

Distribution

Vertical restraints in UK and EU competition law

By *Dermot Glynn and Martin Howe**

What are vertical restraints and why are they an issue?

A vertical agreement is an agreement between parties that operate at different stages in the supply chain. Such agreements often embody a vertical restraint whereby some limitation or restraint is imposed on the freedom of action of one or both of the parties.

Distribution agreements are a commonplace example. Vertical restraints can be a competition law issue because the restraint is inherently a restriction of trade to some degree and so may possibly harm competition.

Chapter I of the UK Competition Act 1998 prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices the object or effect of which is preventing, restricting or distorting competition in the UK or a part thereof and which may affect trade within the UK. However, agreements will be exempt from the prohibition if they provide benefits as specified in the Act.

In fact, vertical restraints can be efficient and legitimate contracting devices. So the question is: where should the line be drawn between when they should be allowed and when prohibited? Even though the Competition Act is modelled on articles 81 and 82 of the EC Treaty, UK and EC competition law currently draw that line differently.

This article discusses the differing treatment of vertical restraints in EC and UK competition law, and looks at the possible effects of the government's proposed changes to UK competition law.

Proposed changes to UK legislation

Currently the Verticals Exclusion Order excludes vertical agreements from the Chapter I prohibition of the Competition Act – with the noteworthy exception of vertical agreements that have the intention or effect of fixing prices. This reflected the government view that vertical agreements that did not include a restraint on prices would not usually have an appreciable adverse effect on competition.

This has not meant that all non-price-fixing vertical agreements can operate without restriction. First, EC competition rules apply to all agreements that might affect trade between member states, and agreements exempt under EC law can obtain a parallel Competition Act exemption. Second, agreements giving rise to an abuse of a dominant position can be challenged under Chapter II of the UK Competition Act.

In June 2000, following widespread pressure to make the law less burdensome on a host of beneficial or neutral agreements, the EC adopted a wide-ranging block exemption for vertical agreements. This replaced a number of block exemptions for specific types of vertical agreement and provided a general exemption, in defined circumstances, for vertical agreements that previously had to be notified to the European Commission in order to obtain an individual exemption under article 81(3). This was a different way of achieving a similar purpose to that of the UK Verticals Exclusion Order.

The government has now had to reconsider the way vertical agreements are dealt with in UK law because in December 2002 the EC adopted the “modernisation” regulation (Regulation 1/2003) by which the enforcement of article 81 is to be “decentralised” to national competition authorities and courts, with effect from 1 May 2004.

The government proposes that the Verticals Exclusion Order should be repealed and that the EC block exemption for vertical agreements should apply to all vertical agreements whether they affect interstate trade or only trade within the UK. Its proposals are set out in some detail in a consultation paper issued in June 2003.

The EC verticals block exemption

There are significant differences between the UK Verticals Exclusion Order and the EC verticals block exemption.

First, the EC verticals block exemption applies only to agreements where the market share of the supplier (or buyer, in the case of an agreement with an exclusive supply obligation) does not exceed 30% of the relevant market. There is no market share cap in order to benefit from the Exclusion Order.

Second, the EC verticals block exemption contains a number of so-called “hardcore” restrictions which, if included in the vertical agreement, have the effect of taking the agreement outside its scope. These relate to agreements or concerted practices that:

- have 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 (this is similar to the exemption in the UK Exclusion Order).
- have as their direct or indirect object the restriction of sales by the buyer, relating to territorial restrictions (although circumstances in which such restrictions do not count as hardcore practices are defined)

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- place certain restrictions on selective distribution systems, notably those that would restrict selling by the authorised distributors to end-users
- restrict cross-supplies or purchasing of the contracted good between appointed distributors within a selective distribution system, or
- prevent or restrict end-users and independent repairers from obtaining spare parts directly from the manufacturer

The only equivalent restriction in the UK's Verticals Exclusion Order is that relating to price-fixing vertical agreements.

Effects of the proposed changes

As is made clear in the consultation paper, the proposed changes will not affect the application of articles 81 and 82 to vertical agreements that may influence trade between member states, which already come directly within the scope of the EC law.

