for lottery sales. SVL's set-up costs for its retail outlets are therefore limited to the provision of supplies and services that are directly related to the sale of tickets, such as: provision of terminals and their accessories, radio, antenna, point of sale materials and training of sales personnel (how to operate terminals and games information). Most, if not all, of these start-up costs would still have been faced if SVL shared retail outlets with JLC.

***Summary***

71. JLC's exclusive dealing clause does not appear to have the effect of foreclosing the horizontal market, i.e., from the perspective of competing lottery operators. This fact is brought out by the SVL's ability to garner almost as many retailers as JLC in its first three months of activity.


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## 5.2 Exclusive dealing (clause 19): impact on the ability of retailers to expand their operations

### 5.2.1 Assessment of anti-competitive effect

72. The exclusive dealing clause in the JLC retailer agreement prevents its retailers from doing business with any other lottery company. This means that the retailer will be unable to expand the lottery segment of his business. Retailers are also prevented from engaging in competitive conduct in that market, as retailers of one brand will not be able to sell the other brand. Note that Section 20(1)(b) of the FCA speaks specifically to the abuse by a dominant enterprise that "impedes the maintenance or development of effective competition in a market and in particular but without prejudice to the generality of the following, if it prevents or deters any person from engaging in competitive conduct in that or any other market…".

    Also by virtue of the fact that there are only two lottery companies currently operating in Jamaica, the exclusive clause also prevents the SVL retailers from expanding their operations.

73. There are two potential effects on retailers. The first is the opportunity cost of the business lost, i.e. the potential revenue foregone, by their inability to sell the new product. It is not possible to pinpoint the exact level of revenues forgone. Nevertheless, as shown in Table 3, SVL's current and forecasted sales are estimated to be [40-50]% and [50-60]% of the market respectively. If all of this is due to an expansion of the total market, than the average JLC retailer may be foregoing a potential increase in lottery revenue between [40 – 60]%.

    If JLC's total revenues fall as SVL's share of the market increases, then the average revenue of the JLC retailer would also fall. The contractual restriction would prohibit him from making up this loss in revenues by expanding his operations to include the competing product. In other words, whether or not SVL's forecasted market share comes at a cost to JLC's sales, clause 19 of the JLC agreement imposes an opportunity and/or real cost to the retailer by prohibiting him from expanding his operations.

74. Given that sales of lottery tickets are incremental to other types of businesses, the restriction on the retailer's ability to engage in competitive conduct may affect his other business as well. In particular, some of a retailer's lottery customers are also customers of his other businesses, i.e., a customer who walks into a grocery store to purchase a lottery ticket may also purchase groceries. The question is, how will these dual customers react if they switch their preference to the products of the new lottery company but discover that this brand of lottery tickets is not available at the outlet they frequent? Some of these dual customers may modify their shopping habits in order to find the tickets elsewhere. In this scenario, the retailer may end up losing revenues, not only on the lottery but also on the other goods that the customers now purchase elsewhere.

    In other words, the sale of only one type of lottery tickets may affect the other segments of the retailers' businesses. Many of these retailers stock impulse items and the increased traffic from selling both lottery tickets could lead to an increase in the


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sales of these other goods. The sale of non-impulse items could also be enhanced by the increase in lottery related traffic.

75. In sum, we consider that the exclusive dealing clause is anti-competitive and, in particular, it prevents and deters retailers from engaging in competitive conduct in that market. The adverse effect is not limited just to the JLC retailers but applies to the SVL retailers as well.

### 5.2.2 Pro-competitive benefits

76. Under certain circumstances, vertical restraints such as exclusive dealing may be necessary to facilitate competitive conduct in the market, i.e., they may result in pro-competitive benefits. Appendix A of this report discusses the circumstances under which vertical restraints may lead to pro-competitive benefits.

77. To assess the pro-competitive benefits from JLC's exclusive arrangement, the JLC was asked about the benefits that redound to the JLC, the dealers and consumers from the use of exclusive dealers. JLC's responses allude to the existence of the free-rider problem and the need to recover their investments in equipment supplied to retailers as pro-competitive justifications for the exclusive arrangement (see JLC's Point 5 and Point 7 in ¶ 75).

