Simmons & Simmons

Review of the competition rules applicable to vertical agreements

Introduction

The Simmons & Simmons EU, Competition & Regulatory Group welcomes the opportunity to respond to the Commission's Review of the competition rules applicable to vertical agreements. Our response reflects the consensus across our offices.

General comments

In a number of respects, the draft Regulation and draft Guidelines propose to take a narrower approach to the assessment (and continuing exemption) of vertical agreements than is currently the case. This is so notwithstanding the Commission's acknowledgement in the press release launching the consultation that it considers that the rules are working well overall and should not be fundamentally modified. We, in contrast, would be in favour of the Regulation taking a more generous approach, given the essentially benign nature of vertical agreements. Greater use could then be made of the withdrawal mechanism where appropriate, rather than, for example, the market share threshold also being applied to buyers, which we believe will in practice contribute to greater legal uncertainty and potentially deter parties from entering into benign business arrangements. We do not see the case for narrowing the scope of the exemption.

The goal of post-modernisation guidelines should be both to provide clear guidance to individual parties on how to assess agreements and to assist national courts and competition authorities in determining cases by setting out the Commission's enforcement practice and priorities. Regretfully, however, the draft Guidelines appear to us instead oriented more towards Commission enforcement than towards assisting companies to self-assess. This is evident, for example, in the approach to assessing hard core restrictions set out from the perspective of the enforcer in paragraph 47, and in the introduction of new descriptive sections on category management and upfront access payments, which nonetheless fail to provide real guidance to companies.

Our views on these issues are set out in further detail below.

Specific comments

Buyer's market share threshold and withdrawal procedure
Regulation: Articles 3 and 6; draft Guidelines §23, §§70-74 and §§83-91

The introduction of the 30% buyer's market share threshold is stated to be driven by increased concentration in the retail sector: "*the increased buyer power of big retailers*" according to the Commission's press release heralding publication of the drafts. We recognise that the market share threshold has value where there are concerns about foreclosure, but we query whether the cited developments in one sector justify such a significant change across all sectors. The concerns underlying the introduction of a buyer market share threshold appear driven by market power and could in our view be dealt with through the application of Article 82 where the conduct is imposed upon the supplier unilaterally, or through the Commission or relevant national competition authority withdrawing the benefit of the block exemption using Article 6 of the Regulation in other cases.

Paragraph 22 of the 1999 Guidelines states that "*only having to consider the market between supplier and buyer makes the application of the Block Exemption Regulation easier and enhances the level of legal certainty, while the instrument of withdrawal remains available to remedy possible problems on other related markets*." We believe that this assertion not only remains valid, but highlights an adverse effect of the proposals. Instead of analysing the immediate market as between seller and buyer, the seller will also need to analyse the downstream market share of the buyer on the resale market – or markets. This introduces an additional burden, as well as a significant element of additional uncertainty. Market definition and the analysis of market shares are in general an imprecise activity. Making the assessment on more than one level increases the uncertainty and in retail markets it can be particularly difficult to delineate local geographical markets.

The 1999 Guidelines refer to withdrawal decisions being taken in "*situations where the buyer, for example in the context of exclusive supply or exclusive distribution, has significant market power in the relevant downstream market where he resells the goods or provides the services*." From our perspective, the principles underlying this approach remain valid, and deletion of the sentence (in what was formerly paragraph 73 of the Guidelines) is likewise to be regretted.

We believe that the instruments to counteract buyer power are already in place and that the cited increased buyer power of big retailers does not justify applying a market share threshold across all sectors. In our view, the 30% seller only market share threshold should continue to apply, and the withdrawal procedure should be used to address any adverse consequences of buyer power.

Hardcore restrictions
Draft Guidelines §47

Paragraph 46 of the 1999 Guidelines indicates that individual exemption of vertical agreements containing hardcore restrictions is "unlikely". The abolition of the individual exemption regime clearly required some redrafting of the paragraph. Paragraph 47 of the draft Guidelines contains a presumption that an agreement containing hardcore restrictions will fall within Article 81(1), and a second, rebuttable, presumption that the agreement is unlikely to fulfil the conditions of Article 81(3). The paragraph continues

"In case the undertakings substantiate that likely efficiencies result from including the hardcore restriction in the agreement and that in general all the conditions of Article 81(3) are fulfilled, this will require the Commission to effectively assess - and not just presume - the likely negative effects on competition before making the ultimate assessment of whether the conditions of Article 81(3) are fulfilled."