Under the government's consultation paper proposals, agreements that do not affect interstate trade that will be affected by repeal of the Exclusion Order will be those where one of the following applies:

- the supplier or buyer has a share of the relevant market of more than 30% but the agreement has not been blocked by a successful challenge as an abuse of a dominant position
- the agreement includes one of the hardcore restrictions set out above other than price-fixing (which also debars exclusion under the Exclusion Order) that leads to a vertical agreement not being exempted under the block exemption

Agreements falling outside the block exemption are not, of course, presumed to be illegal. The difference is that they no longer have the shelter offered by the Exclusion Order. For such agreements, it is up to the investigating authorities to show that a vertical agreement infringes competition law (art 81(1) or Chapter I of the Competition Act) through having the object or effect of preventing, restricting or distorting competition.

Even where appreciable anticompetitive effects are demonstrated, companies may seek an individual exemption by showing that there are substantial efficiency gains from the agreement, and that consumers benefit.

The rationale for change

A major reason for the change is the government's view that it can best give effect to the EC modernisation regulation by aligning UK competition law as closely as possible with that of the EU. However, the consultation paper also claims that the new regime will "more precisely reflect agreed economic analysis across the EU of the effects of vertical agreements."

So it is to economic analysis that we must look to help answer the questions:

- what agreements embodying vertical restraints are usually regarded as benign?
- is market power important in the assessment of vertical agreements and, if so, why?

The explanation provided in this article is in terms of a producer and a choice of distribution method, of choices made by the producer, and of market power held by the producer. This is just a convenient way of framing the discussion, and the reasoning applies similarly to any stage in a vertical process, or to market power that is held in the downstream market.

Vertical restraints in distribution

A producer will presumably seek to use the most efficient distribution method available for its product that is consistent with its strategic interests. Several modes of distribution are open to a manufacturer and it will seek to choose the most efficient one. Changes in conditions may mean that a more efficient alternative to the producer's existing system becomes available. In this case, the supplier will need to alter its manner of distribution.

The range of possibilities is wide. An initial typology of distribution arrangements might include:

- distribution through one or more independent distributors with no long-term commitments and no restrictions (or "vertical restraints")
- distribution through one or more independent distributors with long-term contractual commitments, with or without vertical restraints
- distribution by the producer or through an agent whose decisions are controlled by the producer

What determines which will be the most efficient distribution method at any one point in time? This is likely to depend on a number of influences, including the nature of the technology in manufacturing and distribution, the nature of the market, uncertainty over how these may change over time, and the costs of writing – and then monitoring – contracts with distributors.

When are vertical restraints likely to be efficient? To help explain this, it is useful to consider how vertical restraints can generate stronger incentives for efficient behaviour than exist under a distribution system without vertical restraints.

Incentive and efficiency gains from vertical restraints

Vertical restraints can create stronger incentives for efficient behaviour in three key areas:

1. Stronger incentives for distributors to spend on promotion: Where a number of competing distributors are involved in supplying a manufacturer's goods, each distributor confers a benefit, or positive externality, on other distributors by engaging in advertising and general promotion of the product.

A free rider problem ensues – meaning that distributors not promoting the good would get a "free ride" on the expenditures of others – with the result that the level of expenditure on such promotional activities is below what would be optimal. Indeed, in a competitive market the level of such promotional expenditure may be zero, as any distributor seeking to offer additional services would have to charge a slightly higher price and risk losing its market (*see Telser*).

However, if a deal is struck containing an element of vertical restraint (*e.g.* where the distributor has the sole rights to sell the products, or sells only the one producer's products, or agrees to sell the products only to certain specified customers or markets), then the distributor might have an incentive to promote the manufacturer's goods more intensively or to train its staff to market the products more vigorously (*see Marvel*).

2. Stronger incentives for distributors to ensure quality control in distribution: The incentives for third party distributors to invest in measures that ensure the quality of products and prevent their misuse may be weaker than the manufacturer would like. Both manufacturers and distributors lose out in the

event of misuse as it means less will be supplied through the appropriate channels. However, this cost is borne by all distributors and the cost to a single distributor might be lower than the cost to the distributor of measures to prevent further misuse.

Similar arguments apply to the maintenance of a product's reputation for quality. A distributor may be reluctant to invest in any better storage and monitoring facilities required to maintain a product's reputation for quality: its stake in the quality reputation of the product may be too limited to justify the costs of the investment.

An exclusive deal may increase the distributor's incentive to invest in the integrity of the delivered product, or remove the incentive to allow the quality or reputation of the product to be damaged.