78. There is no free-rider problem associated with the supply of equipment, as the equipment would not be shared. If SVL were to contract an outlet as its retailer, it would put up its own equipment. If there was any potential for equipment sharing, JLC could protect against this by inserting an equipment exclusive provision in its contract. Outlet-exclusivity is not necessary.[15] (See FTC response to JLC's Point 5)

    An argument may also be made about a free-rider problem associated with the training of staff, i.e., where training provided by the incumbent makes it unnecessary for the new entrant to provide training itself. For the following reasons, however, this effect will not be significant enough, if at all existent, to warrant the exclusivity in the Jamaican lottery market:

    - The skills required to facilitate lottery sales and collections are not especially technical and do not require substantial amounts of training;
    - The two lottery companies offer different games, which means the rules of the games will differ. SVL would also have to train retailers about the rules specific to their games;
    - Both may use different operating systems, making training by the new entrant necessary even for retailers who have been retailers for JLC.

79. With regard to the need to recuperate its investments on equipment, the exclusive arrangement is also redundant. To ensure that the return on investments is recovered, an operator needs to ensure that some minimum threshold of sales must be met. Indeed, in JLC's retailer agreement, there is such a provision. In particular, JLC's

[15] Indeed, if there was the possibility of sharing some equipment, for example, computer terminals, JLC and SVL may find it efficient to come to some form of sharing arrangement in future.


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agreement stipulates a minimum level of sales of $[∃] per "settlement". With "settlement" occurring twice a week, the weekly level of expected sales is $[∃]. This provision is sufficient to ensure that the appropriate return on investments is made. An outlet-exclusive arrangement is not necessary.

80. The following details JLC's responses to the question of "what benefits are enjoyed by your company, the dealers and consumers from the use of exclusive dealers". Also provided are FTC's comments on each point made.

- *JLC point 1*—JLC benefits from being able to recover through sales, the substantial costs which it incurs in the provision, installation and maintenance of computer hardware, radio and communications equipment, the acquisition of necessary software licences and the installation and maintenance of such software, and system training, all of which are provided to outlets free of charge.

- *FTC comment 1*—The issue at hand is whether JLC's investment is viable only if the distribution of its lottery tickets relies upon the use of exclusive dealers. SVL, who also made a similar investment in the lottery market, effectively entered the market without imposing any such exclusive requirements on its retailers. In light of this occurrence one can infer that investments in the lottery market can be viable without the use of exclusive retailers.

  Further, the JLC retailer agreement states that retailers should attain weekly minimum sales of $[∃] which implies that the JLC is of the opinion that this amount is sufficient to allow it to recoup its investments. The retailer is already bound by this requirement and would be working towards achieving at least that amount of sales. The exclusivity clause is therefore redundant as a means of recouping JLC's investment.

- *JLC point 2*—The Company is also able to maintain the security of its information and communication systems and ultimately the security and value of the product itself.

- *FTC comment 2*—Clause 16 of JLC's retailer agreement reads: *"The Retailer will ensure that the user security password and keys for the equipment are securely protected at all times and are known and used only by such persons that are known that are so authorized by the Retailer…….".* Inclusion of such a clause as well as other confidentiality clauses in the agreements will ensure that the security of JLC's systems and information is maintained. Exclusivity is therefore not indispensable to the achievement of this goal.

- *JLC point 3*—The arrangements allow the company to recoup substantial advertising and promotional costs.

- *FTC comment 3*—The advertising done by JLC is generic and the costs incurred are fixed and independent of any one JLC dealer, i.e., the cost of advertising would be the same if the dealer network consisted of one dealer or several dealers. Advertising and promotional costs should be recovered from sales and are therefore not a justification for outlet-exclusivity.


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*JLC point 4*—The arrangements encourage dealers to devote more time and resources to the promotion of sales of JLC products.

- *FTC comment 4*—Efforts to ensure that dealers devote less time to competing products, are *per se,* suggestive of an anti-competitive, not pro-competitive outcome. To the extent that JLC needs to achieve a minimum level of sales to justify its investments, quantity contracts are sufficient. JLC's agreements already require their retailers to maintain a minimum sales level. The efficient distribution of JLC lottery tickets is therefore not contingent on the use of exclusive dealers. In addition, the retailer's self-interest based on the fact that more sales are synonymous with more commission will also provide an additional incentive to promote the sale of JLC's lottery tickets.

- *JLC point 5*—The JLC is able to ensure that the benefits of the support, which it provides to dealers, redound to the benefit of JLC, thereby avoiding a 'free rider' problem where the benefits might redound to a competitor who had not provided such support.

- *FTC comment 5*—Exclusive arrangements may be necessary if there is a free rider problem (see Appendix A). Free riding may occur for instance if investments that are made in a retail outlet by a supplier can be used to sell the goods of a competing supplier, to the detriment of the investor. The justification will be valid however, only if the free riding effect is significant enough to warrant the exclusivity. The free rider effect is insignificant in the lottery market. For instance, the type of training required to competently sell lottery tickets is not especially technical and does not require substantial amounts of training. Also the two lottery companies offer different games, which means the rules of the games will differ. SVL would also have to train retailers about the rules specific to their games.

