Vertical Agreements: New Competition Rules for the Next Decade

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I. INTRODUCTION

On 20 April 2010 the Commission adopted a new Block Exemption Regulation applicable to vertical agreements\(^2\) (hereinafter "the Regulation"). At the same time it adopted the contents of accompanying Guidelines on vertical restraints\(^3\) ("the Guidelines"), which were subsequently formally adopted in all official languages of the Union by Vice-President Almunia on behalf of the Commission on 10 May 2010. Both of these instruments will be applicable from 1 June 2010.

The competition rules embodied in these instruments are particularly important given the pervasiveness of vertical agreements. Vertical agreements are agreements between firms operating at different levels of the production or distribution chain for the sale and purchase of intermediate products and the purchase and resale of final products. Typical examples of vertical agreements are distribution agreements between manufacturers and distributors, or supply agreements between a manufacturer of a component and a producer of a product using that component. Because each firm has to purchase certain inputs and most firms need to sell their products to producers further downstream or to distributors, most companies are concerned by these rules.

These instruments also play an important part in ensuring a consistent approach to vertical restraints under Article 101 of the Treaty on the Functioning of the European Union, as enforcement has mostly been carried out by the national competition authorities and national courts since the 2004 decentralisation. Vertical restraints are restrictions of competition included in vertical agreements which may foreclose and/or segment markets and facilitate collusion. For instance, vertical agreements which have as their main element the fact that the manufacturer sells to only one buyer or a limited number of buyers (exclusive distribution or selective distribution) may lead to foreclosure of other buyers and/or to collusion between buyers. Similarly, non-compete obligations which prohibit distributors from purchasing and reselling competing products may foreclose new manufacturers and make the market positions of incumbent manufacturers rigid.

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The new rules were adopted following a review process that was launched in the spring of 2008 because of the expiry of the Block Exemption Regulation of 1999 ("the 1999 Regulation") on 31 May 2010. The Commission services took stock of enforcement with the national competition authorities and a consensus was quickly reached confirming that the architecture put in place in 1999 had worked well and only needed some up-dating and clarification. This was subsequently confirmed by a public consultation which elicited a very high response rate.

The 1999 Regulation and Guidelines on vertical restraints formed the very first package of a new generation of block exemption regulations and guidelines inspired by a more economic and effects-based approach, which was subsequently implemented in other antitrust areas. Under this approach, in order to conduct a proper assessment of a vertical agreement, it is necessary to analyse its likely effects on the market. For companies lacking significant market power (i.e. whose market share is below 30 percent), the 1999 Regulation provided for a block exemption, because it is presumed that vertical agreements concluded between such companies will either have no anticompetitive effects or, if they do, that the positive effects will outweigh any negative ones. In contrast, for vertical agreements concluded by companies whose market share exceeds 30 percent, there is no such safe harbour, but there is no presumption that the agreement is illegal either: it is necessary to assess the agreement's negative effects and positive effects on the market (under Article 101(1) and Article 101(3), respectively). The 1999 Regulation was accompanied by Guidelines which assist companies in making this assessment, and which have proved particularly important since the discontinuation, in 2004, of the former notification system whereby companies had to notify their agreements to the Commission in order to obtain an exemption.

It was decided to maintain this architecture, but to adapt and update it in the light of two major developments since 1999, namely a considerable increase in online sales, and enforcers’ increased attention to and experience with the possible anticompetitive effects of a buyer’s market power. This short article does not deal with all the aspects of the Regulation and Guidelines, but focuses instead on the novelties and clarifications introduced by these recently adopted texts.

II. SCOPE OF THE REGULATION

A. Extension of the 30 Percent Market Share Threshold to Buyers

The main change to the scope of the Regulation is that the benefit of the block exemption no longer depends only on the supplier's market share not exceeding 30 percent, but also on the market share of the buyer not exceeding the same threshold. This reflects increased recognition and evidence that vertical restraints need not generally be supplier-led: also buyers can have market power that may be used to impose anticompetitive vertical restraints. For instance, an exclusive supply obligation or similar obligation imposed by a powerful buyer (i.e. with a market share above 30 percent) on small suppliers (i.e. with a market share below 30 percent) may lead to anticompetitive foreclosure of other buyers, and may therefore harm consumers.

In the draft Regulation which was submitted to public consultation, the Commission proposed that the market share of the buyer, as that of the supplier, should be assessed in the downstream market(s) in which it resells the products/services, as it is in these markets that the

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4 The Commission also added two new sections in the Guidelines on upfront access payments and category management (see sections VI.2.7/8) to give guidance on vertical restraints which are typically buyer-led.
negative effects on consumers are felt. However, many stakeholders voiced concerns about the increased compliance costs for companies resulting mainly from having to assess the buyer's position on potentially many local downstream markets on which the suppliers themselves are not present.