3. Stronger incentives to invest in specific assets: Suppose there are potentially substantial efficiency gains – cost savings – if both producer and distributor invest in and use a new information and control system specific to that company's own products.

The distributor may still not go ahead with the investment because:

- the distributor is taking a risk on the continuing success of those products over which it has minimal control (*e.g.* the price is largely set or negotiated by the manufacturer) and in which it will not have all the relevant information (*e.g.* the producer may not share with the distributor its inside knowledge of rival products under development and their likely impact on sales of the product in question)
- once the distributor has made the investment, the manufacturer may seek to appropriate all the potential efficiency gains because it would know that, by construction, the distributor cannot use the asset for any other purpose: this is known in economics as the “hold-up problem” (*see Tirole*)

The manufacturer is more likely to help a downstream partner in doing business than it is a third-party distributor. This might involve teaching, sharing software, linking administrative systems or providing information on potential clients.

A long-term contract reduces the risk of either trying to appropriate the gains and so strengthens the incentive for both to invest in assets that increase the efficiency of their joint operations.

Note that, where there are potential efficiency gains from vertical restraints but these cannot be achieved because of transactions costs or inability to agree on risk-sharing, full vertical integration may be the efficient solution.

In analysing competition policy treatment of vertical restraints, it is important to bear in mind that vertical integration may be one of the alternatives to vertical restraints, and that restrictions on vertical restraints may sometimes push parties towards such an outcome.

Does market power matter?

The above discussion shows that vertical restraints can allow greater efficiency in distribution by strengthening incentives for producers and distributors to act in each other's interest. However, vertical restraints have often been a matter of concern to competition authorities. Why, and under what conditions?

Vertical restraints are, by definition, and like many other forms

of significant commercial contract, a restraint on competition, and there can clearly be cases in which they represent a material constraint on competition. For example, exclusive distribution agreements, whereby a manufacturer agrees to distribute only to approved distributors (perhaps in a specified territory), and exclusive dealing (or purchasing) agreements, whereby a distributor agrees to buy only from the one manufacturer, are intended to have the effect of excluding (“foreclosing”) other distributors, in the one case, and other manufacturers in the other, from a part of the market.

The effect of this on competition will depend upon the proportion of the market foreclosed, the length of time before such agreements are renegotiated, and the scope for other distributors and manufacturers to enter their respective level of the market notwithstanding the agreements (*i.e.* the ease of finding alternative suppliers or outlets).

However, even if one were to put aside the efficiency questions discussed above, it is not straightforward to jump from the expectation that competition will be reduced to the conclusion that vertical restraints are against the public interest or against the interests of consumers.

Consider even the simplest case of there being only one producer of a product that has few close substitutes. If the producer agrees to deal only with certain distributors, other distributors are thereby at a disadvantage *versus* their competitors (they have no producer to deal with). Intra-brand competition is reduced.

If, before the vertical agreement, the distributor had had market power (perhaps a case in which the distribution market had previously had one dominant player and several small players), the consequence of the vertical restraint may be lower prices to consumers, since the price charged by one vertically-integrated monopolist will be lower than that charged by a chain of monopolists.

Even when distributors are competitive, one needs to avoid jumping to the conclusion that greater vertical integration might work against the interests of consumers.

It is tempting to believe that, if consumers previously faced competition among distributors, but now face a monopoly distributor, their prices will typically be higher (putting aside economies of scale issues and the efficiency questions discussed above). However, in a supply chain a monopolist can exercise its market power only once. If there was a monopoly producer prior to the vertical restraint, then the monopolist was able to charge a monopoly price to the competitive distributors, who would then reflect that (for them, monopoly supply) price in their sales to final consumers. Even if a producer is a monopolist, then in this straightforward case vertical restraints cannot lead to higher (short-term) prices to consumers.

Vertical restraints also sometimes raise concerns that inter-brand competition may be damaged. Suppose a supplier with market power imposes exclusive dealing on its distributors. Competition between suppliers might be reduced if other suppliers cannot find alternative distribution for their products. Entry barriers may also be increased in that a new entrant may have to enter at both levels of the supply chain.

Hence, where the producer has market power, or where networks of vertical agreements operate in a market, competition authorities can be concerned that vertical agreements might

reduce the effectiveness of competition and might sooner or later lead to higher prices for consumers.

