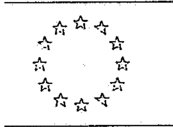

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.09.1998
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COMMUNICATION FROM THE COMMISSION

on the application of the Community competition rules to vertical restraints

Follow-up to the Green Paper on Vertical Restraints

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SECTION I: INTRODUCTION

1. Shortcomings of current policy

Community competition policy concerning vertical restraints has a history of nearly forty years. Although this policy has been successful a review is necessary. The reasons for this review were amply described in the Green Paper on Vertical Restraints[1]. The Green Paper has identified a number of shortcomings in current policy, which can be summarised as follows.

First, the current Block-Exemption Regulations (BEs) comprise rather strict form-based requirements and as a result are considered too legalistic and work as a strait-jacket. This is especially awkward in the light of the major changes in methods of distribution that have taken place and still are taking place. For the vertical agreements that, sometimes with difficulty, do fall within the current BEs a compliance burden is created through unnecessary legal uncertainty. Companies without significant market power suffer unnecessary regulation and may even be prevented from using vertical restraints to improve their competitive position in the market.

Secondly, for those agreements that fall within the BEs there is the real risk that the Commission is exempting agreements that distort competition. As the BEs are form-based instead of effect-based and do not contain any market share limit, companies with significant market power can benefit from them. The sanction of withdrawal is in this respect not seen as a real deterrent because it works only with effect for the future. Thus, the present BEs exempt for instance, non-compete obligations up to 100% market share although these may cause serious foreclosure effects and allow the charging of exorbitant prices on the market to the detriment of consumers.

Thirdly, as the BEs only cover vertical agreements concerning the resale of final goods and not intermediate goods or services[2] a significant part of all vertical agreements are not covered by the current BEs, even when the parties involved have no market power. This means that an unnecessarily large number of vertical restraints could in principle be scrutinised, resulting in legal uncertainty and unnecessary enforcement costs.

2. Need for a more economics based approach

To remedy these three shortcomings and better protect competition, the primary objective of Community competition policy, a more economics based approach is required. Such an approach should be based on the effects on the market; vertical agreements should be analysed in their market context. It is only when inter-brand competition is weak and market power exists that it becomes important to control vertical agreements. This should facilitate a relaxation of the form-based requirements, ensure that fewer agreements are covered by Article 85(1) and afford a better scrutiny of agreements of companies having substantial market power. This can be depicted as follows.

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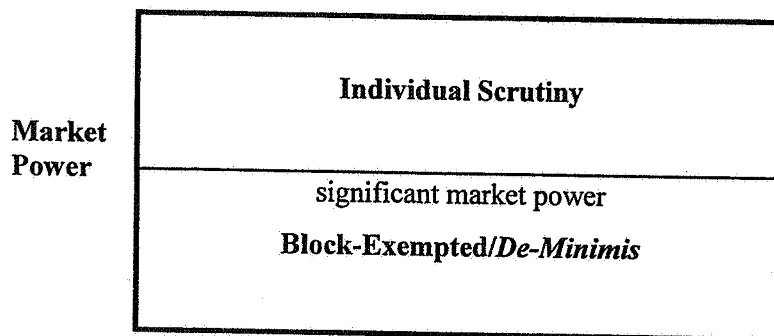
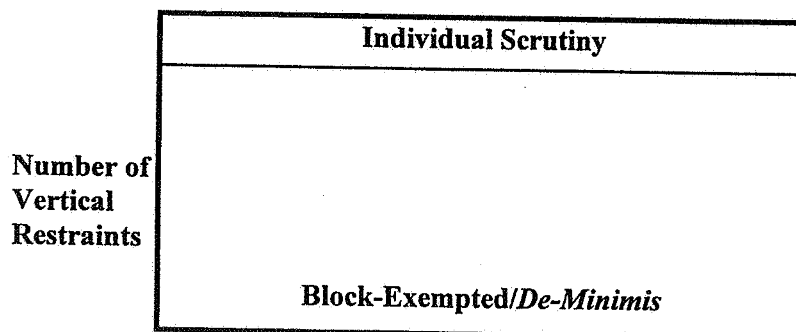
[1] Green Paper on Vertical Restraints in Community Competition Policy, COM(96) 721 final, adopted by the Commission on 22. 1.1997.

