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### The New EC Block Exemption for Vertical Restraints: A Step Forward and a Missed Opportunity

Paul Lugard & Theon van Dijk

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### I. INTRODUCTION

On April 20, 2010 the Commission adopted the final text of Regulation 330/2010, the block exemption for vertical restraints that replaces Regulation 2790/1999.<sup>2</sup> It also adopted the final guidelines on vertical restraints that *inter alia* seek to provide guidance for the evaluation of vertical restraints that are not automatically exempted from the prohibition of Article 101(1) TFEU.<sup>3</sup>

Regulation 2790/1999 fundamentally changed the analytical framework that had, until then, applied to vertical restraints by limiting the benefit of the block exemption to vertical restraints that did not involve parties with (significant) market power. At the time it was felt that the device for bringing about that result, i.e. the 30 percent market share threshold included in Article 3, would be difficult to apply in practice and would in any event significantly increase compliance costs. Moreover, it was argued that there was little justification for blacklisting a number of intra-brand hardcore restrictions that, in the absence of market power, would be unlikely to produce net negative effects.

Today, more than 10 years after the adoption of Regulation 2790/1999, much has changed. First, while the adoption of Regulation 2790/1999 marked a more favorable reception of economic insights in EU competition law, those insights have, to some extent, subsequently been laid down in the Article 81(3) Notice of 2004 and have nowadays become commonplace.<sup>4</sup> This is despite a somewhat ill-defined preference for empirical research (as opposed to theoretical insights), in particular in the area of resale price maintenance, and the continuing treatment of a number of specific vertical restraints as hardcore restrictions that do not necessarily decrease consumer welfare.

Second, following the adoption of Regulation 1/2003, the enforcement of competition law in the area of vertical restraints has become predominantly a matter for national competition agencies. In fact, since the entry into force of Regulation 2790/1999, there have only been a few

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<sup>2</sup> Commission Regulation 330/2010 of 20 April 2010 on the [application of Article 101\(3\) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices](#), Official Journal L 102, 23.4.2010, p.1-7, *available at* <http://ec.europa.eu/competition/antitrust/legislation/vertical.html>.

<sup>3</sup> Commission notice - Guidelines on Vertical Restraints, *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:130:0001:0046:EN:PDF> Official Journal C 130, 19.05.2010, p. 1.

<sup>4</sup> Communication from the Commission - Notice - [Guidelines on the application of Article 81\(3\) of the Treaty](#) Official Journal C 101, 27.04.2004, p. 97-118, *available at* [http://ec.europa.eu/competition/antitrust/legislation/art81\\_3.html](http://ec.europa.eu/competition/antitrust/legislation/art81_3.html).

Commission decisions specifically dealing with vertical restraints.<sup>5</sup> But with the decentralizing of the overview of these types of restraints to national competition agencies, the risk of diverging analytical approaches and prioritization approaches increases.<sup>6</sup> For instance, during the discussions on what would become Regulation 330/2010, four member states questioned whether resale price maintenance should continue to be treated as a hardcore violation.<sup>7</sup>

Three additional developments seem to have had a clear impact on the new regime for vertical restraints. The first one is the decision of the U.S. Supreme Court in *Leegin*, in which the Court held that, in light of current economic insights, resale price maintenance arrangements merit a fuller appreciation of pro- and anticompetitive effects than would be possible under the traditional *per se* standard of analysis and, as a consequence, mandated that these types of arrangements be analyzed under a—yet to be further defined—rule of reason standard.<sup>8</sup> While the Commission eventually decided to maintain the existing Article 4 hardcore restraint label for resale price maintenance, the new regime cautiously and, in our opinion, to an insufficient extent acknowledges that that restraint may in certain circumstances be efficiency enhancing. Unfortunately however, the burden of proof that the parties would have to meet seems unrealistically high.

The second development that the Commission felt it needed to accommodate in the new regime is the increasing importance of the internet as a sales channel. The Commission found in this respect that, although the internet retailing channel grows 25-45 percent annually, those sales are still predominantly made nationally. Moreover, as a result of cross-border regulatory barriers, the gap between domestic and cross-border e-commerce is widening. This phenomenon explains the Commission's wish to combat private distribution practices that would further restrict internet sales. It has attempted to do so by striking a balance between two positions. The first, advocated by some manufacturers of branded luxury products, is that the use of internet is to be considered as a form of passive selling which manufacturers should, at least in the context of exclusive distribution arrangements, be able to prohibit. The opposite view held by firms like eBay is that all restrictions on the use of internet are hardcore restrictions.

