Comments on proposed changes to EC Commission Guidelines on Vertical Restraints

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RBB | Economics

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Executive Summary

RBB Economics welcomes the opportunity to comment on the proposed amendments to the Block Exemption Regulation (BER) and the associated Guidelines on Vertical Restraints (the July 2009 draft). Our main points are as follows.

It is important to place the role of the BER in context. Formally, a BER should be used to provide a safe harbour of legality for agreements that would presumptively have benefits for consumers that outweigh an appreciable restriction of competition. Where no such restriction exists, an agreement should not be caught by Article 81 at all. However, in practice, due to a historically overly-inclusive notion of what constitutes a restriction of competition, firms look to BERs as their first port of call to provide assurance that their agreements are lawful, even if the prior question ought to be whether their agreements are anti-competitive in the first place. Put differently, many of the situations where the Guidelines presume that the Article 81(3) criteria would apply, in practice are cases where the vertical agreement in question has no real potential to be anti-competitive and so should not be caught by Article 81(1). In short, where parties to a vertical agreement have no market power, the agreement is benign or pro-competitive (absent cumulative effects).

For this reason, agreements that fall outside the BER will in many cases be discouraged even if there is an arguable case that such agreements do not fall within Article 81(1) or even that they would qualify for an individual Article 81(3) exemption. Hence, the content of the Guidelines has a real impact on the way in which businesses active in the European Union arrange their commercial conduct. If the BER is drawn too narrowly such as to exclude restrictive agreements that would be pro-competitive, that is likely to have a harmful effect on economic efficiency and consumer welfare.

In section 2 we address the Commission's proposal to extend the 30% share threshold to both the supplying and buying party to a vertical agreement. While much of the debate has focused on how practical it is for the supplier to assess the downstream share(s) of its buyers in potentially many different product and geographic markets, our principal issue is whether economic theory provides strong support for the adoption of a more interventionist approach. To answer this question we consider the main theories of harm usually associated with vertical agreements (customer foreclosure, input foreclosure, and competition dampening and cumulative effects) and the need (or not) for a downstream market share cap. We conclude that a 30% cap on the market share of the upstream firm is a sufficient safe harbour and that there is no compelling reason to include an additional downstream share cap as well.

Given that the new requirement to meet a downstream market share threshold significantly reduces the scope of the BER, we believe it should be incumbent on the Commission to provide compelling empirical evidence of harmful anti-competitive conduct that has slipped through the net of the existing BER and caused harm to efficiency and consumers. In the absence of any such evidence, we do not agree that the Commission has made a valid case for the proposed reduction in scope of the BER.

In section 3 we discuss hard-core restrictions, focussing in particular on passive sales, the internet and RPM. From an economics perspective, hard-core restrictions are unappealing; where the parties concerned have no market power, a vertical agreement (whether hard-core or not) would not create or enhance market power. Hard-core restrictions create the paradoxical situation where firms operating at different levels in the supply chain would be free to merge but are constrained in their ability to strike a (less restrictive) vertical agreement. Such a policy position is nonsensical.

We recognise that in principle hard-core restrictions could pass the Article 81(3) exemption criteria although it is not clear whether this is more likely to be the case in the new regime as the Guidelines indicate that hard-core restrictions are presumed unlikely to meet the Article 81(3) criteria irrespective of market share.[1] We welcome the recognition that minimum RPM can give rise to efficiencies. However, we are concerned with the revised Guidelines' approach to hard-core restrictions that relate to internet sales. First, the distinction between active and passive is unclear (and is shifting over time) given modern day techniques used by internet sellers to reach customers. Second, the revised Guidelines seek to micro-manage the behaviour of firms that are unlikely to have market power by introducing highly prescriptive requirements that arbitrarily discriminate in favour of the internet channel.

In section 4, we discuss the new sections on upfront access payments and category management agreements which are aimed at giving guidance for firms that fall outside the 30% market share thresholds. In our view, these sections provide little helpful guidance. Specifically, the revised Guidelines devote substantially

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The Commission now explicitly recognises that 'hard-core' restraints can give rise to efficiencies, although it is not clear how material a change this represents given that in the old regime hard-core restrictions could be exempted if they met the Article 81(3) criteria. If the Commission wishes to signal a more permissive approach to hard core restrictions it should say so explicitly.

more space to theories of harm than to efficiencies; yet fail to make clear that the theories of harm covered would be relevant only in limited special cases. The Guidelines therefore send out the wrong message – one that suggests upfront access payments and category management agreements are more harmful than they are likely to be in practice. In particular, the revised Guidelines should acknowledge that such arrangements are an established part of the commercial environment in manufacturer-retailer relationships and that, as a general rule, buyers do not wish to reduce competition among their suppliers other than in some very special cases.

