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Unfinished Business: The New Approach to Assessing Vertical Restraints

The publication of the EC Commission Guidelines on vertical restraints (hereafter "the Guidelines") represents a significant and substantive change in the competitive analysis of vertical agreements.[1] The Guidelines contain the rationale underpinning the new Block Exemption Regulation (BER), whereby firms with low market shares are granted an automatic exemption from Article. 81. They also contain an analysis of how the competitive effects of those vertical agreements that do not qualify for the BER will be assessed.

This paper addresses the economic rationale for the new approach to assessing vertical agreements. In general, the policy changes are to be welcomed. However, a number of issues remain and this paper also addresses a number of areas that raise practical issues. The practical issues can be divided into issues of implementation, for example, the definition of the relevant market and, more importantly, on-going policy issues. In the latter case, this paper provides an economic critique of the economic approach as it is set out in the EC Commission's Guidelines. A particularly important area for future policy debate concerns the treatment of dominant firms. The current Guidelines can therefore at best represent only a staging post on the road towards the stated goal of a coherent economic-based policy.

The remainder of this paper is organised as follows. First, it provides a brief background of the economic rationale of the new approach and considers the changes in economic thinking as applied to vertical restraints. This forms the background to the consideration of the economic principles that lie behind the Commission's approach and in particular why it is appropriate to take a more relaxed approach to vertical agreements than to horizontal agreements and why the market share threshold represents a sensible policy development.

The next part considers some of the policy issues that the new approach raises. On the practical implementation, the difficulties of defining the relevant market in the context of assessing vertical agreements are briefly considered. The main issues are the availability of information, the cellophane fallacy and whether competition authorities can be relied upon to apply a consistent approach.

The subsequent part provides an economic critique of the guidelines. Three areas are considered: the tension between inducing investment and promoting the single market; the tension between a dynamic analysis and a static analysis; and the issue of "double marginalisation". Finally, the proposed treatment of dominant firms is addressed. The Commission's current thinking on this issue appears to be one of denying any firm that would be held to be dominant from employing any vertical agreement. But as explained, such a policy is not justified by economics and no confidence can be placed in pro-competitive vertical agreements employed by dominant firms being held to fall outside the scope of Article 81(1).

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[1] http://europa.eu. int/eur-lex/pri/en/oj/dat/2000/c_291/c_29120001013en00010044.pdf[2]

The Economic Rationale for the New Approach

The approach embodied in the Guidelines represents a move away from the largely form-based system of appraisal towards an economic effects-based assessment in which the economic concept of market power plays (or ought to play) a key role.

In the past, an extremely wide interpretation has been given to Article 81(1) in which all vertical agreements were held to "prevent, restrict or distort competition". The compatibility of vertical agreements was then assessed under the criteria set out in Article 81(3). But from an economic perspective the distinction between Article 81(1) and Article 81(3) has always seemed (at least to me) rather artificial - either the vertical agreement gives rise to anticompetitive effects or it doesn't.[2]

The relevant question is therefore when is a vertical agreement likely to give rise to an anticompetitive outcome. Economic theory tells us that vertical agreements warrant a more benign treatment from competition authorities than horizontal agreements. Unlike horizontal agreements, vertical agreements typically occur between suppliers of complementary rather than competing goods and services, and consequently do not directly suppress head-to-head competition. Modern economic analysis no longer suggests that vertical restraints always improve efficiency and enhance welfare, a view often ascribed to the so-called Chicago School. The Chicago school views all vertical agreements as having one or more of the following effects: removing any downstream pricing distortion; optimising investment decisions; and eliminating avoidable transaction costs or ex *post* opportunistic behaviour. According to this view, any competition concerns arise from a lack of horizontal competition and not from any vertical agreements. But advances in economic theory have questioned this permissive approach to vertical restraints. Recent literature has shown that under certain conditions, vertical agreements can give rise to anticompetitive outcomes. The current consensus is that vertical restraints can give rise to genuine competition concerns, but only where market power exists either in the upstream or downstream markets. Unless at least one of the two parties to the vertical agreement possesses significant market power, the agreement will have a benign or even a positive impact on competition.