[2] Only under the Franchise Block Exemption Regulation (No 4087/88 of 30 November 1988) are services covered.



Most markets are fairly competitive, the companies not having market power. Therefore, the number of cases that may need scrutiny, as depicted below, will be relatively low. This is confirmed by an analysis of recent merger cases[3].



In reforming Community competition policy in the field of vertical restraints, the Commission pursues the following objectives:

* the protection of competition, which is the primary objective of Community competition policy, as it enhances consumer welfare and creates an efficient allocation of resources;

* market integration, in the light of enlargement, which remains a second important objective when assessing competition issues.

In addition, the effects on the overall level of legal certainty for business, the enforcement costs to business and competition authorities, and the possibilities for improving decentralisation have to be taken into account.

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[3] In more than 80% of the merger cases dealt with under the Merger Regulation in 1997, the market shares of the individual parties were below 25%. As these merger cases only concern large companies and often the most narrow market definition is looked at in the first phase of investigation in order to clear the merger, it can be expected that in the economy as a whole, market shares will be even lower.

The policy proposal set out in this Communication is based on a more economic approach. This is required, as was explained above, to remedy the shortcomings of current policy. For situations without significant market power a safe harbour needs to be created, thus providing a presumption of legality for those vertical restraints that are likely to have no net negative effects. Vertical restraints falling outside the safe harbour will not be presumed to be illegal but may need individual examination. In the context of individual examination, the Commission will have the burden of proof that the agreement in question infringes Article 85(1) and will have to examine whether the agreement does or does not fulfil the conditions of Article 85(3).

The proposed safe harbour consists of one broad umbrella Block-Exemption regulation covering all vertical restraints for the distribution of goods and services[4]. This regulation uses market-share thresholds to distinguish between agreements that are or are not block-exempted. By being based primarily on a black-clause approach, i.e. defining what is not block exempted instead of defining what is exempted, it avoids the strait-jacket effect and facilitates the simplification of the applicable rules. The policy will ensure that the vast majority of vertical agreements where no significant net negative effect can be expected no longer require individual scrutiny. It will thereby allow the Commission and national competition authorities to concentrate on the important cases. It treats different forms of vertical agreements having similar effects in a similar way, preventing unjustified differentiation in policy between forms or sectors and avoiding a policy bias in the choice companies make concerning their formats of distribution. In order to maintain a sufficient level of legal certainty the Block-Exemption regulation will be supplemented by guidelines detailing the Commission's policy concerning individual examination above the market share thresholds and possible withdrawal of the Block-Exemption below the thresholds.

3. Structure of the present communication

This Communication has the following structure:

- Section II summarises the comments the Commission received on the Green Paper;
- Section III provides an economic assessment of vertical restraints and their effects;
- Section IV discusses the issues of market-share thresholds and legal certainty;
- Section V describes the proposed new policy;
- Section VI describes the procedural steps which will be followed to adopt the proposed policy.

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[4] Motor vehicle distribution is the only sector not covered by this exercise, see Green Paper on Vertical Restraints in Community Competition Policy, p. 2, footnote No 2.

SECTION II: SUMMARY OF REACTIONS TO THE GREEN PAPER

1. Written submissions on the Green Paper

The consultation exercise launched by the Green Paper produced 227 written submissions. A large majority (64%) of the submissions came from either companies or associations representing companies. Only 6 submissions were received from consumer organisations. Of the companies and associations of companies who made submissions, a large percentage (31%) came from either the beer or petrol sector. The primary concern of most submissions was legal certainty (37% of all submissions). Only 41 submissions (18%), mainly from academics and national authorities, placed their primary emphasis on the protection of competition.

