

## Comments of Dr Robert Stillman, Charles River Associates

### 1. INTRODUCTION

1. My name is Robert Stillman. I am a vice president in the London and Brussels offices of Charles River Associates (“CRA”), an economic consulting firm that works regularly on competition issues before the European Commission (“Commission”).
2. This note presents comments on the Commission’s draft notice of its revised Guidelines on Vertical Restraints (“draft Guidelines”). These are my personal comments and do not necessarily reflect the views of other economists working or associated with CRA.
3. I will comment in this note on only on a few of the many topics covered by the draft Guidelines. The fact that I do not comment on a particular topic covered by the draft Guidelines should not be interpreted as signifying that I necessarily agree with the Commission’s views on the topic.
4. In recognition of the fact that the current draft is well advanced and has already been reviewed extensively within the Commission, I will avoid suggesting any large-scale changes to the draft and instead will comment on the treatment of specific topics and/or specific paragraphs.

### 2. THE FRAMEWORK OF THE COMMISSION’S ANALYSIS IN INDIVIDUAL CASES

5. Paragraphs 92-123 describe the general framework that the Commission will apply to vertical agreements that do not qualify for the Block Exemption.
6. From my perspective as an economist, one of the encouraging features of this section is the apparent promise in paragraph 93 and in paragraphs 107-23 that the assessment of whether a vertical agreement is caught by Article 81(1) will be a “full competition analysis” – i.e. an effects-based analysis, in which the likely market outcomes with the vertical restraint are compared with the likely market outcomes in an appropriately defined “counterfactual” and in which “the likely negative effects must be appreciable”. I also take encouragement from the comment in paragraph 93 that “appreciable anticompetitive effects are likely to occur when at least one of the parties has or obtains some degree of market power and the agreement contributes to the creation, maintenance or strengthening of that market power or allows the parties to exploit such market power”. Whether this promise of an effects-based analysis proves to be the way Article 81(1) is applied to vertical restraints in practice remains to be seen, but I do not think any economist can fault this statement of intent. Described this way, the proposed approach to determining whether a vertical agreement is caught by Article 81(1) does not sound like a rigid form-based analysis.

7. There are other sections of the draft Guidelines, however, which make me concerned whether the Article 81(1) assessment will in fact be an effects-based analysis that requires a coherent economic theory of harm and evidence that likely anti-competitive effects will be “appreciable”. I am particularly concerned when I compare the statement of intent in paragraph 93 and paragraphs 107-23 with the discussion in paragraph 96 of the four ways in which the Commission believes vertical restraints might have effects on the market which EC competition law aims to prevent.
8. The first concern described in this paragraph is the possibility of foreclosure. This possibility is well recognized in the economic literature. For example, the literature on “naked exclusion” explains how, under some circumstances, suppliers might use exclusive dealing arrangements to reduce the “left over” market demand to the point where it becomes uneconomic for fringe suppliers to continue to operate and/or for new firms to enter.<sup>1</sup> Once competition among suppliers is reduced in this manner, the remaining firms may be able to increase prices.<sup>2</sup> Similarly, the literature discusses how, under some circumstances, firms might use exclusive supply arrangements to “raise rivals’ costs”.<sup>3</sup> An increase in rivals’ costs will also lead to higher prices to downstream customers.
9. The second concern described in paragraph 96 is the possibility that vertical restraints might soften competition among suppliers, i.e. that vertical restraints might facilitate tacit (or explicit) collusion. This is another argument that has been explored in the economic literature.
10. The third concern in paragraph 96 refers to the fact that some vertical restraints (such as exclusive territories or selected distribution) reduce intra-brand competition. This is the concern that troubles me. It suggests that if a vertical restraint reduces intra-brand competition (as many do), then this alone might be regarded as sufficient basis for concluding that the vertical agreement is caught by Article 81(1) unless the parties are able to affirmatively prove that the effects of the reduction in intra-brand competition are more than offset by one or more of the positive effects discussed in paragraph 103 of the draft Guidelines.
11. An approach in which evidence of a reduction in intra-brand competition was enough to trigger Article 81(1) would be an unfortunate step away from the effects-based analysis of Article 81(1) seemingly promised in paragraph 93 and paragraphs 107-23. Consistent with the discussion in the first two sub-sections of paragraph 96, there are two main ways recognized in the economics literature by which vertical restraints might have anti-competitive effects. Vertical restraints in some circumstances can lead to foreclosure of actual or potential rivals; in other circumstances vertical restraints can facilitate collusion. While there are other ways in theory in

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<sup>1</sup> See e.g. Rasmusen, Ramseyer & Wiley, “Naked exclusion”, American Economic Review (Dec 1991); and Segal & Whinston, “Naked exclusion: comment”, American Economic Review (Mar 2000).

<sup>2</sup> The customers who are party to exclusive dealing arrangements may or may not suffer from this post-foreclosure price increase, depending on the terms of their exclusive dealing arrangements.

<sup>3</sup> See e.g. Salop & Scheffman, “Raising Rivals’ Costs”, American Economic Review (May 1983); and Krattenmaker & Salop, “Anticompetitive exclusion: raising rivals’ costs to achieve power over price”, Yale Law Journal (Dec 1986).

which vertical restraints can reduce consumer welfare<sup>4</sup>, I would submit that foreclosure and collusion should be the main concerns of competition policy towards vertical restraints and that one should assume that the competitive effects of vertical restraints are at least competitively neutral unless one is able to present a coherent argument as to how the vertical restraints in question are likely to result in foreclosure or to facilitate collusion.