That consensus can be seen to form the basis of the new approach to assessing vertical agreements as set out in the BER. Essentially the 30% market share threshold states that firms with market shares below this threshold can be held not to possess significant market power and therefore any vertical agreement employed by such firms can have either only a benign impact on competition or be pro-competitive with benefits for consumers.[3]

Not only does the new approach introduce a more economically coherent approach to the competitive assessment, it also provides a clear filter for those situations where there can be no conceivable adverse impact on competition. As an example, consider the (hypothetical) situation in which a manufacturer with a 15 per cent share of a product market concludes a vertical agreement with a retailer who accounts for just 15 per cent of sales of those products in an economically meaningful geographic territory. Furthermore suppose that under the agreement the manufacturer agrees to sell exclusively through the retailer and the retailer agrees to buy exclusively from that manufacturer. Under the old "form-based" approach to Article 81, such an agreement would be said to prevent, restrict or distort competition. Unless the agreement could be tailored to fall within the scope of a block exemption, it would require an individual exemption under Article 81(3), a decision that would not have been forthcoming for many months.

Yet provided that the market has been correctly defined, this agreement can very quickly be seen not to raise substantive competition concerns. It would be hard for competitors or potential competitors of the manufacturer to argue that the retail network had been foreclosed to them if 85 per cent of the retail network lay beyond the scope of the agreement. Similarly 85 per cent of all manufacturing capacity

[2] For further discussion see Simon Bishop and Mike Walker: The Economics of EC Competition Law, London 1999, Sweet & Maxwell. Also see Valentine Korah: An introductory guide to EEC competition law and practice, 4th ed., Oxford 1990, ESC Publishing.

[3] Despite the logic of a market share threshold, a small number of so-called "hardcore" restrictions will remain prohibited regardless of market shares. With the notable exception of resale price maintenance, these are largely restrictions of the kind which have been found contrary to European competition law because of their perceived impact on the creation of a single market, rather than their propensity to suppress competition. Beyond these "hardcore" restrictions, the Commission has set out a list of clauses and combinations of clauses which will be presumed benign at market shares of below 20 per cent. A further set of clauses are presumed benign below 40 per cent.

would remain free to supply competing or potentially competing retailers.[4] It is also unlikely that an agreement concluded by such a small player could materially suppress inter-brand competition.

Now contrast this with the case where a firm controlling, say, 50 per cent of sales in a market signs an exclusive deal with a retailer distributing 40 per cent of such products. The potential foreclosure effect is much greater. While this agreement could be pro-competitive, it certainly warrants close scrutiny under competition rules. This approach was recently applied by the UK Office of Fair Trading in its assessment of Dixons agreement with Compaq and Hewlard Packard. The possibility of applying a filter will permit competition authorities to focus on those cases that raise genuine competition concerns.

But the new approach does not provide a *per se* prohibition on vertical agreements for those firms with market shares above 30%. Importantly, the BER stresses that whilst firms below the 30% threshold will benefit from the exemption, there is still no presumption of illegality above the market share threshold. In short, the competitive assessment of vertical agreements employed by firms with market shares exceeding 30% requires a case-by-case assessment. To the extent that this approach is followed it represents a coherent policy that is based on sound economic principles.

Issues of Implementation

However, although the principles underlying the new approach are sound, this does not mean that there are no outstanding issues to be debated and resolved. Indeed, there are a number of outstanding issues. There are issues raised by the practical implementation of the market share threshold. This unavoidably requires the definition of the relevant market. This, as those involved in competition policy know, is seldom a straightforward task.