The compromise chosen in Regulation 330/2010 consists of two parts. First, the regulation stipulates that while, in principle, manufacturers may not deprive distributors of the right to sell products over the internet, manufacturers operating a selective distribution system may require its distributors, as a selection criterion, to have a brick and mortar shop to allow customers to experience the products. This enables manufacturers to exclude internet-only distributors from the network. The second part consists of a clarification and refinement of the notions of active and passive selling in the context of internet sales. The Guidelines, for instance, make clear that the operation of a website that is specifically targeted at a certain area, for example through search engine optimizers, is considered as active selling into that area. This is of

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<sup>5</sup> See Lugard, *Some Reflections on the Treatment of Resale Price Maintenance Under EC Competition Law in Light of Leegin, Vertical Restraints and Distribution Agreements*, 2<sup>nd</sup> FEB-IEJE Competition Day (Gheur and Petit, Editors), forthcoming.

<sup>6</sup> See Reindl, *Resale Price Maintenance and Article 81 EC: Developing a More Sensible Analytical Approach*, International Antitrust Law and Policy: Fordham Law 2009 (Barry Hawk, Editor), forthcoming.

<sup>7</sup> See Commission Staff Working Document Impact Assessment, Accompanying document to the Draft Commission Regulation (EC) No.../. on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices and Draft Commission Notice Guidelines on Vertical Restraints, p. 10, available at [http://ec.europa.eu/governance/impact/ia\\_carried\\_out/cia\\_2010\\_en.htm](http://ec.europa.eu/governance/impact/ia_carried_out/cia_2010_en.htm).

<sup>8</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

significant practical importance because, as was the case under Regulation 2790/1999, the new regulation permits manufacturers to prohibit dealers to “actively” sell into exclusive territories allocated to other buyers.<sup>9</sup> Obviously, when the authors of Regulation 67/67 introduced the—controversial and somewhat artificial—distinction between active and passive sales, they could not have imagined that the same distinction would be applied by the Commission some forty years later to categorize various types of online sales as passive and active.<sup>10</sup>

The third development that has left its marks on the new regime is an increased concern about buyer power, together with the growing recognition in economic doctrine over the past ten years that large buyers with buyer power may impose vertical restraints on manufacturers. One such scenario occurs where a buyer uses its power to “induce” its supplier into an exclusivity arrangement that will foreclose competing downstream buyers. Regulation 330/2010 addresses buyer power and buyer-induced anticompetitive restraints in a fairly straightforward manner: by excluding from the scope of the block exemption agreements involving buyers with market shares exceeding 30 percent on the market on which they purchase the contract goods. This is a clear departure from the one-sided emphasis on market power held by suppliers as it prevailed in 1999. In addition, the vertical guidelines have been supplemented by two sections on vertical restraints that can be observed with large retailers: access payments and category management agreements.

## II. A MODEST STEP FORWARD

Compared to the exemption under Regulation 2790/1999, the exemption afforded by Regulation 330/2010 is more limited in scope. A minor but still significant change relates to vertical agreements between competitors. Regulation 330/2010 no longer exempts non-reciprocal vertical agreements between competitors involving “small” buyers with less than EUR 100 million in sales.<sup>11</sup> This is because these types of buyers may, despite their limited turnover, still be prominent competitors in certain markets.

The largest modification is the limitation of the scope of the exemption to agreements involving buyers with market shares not exceeding 30 percent. As a consequence, the exemption applies on the condition that both the supplier’s and buyer’s market shares do not exceed 30 percent. The Commission had initially proposed that the market share of the buyer should be assessed on the downstream market but later changed its position. The new regulation now provides that the buyer’s market share on the market on which it purchases the products is decisive for the application of the exemption.<sup>12</sup> While the Commission believes that the downstream market share of the buyer is the more precise criterion for assessing consumer harm, because the circumstances on that market determine the extent to which lower purchase prices

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<sup>9</sup> Article 4(b), first indent Regulation 330/2010.