- *JLC point 6*—By the promotion of sales, the company is able to justify the expense of limited settlement of funds to twice a week instead of daily settlement.

- *FTC comment 6*—JLC's decision to offer this credit to its retailers should have been based on its expected revenues from lottery tickets sales. If the retailer is achieving his weekly minimum sales target it means that JLC will be on target for its projected earnings. Since it has already been determined that retailers are likely to meet their sales target without the exclusivity this requirement is not indispensable to ensuring the continuation of twice weekly settlement

- *JLC point 7*—The dealer is able to obtain computer hardware, radio and communications equipment, and software licences, installed and maintained free of charge. The dealer benefits from initial and on-going systems training provided to dealers and their staff, again free of charge. The training in computer systems improves the quality and skills of the dealer's staff and redounds to the benefit of the dealer. As a result of the equipment and training, the dealer is able to ensure the reliability and surety of the products on offer.


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- *FTC comment 7*—The provision of the above listed services is a part of the JLC's investment in the Jamaican lottery market. The question is whether JLC's investment would be viable without exclusivity. Exclusive dealing is sometimes allowed on a limited basis in order to allow an investor to recoup relationship-specific investments. Relationship-specific investments refer to those that are specifically tailored for a particular client's needs and that cannot be used for other purposes. This is done however, when specification of quantities is too costly and thus rules out the use of quantity contracts. The JLC agreements clearly specify a minimum weekly sales figure and as such would not necessitate the use of exclusive dealing.

  As discussed in the assessment of point 1 above such an investment is viable without the imposition of exclusivity requirements on dealers. The JLC would not have contemplated the provision of such services unless it was likely to recoup the expense through ticket sales. The retailers' minimum sales targets would therefore have been set taking into account the need to recoup the investment made. JLC may also be apprehensive about 'free riding' but as discussed in point 5 above, the lottery market is not one that facilitates free riding. In this regard, the exclusivity cannot be considered indispensable for the provision of these services to the retailers.

  An option worth exploring is charging dealers a fair price for the services provided. In fact this might prove to be more of a sales promotion incentive than exclusivity, as retailers would need to sell more tickets to achieve the same profit levels as they would if the equipment were free.

- *JLC point 8*—The dealer benefits by receiving substantial commission revenues paid by JLC.

- *FTC comment 8*—The dealer is paid a commission based on his sales and this would be due to him even if he were not an exclusive dealer.

- *JLC point 9*—The dealer benefits from publicity and advertising undertaken by JLC at no cost to the dealer.

- *FTC comment 9*—The promotion done by JLC is generic and the costs incurred are independent of any one JLC dealer, i.e., the promotional costs would be the same if the dealer network consisted of one dealer or several dealers. Further, SVL gives its non-exclusive dealers advertising and promotional support free of charge.[16] Exclusivity is therefore not indispensable to the achievement of this benefit.

[16] It should be noted that SVL provides retailer support similar to that which JLC provides without any exclusivity restraint on its retailers. In its response to a questionnaire similar to that submitted to JLC, SVL indicated that it provides the following forms of retailer support:
-Training
-Games information – rules and regulations of the games etc
-Supplies lottery terminal , radio, antennae and UPS at no cost to dealers;
-Supplies all terminal accessories;
-Services/maintenance of the terminals and equipment;


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- *JLC point 10*—The dealer benefits from offering a product for which the drawing is televised and hence highly transparent.
- *FTC comment 10*— See FTC's response to point 9 above.
- *JLC point 11*—The dealer is provided access to short-term credit, by way of the twice a week settlement system.
- *FTC comment 11*—See FTC's response to point 6 above.
- *JLC point 12*—The consumer benefits from being able to acquire lottery products supplied by way of efficient, electronic, instantaneous, safe and secure computer and communications systems. In other words, the system is trustworthy and the product that the consumer is buying is highly reliable. The consumer acquires the products from dealer staff that are competent and trained in the use of the computer systems.
- *FTC comment 12*— Exclusive dealing may be allowed if it is exclusively directed to improving the efficient distribution of goods or services. In other words, it may be allowed if it is indispensable to the attainment of the benefit. SVL's provision of a similar set of services to its customers without the use of exclusive retailers refutes the fact that exclusivity is indispensable to the achievement of this benefit.
- *JLC point 13*—The consumer is informed by publicity and advertising which make the process highly transparent. Prior to a draw, the consumer benefits from having access to information such as the amount of the current jackpot, the draw, etc., so that he can make an informed choice as to whether to purchase lottery products. At the time of the draw, the consumer obtains immediate information and is reassured of the integrity of the game by the airing of live drawings on television. And after the draw, the consumer benefits from timely and widespread advertising communicating 'winning numbers'.
- *FTC comment 13*— See FTC's response to point 12 above.
- *JLC point 14*—The consumer benefits from facilities that the outlet is able to offer, such as clean, well maintained premises, security, a range of other products, and so on, which the dealer can provide because of the financial benefits accruing to him from his sales of JLC products.
- *FTC comment 14*—While the need to recuperate investments may be offered as a justification for exclusive dealing, the need to accrue financial benefits over and above what was invested is not a valid justification. Further, the ability to sell all brands of lottery tickets may result in an increase of the retailer's financial benefits.