To remedy these concerns, the market share of the buyer in the Regulation is assessed on the upstream market where the buyer procures the products/services from the supplier. This market is generally wider than the downstream market (in most cases it will be at least national in scope), it is only one market as opposed to several possible downstream markets, and suppliers will know or be able to reasonably estimate the position of their buyers on this market. In most cases the position of the buyer on the upstream market is a good proxy for the buyer's market power in the downstream market.\(^5\)

**B. Agency Agreements**

There is no fundamental change in policy with regard to agency agreements.\(^6\) Intra-brand restrictions, including prices and conditions at which the agent must sell or purchase the goods or services, fall outside Article 101(1) if the agent does not bear any contract specific risks, such as financing of stocks, or costs for market specific investments, such as the petrol storage tank of a service station. The Guidelines provide the additional clarification that, in order for an agreement to be considered a genuine agency agreement under the EU competition rules (and thus for any intra-brand restrictions to fall outside Article 101(1)), the principal must bear the costs and risks related to other activities that it requires the agent to undertake within the same market where the agency activity also takes place. Therefore a service station operator can be an independent distributor of shop goods or an independent provider of car wash services without this affecting its agency status with regard to petrol retailing. However, to prevent any "spill-over effects" of intra-brand restrictions (for instance, price-fixing) between the agency activity and the independent activity, the service station operator cannot be a genuine agent for one type of petrol and at the same time be an independent distributor for another type of petrol in the same product market.

**C. Vertical Agreements between Competitors**

As a general rule, neither the 1999 Regulation nor the (new) Regulation cover vertical agreements entered into between competitors. Agreements between competitors, also for the distribution of each others' products, are first and foremost assessed as horizontal agreements.\(^7\) However, the 1999 Regulation did cover a limited number of situations of non-reciprocal vertical agreements between competitors. There are two changes in the Regulation with regard to the coverage of vertical agreements between competitors, both of which set further limits on the scope of the Regulation. First, the 1999 Regulation covered situations in which a producer sold its products to a competing producer that distributed them, as long as the turnover of the latter did not exceed EUR 100 million. This exception has now been removed, because experience

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5 Where an intermediate product such as steel has multiple uses, the position of the buyer on the upstream market may be more relevant than its position in the downstream market, because it is difficult to see how a buyer with a strong position in a particular downstream market, such as cars, but having only a limited position as purchaser on the steel market, can use its purchasing agreements to foreclose other car manufacturers from having access to the steel market.

6 See paragraphs 12-21 of the Guidelines.

shows that, in certain markets, a EUR 100 million company may be the main local or national producer and thus a major competitor. As a result of this change, such agreements fall outside the scope of the Regulation and will have to be assessed as horizontal agreements. Secondly, not just for goods but also for services, the Regulation's coverage of vertical agreements between competitors is now limited to situations of dual distribution, i.e. where the buyer is active at the distribution level only.\footnote{Previously the requirement that the buyer is only active at the distribution level did not apply to services.} For instance, if a brewer operates its own pubs and thus is active at the retail level, its agreements to supply its beer to independent pubs fall within the scope of the Regulation. The same applies to a franchisor's agreements providing services to its franchisees while also operating its own shops.

III. HARDCORE RESTRICTIONS

A. General Approach to Hardcore Restrictions

Article 4 of the Regulation contains a list of hardcore restrictions, in particular restraints on the buyer's ability to determine its sale price and certain types of \( \text{(re)sale} \) restrictions. These are considered serious restrictions of competition that should in most cases be prohibited because of the harm they cause to consumers. The consequence of including such a hardcore restriction in an agreement is that the whole vertical agreement is excluded from the scope of application of the Regulation.\footnote{See paragraph 47 of the Guidelines.} In addition, in these cases there is a double presumption, namely that the agreement will have actual or likely negative effects and therefore fall within Article 101(1), and it will not have positive effects that fulfil Article 101(3).

This is, however, rebuttable: in individual cases the parties can bring forward evidence under Article 101(3) that their agreement leads, or is likely to lead to efficiencies that outweigh the negative effects.\footnote{Where this is the case, the Commission is required to effectively assess (rather than just presume) the likely negative impact on competition before making a final assessment of whether the conditions of Article 101(3) are fulfilled. In effect this means that the usual order of bringing forward evidence is reversed in the case of a hardcore restriction.} Where this is the case, the Commission is required to effectively assess (rather than just presume) the likely negative impact on competition before making a final assessment of whether the conditions of Article 101(3) are fulfilled. In effect this means that the usual order of bringing forward evidence is reversed in the case of a hardcore restriction.