<sup>10</sup> *Regulation No 67/67/EEC* of the Commission of 22 March 1967 on the application of Article 85 (3) of the Treaty to certain categories of exclusive dealing agreements (OJ No 57, p. 849; OJ (English Special Edition) 1967, p. 10.

<sup>11</sup> Article 2 paragraph 4 Regulation 330/2010. Note also that Article 2(4) now requires that for the exemption to apply to dual distribution arrangements for services the buyer be only active at the retail level of the market.

<sup>12</sup> The reason given for this change are the increased compliance costs for companies stemming from the fact that they would have to assess the buyer’s market position on potentially multiple local downstream markets and the assumption that the buyer’s upstream market share can, in many cases, be expected to be a reasonable approximation of the buyer’s power downstream. See Commission Staff Working Document Impact Assessment; *supra* note 7, p. 41.

are passed on to consumers, the scope of the exemption is nonetheless made dependent on the buyer's market share on its purchase market.<sup>13</sup>

It can indeed be debated which criterion, i.e. the buyer's position on the purchase market or its position on the downstream market, is the better choice. It seems that if the Commission had made the exemption dependent on the buyer's downstream market position (as it suggested in July 2009), the exemption would have been drawn too narrowly. Indeed, it is doubtful whether a buyer with a high market share on the downstream market, facing a seller with a market share of less than 30 percent, would be able to restrict competition either through the use of single branding or exclusive distribution arrangements. This is because the ability of single branding arrangements to result in anticompetitive customer foreclosure depends primarily on the buyer's market share on the purchase market. Indeed, that market share is indicative of the possibilities other suppliers have to distribute their products. In addition, customer foreclosure is generally considered as a strategy of suppliers to restrict upstream competition between among suppliers.

However, such a strategy cannot be effective if the supplier holds a market share of less than 30 percent. Similarly, the low upstream market share seems to militate against a high risk of reduced intra-brand competition, increased collusion, and input foreclosure as a result of exclusive distribution and exclusive supply arrangements. As a result, the introduction of a second market-share threshold based on the position of the buyer on the downstream market would probably not have eliminated anticompetitive practices that were automatically exempted under Regulation 2790/1999.

However, the Commission's final choice, i.e. the limitation of the exemption to agreements with buyers that do not have (significant) market power on *purchase* markets, also has a number of drawbacks. In particular, it remains to be seen under which circumstances a combination of a supplier with a low upstream market share and a powerful buyer may result in negative effects if the buyer's market share on the downstream market is low. At the very least, these cases require a particularly robust theory of harm, as one would expect powerful buyers to negotiate low prices, while strong downstream competition leads to high degrees of pass-on of those benefits to consumers. Generally, in case the exemption does not apply for the mere reason that the buyer's share on the purchase market exceeds 30 percent, the Commission, national competition agencies, and courts are well-advised to also take consideration of the structure of the downstream markets to ascertain whether consumers are indeed likely to suffer. Incidentally, following a first-phase review, the NMa, the Dutch competition agency, recently cleared a concentration involving high market shares on the purchase market for this precise reason: Despite high market shares on the (Dutch) purchase market, downstream consumers were unlikely to suffer in light of the competitive nature of the (European) downstream market.<sup>14</sup>

In line with a greater preoccupation with buyer power, the guidelines take a critical view of access payments (slotting allowances and pay-to-stay fees) and category management

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<sup>13</sup> For more on the market circumstances that determine the degree of pass-on of changes in purchase prices to the next layer of customers, see Van Dijk & Verboven, *Implementing the Passing-on Defence in Cartel Damages Actions*, GLOBAL COMPETITION LITIGATION REV., forthcoming.