As formulated, this seems to be a rather circular argument. Paragraph 34 of the Commission's Guidelines on the application of Article 81(3) of the Treaty[1] indicates that when the four conditions are fulfilled, the agreement enhances competition within the relevant markets, because it leads the undertakings concerned to offer cheaper or better products to consumers, compensating the latter for the adverse effects of the restrictions of competition. If the parties have substantiated (ie demonstrated) that all the conditions of Article 81(3) are fulfilled in the course of presenting their efficiency defence, then there is a question as to what more the Commission needs to do by way of effectively assessing the likely negative effects on competition before making the ultimate assessment of whether the conditions of Article 81(3) are fulfilled. Footnote 26 does not necessarily add clarity by suggesting that "*What is described here as two distinct legal steps may in practice be an iterative process where the parties and authority in several steps enhance and improve their respective arguments*."

In our view, the rebuttable nature of the presumption leads logically to the requirement that the Commission should in any event effectively assess and not just presume the likely negative

[1] 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.

effects on competition before coming to any conclusion as to whether the conditions of Article 81(3) are fulfilled. If, in the course of pleading its efficiency defence (by way of iterative process or otherwise), a party is able to substantiate both that efficiencies are likely to result from including a hardcore restriction and that in general all the conditions of Article 81(3) are fulfilled, the parties must in our view be regarded not only as having successfully rebutted the presumption, but also as having demonstrated that the Article 81(3) exemption applies, without a further "ultimate assessment".

Exceptions within the hardcore restrictions: online sales
Regulation Art. 4(b) first indent, draft Guidelines §52-54; §57

The important provisions relating to online sales set out in the draft Guidelines underline just how difficult it is to account for online sales within traditional distribution systems. There is an argument that online sales undermine the very concept of exclusive territories, given the ease with which sales of items that are relatively easy to transport can be made into other territories. Something of this dilemma can be glimpsed in the first two indents of paragraph 52 of the draft Guidelines, which set out instances which the Commission will regard as hardcore restrictions of passive selling. We would welcome clarification from the Commission on whether the provisions apply to all distribution agreements (in which case the word exclusive and the brackets are redundant), or only to exclusive distribution (in which case the brackets are redundant). The difference is significant both in practical terms, and in terms of highlighting how difficult it is to maintain exclusive arrangements in the internet age.

We likewise note that the fourth indent makes price differentiations between online and physical distribution channels a hardcore restriction, although a supplier may still (subject to Article 82) price differentiate between online and other distributors, and between hybrid distributors that sell through both channels and offline only distributors. The outcome of the GSK dual pricing case currently before the European Court of Justice[2] may throw this premise– and indeed other premises – in the block exemption into question.

We recognise the impetus behind the Commission explaining that online sales criteria need not be identical to those imposed on offline sales, provided they pursue the same objectives and achieve comparable results, and that the difference between the criteria must be justified by the different nature of the two distribution modes. However, we believe that both these elements are likely to provide fertile ground for disagreement and ultimately litigation. Both "*equivalence*" and "*comparable results*" are notoriously difficult concepts to assess and we believe that the requirement to justify differences by reference to the different nature of the distribution models will prove no less difficult.

Exceptions within the hardcore restrictions: cross supplies within selective distribution systems
Regulation Art. 4(b) third indent, Guideline §56

We note the insertion of the phrase "*in markets where such a system is operated*" in relation to the restriction on sales by members of a selective distribution system to unauthorised distributors. We recognise that the phrase appears in the equivalent provision in the 2002 motor vehicles block exemption[3]. However it is unclear in relation to the general verticals block exemption whether the insertion is intended to limit the scope of the exception (ie constitutes a shift in practice) or simply clarifies existing practice. It would be helpful if the Guidelines indicated this one way or another.

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[2] Joined Cases C-501/06 P GlaxoSmithKline Services Unlimited, formerly Glaxo Wellcome plc v Commission of the European Communities and: C-513/06 P Commission of the European Communities, C-515/06 P European Association of Euro Pharmaceutical Companies (EAEPC), and C-519/06 P Asociación de exportadores españoles de productos farmacéuticos (Aseprofar) v GlaxoSmithKline Services Unlimited, formerly Glaxo Wellcome plc.

