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Pro-Competitive Exclusive Supply Agreements: How Refreshing!

On 28 May 2002 the Dutch Competition authority (NMa) published a decision in which it permitted Heineken, the large Dutch brewer, to insist on exclusivity when supplying draught pilsner beer to those pubs and other licensed outlets ("on-premises") to which it provided financial and commercial support.[1] This is one of the first formal decisions to apply the approach set out in the EC Commission's Block Exemption Regulation (BER) on vertical restraints.[2]

Under the BER, vertical agreements entered into by firms with market shares below 30 per cent gain automatic exemption from the Article 81 prohibition. This market share threshold is intended to eliminate the regulatory burden from those firms that, to put it starkly, are unable to act anti-competitively even if they wanted. As such, it is welcomed by those who wish to see a more economic effect-based approach to Article 81 enforcement. But many of the interesting economic and policy issues relate to agreements entered into by firms like Heineken, which supplies over 50 per cent of draught pilsner to on premises in the Netherlands, who cannot benefit from the BER.

This Brief assesses the economic analysis conducted by the NMa in the Heineken case.[3] The robust approach taken by the NMa in this case potentially paves the way for a new trend in the application of Article 81.

Overview of the new Heineken beer contracts

Heineken and other brewers in the Dutch market provide financial and commercial support (normally in the form of loans) to on-premise outlets. This financial support is used for a variety of purposes including underwriting the lease of the on-premise or investments in its refurbishment. Brewers, in contrast to banks or other finance providers, are able and willing to provide such loans because they are better placed to monitor the business risks associated with operating an on-premise outlet, and they also stand to benefit from successfully nurturing the growth of an on-premise's business through higher beer sales.[4]

However, the provision of this financial support raises the scope for free-riding. Since the new investment in a particular outlet enhances its beer sales, that financial support potentially benefits competing suppliers of draught pilsner. In the absence of exclusivity in the supply of draught pilsner, other brewers would be able to free-ride on their competitor-financed investment by also supplying draught pilsner to that outlet.[5]

Prior to the implementation of the BER, Heineken and other brewers had in place exclusive long term (typically 5 or 10 year) supply contracts with on-premise outlets that covered all types of beer, whether supplied in draught or in bottles or cans.[6] Following the implementation of the BER regime, Heineken was no longer able to enter automatically into such supply arrangements, though competing suppliers were free to continue to do so because their market shares fell below the 30 per cent threshold. Heineken therefore introduced new supply agreements under which the financial support provided to on-premises was granted in return for exclusivity in respect of the supply of draught pilsner. These new agreements could be terminated at any time, subject to two months' notice, and subject to the repayment of any outstanding loans.[7]

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NMa decision of 28 May 2002, Case 2036/Heineken – Horecaovereenkomsten.

2

Commission Regulation (EC) No 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, OJ L 336, 29.12.1999, p21 and the Commission Notice - Guidelines on Vertical Restraints, OJ C 291, 13.10.2000, p1. The NMa examined Heineken's agreements under Articles 6 and 17 of the Dutch Competition Act which are equivalent to Articles 81(1) and 81(3) respectively.

3

RBB partners advised Heineken in the course of the NMa investigation.

4

Economists would refer to this beer sales pay-off as a "positive externality", similar in kind to the pro-competitive effects associated with vertical integration.

5

Where a brewer makes an investment that is specific to a particular on-premise, this also raises the scope for ex post opportunistic behaviour by pub owners – the so-called hold-up problem. Exclusivity also offers protection against such opportunistic behaviour.

6

Beer contracts used to fall under Commission Regulation 1984/83, which was replaced by the new BER from 1 January 2000 onwards.

7

Heineken also sought to impose exclusivity on those outlets in which it installs cellar tanks and on those outlets that were owned by Heineken.

Economic assessment

The NMa was required to conduct a detailed assessment of the likely economic effects of these new arrangements and reach an individual decision on them. The main competition concern associated with exclusive supply agreements is the risk that denying competitors access to certain outlets will result in those firms being foreclosed from the market, thus harming competition. Although exclusive supply agreements by definition result in other firms being "foreclosed" from selling to the particular outlet in question, that does not necessarily imply that these suppliers are foreclosed from the market. Crucially, the NMa recognised that assessing whether exclusive supply agreements give rise to market foreclosure requires an analysis of their effects at the level of the market as a whole. Did Heineken's new agreements prevent other brewers from competing to gain access to a sufficient number of outlets?