<sup>14</sup> See case 6891 –Van Drie/ Alpuro, NMa decision of 4 May 2010 (low upstream market share on market for breeding and fattening of calves in combination with a 90 percent market share on the Dutch purchasing market for calves for production, i.e. slaughtering and sales, and a 17 percent combined market share on the downstream European market for the sales of veal), *available* (in Dutch) on: [http://www.nmanet.nl/nederlands/home/Besluiten/Besluiten\\_2010/6891BCM.asp](http://www.nmanet.nl/nederlands/home/Besluiten/Besluiten_2010/6891BCM.asp).

agreements.<sup>15</sup> As there are no known precedents at the European level of the anticompetitive effects of these arrangements, the practical need for these sections is somewhat debatable. More fundamentally, the theories of harm as explained in the Guidelines seem, at a minimum, to be unclear. For instance, paragraph 204 of the Guidelines states that upfront access payments may have similar effects as exclusive supply agreements but it is unclear why suppliers, once they have paid the fixed access amount to one buyer, would be more reluctant to also sell to other distributors that may or may not demand access payments. In addition, paragraph 205 mentions that slotting allowances may result in foreclosure of rival suppliers, in particular where access payments are widespread. However, while slotting allowances represent income for them, retailers suffer from diminished competition among suppliers and elevated prices. Thus, restrictions among suppliers as a result of slotting allowances are not in the interest of retailers. Similarly, with respect to category management agreements, paragraph 210 of the Guidelines identifies as a competitive concern the possible foreclosure of competing suppliers. Here again, the question arises why retailers would permit their category captains to limit competition between upstream suppliers.

In sum, while there are a number of reasons to be skeptical about the implementation of the provisions that seek to deal with buyer power, Regulation 330/2010 nonetheless represents a modest step forward as it abandons the overly narrow focus of Regulation 2790/1999 on market power at the supply side of the market only and introduces a more nuanced and realistic analytical framework for vertical restraints.<sup>16</sup>

To some extent, that more realistic view is also reflected in a slightly more lenient view towards hardcore restraints, in particular non-price resale restraints.<sup>17</sup> For instance, in the case of selective distribution systems where appointed wholesalers have to invest in promotional activities, suppliers are now allowed to require that their wholesalers do not actively sell to appointed retailers in other wholesalers' territories, in order to overcome free riding.<sup>18</sup> Unfortunately, however, the Commission's willingness to step away from a formal evaluation of vertical restraints and to increasingly evaluate efficiencies, has not led to a fundamental shift in its treatment of another vertical restraint: resale price maintenance.

#### IV. A MISSED OPPORTUNITY

Under Article 4 of the new regulation, resale price maintenance remains treated as a hardcore restriction.<sup>19</sup> The Guidelines leave no doubt that this type of vertical restraint continues to raise significant suspicion. Indeed, paragraph 224 lists seven ways in which resale price maintenance may restrict competition. These include a number of conventional concerns, such as the facilitation of collusion in upstream and downstream markets and the reduction of dynamism and innovation at the distribution level, as well as a number of more disputed theories

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<sup>15</sup> See respectively ¶¶ 203 and 209. For an overview of the positive and negative effects of slotting allowances, see for instance the Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Market Practices in the Grocery Industry, Federal Trade Commission, February 2001, available at <http://www.ftc.gov/bc/slotting/index.shtm>.

<sup>16</sup> Note also that, in contrast to the previous guidelines, the Guidelines accompanying Regulation 330/2010 discuss private label brands. See in particular ¶¶ 27, 116, 210 and 229.

<sup>17</sup> See in particular ¶¶ 60-63.

<sup>18</sup> See ¶ 63.

<sup>19</sup> The guidelines state that the characterization of a restraint as a hardcore restraint creates a rebuttable presumption that the agreement falls within article 101(1) and is unlikely to meet the conditions of article 101(3). See ¶ 47.

of harm, in particular the potential of resale price maintenance to increase prices and the possibility that it may be implemented by manufacturers with market power to foreclose smaller rivals. The latter situation would occur if an increased profit margin, due to resale price maintenance, would entice distributors to favor the manufacturer's brand, or not to sell rival brands at all. This scenario seems to be the mirror image of that provided in paragraph 210, which describes the situation that distributors may enter into category management agreements with a view of foreclosing upstream suppliers. However, while the use of resale price maintenance as a device for distributors to exclude upstream suppliers is not explicitly mentioned in the guidelines, it is likely that the EC Commission will also consider that scenario.

