BLOCK EXEMPTION FOR VERTICAL AGREEMENTS AND *GUIDELINES ON VERTICAL RESTRAINTS*

RESPONSE OF DLA PIPER UK TO COMMISSION'S CONSULTATION ON DRAFT REPLACEMENTS

1. Introduction

1.1 On 28 July 2009 the Commission invited comments on the draft Verticals Block Exception (VBE) and *Guidelines on Vertical Restraints* which it proposes should replace the existing VBE and *Guidelines* when they expire in May 2010.

1.2 In this submission we consider two of the issues raised by the drafts:

1.2.1 the Commission's proposals concerning the market share test to be applied in determining whether an agreement is capable of falling within the VBE; and

1.2.2 selective distribution on the internet, particularly the problem of free-riding.

2. Market share test

2.1 At present a supply agreement falls within the safe harbour created by the VBE if the market share of the supplier does not exceed 30%.[1] The only exception is where the agreement contains an exclusive supply obligation: in that case the 30% ceiling is calculated by reference to the upstream market of the purchaser.

2.2 The Commission proposes to change the existing market share test so that the 30% ceiling is calculated by reference not only to the market share of the supplier, but also to the (downstream) market share of every party to the agreement. So, for example, where the agreement involves a manufacturer, a distributor and a retailer, the safe harbour will be available only if the market share of each one of these parties is no more than 30%, whether the exclusivity relates to sales orto purchases.

For the purposes of this submission we ignore the other provisions of the VBE which must be satisfied if the agreement is to enjoy the benefit of the safe harbour.

Consequences of the proposed changes

3.1 It is possible that the change in the market share test is intended to resolve the Commission's concern about the further increase in the market power of large distributors since 2000, to which it refers in its press release. If that is the Commission's purpose, it will have some surprising consequences, which we examine in this section.

Exclusive supply

3.2 The effect of the proposed change is that in some circumstances the VBE will apply to exclusive supply only where the market power of the distributor as against his own customers is fairly low, but irrespective of its power on the upstream purchasing market.

3.3 This may lead to some strange results for retailers such as supermarkets and pubs or bars, whose market share is conventionally assessed on both a national basis and a local basis. A retailer could find itself in the odd situation that it has a high share of one local market but not of any other local market, and so is precluded from entering into an exclusive supply agreement which falls within the VBE - even if its upstream market share in the product concerned is low.

3.4 Another example is that a supermarket purchasing (say) milk would have to assess its local market share in milk alone, not its share of the local market in groceries. Not only does this differ from the normal market share test for a supermarket, but it is likely that supermarkets will not have such specific information.

Exclusive purchase

3.5 The effect of the proposal on exclusive purchase also needs to be considered. At present the only market share which is relevant for exclusive purchase is that of the supplier on his own (downstream) market. The intention now is that the (downstream) market share of his customer will also be part of the assessment.

3.6 Leaving aside the point that the two markets may be different (milk and groceries), the result could be that a specialist supplier is denied the possibility of exclusive purchase simply because his customer enjoys a substantial downstream market share.

Exclusive distribution

3.7 Exclusive distribution agreements are the most commonly encountered type of supply agreement, and it is here that the changes proposed will have the greatest effect.

3.8 In an exclusive distribution system the usual restrictions are that the supplier will sell to only one distributor in the territory allocated to him and that the distributor will not sell actively outside that territory. These agreements commonly include exclusive purchase obligations as well. Under the current VBE the only question to be considered is the (downstream) market share of the supplier; the market position of the distributor is not considered, notwithstanding the exclusive supply aspect of the system.

3.9 According to the current *Guidelines* the theory behind this approach is that the main effect of exclusive distribution is a reduction in intra-brand competition, which itself is unimportant if inter-brand competition remains strong. The draft *Guidelines* repeat this analysis, but add that there is also a risk of foreclosure of other distributors.

3.10 If the Commission's proposals are adopted, the downstream market share of both the supplier and the distributor will be relevant for an exclusive distribution system: if either of these exceeds 30% the VBE will not apply. The effect of this change could be that a small supplier is denied access to the market via the most effective route on the sole ground that his preferred distributor has a substantial market share.

