

Review of the competition rules applicable to vertical agreements

Response to European Commission Public Consultation

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1 Introduction and general comments

- 1.1 Norton Rose LLP ("**Norton Rose**") thanks the Commission for the opportunity to respond to its public consultation in relation to the proposed reforms of the competition rules relating to vertical agreements.
- 1.2 This response is set out to respond to specific points raised in both the new Draft Commission Vertical Agreements Block Exemption Regulation (the "**Draft VABE**") and the new Draft Commission Notice (the "**Draft Guidelines**"). The points raised by Norton Rose are made not on behalf of particular clients it represents, but more broadly represent its perspective on the proposed new rules and the impact these rules will have on customer/supplier relationships in the wider EU economy.
- 1.3 In Norton Rose's experience, the current rules covering vertical agreements have been generally well received by industry and provide a framework which is relatively workable and gives a degree of certainty as to the legal position of particular agreements.
- 1.4 The Commission will not be surprised to hear that companies in most cases do not want to spend an extensive amount of time considering the legality of their distribution arrangements, and to the extent that an agreement may only be legal by virtue of Article 81(3), it is our experience that most companies would prefer the certainty of framing something which is consistent with the safe harbour established in the block exemption than to have to conduct a full self-assessment involving detailed analysis of the actual effects on market conditions, economic benefits for consumers etc. This is the case even for companies who cannot benefit from the block exemption due to their market share - they will still typically prefer to frame distribution arrangements in a form consistent with the block exemption and guidelines than run the risk of an investigation or litigation seeking to assess the robustness of their Article 81(3) self-assessment.
- 1.5 In this respect - particularly given the powers reserved for the Commission to disapply the block exemption (under Article 6 of the Draft VABE) - it is crucial that the new proposals do not deter companies from engaging in pro-competitive behaviour, as the position as set out in the guidelines will broadly be the position taken by companies in practice with few willing to take the risk of justifying a system on the basis of Article 81(3) alone. The lack of precedent outlining successful Article 81(3) arguments in relation to vertical agreements only increases companies' unwillingness to take such risks.

- 1.6 We welcome the Commission's effort to take a more economic and pragmatic approach in relation to certain vertical practices, by including concrete examples drawn from everyday business life in the Draft Guidelines. Our reservation, however, is that despite these first steps in the right direction, the Commission remains too vague in elaborating on certain practices, which makes it difficult for companies to assess their own practices and in the end leads to even more legal uncertainty. In particular with respect to **category management agreements** and **resale price maintenance (RPM)** we consider that concrete and practical guidance is indispensable. Such guidance is, however, lacking in the current Draft Guidelines.
- 1.7 Below we comment in more detail on specific elements of the Draft VABE and Draft Guidelines.

2 Buyer market share threshold

- 2.1 Norton Rose notes the Commission's intention to change the current position as regards the market share threshold to be applied for the Draft VABE to apply. Under the previous regime the 30 per cent market share threshold applied only to the supplier, except in the case of exclusive supply agreements where the market share of the buyer was instead to be considered. Under Article 3 of the Draft VABE, the Commission proposes to apply a 30 per cent market share threshold in respect of both the buyer and the supplier for an agreement to benefit from exemption.
- 2.2 Norton Rose has a number of concerns in this respect:

(i) Market power at both levels of the market is generally required for concerns to arise

The Commission correctly identifies that buyer market power is also relevant to potential anti-competitive behaviour arising from vertical agreements, and that this is the case in contexts other than exclusive supply arrangements.

However, the Commission's proposal fails to go far enough in this respect. It is only where both the buyer and supplier have a degree of market power that competition concerns can arise (in the absence of a network of agreements). The current proposal provides a safe harbour for agreements only where neither party has a market share above 30 per cent.

This removes protection for exclusive purchasing agreements between weak suppliers and strong buyers. One consequence of this will be not offering a safe harbour to new entrant suppliers who are one of the greatest beneficiaries of vertical agreements in a pro-competitive sense. New entrants currently have the comfort of the safe harbour when seeking to incentivise investment in new products by established retailers (i.e. buyers with market shares of over 30 per cent), for example by promising the protection of exclusivity or selective distribution to combat free-riding - and will lose this under the new proposals.