The need to calculate market shares gives the definition of the relevant market a much more important role in Article 81 than was previously the case. In many respects, the economic assessment of the competitive impact of vertical agreements will become analogous to the approach adopted in the first phase of a merger.notification. The theoretical and practical basis for defining markets using the concepts of demand and supply-side substitutability is well established and the standard approaches used under the Merger Regulation can normally be transferred to the realm of vertical agreements. However, there are a number of issues. First, there is the issue of the availability of relevant information. While this "problem" arises in all cases of market definition, it can be particularly acute where vertical agreements being introduced represent a significant change in the organisation of the industry or concern the introduction of an entirely new product.[5]

Second, unlike merger inquires, the definition of the relevant market for assessing the competitive effects of vertical agreements will in many instances be subject to the cellophane fallacy. The cellophane fallacy arises since the use of observed industry data is only amenable to assessing the strength of competitive constraints at *prevailing prices.* But in many instances, the competitive constraints of interest in assessing vertical agreements will be the competitive constraints that exist at *competitive levels.* Ignoring the cellophane fallacy will likely lead to the relevant markets being defined too broadly and a return to the *ad hoc* approach based on physical characteristics will likely lead to relevant markets being defined too narrowly.

Finally, there is an issue of competition authorities adopting a consistent approach. A lack of consistency can arise both across competition authorities and also within. It is noticeable that despite the publication of the Commission's Notice on market definition, an unhealthy number of Commission decisions appear to pay scant regard to the principles that the Notice sets out.

Economic Critique

There are three broad areas where the economic approach set out in the Guidelines raises a number of issues. These are as follows.

- Inducing investments versus market integration?
- Dynamic or static analysis?
- Double marginalisation

[4] A caveat arises where many firms in the industry follow a similar policy, perhaps creating a *cumulative* effect that might foreclose entry. The Commission proposals discuss this problem, and suggest some tentative - but not very convincing - solutions.

[5] Strictly speaking, the first issue should only affect the competitive assessment. But given the prominence of market shares and the hostility towards firms with large market shares this is likely to be a significant issue.

Hindering Investment?

There are a number of situations in which vertical agreements can help to promote investment. These situations arise where vertical agreements can resolve either the "free-rider" problem or the "hold-up" problem. The free-rider problem occurs when firms benefit from the efforts of others and so gives rise to the possibility that other firms "free-ride" on those efforts. The hold-up problem occurs where investments are specific to the relationship. In the absence of ex *ante* contractual (i.e. vertical) agreements, there is scope for one party to seek to renegotiate terms *ex post.* In anticipation of such ex *post* opportunistic behaviour investment will be deterred unless appropriate vertical agreements can be put in place ex *ante.*

The free-rider problem is acknowledged in the Guidelines, but it is mainly discussed (see para. 108) in the particularly narrow context of the need for technical pre-sales advice or demonstration facilities (e.g. on a new mechanical product such as a hi-fi or a car). The reality is that free-rider problems can arise in many more settings than this. For example, where a manufacturer uses a number of different firms to distribute its product, each retailer may benefit from the promotional activities of other retailers without having to pay for them. In consequence of such free-riding, a retailer is unable to enjoy the full benefit of its sales effort and will therefore have reduced incentives to incur such effort. Consequently the retailer will sell less of the manufacturer's product. This is particularly the case where the reputation of the product is a major determinant of the demand for that product.

Thus, free-rider effects apply much more generally to vertical restraints than the classic textbook case of the pre-sales service for some technical product. By confining the scope of free-rider effects too narrowly (e.g. by arguing that free-rider effects apply only or primarily where the product is technically complex), there is a danger that the Guidelines eliminate potentially legitimate free-rider arguments.

A particular area where the new approach appears to be less inclined to accept the investment-inducing nature of vertical agreements occurs where there is a tension between "competition goals" and "market integration goals". The Guidelines, in common with the Commission's general enforcement of Community competition law, state that the Commission will not permit vertical measures that appear to partition or segment the European market. It is clear, however, that this commitment can conflict with the promotion of competition. The stance taken in the Guidelines ignores the fact that vertical restraints that "partition" the market provide distributors with the immunity from intra-brand competition that is necessary for important investments to be made and that prohibiting such vertical restraints can lead to some perverse outcomes.