Most submissions believe the current system to be too legalistic and favour a more economic approach. It is felt that an economic, effects-based approach rather than a clause-based approach would be more suitable for dealing with a dynamic sector such as distribution. The current system tends to produce negative effects on the evolution of distribution, preventing undertakings from introducing new and innovative distribution formats which could lead to substantial gains in terms of efficiency. Of those who commented on this issue 95% favour a more economic approach, while 97% believe that the current system has too much of a strait-jacket effect. Of those who commented on the competition effects of vertical restraints, 42% view vertical restraints as having primarily a positive effect on competition, while 50% are of the view that vertical restraints may have both positive and negative effects on competition. As possible negative effects, foreclosure and dampening of competition were mentioned, with the former being seen as the main problem.

While there is general consensus on the need for a more economic based approach, there is no agreement on how to implement such an approach. Nearly half (41%) of those that commented on market-share tests believe market shares to be a good indicator of market power. Most commentators however pointed out the difficulties of defining markets and assessing market shares. These difficulties were said to give rise to a high degree of legal uncertainty and the majority of those who commented did not favour a market-share cap. In the course of the consultation exercise, the support for the use of a market-share test increased, but companies asked the Commission to adopt sufficient flanking measures so as to make the market-share test operable.

In the Green Paper, five options were described, namely:

1. Option I: maintain the current system;
2. Option II: wider block exemptions without a market-share cap;
3. Option III: more focused block exemptions with a market-share cap of [40%];
4. Option IV-I: negative clearance presumption up to [20%] and above wider block-exemptions without a market-share cap; and

5. Option IV-II: negative clearance presumption up to [20%] and above wider block-exemptions with a market-share cap of [40%].

It was stated clearly in the Green Paper that the list of options proposed was not exhaustive. It is therefore not surprising that three other options have been proposed by several interested parties[5], namely:

6. An umbrella block-exemption: one wide block-exemption based on a blacklist approach and without market shares;

7. Guidelines: no block-exemption but only guidelines indicating how the Commission would apply Article 85 in individual cases;

8. A control-of-abuse system: all vertical restraints would be presumed *a priori* lawful, with the Commission having the power to suspend the positive presumption only with effect for the future.

Set out below is a statistical breakdown of support for the various options referred to above:

Options	In favour	Not in Favour	No comment
1. Option I (maintain current system):	16.6%	51.6%	31.8%
2. Option II (wider block-exemptions without a market-share cap):	46.2%	23.3%	30.5%
3. Option III (more focused block-exemptions with a market-share cap of [40%]:	6.7%	59.6%	33.7%
4. Option IV-I (negative clearance presumption up to [20%] and above wider block-exemptions without a market-share cap):	20.2%	59.5%	20.3%
5. Option IV-II (negative clearance presumption up to [20%] and above wider block-exemptions with market-share cap of [40%]):	8.1%	82.4%	9.5%
6. Umbrella Block-exemption without market shares	17%	4.9%	78.1%
7. Guidelines only	1.8%	10.8%	87.4%
8. Control-of-abuse system	10.8%	6.3%	82.9%

5 A number of other individual options were proposed, such as a foreclosure test based on market shares.

2. Public hearing

On 6 and 7 October 1997, the Commission organised a public hearing for industry and other interested parties on the Green Paper. Companies, associations, law firms, consumer organisations etc. who had made a written submission were invited to come to the hearing. Most Member States also sent observers, as did the EFTA Surveillance Authority, Norway, Iceland, and a considerable number of the Central and Eastern European countries.

There was a large element of consensus that market power and a reduction in inter-brand competition are the circumstances under which vertical restraints may have negative effects. There was similar consensus that the Commission should adopt a more economic approach to get away from the current legalistic strait-jacket. Most also considered that there is a link between market power and market share but stressed that they are not synonymous.

In the light of the increased legal uncertainty that a market share test would bring to those who currently benefit from existing BE Regulations, a large majority were against introduction of such a test to limit the applicability of block-exemptions. A limited number of commentators stressed that a market-share test would be feasible and is the best possible indicator of market power available. No alternatives were provided.

On the question of which vertical restraints should remain *per se* prohibited there was consensus that resale price maintenance and absolute territorial protection should not be covered by any block-exemption and should in most cases also not qualify for individual exemption. However, it was argued that individual exemption should not be completely excluded. At the hearing support was expressed to allow true maximum resale price maintenance, it being recognised that it is difficult to identify what a true maximum price is.