In section 5 we comment briefly on efficiencies. We welcome the discussion of the vertical externality issue and note that this is not simply about price but relates to the fundamental point that vertical agreements allow firms to replicate some of the benefits of vertical integration, without having to discard entirely the benefits of market transactions. However, we believe that the revised Guidelines go too far in stating that long term single branding agreements (exceeding five years) will rarely give rise to efficiency benefits that outweigh their foreclosure effects.

We conclude, in section 6, that legal safe harbours must strike the right balance between facilitating the investigation of anti-competitive agreements while promoting beneficial agreements. The proposed changes to the Guidelines give rise to a less permissive regime than before – in particular due to the addition of the downstream market share threshold. This suggests that the Commission has become more concerned about the potential anti-competitive effects of vertical agreements. However, we query whether the experience gained from the operation of the 'old regime' or developments in economic theory provide the basis to support such a change in policy or indeed are consistent with developments in the Commission's practice towards non-horizontal mergers, as set out in the Non-horizontal Merger Guidelines. We are concerned therefore that the 'new regime' will harm end customers by deterring pro-competitive agreements without substantially improving the likelihood of preventing anti-competitive agreements.

2

The introduction of a downstream share threshold

The BER has been amended so that an agreement may benefit from the legal safe harbour only if the downstream party's market share is less than 30%.[2] This threshold is in addition to the current 30% cap on market share of the upstream firm (i.e. the 'supplier').[3] In short, a necessary condition to benefit from the safe harbour is for the agreement to be between firms with less than 30% in their respective relevant markets.

While there has been much debate about how practical it is for the supplier to assess the downstream share(s) of its buyers in potentially many different product and geographic markets, our principal issue is whether or not economic theory provides strong support for the adoption of a more interventionist approach.[4] To answer this question, the following sections consider the three main theories of harm usually associated with vertical agreements:

- customer foreclosure
- input foreclosure
- competition dampening[5]

2.1. Customer foreclosure and single branding agreements

The standard concern with customer foreclosure is that a distributor (D1) agrees to source (almost) exclusively from a supplier (say S1). D1 is an important distributor and so preventing other suppliers from selling through D1 means that rival suppliers may suffer a loss in scale economies so that their unit costs increase. This causes these rival suppliers to offer worse terms to other distributors thereby creating or enhancing the market power for S1. This may lead to anti-competitive effects if end customers ultimately suffer (e.g. because increased market power upstream feeds down through the supply chain in the form of higher prices). The relevant theories of harm in the academic literature concern (near) monopolists in the upstream market as opposed to firms with little or no market power.[6] However, even here, harmful effects are not inevitable – where the agreement leads to D1

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See paragraph 23 of the July 2009 draft.

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We note that in the old regime, the 30% cap applied to the buyer's share of purchases in the upstream market for a special case of exclusive supply agreement where there is only one buyer in the Community (paragraph 21, 2000 Guidelines).

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Nonetheless, our experience of providing compliance advice suggests that there will be many cases where suppliers do not have sufficiently detailed information on downstream markets to derive robust estimates of downstream shares.

5
An extreme form of vertical agreement is a vertical merger. Thus these theories of harm may also arise with vertical mergers (although we note that in recent times the focus has primarily been on input foreclosure).

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We acknowledge that a firm with substantial buyer power could harm competition. However, this could be addressed under Article 82. See also section 4 below for a discussion of buyer power theories of harm.

benefiting from efficiencies that encourage it to offer lower prices, consumers may gain overall.[7]

Where customer foreclosure is the concern, it is clearly important to consider whether the distributor covered in the single branding agreement is a particularly important route to market and its market share may well be relevant to this question.