For example, consider a distributor that wishes to promote the launch of a brand in a new Member State, where that brand has already been established in other Member States. In promoting the introduction of this brand into a new market, the distributor might be expected to make significant launch-related investments in advertising, education and product advice. Of course, such investments will not be made unless the distributor is able to reap the rewards in the form of a flow of income from sales of that brand in its allotted territory. Under this scenario, it is easy to see how the distributor's incentive to make those important investments would be undermined if, having achieved the successful but costly launch, distributors in other Member States where the brand has already been introduced could "free-ride" on those investments by entering the new market that has just been created by someone else's efforts.

Subject to the facts of any particular case, this scenario sets out a valid "free-rider" rationale for territorial protection. But the Guidelines are inherently hostile to any such interpretation. Clearly, the Commission's objective of creating a single European market is a deep one, but it is disappointing that the existence of a trade-off is not acknowledged in the Guidelines. Given the growth of Internet trading and website marketing, these conflicts between the promotion of competition and the attainment of a single market are likely to become an increasingly important issue in the near future.

Too Much Focus on Static Analysis

In many real world competitive markets, firms compete by innovating in order to maintain or improve their market position. In analysing the degree of competition in such markets, it is important not to limit the analysis to static issues, but also to take into consideration such dynamic competition considerations. The Guidelines give some attention to dynamic competition arguments. For example, para. 108 of the Guidelines briefly mentions the possibility of dynamic effects: "The reduction in inter-brand competition [from single branding] may be mitigated by strong initial competition between suppliers to obtain the single branding contracts."

In general, however, the Guidelines are suspicious and/or hostile towards any motivations for vertical restraints that involve increased differentiation or the creation of competitive advantage. For example, the Guidelines imply that vertical restraints in agreements relating to branded goods are in general more harmful than those affecting the distribution of non-branded goods. This seems to be motivated by a view that, since branding tends to increase product differentiation and reduce the substitutability of one product for another, this reduces elasticity of demand and increases the opportunity to raise price.

This framework is implicitly based on assumptions attaching more importance to static than to dynamic efficiency, and equating attempts to differentiate with anti-competitive behaviour. This is a problem when it comes to markets where competition takes the form of pursuit of competitive advantage through branding. In such markets, attempts to seek differentiation are essential elements of competition and consumer welfare.[6]

Double Marginalisation

Oddly, there is little if any explicit recognition of the double-marginalisation problem in the Guidelines, even though this is a mainstream economic argument in favour of vertical restraints. The double-marginalisation problem arises as a result of poorly aligned incentives between manufacturer and distributor, and results in higher prices, lower sales and lower profits, with the result that both consumers and firms lose.

The problem arises where a manufacturer's incremental production costs are small relative to average costs. This is bound to be the case in branded goods industries that face high fixed costs of manufacturing plant, R&D and marketing expenditures. In such circumstances, incremental sales volumes contribute strongly to overall manufacturing efficiency and to profitability. Consequently, suppliers face very strong incentives to achieve incremental sales, and have an incentive to use vertical restraints to influence the decisions of distributors and retailers in order to reflect these incentives.

Consider as an illustration the case where a supplier sells to a retailer at a standard price of 10. The supplier's incremental cost of supplying an extra unit to the retailer is 5, so the extra unit sold yields a profit contribution of 5 to the supplier. Meanwhile, the retailer earns a gross margin of 1, selling on to the retailer at 11.

Suppose the supplier now sees an opportunity to increase its sales by cutting its price to retailers to 10.9. That represents a 10% reduction in the retailer's gross margin, so the retailer will implement the price cut only if it expects a sales volume increase of more than 10%. It is unlikely that demand elasticity will be this high (since the price cut to the retailer from 11 to 10.9 is less than 1%). Let us assume the actual volume increase would be 5%, insufficient to persuade the retailer to make the cut in its gross margin.

However, the supplier would like to find a way to encourage the retailer to implement this price reduction, since every extra unit sold yields a high 50% margin to the supplier - a benefit that the retailer's profit calculation did not take into account.