B. Resale Price Maintenance

Resale price maintenance (RPM), that is agreements or concerted practices having as their direct or indirect object the establishment of a fixed or minimum resale price or a fixed or minimum price level to be observed by the buyer, are treated as hardcore restrictions. However, the practice of recommending a resale price to a reseller or requiring the reseller to respect a maximum resale price is not considered a hardcore restriction.

The section of the Guidelines that deals with RPM provides a good illustration of the above-mentioned general approach to hardcore restrictions, because it explains at length the various ways in which RPM may restrict competition\footnote{See paragraph 224 of the Guidelines.} but also that RPM may, in particular where it is supplier driven, lead to efficiencies which must be assessed under Article 101(3).\footnote{See paragraph 225 of the Guidelines.}
Among the negative effects, RPM may facilitate collusion both between suppliers (by enhancing price transparency on the market) and between buyers (by eliminating intra-brand price competition), and more generally soften competition between manufacturers and/or between retailers, particularly when manufacturers use the same distributors to distribute their products and RPM is applied by all or many of them. It should also be noted that the immediate effect of RPM is that all or some distributors are prevented from lowering their sales price for that particular brand. In other words, the direct effect of RPM is a price increase. Other negative effects include a reduction of dynamism and innovation at the distribution level since, by eliminating price competition between different distributors, RPM may prevent more efficient retailers or distribution formats from entering the market or acquiring sufficient scale with low prices.

Among the positive effects, where a manufacturer introduces a new product, RPM may be helpful during the introductory period of expanding demand as a way to persuade distributors to take more account of the manufacturer’s interest in promoting the product. Indeed, RPM may provide the distributors with the means to increase sales efforts. If the distributors on this market are under competitive pressure, this may prompt them to expand overall demand for the product and make the launch of the product a success, also for the benefit of consumers. Similarly, fixed resale prices, and not just maximum resale prices, may be necessary in order to organise in a franchise system, or similar distribution system applying a uniform distribution format, a coordinated short term low price campaign (2 to 6 weeks in most cases) for the benefit of consumers. In some situations, the extra margin provided by RPM may allow retailers to provide (additional) pre-sales services, in particular in the case of experience or complex products. In such a situation, RPM may prevent free-riding and its consequences: indeed, if customers take advantage of these services but then purchase the product at a lower price with retailers that do not provide such services, high-service retailers may reduce these services or stop providing them altogether.

C. Resale Restrictions
1. Hardcore Resale Restrictions

The hardcore resale restrictions relate to market partitioning by territory or by customer group. In general, the Regulation does not cover agreements that restrict sales by a buyer party to the agreement in so far as those restrictions relate to the territory into which or the customers to whom the buyer may sell the contract goods or services. However, there are a number of exceptions to this general hardcore restriction, which are designed to allow suppliers to sell their products efficiently while preventing the risk of partitioning the internal market.

One such exception is exclusive distribution. Indeed, the Regulation allows a supplier to protect an exclusive distributor from active sales by other distributors in order to encourage that distributor to invest in the exclusively allocated territory or customer group. This is possible, under the block exemption, when the supplier agrees to sell its products only to one distributor for distribution in a particular territory or to a particular customer group and when that exclusive distributor is protected against active selling into its territory or to its customer group by all the other distributors. The Guidelines now clarify that the protection against active sales enjoyed by
the exclusive distributor does not need to extend to the sales by the supplier itself. Moreover, in an exclusive distribution system a supplier can restrict active sales at more than one level of trade. For instance, a supplier can restrict active sales into a territory or customer group exclusively allocated to a wholesaler by all other wholesalers and retailers who are parties to an agreement with that supplier. However, to prevent market partitioning a supplier cannot restrict its distributors from making passive sales, i.e. responding to unsolicited requests from customers and selling to those customers throughout the internal market. Any such restriction of passive sales would be a hardcore restriction of competition.

Selective distribution is another important exception. Under the block exemption, suppliers can implement a selective distribution system which allows them to choose their distributors on the basis of specified criteria and to prohibit any of their sales to unauthorised distributors. The Regulation covers the agreed restrictions of sales to unauthorised distributors in the territory reserved by the supplier to operate selective distribution. A supplier can restrict an appointed distributor from selling, at any level of trade, to unauthorised distributors located in any territory where selective distribution is currently operated or, as is now clarified, where the supplier does not yet sell the contract products. Any other restriction of the authorised distributors' freedom regarding where and to whom they may sell is considered a hardcore restriction. Thus, an authorised distributor should be free to sell to any end-consumer and to supply and/or procure supplies from any other authorised distributors. The reason for protecting this freedom of authorised distributors to sell/procure supplies throughout the internal market is that selective distribution implies a high risk of market partitioning and higher prices because, as was explained above, in that system a supplier is allowed to restrict any sales to unauthorised distributors, in particular to parallel traders.