Paragraph 225 of the final guidelines mentions a number of efficiencies that resale price maintenance may bring about.<sup>20</sup> Significantly, each of the potential efficiencies for resale price maintenance is strictly conditioned. The Commission seems to be significantly more willing to benignly consider restrictions on resale. In conclusion, the stringent language is likely to discourage companies from entering into pro-competitive resale price maintenance arrangements.<sup>21</sup>

It is surprising that the EC Commission has chosen such a radically different approach in relation to resale price maintenance than the U.S. Supreme Court did in the *Leegin* case.<sup>22</sup> Its choice is probably partly inspired by a fundamentally different valuation of the academic literature; while the majority decision of the U.S. Supreme Court in *Leegin* is predominantly based on theoretical economic insights demonstrating the potential for welfare-enhancing effects, the EC Commission seems mostly guided by empirical insights. Indeed, some empirical literature points to increased prices as a result of resale price maintenance. This, however, does not in itself necessarily imply decreased consumer welfare (because a price increase could be the result of an outward shift of the demand curve).<sup>23</sup> Generally, however, empirical evidence on vertical restraints is scant.

The Commission states that where firms substantiate that likely efficiencies result from a hardcore restriction in the agreement and demonstrate that, in general, all conditions of Article 101(3) are fulfilled, it will be required to effectively assess the likely negative impact on competition before making an ultimate assessment of whether the conditions of Article 101(3) are indeed fulfilled.<sup>24</sup> This means that the usual order of bringing forward evidence is reversed in the case of a hardcore restriction. While the guidelines acknowledge that these two distinct steps may in practice come down to an iterative process where the parties and the Commission in several steps enhance and improve their respective arguments, it is clear that the Commission is of the opinion that in the case of hardcore restrictions the initial burden of proof lies with the parties. The Commission may start from the assumption that the restraint is anticompetitive and only after the parties have *prima facie* demonstrated that the conditions of Article 101(3) are met, will it embark on what Article 101 is truly about: the identification of net negative effects.

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<sup>20</sup> This section is in material respects identical to the proposed text of July 2009, although the reference to the use of resale price maintenance as a means to avoid loss leadership has been eliminated from the final text.

<sup>21</sup> The welfare effects thereof will however be difficult to quantify.

<sup>22</sup> See note 8 above.

<sup>23</sup> See in particular Biscourp, Boutin and Verge, The Effects of Retail Regulations on Prices: Evidence from the Loi Galland, available at <http://econpapers.repec.org/paper/crswpdeec/2008-02.htm>.

<sup>24</sup> Guidelines, ¶ 47.

It is submitted that, at minimum, this approach provides the Commission with significant leeway to condemn the hardcore restraint for not having met the indispensability condition or any other Article 101(3) condition, without having to review whether consumer welfare is compromised. While this allocation of the burden of proof observes the requirements of Article 2 Regulation 1/2003, this is potentially problematic, particularly where intra-brand hardcore restraints, such as resale price maintenance, are welfare-enhancing and do not affect inter-brand competition, but may nonetheless be considered as excessively restrictive (because, according to the Commission, a lesser restrictive alternative such as exclusive territories, is available) and therefore be held contrary to Article 101.<sup>25</sup>

The continuing characterization of resale price maintenance as hardcore restraint also brings with it some undesirable, more practical consequences. Indeed, despite some room to implement resale price maintenance, overall firms will be reluctant to experiment with resale price maintenance.<sup>26</sup> This might not only lead to suboptimal market outcomes, but also prevent a body of business practices from coming into existence that could be analyzed empirically.

## V. CONCLUDING REMARKS

The new regulation for vertical restraints and the accompanying guidelines present a mixed picture. On the one hand, the new regime includes a number of ill-needed clarifications and modifications. In addition, Regulation 330/2010 is arguably more effects-based, takes important trends such as growing internet sales into account, and seeks to address risks associated with buyer power.

On the other hand, one may question whether the implementation of those insights has not unnecessarily limited the scope of the exemption. This would potentially discourage companies to implement efficiency-enhancing distribution arrangements. Finally, the Commission has missed an opportunity to revise its policy with regard to resale price maintenance.

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<sup>25</sup> See Lugard & Hancher, *Honey, I Shrunk the Article! A Critical Assessment of the Commission's Notice on Article 81(3) of the EC Treaty*, 25(7) EUR. COMPETITION L. REV., pp. 410-420 (2004).

<sup>26</sup> See Reindl, *Resale Price Maintenance and Article 81 EC: Developing a More Sensible Analytical Approach*, International Antitrust Law and Policy: Fordham Law 2009 (Barry Hawk, Editor, forthcoming).