The problem is how to devise a method of contracting with retailers that reflects these advantages to the manufacturer, and to provide the downstream firm with incentives to seek incremental sales expansion opportunities. This cannot be achieved using standard wholesaler contracts with simple linear payments, but it can be facilitated through various forms of vertical restraints such as non-linear prices and payments to the retailer in return for services provided. Alternatively, the problem can be addressed through long-term arrangements between the parties that use concepts such as "implicit contracts" or "partnership" agreements to discourage short-term opportunism and encourage the parties to act in their long-term best commercial interests.[7]

Given that the desire to resolve double-marginalisation problems lies at the heart of many commercial agreements and this is the basis for much of the economics literature on vertical agreements, it is surprising that the Guidelines give little or no explicit recognition of this important pro-competitive justification for vertical restraints. Indeed, on this subject the Guidelines appear to be schizophrenic. In

[6] Of course, it is not only branding.that creates this kind of dynamic competition. The same arguments apply to any markets in which intellectual property, R&D and technical change play a strong role.

[7] It can also be achieved through vertical integration.

paragraph 100, the Guidelines state that "the exercise of market power by either the upstream or the downstream company would normally hurt the demand for the product of the other. The companies involved in the agreement therefore usually have an incentive to prevent the exercise of market power by the other". This appears to be recognition of the existence of the problem of double marginalisation. But elsewhere the Commission has dismissed double marginalisation as a "textbook problem" that is of "limited practical significance". Such a view is without foundation.

The Treatment of Dominant Firms

A particularly important and immediate issue raised by the Guidelines is the treatment of firms held to be dominant. Given the standard market share threshold for establishing dominance, it is clear that dominant firms will not benefit from the BER. While it is appropriate that dominant firms are not able to benefit from an automatic exemption from Article 81(1), the Guidelines go much further, and appear to take the stance that dominant firms *cannot* even obtain an exemption for their vertical restraints under Article 81 (3): "Where an undertaking is dominant or becoming dominant as a consequence of the vertical agreement, a vertical restraint that has appreciable anti-competitive effects can in principle not be exempted."[8]

Such an approach denies dominant firms from engaging in certain contractual mechanisms, irrespective of their efficiency properties.

The Guidelines' reasoning on this point appears to be motivated by a belief in a consistent trade-off between inter- and intra-brand competition. However, if there is an absence of inter-brand competition, that failure is generally not solved by increasing intra-brand competition - making retailers compete more fiercely does not generally resolve a lack of competition between manufacturers. Similarly, there is no general presumption that restrictions on intra-brand competition will weaken inter-brand competition.

It is true that, where there is vigorous inter-brand competition, there is no reason to be concerned about vertical agreements that diminish intra-brand competition. But the Guidelines then extend this to argue, mistakenly, that where inter-brand competition is ineffective (e.g. where there is a dominant firm) vertical restraints cannot be permitted if they restrict intra-brand competition. This fails to acknowledge that dominant firms have many of the same pro-competitive rationales for implementing vertical restraints as non-dominant firms. The difference between them is that, in the presence of market power, it is also possible that the firms might be able to use restraints on intra-brand competition to achieve an anti-competitive outcome (e.g. market foreclosure). But this is not the same as saying that *all* vertical agreements will have such anti-competitive effects.

The rational way to deal with this situation is to identify the possible anti-competitive effects of vertical restraints when they are employed by dominant firms, and to subject those firms to critical scrutiny when they implement such restraints.[9] But there is no justification for the Guidelines' suggestion of an a priori ban.

Although strictly, dominant firms still have the option to argue that their agreement falls outside Article 81(1) on the grounds that it does not restrict competition in the first place, this should provide little or no comfort to these firms. Given the historical view of what constitutes a restriction or distortion of competition, it must be considered unlikely that competition authorities will hold that a vertical agreement employed by a firm held to be dominant does not have such effects.

Substantive problems will arise in this area in industries where a particular form of vertical restriction is clearly an efficient mechanism and is applied by all suppliers in a market. If one such supplier were deemed to be dominant, it would distort competition to deny that supplier the opportunity to practise the restraint in question whilst others remained free to do so.