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-Fixes any terminal malfunction that occurs between service periods;
-Provides all point of sale material; and
-Marketing and promotional program in support of SVL's games and its retailers.


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- *JLC point 15*—By an agreement with the Government of Jamaica, JLC pays [∃]% of its sales revenues on Lotto and Scratchers games to the Sports Development Foundation, a non-profit foundation established by the Government to promote and fund the development of sports in Jamaica. Under the same agreement, the JLC pays [∃]% of sales revenue on Pick three to the Ministry of Health for development of health in the country and a further [∃]% to the Ministry of Education for the development of education. These contributions benefit the country as a whole."

- *FTC comment 15*—Section 20 (2)(a) provides that an enterprise shall not be treated as abusing its dominance if its behavior is exclusively directed to promoting economic progress. While JLC's contribution to the Government of Jamaica may be viewed as promoting economic progress, exclusivity is not indispensable to the achievement of this benefit. The exclusive arrangement, therefore, does not meet the criteria set out in Section 20 (2)(a) of the FCA. In fact, SVL contributes [∃]% of gross sales revenue from its Lucky Five game and [∃]% of net sales revenue from its Cash Pot game to the Government of Jamaica.

81. When asked what were the consequences of removing the exclusivity clause, the JLC indicated that with the clause removed it would be unlikely that it could justify the free provision, installation and maintenance of computer hardware and software, radio and communications equipment, and the free publicity and systems training to outlets. The JLC felt that its inability to recoup costs by way of sales would force it to reduce the goods and services provided to the dealers and/or pass on the costs to the dealers or consumers. In addition, JLC intimated that without exclusivity the company might be forced to move to a daily settlement system, which would reduce the credit available to, and substantially increase the cash demands on, dealers. The JLC also made mention of the fact that if its revenues fall, the contributions it makes to the Government would also be affected.

82. The extent of pro-competitive gains derived from the restriction on the number of retailers or their product range depends on the nature of both the product in question and the retail service that is associated with it. The strongest case for efficiency is based on situations in which the retail service provides an input into the perceived quality of the good and/or an important source of information for the consumer on products, about which he/she otherwise has only limited information. Table 4 below lists the conditions which appear to offer the strongest case for efficiency gains against the weakest case.

83. When the JLC exclusive dealing arrangement is assessed using the information in Table 4 it falls under the "weakest case" scenario. There is substantial scope for retailing in the relevant market and JLC's products are:

- Simple and non-technical with details and features that are widely known;
- Inexpensive;
- Bought in convenience outlets;
- Clearly and strongly branded; and


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- Established and mature.

**Table 4: The strength of the efficiency argument for vertical restraints across different product/distribution conditions[17]**

| Product/distribution nature | Strongest case | Weakest case |
|---|---|---|
| Product complexity | Highly complex or technical | Simple or non-technical |
| Cost for consumer | Expensive - large part of budget | Inexpensive |
| Consumer buying habits | One-off purchases | Repeat purchases |
| Shopping format | Non-convenience outlet | Convenience-outlet |
| Consumers' product information | Limited knowledge | Details/features widely known |
| Price/quality comparability | Experience or credence goods | Search goods |
| Perceived product differentiation | Unclear - weak branding | Clear strong branding |
| Position in product life cycle | New | Established or mature |
| Entry barriers in retailing | Low | High |
| Economies of scope in retailing | Insignificant | Substantial |

### 5.3 Post-termination non-compete obligation (Clause 36)

84. Clause 36 of JLC's retailer agreement states that, "upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination".

#### 5.3.1 Assessment of anti-competitive effect

85. One characteristic of effective competition is low, or no, switching costs at all levels of the supply chain – suppliers, resellers and consumers. Therefore, exclusive dealing arrangements, where permitted, must be of short duration and easy "terminability" in order to negate the likelihood of having the effect of substantially lessening competition in a market. In *Omega Environmental Inc. vs Gilbarco Inc.* (US 9th Circuit Court of Appeals) the judges' opinion was that since Gilbarco's distributors were available within one year, and most were available on sixty days notice a competitor need only to offer a better product or deal to acquire their services. Also in *Beltone Electronics Corporation vs Federal Trade Commission* (1982) it was opined that "*termination on thirty days notice is an escape valve diluting the*

[17] See P.W. Dobson and M. Waterson (1996), Vertical Restraints and Competition Policy, Office of Fair Trading, Research Paper 12, December.