12. Whether or not the Commission agrees with my recommended focus the likelihood that vertical restraints will result in foreclosure or facilitate collusion, I think the draft Guidelines should state clearly whether the Commission believes that evidence of a reduction in intra-brand competition is sufficient basis for concluding that a vertical agreement is caught by Article 81(1). I hope the answer is “no”, but in all events I think the Commission should address the question head on.
13. The fourth concern in paragraph 96 is the possibility that vertical restraints create obstacles to market integration, “including, above all, limitations on the possibilities for consumers to purchase goods or services in any Member State they may choose”. Market integration is of course a principal objective of the European Union and there are sections of the draft Guidelines (e.g. the sections concerning possible vertical restraints on on-line sales) where the Commission’s principal concern appears to be the potential impact of the vertical restraints on market integration (as opposed to a concern about foreclosure or facilitation of collusion). When the Commission’s position with respect to certain vertical restraints is motivated primarily (if not completely) by concerns about market integration, the Guidelines would be a better document if the Commission said so explicitly. If the Commission took this approach, then readers would understand in such cases that the Commission is *not* suggesting that the vertical restraint is likely to result in foreclosure or to facilitate collusion, and readers would not waste their time complaining that the Guidelines have not presented a coherent foreclosure or collusion argument.
14. As mentioned above, paragraph 103 of the draft Guidelines describes various ways in which vertical restraints can have positive effects. I am concerned with footnotes 39 and 40 to this paragraph. Footnote 39 appears at the end of sub-section (1) – the sub-section that describes how exclusive distribution arrangements can help solve free-rider problems that otherwise might dampen the incentives of distributors to invest in product promotion. Footnote 40 (which simply says “see however footnote 39”) appears at the end of sub-section (6) – the sub-section that discusses how vertical restraints can help overcome the vertical externality issue. The vertical externality issue arises when investments by distributors can help expand demand for a supplier’s product, but when the incentive of distributors to undertake such investments is dampened by the fact that distributors may not internalize the increase in profits at the supplier level that may result from the distributors’ investments.
15. Footnote 39, which appears at the end of the sub-section on how vertical restraints can help solve free-riding problems, states:

*Whether consumers actually overall benefit from extra promotional efforts depends on whether the extra promotion informs and convinces and thus benefits many new customers or mainly*

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For example, under some circumstances vertical restraints that reduce downstream competition might make it easier for a dominant supplier to deal with “commitment problems” and might allow the dominant supplier to charge higher prices.

*reaches customers who already know what they want to buy and for whom the extra promotion only or mainly implies a price increase.*

16. The proposition that a vertical restraint that results in greater promotion and greater output might nevertheless reduce aggregate consumer welfare is a proposition that is recognized in the economic literature. The question – which footnote 39 does not address – is how (if at all) this theoretical possibility should be incorporated into an Article 81 analysis of a vertical restraint. Rather than merely “floating” the proposition in footnote 39, the draft Guidelines should clarify whether this possibility is or is not a possibility that the Commission intends to consider – and, if so, how they plan to conduct this part of the analysis.

### 3. THE BLOCK EXEMPTION MARKET SHARE THRESHOLD

17. Under the approach proposed in the draft Guidelines, a vertical agreement cannot qualify for the Block Exemption unless the market shares of *both* the supplier and the buyer are less than 30%. I share the confusion that many others have already expressed with respect to this formulation of the Block Exemption market share threshold.
18. To explain my confusion, suppose one were trying to assess the risk that exclusive dealing arrangements might lead to the foreclosure of rival suppliers. I understand why it makes sense to consider the market share of the supplier. If the supplier has a small market share, then it is unlikely that it would be successful in “locking up” enough of the downstream demand so as to foreclose rival suppliers.
19. I also understand why one would want to consider the size of the downstream market not covered by exclusive dealing arrangements relative to rivals’ and entrants’ minimum efficient scale. Foreclosure can only result if the enough of the downstream demand is “locked up” that rivals and entrants cannot achieve minimum efficient scale.
20. What I do not understand is why one would want to consider the market share of downstream distributors on the market in which the distributors operate as part of the assessment of the risk of foreclosure. If enough downstream demand is “left over” then exclusive dealing arrangements are not likely to have foreclosure effects even if the downstream distributors are monopolists in their local distribution areas. But if the share of downstream demand covered by exclusive dealing arrangements is unlikely to result in foreclosure, it really does not matter whether any of the distributors or customers who are party to the exclusive dealing arrangements have a market share on their possibly local market that is greater than 30%.
21. Similar points can be made with respect to the analysis of exclusive supply arrangements. In such cases, I understand why it makes sense to consider the market share of the buyer. If the buyer is a relatively small player in its industry, then it seems unlikely that it could ever lock up enough input supplies through exclusive supply arrangements to have a material effect on the input costs of its rivals. I also understand why it would be relevant to consider the portion of upstream input supply that is covered by the exclusive supply arrangements. I do not understand, however, the logic of separately analyzing the market share of the input suppliers who are party to exclusive supply arrangements. The key considerations in assessing the risk that exclusive supply arrangements will “raise rivals’ costs” are the market share of the buyer and the portion of upstream input supply covered by the exclusive supply arrangements.

22. I also understand why it makes sense to consider the supplier's market share in considering the risk that vertical restraints might soften competition and facilitate collusion. On the other hand, if a supplier has a small market share, then I do not see how a vertical restraint such as an exclusive dealing arrangement would facilitate collusion at the supplier level even if the arrangement was with a distributor that happened to be a monopolist in its distribution area.
23. For these reasons, and because similar points have already been made by a number of other observers, the Commission at a minimum should clarify why it believes that the Block Exemption should not apply unless the market shares of both the supplier and the buyer are less than 30%. The current draft of the Guidelines never explains the Commission's reasoning on this point.