Such consumer losses could, in certain circumstances, outweigh the efficiency gains discussed above and therefore render particular vertical restraints against the public interest.

This obviously does not show that all vertical restraints are harmful where a producer has market power, but it does show that some may be. Where a producer has market power, it would not be safe to assume that vertical restraints are innocuous. The same finding applies to market power held by distributors.

Choices facing competition authorities

Given the above analysis of why vertical restraints can often be efficient, it makes no sense to prohibit them outright. Yet the comments on market power show that some oversight or restriction is necessary. Competition authorities can either:

- a) rely on *ex post* redress to block any abuse of market power through vertical agreements, or
- b) specify *ex ante* that, where there is market power, vertical agreements should not be exempted from the general prohibition of anticompetitive agreements

The risk of the second approach is that efficiency-enhancing agreements may not be entered into, alongside those that aim to reduce competition, depending upon how far parties think it will be possible to demonstrate efficiency gains to the competition authority.

So far, the UK authorities have taken the first road, and the EU authorities the second, although both have outlawed vertical agreements that include price-fixing. As noted above, the government's current proposal represents a shift from the first of these approaches towards the second.

Which is more appropriate depends essentially on the judgment made on three key elements:

- whether the balance of vertical agreements in which one or other party has market power are efficiency-enhancing or simply competition-reducing
- the effectiveness of *ex post* mechanisms in preventing the abuse of a dominant position through vertical restraints, *i.e.* how far they can be relied on to bring to an end competition-reducing vertical agreements, and
- whether the effect of moving to a rather more restrictive form of block exemption would discourage firms from entering into efficiency-enhancing vertical agreements

Of course, any vertical agreement could be investigated under the Chapter II prohibition if one or other party was dominant (requiring a market share of 40% or more under EC case law, and therefore a higher share than the EC block exemption safe harbour) and if the effects of that agreement were held to be an abuse of a dominant position.

But, given the presumption of tolerance of vertical restraints, it is likely to be a pretty rare occurrence for such an agreement to be found an abuse, and therefore unlawful and possibly subject to a fine. Even if such proceedings were successful, the damage to competition and to competitors may already have been done by the time it is blocked.

So the *ex ante* alternative is important, and deserves to be weighed against the greater uncertainty presented to companies considering efficiency-enhancing vertical agreements.

Conclusion

This article has outlined the UK government's proposed changes to the exclusion of certain vertical agreements from the Chapter I prohibition on anticompetitive agreements that restrict trade in the UK, and has indicated that fewer vertical agreements may be exempt from the prohibition.

It has explained the ways in which vertical agreements may enhance efficiency, and so why such exemptions are made for vertical agreements. On the other hand, it has explained why the existence of market power may mean that certain vertical agreements may be harmful.

Vertical agreements that would lose the benefit of the Verticals Exclusion Order under the government's proposals are those that lie within its provisions but not within the terms of the EC block exemption.

Even then, the only such agreements that may be withdrawn because of the proposed change are those that would be liable to successful Chapter I challenge as appreciably restricting competition, but would not otherwise be blocked under the Chapter II abuse of a dominant position.

However, the Chapter II prohibition is likely to deal with relatively few vertical agreements, and may not cover all those with anticompetitive effects. It is also unsatisfactory for dealing with networks of vertical agreements (*e.g.* selective distribution) because of the awkwardness of the collective dominance concept.

The government's proposed new approach recognises the efficiency arguments for vertical restraints and the relevance of market power to the possibility of anticompetitive effects. Of course, the 30% threshold is arbitrary. It may be that some anticompetitive agreements will find refuge in the safe harbour that should have been prohibited but, with the 30% threshold, those should be few.

It is also true that some efficiency-enhancing agreements will not qualify for the block exemption, but they can still be individually exempt. After 1 May 2004, parties will be free to decide for themselves that the agreement would meet the criteria in article 81(3) without reference to the authorities, so avoiding the burden of notification.

On the other hand, as noted above, some of the vertical restraints that would be found anticompetitive and lie outside the shelter provided by the Exclusion Order may be replicated through vertical integration, leaving end-users or competitors no better off than if the vertical agreement had been allowed to stand.

Those interested in these issues have until 12 August to respond to the DTI consultation paper.

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