However, the source of the harm is the creation or extension of S1's market power and harm is far more likely to occur where there is pre-existing upstream market power.[8] For this reason, to focus on the supplier's share alone should be sufficient. If the supplier's market share is below 30%, it is reasonable to presume that the agreement will not cause S1 to reach a position of substantial market power in which its single branding agreement might have anti-competitive effects. Moreover, should that case arise, S1's share would persistently exceed 30% and so S1 would fail to benefit from the Article 81 safe harbour and – if the increment in share were large enough – potentially fall within the Article 82 prohibition.[9]

2.2. Input foreclosure and exclusive supply agreements

The need for the 30% buyer market share threshold may also be assessed in relation to exclusive supply agreements. A useful starting point is to note that as long as there is sufficient inter-brand competition, then the fact that one brand is sold exclusively by one retailer should not matter – other retailers should have sufficient choice of alternative products. To give an example, consider a hypothetical supermarket 'Superco' which has a share of grocery sales in excess of 30%. If the supermarket offers a private label brand of, say, an orange flavoured drink, it would be hard to believe that the fact that 'Superco Orange' was sold exclusively in Superco harms competition at the retail level, even if Superco accounts for more than 30% of sales in the relevant drinks category.[10] The reason is that other retailers would have plenty of choice of alternative orange (and other flavoured) drinks to sell.[12]

In short, so long as retailers have a sufficient choice of competing suppliers (as would usually be indicated by the contracting supplier having a market share of less than 30%), an exclusive supply agreement is unlikely to harm competition. A safe harbour that the supplier's share must be below 30% is therefore sufficient.

2.3. Competition dampening and cumulative effects

The foregoing discussion considered scenarios where there was only one agreement in place. If there were numerous similar

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In this regard we welcome the indication that the Commission appears to have softened its approach (a little) as regards single branding and dominance. In the 2000 Guidelines it states (at paragraph 141): 'Dominant companies may not impose non-compete obligations on their buyers unless they can objectively justify such commercial practice within the context of Article 82.' This has historically been interpreted as a de facto prohibition for dominant firms to apply non-compete obligations. This wording has been replaced now by the softer toned 'Single branding obligations are more likely to result in anti-competitive foreclosure when entered into by dominant companies' (paragraph 129, July 2009 draft).

8
Indeed, the revised Guidelines acknowledge that: 'The 'market position of the supplier' is thus of main importance to assess possible anti-competitive effects of single branding obligations' (paragraph 128). Having said this, we would welcome more clarity in that same paragraph on the meaning of a 'must stock item'. The present drafting suggests that such a product is 'preferred by many final consumers' but this is neither a sufficient condition for the product to be a 'must-stock' item nor an indication that a retailer would be substantially locked in to purchasing a large share of its needs from the supplier.

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In principle, it could be 'too late' to intervene by this stage. However, in practice, we expect that the risk of intervening too late is low relative to the risk of deterring pro-competitive agreements for the reasons discussed in section 6.

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We can think of the private label as a case where a supplier produces a Superco brand that it sells exclusively to Superco.

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The Commission effectively makes this point at paragraph 149 of the July 2009 draft: 'The market position of the

agreements of a particular type operating within a market, then the cumulative effects of these could be anti-competitive while individually there would be no anti-competitive effect.[13]

Indeed, many of the competition dampening theories of harm are related to cumulative effects. For example, in the case of exclusive supply agreements, if one manufacturer with 10% of the upstream market sells exclusively to a retailer, this should not harm competition. However, if many other manufacturers which collectively account for a substantial share of the relevant market (e.g. 50%) decide to sell only to one and the same retailer, then anti-competitive effects are more likely (although will not necessarily occur).

Consider a second example. If all the main manufacturers refuse to supply a discount channel, one possible concern could be that by so doing there is a reduction of intra-brand competition (competition among retailers for a given product) that ultimately weakens inter-brand competition (competition among manufacturer brands). For example, where a manufacturer considers that its retailer is less likely to pass on a discount to consumers (due to low intra-brand competition), the manufacturer may be less likely to discount in the first place. If all manufacturers reason in the same way, the disincentive to discount may be enhanced in a way that benefits manufacturers and ultimately harms consumers.[14]

However, while we accept that cumulative effects may make anti-competitive effects more likely, we note that the Guidelines fail to offer any good reason why these concerns are better resolved by a downstream market share threshold as opposed to a specific threshold (or policy) that is targeted at cumulative effects. First, the supplier market share threshold could be adapted to take into account cumulative effects. Second, a specific 'carve out' provision for cumulative effects may be included to leave more scope for intervention. Indeed, we note that the old and new regimes already allow for the withdrawal of the exemption 'when access to the relevant market or competition therein is significantly restricted by the cumulative effect of parallel networks of similar vertical agreements practised by competing suppliers or buyers'.[15]

In sum, even when we consider cumulative effects, there is no compelling reason for adopting a downstream market share threshold.