It was clear to the NMa that, despite Heineken's high market share, they did not. In 2000, there were over 45,000 on-premise outlets in the Netherlands. Almost half of these outlets, representing over 40% of on-premise beer sales volume, had no ties with any brewer (either exclusive agreements or ownership)[8]. So there were plenty of retail outlets available to rival suppliers.

8 See paragraph 91 of the NMa decision.

Moreover, the NMa found that even those on-premises supplied exclusively by Heineken were contestable. Evidence showed that a significant number of outlets switched beer supplier when contracts came up for renewal. Historically, such switching opportunities arose only periodically, on expiry of a long term contract, but since Heineken's new agreements (in contrast to those of competing beer suppliers) allowed on-premise outlets to terminate their contracts at any time, they would in future be continually open to competition from competing brewers.

Finally, since the exclusivity in Heineken's new agreements applies only to draught pilsner, the NMa observed that even those on-premise outlets who signed up with Heineken could be supplied by competing brands. On average, draught pilsner accounts for approximately 80 per cent of the total beer volume sold through on-premise outlets, so the remaining 20 per cent, comprising other draught beers and bottles or cans, provides yet another alternative route to market for competitors.

The NMa also considered whether Heineken's supply agreements had an adverse effect on inter-brand competition within a particular on-premise outlet. Consumer research showed that consumers when ordering pils typically did not specify a brand such as "Heineken", "Grolsch" or "Bavaria" by name but simply ordered "pils". Further evidence that consumers were not brand sensitive in their ordering patterns within a given on-premise outlet is provided by the fact that even those on-premise outlets that were not subject to exclusivity agreements chose to stock only one brand of draught pilsner.[9] Had the NMa chosen to object to this restriction of brand choice within an outlet, it would in any event have been inconsistent to confine that concern to Heineken, since the same restriction applies wherever an outlet offers only a single brand. Indeed, since Heineken's market share indicates that it is clearly the most popular brand in the Netherlands, any consumer detriment from not providing brand choice would be more likely to arise from those outlets that choose to be exclusive to a beer brand with a smaller market share.

9 The fact that consumers are not brand-sensitive also makes it easier for on-premise outlets to switch between different beer suppliers.

In summary, the NMa concluded that exclusivity restrictions inherent in the new Heineken arrangements did not amount to a restriction of competition.

Dominant firms and pro-competitive vertical restraints

In view of Heineken's high market share, the NMa's decision provides useful indications of how the competitive effects of vertical restraints employed by firms with high market shares are to be examined. While it is appropriate that vertical restraints employed by firms with significant market shares do not automatically benefit from the BER, this is not the same as preventing dominant firms from ever employing any vertical restraints. Indeed, the Heineken case provides a clear instance in which a vertical restraint employed by a firm whose market share would normally raise prima facie concerns about dominance can be pro-competitive.

According to the Guidelines, however, dominant firms are unable to obtain an exemption under Article 81(3).[10]

> "… 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. The vertical agreement may however fall outside Article 81(1) if there is an objective justification …"

This approach implies that the only way in which a firm held to be dominant can employ vertical restraints is if those restraints fall outside the scope of Article 81(1).[11] This is precisely the approach adopted by the NMa in its decision.

In assessing whether Heineken's agreements fall outside the scope of Article 81(1), the NMa stresses the importance of examining the overall impact of those agreements on competition and notes that such an assessment cannot be inferred from a firm's market position:

> "The position of Heineken on the relevant market is of importance because the stronger that position is, the larger is the risk of anti-competitive effects. … The question whether Heineken has a dominant position (and whether exclusivity in that case is objectively justifiable) is only relevant, if it can be established that the agreements can have appreciable anti-competitive effects."[12]

In other words, the fact that a firm might be held to be dominant does not necessarily imply that the vertical agreements which it employs give rise to appreciable anticompetitive effects. In this particular instance, for the reasons outlined above, the NMa found that whilst Heineken's market position justified individual scrutiny, its new supply agreements did not have anticompetitive effects and, given the NMa's inability to grant an Article 81(3) exemption, consequently concluded that they fall outside the scope of Article 81(1).[13]

Is Article 81(3) becoming redundant?