[3] Regulation (EC)1400/2002 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector.

Efficiencies
Draft Guidelines (primarily) §103

We welcome, as a further example of the positive effects of vertical restraints, the inclusion of the vertical externality/double marginalisation issue in paragraph 103(6) of the draft Guidelines. We likewise welcome the incorporation of a discussion of efficiencies in respect of individual vertical restraints in section two of the draft Guidelines. We note that the Commission continues to analyse an agreement separately in terms of Article 81(1) and Article 81(3) here and suggest that the text should expressly recognise that applying such an approach to efficiencies could instead take an agreement outside Article 81(1) altogether – see in particular case 258/78 Nungesser v Commission, [1982] ECR2015.

Upfront Access payments
Draft Guidelines §199-204

The new section in the draft Guidelines on upfront access payments defines them as "*fixed fees that suppliers pay to distributors in the framework of a vertical relationship at the beginning of a relevant period, in order to get access to their distribution network and remunerate services provided to the suppliers by the retailers*".

The draft Guidelines list a number of potential positive and negative effects of upfront access payments. On the one hand the draft Guidelines acknowledge the various efficiencies that upfront access payments can generate, such as an efficient allocation of shelf space, a reduction of the asymmetry in information between suppliers and distributors on the potential for success of new products to be introduced on the market and prevention of free-riding by shifting the risk of product failure back to the suppliers, thus contributing to optimize the introduction of products.

On the other hand, the draft Guidelines indicate the anticompetitive effects that upfront access payments may have, both for other distributors (in particular when such payments induce the supplier to channel its products through only one distributor) and for other suppliers, if their widespread use increases barriers to entry for new entrants (in particular, for small potential newcomers with limited budgets). Foreclosure could for instance come about through competitors being prevented from increasing their visibility or accessing the market because another supplier has secured the necessary shelf space through upfront payments, which is particularly true for "small" operators. In our view, as shelf space is by definition limited, the supplier need not be a "small entrant" to suffer from strategic use of access payments by a competitor seeking to impede its rival's economic growth. A further concern, given the combination of limited shelf space and additional cost, is that upfront payments could in fact result in innovation being dampened by discouraging other suppliers from innovating. In principle, competition for space could increase the size of upfront payments and so shift profit from the supplier to the distributor. The Commission points out that upfront access payments could facilitate collusion between distributors: since if the cost of upfront access payments increases the price charged by the suppliers for the products, the incentive of the retailers to compete on prices will be reduced, while their profits are increased as a result of the access payments.

Having set out the positive and negative effects of upfront access payments, little guidance is offered on the circumstances in which they would be prohibited, or on where the Commission stands in relation to such payments generally. The draft Guidelines indicate that the Commission is intending to analyse certain of these arrangements by analogy with single branding obligations or exclusive supply obligations. Without examples, it is not easy to see how the Commission will approach its analysis. We doubt the extent to which this section is useful in its current format. In our view, the Commission should offer more guidance, so that companies can apply that guidance to their business arrangements with some confidence that they will then not fall within Article 81. Without cases or guidance on the issue, companies are left in limbo in relation to a practice that is widespread in the retail sector.

Our reading of the draft Guidelines suggests that, at heart, this is another issue rooted in a concern with the conduct of undertakings with a degree of market power. In our view, therefore, greater use could be made of the withdrawal procedure where such agreements would otherwise be block exempted, but where anti-competitive effects result, including foreclosure because a network of similar agreements is already in place. Whilst this could potentially increase legal uncertainty in the treatment of upfront access payments, a clear indication of the circumstances in which the Commission would invoke the withdrawal procedure or, where the parties are outside the safe harbour of the block exemption, prohibit the conduct, would enable companies to assess their behaviour more accurately.