2.4. The 30% threshold applied to the supplier's share is sufficient

Having considered the three main theories of harm that usually relate to vertical agreements, we conclude that a 30% cap on the

supplier and his competitors is of major importance, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited.'

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We note that this departs from the 2000 Guidelines where in relation to a special case of exclusive supply agreement where there is only one buyer in the Community, consideration is given to the buyer's share of purchases (paragraph 21, 2000 Guidelines).

13
See the theories discussed in Rey, P and T. Vergé , (2008), 'Economics of Vertical Restraints', Handbook of Antitrust Economics.

14
This theory of competition dampening relies on specific assumptions being valid. We note also that there may be efficiency reasons for not supplying the discount channel.

15
Paragraph 71 of the July 2009 draft and paragraph 73 of the 2000 Guidelines. In addition, the Commission has the power to exclude from the scope of the BER, by means of regulation, parallel networks of similar vertical restraints where these cover more than 50% of a relevant market. Such a measure applies to all undertakings whose agreements are captured by the regulation disapplying the BER. See paragraph 75 of the July 2009 draft and paragraph 80 of the 2000 Guidelines.

market share of the upstream firm is sufficient for a safe harbour and that there is no compelling reason to include an additional downstream share cap as well.

We note that this view is broadly in line with the view taken by the Commission in its 2000 Guidelines which focused on the upstream market:

'From an economic point of view, a vertical agreement may have effects not only on the market between supplier and buyer but also on markets downstream of the buyer. The simplified approach of the Block Exemption Regulation, which only takes into account the market share of the supplier or the buyer (as the case may be) on the market between these two parties, is justified by the fact that below the threshold of 30% the effects on downstream markets will in general be limited. In addition, only having to consider the market between supplier and buyer makes the application of the Block Exemption Regulation easier and enhances the level of legal certainty, while the instrument of withdrawal (see paragraphs 71 to 87) remains available to remedy possible problems on other related markets.'[16]

16
Paragraph 22, 2000 Guidelines. The text 'or the buyer (as the case may be)' refers to a special case of exclusive supply agreement where there is only one buyer in the Community where consideration is given to the buyer's share of purchases (paragraph 21, 2000 Guidelines).

3

Hard core restrictions

The inclusion of a hardcore restriction renders the vertical agreement as a whole ineligible for block exemption and the revised Guidelines indicate 'the presumption that the agreement is unlikely to fulfil the conditions of Article 81(3)'.[17] This means that an agreement struck between two firms that have no market power is not block exempted if it contains a hard core restriction.

From an economics perspective, hard core restrictions are unappealing; where the parties concerned have no market power, a vertical agreement between them would not create or enhance market power. Hard core restrictions create the paradoxical situation where firms operating at different levels in the supply chain would be free to merge but are constrained in their ability to strike a (less restrictive) vertical agreement.

Given that the desirability of an effects-based approach to assessing market behaviour is now recognised by the Commission, the Commission has missed an opportunity to revise its approach to hard-core restrictions and pave the way for greater consistency in the treatment of substantively similar practices and for greater contractual freedom for firms with low market shares that are unlikely to have market power.[18]

With this background in mind, the following sections consider two specific hard core restrictions where proposed changes are to be made in the Guidelines:

- Passive sales and the internet
- RPM

3.1. Passive sales and the internet

The Commission clearly and correctly recognises that territorial or customer exclusivity can give rise to significant efficiencies. For example, such restraints may reduce transaction costs or incentivise retailers to invest in promotional efforts which would otherwise be undermined by the threat of free-riding.[19] Moreover, the Commission explicitly recognises that restraints on active selling of a supplier's products across allocated territories or customer groups

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Paragraph 47 of the July 2009 draft

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The Commission now explicitly recognises that 'hard core' restraints can give rise to efficiencies, although it is not clear how material a change this represents given that in the old regime hard core restrictions could be exempted if they met the Article 81(3) criteria. If the Commission wishes to signal a more permissive approach to hard core restrictions it should say so explicitly. We also note that if the Commission persists with the (unnecessary) downstream market share threshold in addition to that applied to the supplier (the latter being sufficient in our view as explained in section 2), it should also recognise that this weighs in favour of reducing the number of hard-core restrictions, not increasing them. This is because the inclusion of the additional threshold substantially narrows the application of the safe-harbour for non hard-core agreements and so reclassifying a hard-core agreement to be 'non hard-core' is much less likely to let harmful agreements slip through the net (compared to the old regime).