This approach will equally exclude protection for agreements between strong suppliers and weak buyers, and remove such protection in relation to exclusive supply agreements which are within the safe harbour under the current regime. While a

network of such agreements could clearly have a negative effect on competition (due to foreclosure of competing suppliers), one such agreement in isolation will not lead to foreclosure for competing suppliers due to the availability of sufficient alternative buyers downstream. Given the powerful supplier will be aware of whether it is party to such a network of agreements, and that any penalty imposed for illegality would focus on the powerful supplier rather than the numerous weak buyers in such a situation, Norton Rose would suggest the Commission considers whether:

- The Draft VABE could be more generous in recognising that the safe harbour should extend to cover all situations where either the buyer or supplier share is below the threshold (the Commission may wish to reconsider whether the appropriate threshold should be lower in such a context); and
- To allay any concerns that this would let through anti-competitive networks of exclusivity agreements, the Commission could revise Article 7 to remove the need for a regulation to declare the non-applicability of the block exemption to parallel networks of similar agreements, and instead state simply that the block exemption will not apply to networks of similar restraints covering more than 50 per cent of a relevant market. (In Norton Rose's view, coherent theories of significant harm to competition in relation to vertical restraints can generally only arise in contexts of either market power or networks of parallel agreements.)

(ii) Difficulty for suppliers to assess market share downstream

One obvious problem with the introduction of a buyer market share threshold is the difficulty for suppliers - particularly those with large numbers of buyers operating in different distribution models - in knowing the exact market share of purchasers downstream. Although we appreciate that the Commission has taken a view that suppliers will generally know the position of their larger buyers, even if not of smaller buyers, this is not necessarily the case.

In retail markets, for example, the relevant geographic markets are frequently local, and suppliers are therefore expected under the Commission's proposals to consider the position of retailers in large numbers of markets where their positions may vary considerably (UK supermarkets for example potentially operate in several hundred relevant geographic markets, with significantly different market shares in each area).

The substitutability of online sales is also unclear in relation to many retail markets, and therefore even the retailers themselves can have great difficulty predicting the market share that would be settled upon by a competition authority. In this context (and given the comments made in paragraph 1.4 above), we suggest the Commission consider adopting language confirming that the application of the block exemption will be judged based on the parties' reasonable estimate of market share.

3 Category management

- 3.1 In the Draft Guidelines, “category management agreements” are defined as agreements by which, within a distribution agreement, the distributor entrusts the supplier (the “category captain”) with the marketing of a category of products including in general not only the supplier’s products, but also the products of its competitors. We agree that a definition must be included in the Vertical Guidelines, since the concept of “category management” in practice is often used to cover a broad range of practices.
- 3.2 In this respect we note the narrower definition of category management adopted by the Commission (the retailer entrusting a supplier with the “*marketing of a category of products*”) in comparison with the UK’s Competition Commission - “*any exchange of information between a retailer and supplier with the overall objective of improving sales or performance across a category of products sold by the retailer*”, and suggest the Commission consider broadening its definition or give specific examples of the types of conduct covered.
- 3.3 We also note that much of the concern in relation to category captains relates to exchange of sensitive commercial information which might facilitate horizontal collusion. The obvious point to make in this respect is that such exchanges (even if indirect via a vertically-related third party) may in any case be examined under competition rules relating to horizontal collusion without the need to be controlled under rules on vertical agreements including the Draft VABE. This has been shown in the UK OFT decisions in the *Toys*¹ and *Replica kit*² cases (and confirmed by the Court of Appeal³).
- 3.4 The Commission suggests in paragraphs 207 and 208 of the Draft Guidelines that category management agreements may facilitate collusion between suppliers on the one hand and between distributors on the other. Such collusion is often initiated by strong distributors who can use their buying power to persuade their common category captain to act as a platform for horizontal collusion. In other words, in this situation, a vertical agreement is used to create effects on a horizontal level. The ability of suppliers on the other hand to use its position as category captain to facilitate collusion appears less plausible given the obvious lack of incentive for a retailer to facilitate collusion between its suppliers which is only likely to lead to an increase in its wholesale prices.
- 3.5 In order to provide category captains with more legal certainty, Norton Rose believes the Commission could provide more coherent theories of harm, and also concrete guidance as to what is allowed and what is not allowed which will give legal certainty to those employed as category captains. For instance in relation to the quality of information exchanged in the framework of category management agreements (e.g. on the price structure or price developments), more substantial guidance than is currently provided in paragraph 208 would be welcome.