On the argument that vertical restraints can help to solve free rider problems, i.e. to ensure that the one who makes an effort is able to appropriate all the benefits the effort engenders, opinions were divided. At the hearing some argued that free rider problems occur quite often, especially through the actions of retailers outside the official dealer network. This was argued by representatives from amongst others the car, perfumes, petrol, consumer electronics and toy industries. They favoured action to stop 'leakage' from the system, including the power to ban parallel imports. However, it was not explained whether real free-rider problems were at the heart of the problem - that is that the outside retailers truly profit from the investments made by the network - or whether the issue was really one of trying to shut out certain retailers in order to reduce competition and increase prices. The latter argument was mentioned by several participants, including distributors and large retailers. These commentators stressed the vital importance of parallel imports to enable them to make use of price differences between Member States.

It was recognised that in order to achieve a more economic approach, a compromise has to be found between such an approach and legal certainty. A number of participants were of the opinion that most vertical agreements are innocuous from a competition point of view or are even pro-competitive. They therefore favoured either option II (wider block-exemptions), Option IV-I (the same in addition to a negative clearance presumption) or one very wide block-exemption, preferably with only black clauses. A few were in favour of a future policy using market share thresholds as in Option IV-II (block-exemptions with a market-share cap) or a foreclosure test based on market shares.

It was stressed that, in the event market-share tests were introduced, the Commission should provide as many flanking measures as possible to protect legal certainty. In particular, it was mentioned that the Commission should (1) provide guidelines on the application of the rules above the market-share thresholds, (2) solve the problem of automatic nullity under Article 85(2) where a company has failed to notify because it incorrectly assessed its market share, (3) possibly introduce a non-opposition procedure, and (4) reduce the burden of notification.

3. Opinions of the Community Institutions and of the Member States

The European Parliament

In its Resolution of 18 July 1997 the European Parliament notes that, apart from the *de minimis* notice, business is opposed to the use of a market-share approach and that this approach is not always the most efficient indicator of market power. It therefore calls on the Commission to examine the possibility of using other parameters. It stresses the need to secure legal certainty for SMEs so that voluntary retail chains are put on the same footing as large integrated groups, particularly in terms of a common pricing strategy. It also calls on the Commission to examine whether it is necessary to draw up a block-exemption regulation for selective distribution and asks for attention to be paid to the special commercial or financial advantages in beer supply and service-station agreements.

The Parliament expresses a preference for a system in which the vertical agreements of companies having less than 10% market share fall outside Article 85(1). Above this threshold, block-exemptions should leave more room for flexibility without disturbing the balance between the contracting parties. Above a certain market share threshold the benefit of a block-exemption should be easy to withdraw. Only if such an easy withdrawal procedure is not possible should the Commission consider creating block-exemptions that do not apply above a certain market-share threshold, and then only for companies with a significant turnover.

The Economic and Social Committee

In its Opinion of 4 June 1997 the Economic and Social Committee recognises that the current block-exemption regulations are too rigid and often difficult to interpret. Emphasis should be placed on the importance of market structure in assessing the effects of vertical restraints, together with the need to focus on the market impact, rather than the formal content of agreements. The Committee is in favour of expanding the block-exemptions to apply to upstream linkages in the supply chain between producers and suppliers of necessary inputs. The wider the coverage of the block-exemptions, the less the need for individual notifications of vertical agreements. It would also welcome the addition of a non-opposition procedure.

While not opposed to Option II (wider block-exemptions without a market-share cap) the Committee strongly recommends Option IV, Variant I (Option II with a negative clearance presumption up to [20%]). It has reservations about Option IV, Variant II (Option IV-I with a market-share cap of [40%]). However, if the Commission were able to introduce Option IV, Variant I, combined with extremely wide block-exemptions, then the Committee could see a

case for a procedural mechanism for monitoring vertical distribution agreements with high market shares.