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Indeed, the revised Guidelines recognise that granting territorial or customer exclusivity may fall outside 81(1) when the restriction brings about entry into a new market. The logic is that the restraint on active and passive sales into a territory or to customer groups during the first two years following entry may enhance the ability of the entrant to recover sunk expenditures required to establish itself in the new market.

will almost always have benign consequences, provided there is effective inter-brand competition.[20] Such restraints are therefore permitted within the BER, provided the supplier (and as proposed also the buyer) enjoys a share of less than 30% of the relevant markets.

This begs an important question: if restrictions on active selling across allocated territories or customer groups are deemed desirable, why is a blanket exclusion of restraints which limit passive selling justified?

The Commission does not provide a satisfactory answer to this question. For example, if the principal desire to allow passive sales reflects the Commission's historical (and philosophical) commitment to promoting market integration across the Community, the Commission should explain exactly how the 'market integration motive' serves consumers better than a policy that facilitates firms without market power to strike efficiency enhancing agreements.[21]

The problem here stems from the fact that a single legal instrument is being used to pursue two, partly conflicting, policy objectives. On the one hand, the competition objective of securing welfare-enhancing economic efficiencies requires that in some circumstances suppliers should be allowed to implement vertical restraints that provide a material degree of protection to their distributors from intra-brand competition, even if that causes some degree of market-segmentation. On the other, the political objectives associated with the Common Market find any device that tends to partition markets inherently objectionable. The Commission has lighted on the distinction between active and passive sales as an arbitrary compromise between these conflicting objectives.

The revised Guidelines risk aggravating this situation by attempting to pigeon-hole types of internet practice into 'active' or 'passive', when in many cases the distinction is blurred and subject to shifts as technology changes. We appreciate that in so doing the Commission's motive is to be helpful and provide the business community and practitioners with more certainty. However we are concerned that in so doing the Commission has been too prescriptive and failed to take into account modern day techniques used by internet sellers to reach customers. For example, when a consumer chooses a website from which to purchase, is this always an unsolicited sale? There are many reasons why the sale would not be unsolicited, including where the website owner has advertised the website to consumers or paid to obtain a prominent position on the rankings a search engine.

In addition, the revised Guidelines:

- state (as they did before) that every distributor must be free to use the internet to advertise or to sell products;

20
'The loss of intra-brand competition can only be problematic if inter-brand competition is limited'. Paragraph 149 of the July 2009 draft.

21
Indeed, even with a single market objective, it is not clear why active sales may be restricted but passive sales may not.

- prohibit suppliers from requiring a distributor to limit the proportion of overall sales made over the internet;[22] and
- prohibit suppliers from requiring a distributor to pay higher prices for products intended to be resold online.

Such micro-management of firms is undesirable. First, the internet is a distribution channel – efficiency reasons exist for suppliers to restrict their distributors from using certain channels, and the internet is no exception. Second, if the Commission's aim is to guard against practices that may limit passive sales on the internet, the Guidelines approach is rather blunt; it could facilitate active sales as much as passive sales due to the blurring between the two types of sale on the internet. Third, even if passive sales on the internet were restricted, there is no reason to suspect that this would harm consumers where the firms in question are not likely to have market power (and on the contrary such a restriction could benefit consumers through giving rise to efficiencies).[23]

The underlying problem here is a complex one, and derives from the fact that in some cases it is essentially impossible to square the circle between competition and Common Market policy objectives where (as in the case of territorial restrictions) they can come into direct conflict. In our view, however, the distinction between active and passive sales does not hold the key to resolving this dilemma. If a compromise between the conflicting objectives must be found, it should be based on a more transparent and empirical analysis of the underlying problem.

3.2. RPM

We note, as above, that RPM is unlikely to harm competition when the up- and downstream firms have no market power (absent cumulative effects, which are discussed above in section 2.3). In that regard, we welcome the fact that the Commission has recognised that minimum RPM can be pro-competitive in certain situations, such as where it facilitates the entry of a product into a new market.