¹ OFT decision number CA98/8/2003 of 21 November 2003.

² OFT decision number CA98/6/2003 of 1 August 2003.

³ *Argos Ltd & Anor v Office of Fair Trading* [2006] EWCA Civ 1318.

4 Resale price maintenance

- 4.1 We welcome the Commission's rethinking and, in line with the recent discussions coming from the US following the *Leegin* case⁴ the Commission's more pragmatic approach in relation to RPM. We also welcome the Commission's clarification that "hard-core" restrictions, such as RPM, may lead to efficiencies which might allow for an exemption on the basis of Article 81(3). We are of the opinion, however, that without more substantial guidelines from the Commission as to when the exemption criteria might apply, the current proposals will deter any companies intending to introduce pro-competitive RPM as the inclusion of RPM in an agreement will lead to absolute legal uncertainty.
- 4.2 Considering the high burden of proof for companies wishing to demonstrate that the conditions of Article 81(3) EC are fulfilled, companies will not be willing to run the huge legal risk which exists when no concrete guidance is provided as regards efficiencies which may be "accepted" by the Commission. This is even more likely to be the case where the agreement includes a restriction, such as RPM, which creates a presumption of an infringement. It is, therefore, of fundamental importance that concrete and clear guidance on the circumstances when RPM is likely to be found to satisfy Article 81(3) is included in the Draft Guidelines. The only current examples of this are in paragraph 221 where the Commission mentions briefly new products and brands, and regarding a coordinated short term low price campaign which, according to the Commission, may not even have any appreciable negative effects if it is of a short duration (2 to 6 weeks).
- 4.3 However, there are other circumstances in which RPM may not have any appreciable negative effects⁵. One example is that of suppliers with very low market shares, facing strong competition from other suppliers in a fragmented market. In order to maintain their position on the market, these suppliers may benefit from certain resale price restrictions to avoid free-riding by their distributors and maintain the quality of their brands. In this situation the risk to a potential loss of interbrand competition and collusion between suppliers which would result from RPM is non-existent.
- 4.4 In addition, and contrary to the Commission's view (in paragraph 220 of the Draft Guidelines) it may even be helpful to new retailers entering the market, who, while being able to maintain a certain resale price level, may focus on other promotional efforts to attract customers. Considering the unlikelihood of negative effects on competition in such circumstances, it would increase legal certainty if the Commission would introduce an absolute level of market share threshold for the supplier (e.g. below 10%), and possibly an HHI index threshold (e.g. below 1,500), under which it is recognised that RPM is highly unlikely to have any appreciable negative effects on competition and would therefore benefit from the block exemption⁶.

⁴ Decision of the Supreme Court of the United States of 28 June 2007 in Case No. 06-480, *Leegin Creative Leather Products, Inc v PSKS, Inc.*

⁵ In its decision in *Leegin*, the US Supreme Court placed weight on the argument that there is usually no incentive for the manufacturer to try and impose excessively high prices on retailers because uncompetitive retail pricing affects the manufacturer as well as customers (by discouraging sales). For this reason, a single manufacturer will only set minimum resale prices if the increase in demand resulting from enhanced service will more than offset a negative impact on demand of a higher retail price. We believe that the Commission should recognise in the Draft Guidelines that these arguments support the fact that there are a number of circumstances in which RPM may not have any appreciable negative effects.