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*limitations on access to the distributors*". The appropriate contractual period depends on the specific characteristics of each industry.

86. The post-term clause and its possible enforcement imposes a high switching cost for the retailer, making termination of contract difficult and thus operating as a barrier to competition. Retailers who are considering switching to a different supplier must weigh the benefits of the switch (e.g., higher sales and/or commissions) against the cost of switching, including the loss in revenues due to the post-term non-compete obligations. The longer the non-compete period, the higher the switching costs.

    The potential loss of sales is likely to restrict retailers from switching between suppliers, leading to reduced competition. Consider the case where retailers could switch without costs. Better commissions and sales prospects, for example, would cause a retailer to switch to a competing operator. This "threat" puts competitive pressure on all lottery operators to offer a better product, to retailers in order to retain them, and to consumers, in order to ensure sales. Any restriction on the ability of retailers to switch to competing products reduces this competitive pressure.

87. In regard to this, we consider that any restrictions which apply after the termination of the agreement generally contravene Sections 17(3) and 20(1) of the FCA. As such, they are prohibited unless they can be objectively justified based on the criteria set out in Sections 17(4) and 20(2) of the Act respectively.

88. This position is consistent with that taken by other competition authorities. The European Commission, for example, considers that post-term non-compete obligations may have the effect of significantly lessening competition even if the market share of the supplier is small. Such obligations are normally not exempted from consideration of Article 81 of the EC Treaty (equivalent to Section 17 of the FCA), unless the obligation is indispensable to protect know-how transferred by the supplier to the buyer, is limited to the point of sale from which the buyer has operated during the contract, and is limited to a maximum period of one year. [18]

89. The European Commission further defines "know-how" as "a package of non-patented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified: in this context, "secret" means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or accessible: "substantial" means that the know-how includes information that is indispensable to the buyer for the use, sale or resale of the contract goods or services: "identified" means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality".[19]

90. JLC's 6-months' post-term non-compete obligation is stringent enough to potentially eliminate switching altogether – the loss of 6 months' lottery revenues is not insignificant. SVL requires its retailers to maintain a minimum level of projected sales in the amount of $[∃]. A retailer who switches from JLC with the intention of

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[18] See Article 5 of EC Regulation 2790/99 on the application of Article 81(3) of the Treaty to Categories of Vertical Agreements and Concerted Practices.

[19] See Article 1(f) of EC Regulation 2790/99.


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selling SVL lottery tickets will therefore have to forego revenues of at least $[∃].[20] Even though Clause 45 of JLC's sub-agency agreement allows either party to terminate the agreement with thirty (30) days of written notice, the post-term non-compete obligation makes it unlikely that retailers will terminate the contract and switch to the competing operator. The obligation is therefore anti-competitive.

### 5.3.2 Pro-competitive benefits from Clause 36

91. Under certain circumstances, post-term non-compete obligations may be necessary to facilitate participation, investment and expansion into a market, in particular when a significant level of technical know-how is involved. Technical know-how is a body of technical information that is secret, substantial and can be identified in appropriate form. This type of information is usually imparted in franchise arrangements whereby the franchisor provides the franchisee with the necessary information, intellectual property and other technical know-how to operate the business.

92. Further, where exclusivity is permitted, an exclusive agent or distributor may be prevented from selling competing products during the lifetime of the agreement. However, it should not be prevented from competing with the supplier or manufacturer when the exclusive distribution agreement has expired. The fundamental principle is that the agent or distributor must be able to compete immediately upon termination of the exclusive distribution agreement.[21]

93. There is, however, no technical know-how or other pro-competitive justifications for the existence of JLC's post-term non-compete obligations. The information concerning the rules of the games imparted to the JLC dealers is not likely to give the dealer a competitive advantage should he decide to sell the product of JLC's competitor. SVL's games are different from those of JLC and as such the retailer will have to learn the rules that are specific to SVL's games. In terms of technical know-how, the type of training required to competently sell lottery tickets is not especially technical and does not require substantial amounts of training.

94. Clause 36 of JLC's retailer contract therefore does not meet the criteria set out under Sections 17(4) and 20(2) of the FCA. JLC should therefore, not impose any restriction that prevents the retailer from competing after the termination of the agreement, except in the case of prohibiting the use or disclosure of confidential information.