We would welcome some greater balance in the discussion on the distinction between maximum RPM and minimum RPM (paragraph 223). Where RRPs and maximum RPM are effective at constraining price rises, they will necessarily 'bind' on many retailers, such that a large share of retailers could be observed to price at the RRP or maximum price, while most other retailers price below the maximum. This situation should not be confused with a focal point for collusion or minimum price RPM. Moreover, it would still be important to take into account all other factors that are required to sustain collusion.

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Footnote 29 of the Guidelines tempers this restriction to some degree by allowing suppliers to require a minimum amount of offline sales (including on a buyer by buyer basis) as well as requiring that online activity 'remains consistent with the suppliers' distribution model'. These are welcome clarifications but they beg the question of why there is a need to prohibit suppliers requiring their distributors to limit the proportion of overall sales made over the internet.

23
Indeed, even where firms do have market power, the decision to limit passive sales does not necessarily give rise to anti-competitive effects.

4

Retailer practices

The Commission has introduced sections on upfront access payments and category management agreements which aim to provide guidance on agreements where the safe harbour does not apply. The Commission's theories of harm centre on:

- foreclosure of suppliers;
- facilitating coordination among suppliers;
- foreclosure of distributors; and
- facilitating coordination among distributors.

In our view, these sections provide little helpful guidance. As currently drafted the Guidelines devote substantially more space to theories of harm than to efficiencies yet fail to make clear that the theories of harm covered would be relevant only in some limited special cases. The Guidelines therefore send out the wrong message – one that suggests upfront access payments and category management agreements are more harmful than they are likely to be in practice.[24] The risk that this sceptical approach will chill competition is especially problematic in view of the fact that category management arrangements and a broad range of looser agreements between manufacturers and retailers (e.g. payments to reserve promotional space) are an established part of the commercial environment in which many firms operate and which deliver pro-competitive benefits for consumers.

For example, consider the theory that retailers would harm competition among their suppliers. The revised Guidelines should acknowledge that as a general rule, buyers do not wish to reduce competition among their suppliers (whether by facilitating collusion or by raising entry barriers). They may have an incentive to do so in highly special cases where reduced upstream competition substantially raises the cost of their rivals (but has no material impact on the buyer concerned). This would include the extreme case of a 'rent sharing' agreement that facilitates upstream collusion where, for example, the conditions for sustainable collusion apply and where colluding suppliers set higher prices to the contracting buyer's rivals but not the contracting buyer.[25]

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We acknowledge that many of the theories of harm can be underpinned by academic papers but query the relevance of those models to the revised Guidelines, given the specific assumptions made in the theoretical papers.

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For a comprehensive discussion of these and other buyer power theories of harm see: 'The Competitive Effects of Buyer Groups' January 2007, A report prepared for the OFT by RBB Economics http://www.oft.gov.uk/shared_oft/economic_research/oft863.pdf

The following sub-sections provide further examples of why we view the revised Guidelines to have put forward theories of harm that are special cases. We focus primarily on the theories of harm that relate to the downstream level (as we have already explained that other theories of harm are likely to be rare because retailers would not normally harm competition upstream).

4.1. Upfront access payments

The claim that upfront access payments may induce the supplier to limit the distributors used and thereby foreclose other distributors needs further clarity.[26] The suggestion seems to be that a supplier may refrain from providing its products to many retailers so as to avoid paying too many upfront fees. However, if an additional retailer wants to stock the product, it can decide not to require an upfront payment and thereby obtain the product concerned. A 'problem' that can be resolved though unilateral conduct of one of the parties in this way is not worthy of the heavy-handed intervention that is proposed by the Guidelines.

26
Paragraph 200 of the July 2009 draft

The revised Guidelines also suggest that an increase in 'supply prices may reduce the incentive of the retailers to compete on price on the downstream market, while the profits of distributors are increased as a result of the access payments' (paragraph 202). The idea is that retailers dampen competition at the retail level by agreeing to pay higher input prices in return for slotting allowances. However, the economic literature suggests that this effect on incentives can only take place when retailers openly commit to paying higher wholesale prices. However, retailer-supplier contracts are usually confidential in which case they could not signal a commitment to pay higher wholesale prices.