Committee of the Regions

In its Opinion of 12 June 1997 the Committee of the Regions considers that the multi-faceted nature of the question of vertical restraints makes it difficult to select a single option which is not highly debatable for one sector or another. Whichever option is selected, agreements - such as those for beer - must be safeguarded. Views other than those of manufacturers and distributors should be brought into the process of assessing consumer benefit. In relation to Options III and IV, the introduction of market share thresholds only makes sense if these are expressed in terms of the entire Community market. The Committee believes that ultimately the option which should be selected is Option I.

Member States

All but one of the fifteen Member States made written submissions on the Green Paper. Many of these submissions were made on a preliminary basis. There was no clear consensus on the format of future policy in this area. With regard to the options set out in the Green Paper, none of the Member States expressed a preference for Option I or III, four gave a preference for Option II, three gave a preference for Option IV, Variant I, and two gave a preference for Option IV, Variant II. The remaining five Member States put forward other substantive options of their own. These may be summarised as follows:

1. a negative-clearance regulation providing that almost all vertical restraints would be deemed *a priori* lawful, irrespective of market share, with the Commission, national authorities and national judges having the power to declare the regulation inapplicable with retroactive effect if there is no effective competition or if there are high barriers to entry in the market;

2. a single block-exemption for all vertical agreements, with a market-share threshold of [25%]. Above this market share, agreements would be covered by the individual exemption system. Below this threshold, the Commission would have the power of withdrawal for problematic cases;

3. a negative clearance regulation with two market share thresholds. The first (25-40%) to indicate the market share level above which a company is likely to exercise substantial market power. The second (60-80%) to indicate the possible restrictions caused by companies with at least a 10-15% market share in case of a cumulative effect of parallel network agreements;

4. a single black-clause block-exemption. The exemption would apply irrespective of market share. The Commission would be able to ask for individual notifications. The block-exemption would confer provisional validity upon vertical agreements, which could be withdrawn only with effect for the future;

5. broader and more flexible block-exemptions, the application of which would be controlled, *a posteriori* by the national competition authorities.

The first element of general consensus amongst the Member States relates to the need to change the Commission's current policy on vertical restraints. It is recognised that the adoption of a more economic based approach would of necessity result in a system with less legal certainty for companies with market power who currently benefit from existing BE Regulations. The second element of consensus relates to the most recent economic literature, according to which vertical restraints should only be considered as capable of harming competition when they are linked to some degree of market power. The third element of consensus relates to the need for maintaining the importance given to the market integration objective in the assessment of vertical restraints, particularly in the light of future enlargement.

As a follow up to this consensus there appear to be two trends of thought. The first tends to simply promote the introduction of a level of flexibility within the existing system by reducing the regulatory approach of the current block-exemption regulations. A second approach is based on the need to adopt a real change in policy. This second approach has two major hypotheses. The first is based on maintaining the current prohibition system of Article 85. This system could be adjusted by the introduction of market-share thresholds. The aim of these thresholds would be to determine, on the basis of the market-power level, both the absence of grounds for the application of Article 85(1) and the field of application of a single, wide block-exemption covering all vertical restraints. The second hypothesis is based on a switch from a prohibition to a control of abuse system. This system would in effect grant almost all vertical restraints an *a priori* presumption of compatibility with Article 85(1), with the possibility for the Commission to withdraw this positive presumption with effect only for the future.

In the course of the consultation exercise, the positions expressed by the Member States on the Green Paper have evolved and led to a greater consensus on the policy proposal set out in this communication, i.e. one broad Block-Exemption regulation limited by one/two market-share threshold(s).

SECTION III: ECONOMICS OF VERTICALS

1. Vertical restraints and market power

As indicated in the introduction, economics tells us that in the field of vertical restraints competition concerns can only arise if there is insufficient inter-brand competition, i.e. if there exists a certain degree of market power. On the one hand, the fiercer the inter-brand competition is, the more likely it is that vertical restraints have no negative effect or at least a net positive effect. On the other hand, the weaker the inter-brand competition, the more likely it is that vertical restraints have a net negative effect. This means that the same vertical restraint can have different effects depending on the market structure and on the market power of the company applying the vertical restraint.