There is also an important issue concerning the consistency of the Commission's approach under Articles 81 and 82. It would be perverse if a vertical agreement that imposed some restraints on intra-brand competition was banned whilst the same firm remained free under Article 82 to adopt a vertically integrated structure in which its downstream operation was completely "exclusive" to the upstream sister company that gave rise to precisely the same

[8] Guidelines, paragraph 135.

[9] Of course, the Commission has the ability to use either Article 81 or Article 82 to conduct this analysis.

economic effects. As was recently confirmed by the *Oscar Bronner* ECJ Judgment, even dominant firms are (under certain conditions) permitted to engage in exclusive in-house distribution that preserves their competitive advantage. It would be perverse indeed to force dominant firms towards vertical integration as the only way to avoid an unduly harsh Article 81 regime.[10]

Market Share Thresholds and the Use of "per se" Rules

A *per se* approach whereby certain specified behaviour (for example, the adoption of vertical restraints, or of certain discount structures by dominant firms) is prohibited places undue weight on the appropriate definition of the relevant market. In particular, it requires that the correct relevant market can be easily and unambiguously defined. As noted above, this is not always or indeed often the case. Clearly, the *per se* approach can reach quite different conclusions depending on what market definition is adopted. There will often be two or more plausible definitions of the relevant market. (By plausible, we mean that the market definitions are consistent with the standard approach to market definition as contained in *inter alia* the Commission's Notice on market definition). As noted above, in many cases the available evidence will be inconclusive as to which plausible relevant market definition is most appropriate, often due to the existence of the so-called *Cellophane fallacy."* Moreover, it is disingenuous to argue that market definition plays only a minor role in the establishment of dominance.

Due to these difficulties, a *per se* approach will result in many flawed decisions in which pro-competitive vertical restraints are prohibited in some cases while in others those with anti-competitive effects are permitted. The only way in which the incidence of such flawed decisions can be reduced is by placing less emphasis on market definition and market share calculations, and undertaking a more detailed assessment of the actual competitive effects of the vertical restraint in its particular context.

The unhealthy emphasis placed by the Guidelines on market share is also inconsistent with the Commission's stated desire to move towards an effects-based policy. A robust effects-based policy requires an evolving case law to aid the interpretation of the law; and that in turn requires reasoned and published decisions. But as the Guidelines currently stand, investigations involving a detailed decision would be required only for those firms that have a market share of between 30 per cent and 40 per cent. Vertical agreements entered into by all other firms are either automatically exempt (those with market shares below 30 per cent) or automatically assumed anticompetitive (those with market shares above 40 per cent). This will artificially reduce the number of decisions and encourage firms, their advisers and the Commission to engage in unproductive disputes about market definition when what is really required is a proper in-depth analysis of when and why vertical restraints can harm competition and consumers. A successful enforcement policy on vertical restraints would be one where firms employing pro-competitive vertical restraints were relatively relaxed about whether they qualified for market share "safe harbours" because they had confidence in the Commission's economic analysis in those cases that fall outside the scope of the BER.

Conclusions

The new approach to assessing the competitive effects of vertical agreements is to be welcomed. For too long, European competition law on vertical restraints has been dominated by the "block-exemption dependency culture" that has stifled discussion about economic effects and cut down the number of reasoned decisions the Commission has been forced to issue.

There is however a long way to go before a fully coherent policy on vertical agreements is developed, and this paper has highlighted some areas where the current views on the application of the new approach are either misconceived or incomplete. In particular, there remains a danger that the number of decisions will be stifled by excessive reliance on market share tests. Under the new regime, there should be a strong onus on the Commission and national competition authorities both to develop and extend the economic thinking contained in its Guidelines and to produce reasoned decisions that set out what agreements will be viewed as acceptable and those which will not.

[10] See Simon Bishop and Derek Ridyard: Oscar Bronner: Legitimate Refusals to Supply, in: John Grayston (ed.): European Economics & Law - Competition, Trade and the Single Market, Poole 1999, Palladian Law Publishing.

[11] See Simon Baker and Simon Bishop: Market definition in monopoly and dominance cases, OFT Economic Research Paper No. 2,2001.