Finally, as an example of an upfront access payment, the revised Guidelines refer to 'payments to have access to a distributor's promotion campaigns' (paragraph 199). We are concerned that this reference could deter promotional payments made by suppliers to retailers – such payments are commonly used to fund lower prices for consumers, yet this is not mentioned in the discussion of possible efficiencies.

4.2. Category management agreements

The definition of category management set out at paragraph 205 may not be familiar to many suppliers and retailers. Perhaps a more accurate description is that set out by the UK Competition Commission in 2008: 'any exchange of information between a retailer and supplier with the overall objective of improving sales or performance across a category of products sold by the retailer'.

The revised Guidelines should also acknowledge that the retailer makes the ultimate decision as regards whether or not to appoint a category captain and so has the final say in product placement decisions and prices, not the supplier. This is relevant, for example, in relation to paragraph 206 which suggests that a single branding effect could arise because a category captain gave the retailer biased advice. However, it is self-evident that where the retailer is sovereign it will appoint a category captain that will best serve its interests, and to discipline any category captain that sought to provide self-serving advice that was aimed at providing commercial advantage to the supplier at the retailer's expense.

In relation to facilitating collusion among retailers, set out at paragraph 207, the following should be noted. First, the theory seems to rely on a special case where there is widespread adoption of the same category captain and the same advice by all retailers. Second, it would be relevant to assess whether the advice adopted is likely to have a significant impact on competition between retailers. A category captain's role may often be to provide advice about stocking and how a category should be presented. It is extremely unlikely that a category captain will set the retail selling price. In general we would not expect it to be likely that similarity in practices regarding the stocking and presentation of a category would significantly soften competition between retailers, especially where that category accounts for a small share of retailer revenues.

5

Efficiencies

This section comments briefly on vertical externalities and long term non-compete obligations.[27]

We welcome the discussion of the so called 'vertical externality issue'.[28] At present, this is described largely as a matter of reducing double marginalization. The revised Guidelines could usefully emphasise that, in practice, this issue is not simply a matter of price. It relates to the fundamental point that vertical agreements are important to align the incentives of the parties to the agreement – for example to ensure that one party does not then act opportunistically in a way that would harm the other party (i.e. cause a 'negative externality'), ultimately undermining the 'surplus' generated by the agreement and the incentive for the parties to deal with each other. Put differently, vertical agreements allow firms to replicate some of the benefits of vertical integration, without having to discard entirely the benefits of market transactions.

When applying 81(3), the revised Guidelines recognise that 'it is necessary to take into account the investments made by any of the parties and the time needed and the restraints required to commit and recoup an efficiency enhancing investment'.[29] This appears to be a more general and explicit statement of the need to consider the time taken for investment recovery than appeared in the 2000 Guidelines and is welcomed.

However, despite this explicit recognition, single branding agreements which have a duration of longer than five years do not fall within the scope of the block exemption. Indeed, the Guidelines note that 'single branding obligations exceeding five years are for most types of investments not considered necessary to achieve the claimed efficiencies or the efficiencies are not sufficient to outweigh their foreclosure effect'.[30] This last statement appears unnecessary and likely to discourage significant investments in markets which may then benefit consumers. Rather, the Guidelines should recognise that a single branding constraint for a period longer than five years may be necessary

27
For a detailed description of efficiencies arising from vertical agreements see 'Efficiency
Effects of Non-horizontal Mergers', report prepared for DG Enterprise by RBB Economics 2005.
http://ec.europa.eu/enterprise/library/lib-competition/doc/non_horizontal_mergers.pdf

28
Paragraph 103 of the July 2009 draft

29
Paragraph 119 of the July 2009 draft

30
Paragraph 129 of the July 2009 draft

when significant sunk cost investments are required. While the agreement may not benefit from the block exemption, at least it would not be pre-judged as being likely to be anti-competitive.

The emphasis placed by the Guidelines on restricting the applicability of the BER to shorter term restrictions that are applied to new entrant suppliers and to suppliers of technically complex products reflects an excessively limited and rather formalistic view on the circumstances in which efficiency rationales such as free rider concerns can have genuine merit.[31] The general indication that vertical restraints are problematic when applied to branded goods because of the tendency of branding to 'increase product differentiation and reduce substitutability of the product, leading to a reduced elasticity of demand and an increased possibility to raise price' seems to reflect an alarming (and unwarranted) ideological objection to branding that should have no place in a modern competition law regime.[32] There is a failure to acknowledge that customer loyalty and differentiation can be achieved through offering higher quality products and services. Brand owners that successfully use vertical restraints or other methods to increase demand and/or consumer loyalty for their products, unless they have exercised market power to foreclose rivals in reaching that position, are best seen as having created consumer welfare through their efforts.