At a more general level, the Regulation now provides for the possibility of a supplier restricting the place of establishment of its distributor, whatever the type of distribution system opted for. It can be agreed that the distributor will restrict its outlet(s) and warehouse(s) to a particular address, place or territory. This is designed to facilitate the parallel use of different types of distribution systems in the internal market by providing the possibility of protecting the investments of other than exclusive distributors.

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13 This means that exclusive distribution is covered by the Regulation also if the supplier sells directly to customers otherwise exclusively allocated to a particular distributor, i.e. if the exclusivity is shared between the distributor and the supplier.

14 However, if a supplier operates selective distribution in one territory while using another type of distribution system in another territory, that supplier cannot restrict sales to unauthorised distributors located in the territory where the other type of distribution system is used (see however footnote 15).

15 This is without prejudice to any other exceptions provided in the Regulation. For instance, authorised distributors can be prohibited from operating out of an unauthorised place of establishment or restricted in their active sales into a territory where exclusive distribution is applied.

16 For example, because of differences in the available infrastructure and/or consumer preferences for services, a supplier may rely on a selective distribution network in country A, but decide to use exclusive distribution in country B. In both cases distributors may have to undertake important investments which are worth protecting against “free riding.” The exclusive distributor in country B is protected against active sales from distributors in country A. On the other hand, the exclusive distributor in country B can be prevented from opening a shop next door to, and free riding on, the shop and services of an authorised distributor in country A. However, any other restrictions on the distributor's active sales from country B into country A, including active sales over the internet, continue to be treated as a hardcore restriction and an individual justification should be advanced for a more radical restriction of their active sales.
It is also permissible, under the Regulation, to restrict a wholesaler from selling to end-users. This allows a supplier to keep the wholesale and retail level of trade separate. Thus, a supplier can require the buyers of its products to "specialise" in the wholesale or retail activity. The novelty here is that it is specified that this does not exclude the possibility that a "specialised" wholesaler can sell to certain end-users, such as bigger end-users, while sales to (all) other end-users are not allowed.

2. Restrictions on the Use of the Internet

The general rules explained in the previous section apply to both offline and online sales. Since the internet makes it easy to reach different customers and different territories, restrictions of the distributors' use of the internet are generally considered as hardcore resale restrictions. In principle, every distributor must be allowed to use the internet to sell products. Therefore, the Guidelines make it clear that any obligations on distributors to automatically reroute customers located outside their territory, or to terminate consumers' transactions over the internet if their credit card data reveal an address that is not within the distributor's territory, are hardcore restrictions. Similarly, any obligation that dissuades distributors from using the internet, such as a limit on the proportion of overall sales which a distributor can make over the internet, or the requirement that a distributor must pay a higher purchase price for units sold online than for those sold offline ("dual pricing"), is also considered as a hardcore restriction.

As in the offline world, under the block exemption a supplier can restrict active sales into exclusively allocated territories or customer groups, while passive sales should remain free. The Guidelines contain a careful delineation of active and passive sales, aimed at allowing the internet to continue contributing to cross-border trade in the internal market while preserving the efficiency of exclusive distribution. The general principle is that if the distributor has a website and a customer visits the web site and contacts the distributor (without being solicited), and if such contact leads to a sale, including delivery, then that is considered passive selling. The same is true if a customer opts to be kept (automatically) informed by the distributor and this leads to a sale.

In contrast, any efforts by distributors to be found specifically in a certain territory or by a certain customer group amount to active selling into that territory or to that customer group. For example, paying a search engine or online advertisement provider to have advertisements displayed specifically to users in a particular territory is active selling into that territory. Territory-based banners on third party websites are also a form of active sales into the territory where these banners are shown. However, offering different language options on the website does not, of itself, change the passive character of such selling.