⁶ This would require amendment of the *De minimis* notice in order to make clear that RPM is not excluded from its scope. Norton Rose would even suggest that the Commission should be concerned not to prevent smaller suppliers entering RPM arrangements with larger buyers to the extent this is necessary to incentivise investment, and that the market share of the

- 4.5 There are other commercial practices which also lead to more efficiencies than negative effects and should therefore be treated favourably, for instance in industries where distributors (who provide their know-how with respect to marketing or logistics) work strongly together with the supplier's experts (who provide their know-how on the functioning of the products or other questions related to the product market). In these cases, the distributor may undertake joint activities with the supplier to the benefit of his customers, such as joint meetings with potential customers. Such activities may indeed lead to more efficiencies than negative effects on competition, despite the fact that the supplier will have a strong influence over the resale price level.
- 4.6 In addition, and contrary to the Commission's view (in paragraph 220 of the Draft Guidelines) resale price restrictions may even be helpful to new retailers entering the market, who, while being able to maintain a certain resale price level, may focus on other promotional efforts to attract customers.
- 4.7 Further, while the Commission mentions in paragraph 221 of the Draft Guidelines the possibility that resale price restrictions for an initial period may enable the launch of a new product by encouraging investment in marketing and service to support it, it does not give guidance on the circumstances in which such a policy would be likely to satisfy Article 81(3).

5 Up front access payments

- 5.1 A developing trend in retail markets is the requirement for suppliers to pay distributors/retailers a slotting fee or other access payment in order to secure access to shelf space or the distribution network. Such payments can be seen in part to be a consequence of the buyer power of these distributors and retailers, and therefore the Commission's adoption of a market share threshold in relation to the downstream party is a welcome development.
- 5.2 Norton Rose recognises the Commission's concern that such payments may represent a barrier to entry for smaller suppliers (paragraph 201 of the Draft Guidelines).
- 5.3 However, we are less convinced by the logic of paragraph 202 where the Commission suggests that "*higher supply prices may reduce the incentive of the retailers to compete on price on the downstream market, while the profits of distributors are increased as a result of the access payments*". Norton Rose is concerned that this is an overly speculative proposition, and the concern in relation to access payments stems primarily from buyer power rather than the increased scope for collusion amongst retailers (the Commission tacitly acknowledges this by stating that such collusion will normally only occur where the "*distribution market [is] concentrated*").

supplier (rather than the buyer) should be the principal focus. (As stated above in relation to category management, to the extent that RPM facilitates horizontal collusion, this would still be illegal under Article 81(1) in any event as the agreement is effectively an indirect horizontal - rather than a vertical - agreement.)

6 Mixed distribution systems

- 6.1 We have found that our clients will quite frequently use a range of distribution systems within the wider EU market. In certain jurisdictions a single exclusive distributor may be appointed, while in other jurisdictions, a selective distribution system may be put in place with several dealers competing against each other. It may also be the case that in other jurisdictions, the supplier has an open distribution network with intrabrand competition for its products between any interested distributors.
- 6.2 The logic for such an approach is not always clear, but in many cases is grounded in clear pro-competitive thinking - for example, allocating an exclusive dealer in a territory may be the most effective way of entering that market, while operating a selective distribution system in another territory may achieve better coverage with the intrabrand competition reducing retail prices, and thus increasing sales volumes.
- 6.3 Under the current rules, and in the Draft VABE and Guidelines, the Commission has retained the position that active sales can only be restricted in relation to territories which have been exclusively allocated to other dealers or reserved to the supplier itself. Where the supplier is using a selective distribution system it cannot restrict either passive sales or active sales into the non-exclusive territory or to non-exclusive customer groups.
- 6.4 Our concern here is that the Commission has missed an opportunity to address this imbalance and allow suppliers to also restrict active sales in relation to selective distribution systems. We also note the inconsistency between the Commission's approach to restrictions of active sales outside a territory in relation to the Draft VABE with the approach taken in the Technology Transfer Block Exemption Regulation.
- 6.5 The Technology Transfer Guidelines (at paragraph 99) highlight the benefits of such restrictions which are assumed to "*promote investments, non-price competition and improvements in the quality of services...by resolving free rider... and hold-up problems*" (paragraph 99), and therefore allow such restrictions to be block exempted even where more than one licensee has been appointed for a particular territory.
- 6.6 We suggest the Commission consider revisiting this position in order to give greater clarity and consistency for companies operating mixed distribution systems in the EU. Again, in the absence of market power, it is difficult to see a coherent theory of harm to justify the current approach.