31
Paragraph 104 of the July 2009 draft

32
Paragraph 100 of the July 2009 draft

6

Conclusion – risk of chilling competition

In our view, the revised Guidelines give rise to a less permissive regime than before, in particular due to the addition of the downstream market share threshold (as we explained in section 2). This suggests that the Commission has become more concerned about the potential anti-competitive effects of vertical agreements. This section considers whether there is any high level evidence to suggest that a less permissive approach is justified.

The Guidelines recognise correctly that vertical restraints may provide scope for efficiencies, inter alia through reducing double marginalisation, facilitating investments, lowering production costs, promoting non-price competition such as improved quality of product or service, and entering new markets.[33] A less permissive approach to vertical restraints is likely to lead to a reduction in the realisation of these efficiencies and associated consumer benefits. This is because companies will perceive the compliance risk associated with pro-competitive agreements to have increased where the agreements formerly fell within the safe harbour but would not do so under the new regime.[34]

In theory, foregoing such efficiencies would be desirable if adopting the less permissive stance meant that the Commission caught and/or deterred a sufficiently large number of anti-competitive agreements that it otherwise would have failed to detect or deter. However, in practice, there is little, if any, support for a more interventionist approach.

If a more interventionist stance were justified, we would have expected the experience of the last 10 years to indicate that the BER had let through too many anti-competitive agreements. So, for example, we might expect to have seen numerous examples of the Commission withdrawing the benefit of the block exemption. Further, the Commission defends its inclusion of the downstream market share threshold by an allegation of 'increased buyer power of big retailers' without providing any evidence as regards the validity of the claim or why this means that the current regime is not appropriate.[35] First, if the concern is with retailers, why should the market share threshold apply to all levels of the supply chain?

33
Paragraphs 6 and 102–103 of the July 2009 draft.

34
Take a simple example. Increased risk and compliance costs increase both the upfront costs of the initial risk assessment and the expected future costs (e.g. the risk of litigation and fines). Suppose, for example, that the new regime means that proceeding with an agreement that lies outside the safe harbour leads to a small, e.g. 1%, increase in the probability of being fined 10% of turnover compared to the old regime where the agreement would have fallen within the safe harbour. For a large multinational corporation, this could be sufficient to deter an investment project taking place. For example, just a 1% increase in the risk of being fined €1bn increases the expected cost by €10mn – sufficient to deter many investments.

35
http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1197&format=HTML&aged=0&language=EN&guiLanguage=en

Second, if buyer power created an important loophole in the old regime, we might expect there to have been many instances of Article 81 infringements by suppliers with market shares just above 30% where their agreements are with retailers who have in excess of 30% of their downstream market(s) but are not dominant.[36]

In practice, however, vertical agreements would not appear to have been a high priority for the Commission. To our knowledge, there are no examples of the block exemption being withdrawn over the past decade and very few examples of the Commission pursuing vertical agreements under the Article 81 prohibition.[37]

Furthermore, if greater intervention were warranted, we might also expect to have seen a weight of empirical economic evidence identifying harmful effects from vertical agreements at relatively low levels of market power. While we acknowledge that there is limited empirical evidence on the impact of vertical agreements, recent surveys of the empirical literature do not provide support for a more interventionist role.[38] Moreover, the Commission has not advanced empirical evidence to support its less permissive proposed approach.

In our view the new regime is less permissive than the old regime. We conclude that the new regime is likely to harm end customers through deterring pro-competitive agreements without substantially improving the likelihood of preventing anti-competitive agreements.

36
Where firms are dominant, their agreements are subject to the risk of infringing the Article 82 prohibition.

37
The Commission has only taken 10 decisions on vertical agreements since 2000 with most of these concerning parallel imports. There have been no decisions since 2004.

38
See Lafontaine, F. and M. Slade, (2008) 'Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy' Handbook of Antitrust Economics and Cooper, J. C., L. M. Froeb, D. O'Brien and M. G. Vita, (2005), 'Vertical Antitrust Policy as a Problem of Inference', Vanderbilt University Law School Law and Economics Working Paper, Number 05–12.

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