Components

3.11 Another difficulty arises out of the treatment of agreements for the supply of components. For these agreements, as for any vertical agreement, the downstream market share of the manufacturer of the final goods will be taken into account as well as that of the supplier of the components which he incorporates into those goods.

3.12 That is likely to lead to some strange results where the component is a relatively unimportant input into the final goods. Again a high market share enjoyed by the manufacturer of the final goods could inhibit the use of both exclusive supply and exclusive purchase.

3.13 Manufacturers are not said to be in the Commission's sights when it discusses market power, but an exclusive supply or an exclusive purchase agreement between manufacturers at different levels of the supply chain will also be caught by the new provisions.

4. Practical consequences

4.1 It is not difficult to foresee practical problems arising from the new test. For example, a supermarket may well have a local market share above 30%, and in a small and isolated town there may be only two or three pubs or bars, at least one of which must have a local market share above 30%.

4.2 Specialist suppliers to such retailers may therefore not be able to use exclusive arrangements, even though they need to rely on exclusivity much more than their larger competitors. The new rules could have the effect of denying such a supplier, who might well be a new entrant, the most efficient route for his products to reach the consumer.

4.3 This result runs contrary to the Commission's policy of fostering SMEs and facilitating innovation, as well as deterring the prospect of new entry which can be a stimulus to competition between incumbent suppliers. The new test would actually weaken the position of small suppliers in their dealings with large distributors, who will use it as a reason to refuse to accept restrictions.

4.4 It would be surprising if the Commission intended that the new VBE should have these consequences. But in the absence of any clear purpose for the changes the only effect can be to reduce the ambit of the safe harbour and therefore to increase the burden for the parties of self-assessment with the uncertainty.

4.5 We therefore urge the Commission to re-consider the proposed change to the market share test to be applied under the VBE, with a view both to protecting distributors from the risk of foreclosure and so as to eliminate the effects of the changes which we discuss above.

5. Passive selling and the internet

5.1 The current rules on distribution via the internet are opposed by eBay and some consumer pressure groups, but the concern for manufacturers is the risk of free riding by internet traders.

5.2 The Commission proposes that manufacturers will still be able to insist that retailers have an efficiently operated bricks and mortar (B&M) outlet, but (health and safety concerns apart) they must not restrict internet sales, at least in so far as these are passive. The manufacturer can require that the outlet achieves a minimum turnover, which can vary between different retailers, but only in accordance with objective criteria.

5.3 It will be a hardcore restriction to impose on a retailer any obligation which dissuades him from using the internet by imposing criteria which are "not equivalent" to those required of a B&M outlet. The criteria applied need not be identical, but they must pursue the same objective and achieve comparable results, with any difference between them corresponding to differences between the two methods of distribution.

5.4 Complying with this requirement will difficult, since it imports an element of subjectivity into what the manufacturer is allowed to do. It may be almost impossible to compare the conditions under which products are sold in a B&M outlet and online. Furthermore, characterising the restriction as hardcore imposes a disproportionate penalty in circumstances where a manufacturer may in good faith reach a conclusion different from that reached by the Commission or his retailer. The effect will be to "chill" selective distribution on the internet, allowing on-line traders an unreasonable degree of free-riding. They rely on the B&M distributors the opportunity to see and "feel" the product.

5.5 One strategy currently open to manufacturers is to encourage B&M outlets to invest in premises and staff training by offering discounts which reflect the cost involved. This can reduce the negative effects of free-riding by on-line traders. But under the new proposals a distributor must not be charged a higher price for products to be sold on-line than for products to be sold in a B&M outlet. The supplier can offer a fixed fee to support either on-line or off-line sales efforts. However, a fixed fee does not deal with support for important variable costs such as deploying trained staff. Again the effect will be to limit the ability of manufacturers to prevent free-riding.

5.6 Whilst the Commission's more general policy of encouraging e-commerce may be perfectly justifiable, these proposals are more likely simply to damage shops and other "real" outlets and to threaten the viability of the High Street. We assume that this would be an unintended consequence.

5.7 For these reasons we again urge the Commission to re-consider its proposals on marketing goods on the internet, with a view to ensuring that a proper balance is achieved between the interests of B&M and on-line retailers.

DLA Piper UK LLP

28 September 2009