[20] [(SVL minimum projected sales x # of non-compete months) x 5%]

[21] This principle would also apply to clauses relating to non-solicitation of customers and employees.


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## 6. Conclusions and recommendations

95. *Clause 19 of JLC's retailer agreement*—" During the existence of this Agreement, the Retailer will refrain from engaging in the sale of any tickets or products of any other games of chance without the consent in writing of JLC".

There is no evidence that this clause has foreclosed the new entrant from competing effectively n the lottery market. The lack of foreclosure in this horizontal segment of the market can be attributed to the fact that SVL's start-up costs were not aggravated by JLC's exclusive arrangement due to (i) the fact that lottery retail outlets are incremental services to existing business; and (ii) a wide range of existing businesses is suitable and available for outlets.

This clause however, isfound to have prevented retailers from engaging in competitive conduct in that market. Further, it is also not exclusively directed to improving the production or distribution of goods or to promoting technical or economic progress as required under Section 20(2)(a).Clause 19 is therefore in breach of Section 20 of the FCA and should be removed.

96. *Clause 36 of JLC's retailer agreement*—"upon termination of this agreement for whatever cause, the Retailer agrees that he/she will not engage directly or indirectly, in the organization, sale or promotion of any other game(s) of chance for a period of six (6) months after the date of such termination".

97. Clause 36 is found to have or is likely to have the effect of substantially lessening of competition in a market. Further, it impedes the maintenance or development of effective competition in the market as it restricts retailers from switching to the competing lottery operator. It also does not contribute, or is exclusively directed, to improving the production or distribution of goods or to promoting technical or economic progress as required under Section 20(2)(a). Clause 36 is therefore in breach of Sections 17 and 20 of the FCA and should be removed. Note that the removal of Clause 19 also makes Clause 36 redundant.


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## Appendix A: Vertical restraints and competition policy

1. Vertical restraints are provisions made between undertakings operating at different levels in the economic process in relation to any particular agreement that restricts the commercial freedom of one or more parties. The agreement might, for example, be between a manufacturer and a retailer, a manufacturer and a wholesaler, a wholesaler and a retailer, a retailer and a customer, or even between two wholesalers which, for the purposes of the agreement, operate at different stages in the supply chain. In this document, reference is made to agreements between a supplier and a retailer, but the same principles apply to agreements between any two parties which, for the purposes of the agreement, operate at different stages in the supply chain.

2. Vertical agreements impose many conditions and restraints upon both parties. Most of these would be considered to be common and acceptable contractual arrangements. Indeed, clear contractual arrangements are necessary for facilitating the smooth functioning of businesses and, by virtue of this, vertical restraints often allow firms to improve the efficiencies of their operations either through creating transaction cost efficiencies.

3. While they are generally beneficial, however, some vertical restraints may restrict competition. The types of restraints that may restrict competition, include, but are not limited to, the following:

- *Resale price maintenance*—this occurs when the supplier specifies the resale price of the product. Commonly, the supplier will specify only a minimum or a maximum price.
- *Selective distribution*—is when a manufacturer supplies only a limited number of retailers who are restricted in their ability to re-sell products.
- *Exclusive distribution*—is a particular form of selective distribution where the supplier supplies only one distributor in a particular territory or allows only one distributor to supply a particular class of customer, businesses or consumers for example.
- *Exclusive dealing*—whereby a supplier agrees to supply goods to a retailer on the condition that the retailer does not sell goods from competing suppliers;
- *Tie-in sales* and *bundling*—refers to the case where the supplier makes the purchase of one product (the “tying” product) conditional on the purchase of a second product (the “tied” product).
- *Full-line forcing*—is an extreme form of tie-in sale where the distributor must stock the full range of the supplier’s product range.
- *Quantity forcing*--occurs when the supplier is required to purchase a minimum quantity of a certain product.
- *Fidelity discounts*—is where the distributor receives discounts based on the percentage of its sales, which come from the supplier.

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4. An assessment of the effects of a vertical restraint needs to take account of both its potential anti-competitive effects and any countervailing benefits it produces. The task at hand is, therefore, to determine whether a particular vertical restraint is anti- or pro-competitive. In order to do so, it is useful to understand the conditions under which a vertical restraint is anti-competitive, compared to conditions under which it would be pro-competitive. The following discusses both the potential anti-competitive and pro-competitive effects of vertical restraints. Much of the discussion is relevant to a wide range of vertical restraints (see above beyond the specific elements under investigation.