7 Internet sales

- 7.1 The Commission's efforts to provide more guidance in the Draft Guidelines on the rules applying to sales over the internet are to be welcomed, as this was one of the areas where the old guidelines had become increasingly out-of-date. Our experience is that our clients use internet sales channels widely and recognise that internet sales are an invaluable method of broadening access to customers.
- 7.2 The internet is also an extremely valuable source of information for consumers and in many ways give consumers access to more detailed and objective information than may be available

to consumers with in a brick and mortar retail establishment. The barriers to online trade (consumer confidence, issues with secure payment systems, language, etc) are increasingly falling away as consumers become more familiar with the internet and technology, companies and regulators make internet commerce ever easier to engage in. It is notable that online sales in the UK in the last year increased by 16 per cent, while retail sales more broadly have fluctuated between decline and minimal growth.

7.3 However, the suitability of internet sales for all products and services is not certain. Online is one of many distribution channels available to suppliers, and we would argue that in the absence of market power, suppliers should retain discretion as to whether they wish to allow their distributors unfettered licence to sell their products online (we note that this debate has in part been clouded by suppliers' (justified) concerns about the high volumes of "grey market" and counterfeit goods sold online. Although we recognise that such issues are not an immediate competition policy concern, we would ask the Commission to also recognise that the decisions it makes in relation to the Draft VABE will have an impact on how easily suppliers are able to police such issues).

7.4 In this context, we would encourage the Commission to take on board the increasing importance of the internet by providing more guidance than is currently envisaged.

7.5 Active/passive sales

7.5.1 The Commission continues to classify online sales as passive sales - with the consequence that any attempt to limit distributor's online sales is effectively treated as a hardcore attempt to limit parallel trading. The Commission's continued referral to online commerce as only being "active" where a company sends unsolicited emails is also out of synch with modern business practices. Companies make significant investments for example in ensuring their "Google ranking" is high so that consumers using search engines are more likely to be directed to their sites. Under the Commission's proposed approach, it is not clear that suppliers will be able to control such practices where they specifically target customers outside a defined territory.

7.5.2 At paragraph 52 of the Draft Guidelines, the Commission says that the language options on a website normally play no role in identifying whether it is actively targeting groups in other distributors' exclusive territories. This also seems unrealistic. Companies are generally unlikely to invest in alternative languages on a website if they are not attempting to target customers in the location where that language is dominant. In this context, the Commission should recognise that where a particular language is available on a website, the assumption should be that the distributor is targeting customers in a certain region, and it is then for the distributor to demonstrate that this is not the case if it is to succeed in classifying its sales in that region as passive.

7.5.3 We would suggest that the Commission's comment in paragraph 51 - that the assessment should be made on the basis of whether it would be attractive for the buyer to undertake these investments even if they would not reach customers in other distributors' exclusive territories - is a more useful assessment criterion.

7.6 Online versus brick and mortar

7.6.1 The Commission has remained robust in the position that a supplier cannot reserve online sales for itself (despite the fact that this gives it the greatest control over the format and presentation

of its products when they are sold online), and that companies cannot require distributors to sell only a proportion of goods through online channels. Instead suppliers may require a minimum quantity to be sold through a brick and mortar establishment in order to ensure a physical sales presence is retained to protect brand value.

7.6.2 In our experience, suppliers fundamentally want to maximise profitability, and this is normally achieved through maximising sales. In this context, their preference is to allow dealers to sell their products offline or online as they choose. To the extent that suppliers do wish to control their distributors' ability to sell online, this is typically related to:

- ◆ brand devaluation as a consequence of the online format;
- ◆ concerns about free-riding undermining the viability of brick and mortar outlets; or
- ◆ concerns relating to grey market imports or counterfeit goods being sold through online channels.