The NMa's approach adopts a narrower and more economic interpretation of when an agreement can be said to restrict or distort competition than that traditionally adopted by the EC Commission, which usually views almost any restriction agreed between two firms as falling within the scope of Article 81(1). Indeed, it is this wide interpretation of Article 81(1) that made block exemptions necessary to reduce the log-jam of notified agreements. The NMa's approach is not only more in accordance with an economic interpretation as to when an agreement can be said to restrict or distort competition but is also more in line with that adopted by the Courts (see for example, the Court of First Instance's European Night Services judgment).[14]

This more robust interpretation of Article 81(1), however, calls into question whether Article 81(3) has much of a role to play in the analysis of vertical agreements.[15] Even if formally the BER grants those firms with market shares below 30 per cent an automatic Article 81(3) exemption, the reality is that those agreements are deemed acceptable only because the firms in question do not possess significant market power and therefore are incapable of entering into anticompetitive vertical agreements. Such agreements might therefore be said to fall outside the scope of Article 81(1). Moreover, for most firms lying outside the scope of the BER, the Guidelines' approach carries no hope of an Article 81(3)

10 Guidelines, paragraph 135.

11 See Bishop and Ridyard, "EC Vertical Restraints Guidelines: Effects-based or per se Policy?", European Competition Law Review (2002) and the reply of Peeperkorn in the same issue on the appropriateness of denying dominant firms an exemption under Article 81(3).

12 See paragraph 85 of the decision, RBB translation from Dutch.

13 Paragraph 119 of the NMa decision.

14 The CFI held that agreements between several European railway undertakings to provide passenger rail services between the United Kingdom and the Continent did not infringe Article 81(1).

15 The roundtable discussion reported in Ehlermann and Atanasiu, "European Competition Law Annual 2000: The Modernisation of EC Antitrust Policy", Hart Publishing (2001) discusses this issue form both legal and economic perspectives.

exemption. But it is an established economic fact that even dominant firms may enter into vertical agreements that do not give rise to any appreciable anticompetitive effects. Effectively denying the possibility of an Article 81(3) exemption for dominant firms forces regulatory agencies to undertake any substantive competitive assessment of the type observed in the Heineken decision in the context of Article 81(1).

Furthermore, if it is accepted that Article 81 analysis of vertical agreements collapses in effect to a single-stage assessment of whether the agreement is anticompetitive, then the distinction between Article 81 and Article 82 in this area also becomes blurred. Perhaps the only difference is that, through the BER approach, the regulatory agencies have ensured that the vertical agreements of firms with market shares as low as 30 per cent (i.e. somewhat short of traditional dominance territory) potentially require competition law intervention.[16]

16 Although of course, it ought to be harder to make a case against a firm whose share only just exceeded the 30 per cent threshold than one whose market share is 60 per cent, say.

Conclusions and implications

The mark of a successful effects-based regulatory regime on vertical agreements would be one in which firms and their advisers were able to move away from an unhealthy dependence on formalistic block exemptions, and instead felt assured that the legal treatment of an agreement would depend on whether it had a harmful effect on competition. The NMa's decision in the Heineken case marks a real move in this direction. It shows that even a firm with a market share well in excess of the 30 per cent BER threshold can adopt agreements that bind customers to real and meaningful exclusivity, sufficient to protect their investments, without that necessitating a concern about market foreclosure or restrictions in choice.

The NMa's competitive analysis in the Heineken decision provides an important clarification as to the assessment of vertical agreements falling outside the scope of the new BER. The fact that Heineken enjoys a high market share required, quite reasonably, the regulatory authority to make a detailed assessment of the effects of that firm's new exclusive distribution arrangements on competition. But in denying the possibility of dominant firms gaining an individual exemption from Article 81, the BER regime has forced the NMa to conduct its detailed analysis of the economic effects of these agreements within the confines of Article 81(1). Such an approach has much to commend it. Although one decision by a single national authority does not in itself mark a revolution in Article 81 enforcement, it is a step in the right direction in aligning the Guidelines' approach to dominant firms with economic reality. As Heineken's marketing department might put it – "How Refreshing!"