## A.1 Anti-competitive effects of vertical restraints

5. The negative effects on the market that may result from vertical restraints and which competition law aims at preventing are the following:

- Foreclosure of other suppliers or other buyers by raising barriers to entry;
- Reduction in inter-brand competition between the companies operating in a market, including facilitation of collusion amongst suppliers or buyers; by collusion is meant both explicit collusion and tacit collusion (conscious parallel behaviour);
- Reduction of intra-brand competition between distributors of the same brand.

The anti-competitive effects depend on various factors including the market share of the supplier(s) involved in the restraint, the proportion of the market covered by the restraint, the specific nature of the market and the exact nature of the restraint.

6. For most vertical restraints, competition concerns can arise only if there is insufficient inter-brand competition, i.e., if there exists a certain degree of market power at the level of the supplier, of the buyer or both. Conceptually, market power is the power to raise price above the competitive level and, at least in the short term, to obtain supranormal profits. Where there are many firms competing in an unconcentrated market, it can be assumed that non-hardcore vertical restraints will not have appreciable negative effects. The European Commission, for example, considers that market as unconcentrated when the Hirschman-Herfindahl Index (HHI) index, i.e., the sum of the squares of the individual market shares of all companies in the relevant market, is below 1,000.[22]

[22] See Commission Notice: Guidelines on Vertical Restraints (2000/C 291/01), Official Journal of the European Communities.
Market concentration reveals the extent to which market power is vested in a few firms. One expedient way to measure concentration is the Hirschman-Herfindahl Index (HHI). The HHI is:

$$HHI \equiv \Sigma_i \partial_i^2;\ \text{Where } \partial_i \text{ represents market share of firm i}$$

The HHI uses the squared sums of the market shares of each firm in the industry as a "weight" in assessing the degree of market concentration. The premise behind this "weight" is that if firms in the relevant market have equal market power the HHI equals 1/N and that the more skewed the index is from 1/N the more concentrated is the market. To put the numbers into perspective, a market where two players each has 50%

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7. There are, however, some restraints that are considered to be anti-competitive regardless of the market power of the player. The restraints that would fall into this category are typically price restraints, for example, resale price maintenance. Since resale price maintenance directly restricts price competition, it is considered to significantly lessen competition regardless of the market shares of the undertaking.

## A.2 When are vertical restraints pro-competitive?

8. It is important to recognize that vertical restraints can also have positive effects by, in particular, promoting non-price competition and improved quality of services. When a company has no market power, the only way that it can increase its profits is by using its manufacturing or distribution processes optimally. In a number of situations, vertical restraints may be helpful in this respect since the usual arm's length dealings between supplier and buyer, determining only price and quantity of a certain transaction, can lead to a sub-optimal level of investments and sales. To be considered pro-competitive, however, conditions must be such that there are higher levels of investment and sales (output) with the imposition of the restraints than without. The following describes some reasons that may justify the application of certain vertical restraints:

c) *To 'solve a "free-rider" problem'*—one distributor may free-ride on the promotion efforts of another distributor. This type of problem is most common at the wholesale and retail level. Exclusive distribution or similar restrictions may be helpful in avoiding such free-riding. Free riding can also occur between suppliers, for instance where one invests in promotion at the buyer's premises, in general at the retail level, that may also attract customers for its competitors. Non-compete type restraints can help to overcome this situation of free-riding.

For there to be a problem, there needs to be a real free-rider issue. Free-riding between buyers can occur only on pre-sales services and not on after-sales services. The product will usually need to be relatively new or technically complex as the customer may otherwise very well know what he or she wants, based on past purchases. And the product must be of a reasonably high value as it is otherwise not attractive for a customer to go to one shop for information and to another to buy. Lastly, it must not be practical for the supplier to impose on all buyers, by contract, effective service requirements concerning pre-sales services.

Free-riding between suppliers is also restricted to specific situations, namely in cases where the promotion takes place at the buyer's premises and is generic, not brand specific.

(e) *To 'open up or enter new markets'*—where a manufacturer wants to enter a new geographic market, for instance by exporting to another country for the first time this may involve special 'first time investments' by the distributor to establish the

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of the market would have an HHI of 5000. A market where the six players each has 13% market share would have an HHI of 1014.


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brand in the market. In order to persuade a local distributor to make these investments it may be necessary to provide territorial protection to the distributor so that he can recoup these investments by temporarily charging a higher price. Distributors based in other markets should then be restrained for a limited period from selling in the new market. This is a special case of the free-rider problem described under point (a).