7.6.3 In our view, if suppliers have such concerns - and provided the supplier does not have market power (i.e. there is sufficient interbrand competition) - then they should generally be free to control how their products are sold in the interest of protecting their business.

7.6.4 Paragraph 52 of the Draft Guidelines says that the Commission will regard a limit on the proportion of sales made over the internet to be a hardcore restriction, but will allow the supplier to set an absolute amount of sales (by volume or value) that must be made in store. It is acceptable for the supplier to tailor offline sales requirements individually based on, for example, the buyer's size. Notwithstanding the increased burden on the supplier to calculate and apply a suitable value or volume based threshold in relation to each of its dealers throughout the EU (which for some suppliers can be several thousand), such a position denies the supplier the opportunity of requiring its distributors to be primarily brick and mortar sellers - and therefore it denies the supplier the opportunity of having its product sold primarily through brick and mortar outlets *should it decide that this is what best serves its interests*.

7.6.5 We suggest that the supplier should be allowed to set a percentage of sales to be made through either the brick and mortar or online channel across its network, which would be fair and predictable for buyers and simple for the supplier to operate. The online channel is currently being treated in a completely different way to other distribution channels over which a supplier is allowed much greater control - a position we see as being hard to justify in terms of competition policy. We would note that in practice, the vast majority of suppliers will have no interest in limiting online sales as it is against their economic interest to do so, but that they should have the right to do so without interference from regulation should they so decide.

7.6.6 We also note the Commission's position as regards the quality criteria. Paragraph 54 explains that a supplier may require a distributor to meet quality standards to sell goods over the internet, in a similar way to that which might be used by a supplier in an offline selective distribution network. However, the Draft Guidelines do not give any indication of how the Commission expects such quality standards might work in practice. In paragraph 171 the Commission gives examples of objective criteria in an offline network: training of sales personnel, the service provided at the point of sale, a certain range of the products being sold, and refers to case law for further guidance.

- 7.6.7 However, there is no such guidance for online sales and it is not necessarily obvious how these criteria (with the exception of the range requirement) might apply in an online environment. The Commission suggests that online criteria are permitted to ensure online sales “*remain consistent with the supplier’s distribution model*”, but puts the burden on the supplier to show that such criteria are “*equivalent*” to criteria applied to brick and mortar outlets.
- 7.6.8 We think this puts an undue burden on suppliers and - in the absence of more explicit guidance - opens the door to extensive disputes between suppliers and distributors (including litigation of the type that has arisen notably in France in recent years) as to whether online criteria are acceptable. It is our strong view that suppliers should be free to decide the criteria they apply to their online retailers, just as they can for brick and mortar sellers, without fear of litigation caused by regulatory interference and inadequate guidance.
- 7.6.9 In the absence of supplier market power, the ability of suppliers to use online sales criteria to cause any significant harm to competition is not apparent. We therefore suggest it would be helpful for operators of selective distribution networks if the Commission gave similar examples of the types of objective criteria that would typically be acceptable to set for an online selective distribution network to those it has given for offline sellers.

We hope the Commission finds these comments helpful, and look forward to the Commission’s final VABE and Guidelines.

Our general approach is to ask that the Commission be cautious in taking any excessive regulatory steps in relation to vertical conduct which will impact on the position of suppliers and distributors under the new VABE for the next 10 years. The online market in particular will change enormously in this time and setting hard restrictions in place now may cause problems later. The evidence that online sales are thriving is self-evident, and suppliers are only likely to seek to restrict such sales in very limited (and generally justified) circumstances.

Uncertainty in the Commission approach will also inevitably create problems not only for the companies seeking to frame agreements within the scope of the rules for the sake of legal certainty, but also for the myriad authorities and courts throughout the EU which will be required to interpret and apply the Commission’s rules.

Given the difficulties in identifying clear anti-competitive effects in the context of vertical agreements unless there is either (i) market power (and therefore foreclosure), (ii) a network of a such agreements, or (iii) facilitation of horizontal collusion through indirect means, we would ask the Commission to resist the need to complicate the position for businesses.

We would of course be happy to engage further with the Commission to discuss these issues to the extent required.

Norton Rose LLP

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