In economics, market power is usually defined as the power to raise price above the competitive level (in the short run marginal cost, in the long run average total cost). In other words, a company has market power if it has a perceptible influence on the price against which it can sell and if by charging a price above the competitive level it is able, at least in the short term, to obtain supra-normal profits. Most economists would agree that there exists market power below the level of dominance as defined by the Court of Justice. This view was also expressed in the Green Paper[6], to indicate that vertical restraints can harm competition below the level of dominance and therefore that Article 86 and merger control will not suffice. Article 85 needs to be applied to vertical restraints, in particular in oligopolistic markets where none of the individual companies hold a dominant position.

It is also generally recognised that vertical restraints are on average less harmful than horizontal competition restraints. The main reason for treating a vertical restraint more leniently than a horizontal restraint lies in the fact that the latter may concern an agreement between competitors producing substitute goods/services while the former concerns an agreement between a supplier and a buyer of a particular product/service. In horizontal situations the exercise of market power by one company (higher price of its product) will benefit its competitors. This may provide an incentive to competitors to induce each other to behave anti-competitively. In vertical situations the product of the one is the input for the other. This means that the exercise of market power by either the upstream or downstream company would normally hurt the demand for the product of the other. The companies involved in the agreement may therefore have an incentive to prevent the exercise of market power by the other (so called self-policing character of vertical restraints).

However, this self-restraining character should not be over-estimated. When a company has no market power it can only try to increase its profits by optimising its manufacturing and distribution processes, with or without the help of vertical restraints. However, when it does have market power it can also try to increase its profits at the expense of its direct competitors by raising their costs and at the expense of its buyers/consumers by trying to appropriate some of their surplus. This can happen when the upstream and downstream company share the extra profits or when one of the two imposes the vertical restraint and thereby appropriates all the extra profits.

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[6] Green Paper on Vertical Restraints in Community Competition Policy, point 303.

2. The negative effects

2.1. Individual vertical restraints

The negative effects on the market that may result from anti-competitive vertical agreements and that Community competition law aims at preventing are the following:

- foreclosure, either of other suppliers or of other buyers;

- the deterioration of price and non-price conditions available to consumers, either for one particular brand (reduction of intra-brand competition) or between different brands (reduction of inter-brand competition);

- collusion amongst suppliers or buyers facilitated by vertical restraints;

- the creation of obstacles to market integration, including, most of all, limitations on the freedom of the European consumers to purchase a good or service in any Member State they may choose.

Such negative effects may result from various vertical restraints. Special care is needed due to the fact that agreements which are different in form may have the same substantive impact on competition. To analyse these possible negative effects it is appropriate to divide vertical restraints into four groups: an exclusive-distribution group, a single-branding group, a resale-price maintenance group and a market-partitioning group. The vertical restraints within each group seem to have similar negative effects on competition.

Before describing the four groups a number of general points need to be made. First, the analysis applies to both goods and services, although certain restraints are mainly used in the distribution of goods. This is why throughout this text the term good(s) means both good(s) and service(s) unless otherwise stated. Secondly, vertical agreements can be concluded for intermediate and final goods and services. Unless otherwise stated the analysis and arguments in the text apply to all levels of trade and the neutral terms supplier and buyer are used. When only a specific level is implicated this is indicated. Thirdly, the classification is based upon what could be described as the basic components of vertical restraints. In practice many vertical agreements make use of more than one of these components. To give an example, exclusive distribution usually limits the number of buyers the supplier can sell to and often at the same time limits the area where the buyers can be active. The first component may lead to foreclosure of other buyers while the second component may lead to market partitioning.

Exclusive-distribution group

Under the heading of <u>exclusive distribution</u> come those agreements/components that have as their main element that the manufacturer is selling only to one or a limited number of buyers. This may be to restrict the number of buyers for a particular territory or group of customers, or to restrict the kind of buyers. This group comprises amongst others exclusive distribution and exclusive customer allocation as the supplier limits its sales to only one buyer for a certain territory or class of customers. It also comprises exclusive supply and quantity forcing on the supplier, where an obligation or incentive scheme agreed between the supplier and the buyer makes the former to sell on a particular market only or mainly to one buyer. This group