(f) *The 'certification free-rider issue'*—in some sectors, certain retailers have a reputation for stocking only 'quality' products. In such a case, selling through these retailers may be vital for the introduction of a new product. If the manufacturer cannot initially limit his sales to the premium stores, he runs the risk of being de-listed and the product introduction may fail. This means that there may be a good reason for allowing for a limited duration, a restriction such as exclusive distribution or selective distribution. It must be enough to guarantee introduction of the new product but not so long as to hinder large-scale dissemination. Such benefits are more likely with 'experience' goods or complex goods that represent a relatively large purchase for the final consumer.

(g) *The so-called 'hold-up problem'*—sometimes there are client-specific investments to be made by either the supplier or the buyer, such as in special equipment or training. For instance, a component manufacturer that has to build new machines and tools in order to satisfy a particular requirement of one of his customers. The investor may not commit the necessary investments before particular supply arrangements are fixed.

As in the other free-riding examples, however, there are a number of conditions that have to be met before the risk of under-investment is real or significant. Firstly, the investment must be relationship-specific. An investment made by the supplier is considered to be relationship-specific when, after termination of the contract, it cannot be used by the supplier to supply other customers and can be sold only at a significant loss. An investment made by the buyer is considered to be relationship-specific when, after termination of the contract, it cannot be used by the buyer to purchase and /or use products supplied by other suppliers and can only be sold at a significant loss. An investment is thus relationship-specific because for instance it can only be used to produce a brand-specific component or to store a particular brand and thus cannot be used profitably to produce or resell alternatives. Secondly, it must be a long-term investment that is not recouped in the short run. And thirdly, the investment must be asymmetric; i.e. one party to the contract invests more than the other party. When these conditions are met, there is usually a good reason to have vertical restraints for the duration it takes to depreciate the investment. The appropriate vertical restraint will be of the non-compete type or quantity-forcing type when the investment is made by the supplier and of the exclusive distribution, exclusive customer-allocation or exclusive supply type when the investment is made by the buyer.

(h) *Transfer of knowledge*—this refers to the 'specific hold-up problem that may arise in the case of transfer of substantial know-how'. The know-how, once provided, cannot be taken back and the provider of the know-how might not want it to be


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used for or by his competitors. In so far as the know-how was not readily available to the buyer, was substantial and indispensable for the operation of the agreement, such a transfer may justify a non-compete type of restriction.

(i) '*Economies of scale in distribution'*—in order to have scale economies exploited and thereby see a lower retail price for his product, the manufacturer may want to concentrate the resale of his products on a limited number of distributors. For this he could use exclusive distribution, quantity forcing in the form of a minimum purchasing requirement, selective distribution containing such a requirement or exclusive purchasing.

(j) '*Capital market imperfections'*—the usual providers of capital (banks, equity markets) may provide capital sub-optimally when they have imperfect information on the quality of the borrower or there is an inadequate basis on which to secure the loan. The buyer or supplier may have better information and be able, through an exclusive relationship, to obtain extra security for his investment. Where the supplier provides the loan to the buyer this may lead to non-compete or quantity forcing on the buyer. Where the buyer provides the loan to the supplier this may be the reason for having exclusive supply or quantity forcing on the supplier.

(k) '*Uniformity and quality standardization'*—a vertical restraint may help to increase sales by creating a brand image and thereby increasing the attractiveness of a product to the final consumer by imposing a certain measure of uniformity and quality standardization on the distributors. This can for instance be found in selective distribution and franchising.

9. The eight situations mentioned above make clear that under certain conditions vertical agreements are likely to help realize efficiencies and enhance the development of new markets and that this may offset possible negative effects. The case is in general strongest for vertical restraints of a limited duration, which help the introduction of new complex products or protect relationship-specific investments. A vertical restraint is sometimes necessary for as long as the supplier sells his product to the buyer (see in particular the situations described in points (a), (e), (f), and (h).

10. Finally, in circumstances where a vertical restraint is implemented due to its pro-competitive benefits, efforts must be made to ensure that the following two conditions hold:

- The restraint is not more limiting than it should be—in this regard, it should be noted that there is a large measure of substitutability between the different vertical restraints. This means that the same inefficiency problem can be solved by different vertical restraints. For instance, economies of scale in distribution may possibly be achieved by using exclusive distribution, selective distribution, quantity forcing or exclusive purchasing. This is important as the negative effects on competition may differ between the various vertical restraints. This plays a role when indispensability of the restraint is discussed.


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- The "switching costs" of resellers to move between suppliersare not unduly high—that is, it is not excessively difficult for resellers to switch to a different supplier. To this end, contracts with anti-competitive vertical restraints must not be for long duration and, in general, there should be no post-non-compete obligations imposed on resellers. The only exceptions would be when there are trade secrets or customer goodwill in the business.


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