Since suppliers can appoint the exclusive distributor of their choice or implement a selective distribution system which allows them to freely choose their distributors on the basis of specified criteria and to prohibit any of their sales to unauthorised distributors, the block exemption covers a requirement by the supplier that its distributors should have one or more bricks-and-mortar shops or showrooms as a condition for becoming a member of its distribution system. In other words, under the regulation the supplier may choose not to sell its product to internet-only distributors. To ensure an efficient operation of the brick and mortar shops, a supplier can also require from a distributor that it sells at least a certain absolute amount (in value
or volume) of the products offline. A supplier can also pay a fixed fee to its distributor to support the latter’s offline sales efforts. However, under the Regulation a supplier cannot restrict the online activities of its appointed distributors since, as was explained above, such a restriction is a hardcore resale restriction. For instance, a supplier cannot apply a "dual pricing" policy or limit the proportion of overall sales which a distributor may make over the internet. Similarly, a supplier cannot use the brick and mortar requirement to "punish" a distributor for selling successfully over the internet (in particular in the territories where the supplier/other distributors charge higher prices).

More generally, under the block exemption, the supplier may require quality standards for its distributors' online sales, just as the supplier may require quality standards for offline sales. However, imposing criteria for online sales which are not overall equivalent to the criteria imposed for the sales from the brick and mortar shops, and which dissuade distributors from using the internet, is a hardcore restriction. This does not mean that the criteria imposed for online sales must be identical to those imposed for offline sales, but rather that they should pursue the same objectives and achieve comparable results and that the difference between the criteria must be justified by the different nature of these two distribution modes. Similarly, if a distributor wants to distribute contract products via third party platforms, a supplier may require that its distributor uses third party platforms only in accordance with the standards and conditions agreed between the supplier and its distributor for the distributor's use of the internet. For instance, where the distributor's website is hosted by a third party platform, the supplier may require that customers do not visit the distributor's website through a site carrying the name or logo of the third party platform.

3. Individual Justifications of Hardcore Resale Restrictions

As for RPM, the parties can bring forward evidence in an individual case that their agreement containing hardcore resale restrictions may fall outside the scope of Article 101(1) or may fulfil the conditions of Article 101(3). The Guidelines contain some examples of such individual justifications of hardcore resale restrictions.

Hardcore restrictions may be objectively necessary in exceptional cases for an agreement of a particular type or nature and therefore fall outside Article 101(1). For example, a hardcore restriction may be objectively necessary to ensure observance of a public ban on selling dangerous substances to certain customers for health and safety reasons.

Where substantial investments by a distributor are necessary in order to start up and/or develop a new market, any restrictions of (active and) passive sales by other distributors into such a territory or to such a customer group which are necessary for the distributor to recoup those investments generally fall outside the scope of Article 101(1) during the first two years that the distributor is selling the contract goods or services in that territory or to that customer group. This justification relates to a genuine entry of the supplier on the relevant market, where there was previously no demand for that type of product in general or for the particular type of product from that supplier.

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17 This absolute amount of required offline sales can be the same for all buyers, or determined individually for each buyer on the basis of objective criteria, such as the buyer's size in the network or its geographic location.
18 Paragraph 56 of the Guidelines provides some examples of quality standards for online/offline sales which are not identical, but which are overall equivalent.
In the case of genuine testing of a new product in a limited territory or with a limited customer group, and in the case of the staggered introduction of a new product, the distributors appointed to sell the new product on the test market or to participate in the first round(s) of the staggered introduction may be restricted in their active selling outside the test market or the market(s) where the product is first introduced. This restriction falls outside the scope of Article 101(1) for the period necessary for the testing or introduction of the product.

A restriction of active sales imposed on wholesalers within a selective distribution system may be necessary to solve a possible problem of "free riding" and therefore may fulfil the conditions of Article 101(3) in an individual case, that is when wholesalers are obliged to invest in promotional activities in "their" territories to support the sales by appointed retailers and it is not practical to specify in a contract the required promotional activities. Similarly, in some specific circumstances, an agreed "dual pricing" policy may fulfil the conditions of Article 101(3), that is when online selling by distributors leads to substantially higher costs for the supplier than their offline sales and when a "dual pricing" policy allows the supplier to recover those additional costs. For example, where offline sales include home installation of a technical product by the distributor but online sales do not, the latter may result in more customer complaints and warranty claims for the manufacturer.

**IV. CONCLUSION**

The newly adopted rules mark an evolution and adaptation of the effects-based approach to recent market developments, in particular regarding online sales. While there is a large measure of continuity in the approach embodied in the Regulation and Guidelines, more attention is paid to buyer power issues and online resale restrictions. The rules do not aim to impose or favour particular distribution formats. Instead of forcing manufacturers and distributors to offer all or some distribution models, the rules allow a large measure of freedom for manufacturers to agree with distributors about how they want their products to be distributed. Consumers can then make their choice based on these offers, thereby rewarding the best available options and stimulating business to adapt to what consumers want and to ensure that European supply and distribution remain globally competitive.