Category management agreements
Draft Guidelines §205-209

As with upfront access payments, category management agreements, under which a distributor entrusts the supplier (the so called "category captain") with the marketing of a whole category of products (rather than just its own products in that category), are exempted up to the 30% market share test. The draft Guidelines again list the benefits of category management agreements (such as better use of shelf space and promotional resources, greater consumer satisfaction), as well as a number of its potential concerns. These revolve around anticompetitive foreclosure if the category captain favours his own products, encouragement of collusion between competing distributors if a category captain acts for all or most of the competing distributors in a market, the provision of a common point of reference for distributors' marketing decisions and the facilitating of collusion between suppliers through increased opportunities to exchange, via retailers, sensitive commercial information such as future pricing information, promotional plans or advertising campaigns.

As with the upfront access payments, the draft Guidelines fail to give clear guidance on the Commission's likely approach to category management agreements. They send out a creeping negative message about these practices which is likely to chill (in our view unnecessarily) business people's confidence in their use without helping them properly to assess their conduct and ensure that it is permitted. Neither category management nor upfront access payments are *per se* offensive, nor is there decisional practice on which the Commission's position is based. From that perspective, the inclusion of new sections on both these topics operates as a warning without real guidance.

We would prefer to see a rather different approach to supply chain practices, in which the Commission indicated that, whilst it has to date had little experience of vertical agreements of either kind, it recognises that both category management agreements and upfront access payments are widespread practices that largely bring benefits. It could go on expressly to set out its initial thinking on the matter, and to flag those areas in which nonetheless would have concerns and be likely to take action, for instance if foreclosure or collusion resulted.

The UK Competition Commission re-addressed issues of supply chain practices in its Final Report on the Groceries inquiry[4] and on lump sum payments, concluding that "*In general terms, we do not consider that obtaining lump-sum payments from suppliers distorts competition between grocery retailers or between suppliers with the exception of the possible effect of these payments on small suppliers.*"[5] It too expressed some concern about the prevalence of certain supply chain practices, in particular those that transfer excessive risks and unexpected costs to suppliers and the impact that these may have on innovation or investment in the future. The approach, following an in-depth analysis of the UK groceries market, is a nuanced one, but even then, no strong antitrust remedy emerged.

4 Groceries Market Investigation Final Report, 30.08 2008 paragraphs 9.37-9.81 and Appendix 9.
5 Ibid,. Appendix 9.66.

The European Commission is clearly concerned about the potential for anti-competitive behaviour in aspects of these retail practices, but it should not give the impression that these (very) common practices in retail markets are at heart improper. It seems premature in the circumstances for these issues to be included in the general regime for vertical restraints. The impression given is one of creeping regulation where the Commission in the draft Guidelines identifies that it could have relevant concerns in a new category of agreements, but does not have the experience to give real guidance. The overall effect will tend to create uncertainty amongst parties to such arrangements when this is not justified. The emphasis should instead be upon assisting companies to assess their activities within clear parameters.

Resale price restrictions
Article 4(a) draft Guidelines §219-225)

Article 4(a) of the current block exemption Regulation on vertical restraints provides that resale price maintenance (RPM) is a hardcore restriction. Consequently, an agreement that includes an RPM provision cannot benefit from exemption under the block exemption, though it could, in theory, be exempted on the grounds of Article 81(3).

Notwithstanding the theoretical possibility of exemption, case law shows that the Commission and the National Competition Authorities' approach to RPM is more a *quasi per se* approach. However, the *Leegin* case[6], admitting that the rule of reason should also apply to RPM, has reopened the question of the *quasi per se* ban in Europe.

Whilst the draft Regulation continues to categorise RPM as a hardcore restriction, and the European Commission still considers that the efficiency arguments in support of RPM "*are not very strong and that RPM is not an efficient instrument to bringing about efficiencies*"[7] the draft Guidelines indicate that the European Commission does now intend to apply all the conditions of Article 81(3) to RPM.

We believe that this is a welcome development. We are not in favour of *per se* prohibitions. Moreover, a general prohibition is not appropriate insofar as every type of vertical restraint can have a positive effect on consumer welfare, even if the likelihood of this effect varies from one type of vertical restraint to another.

We acknowledge that, as the draft Guidelines suggest (paragraph 220), RPM has a tendency to decrease competition and consumer welfare. This may be through enhancing price transparency in the market, facilitating collusion between buyers by eliminating intra-brand price competition, softening competition between manufacturers and/or retailers, increasing prices and lowering the pressure on the margin of the manufacturer. However, it is not the case that RPM facilitates collusion in relation to all market structures, and in any event is only true if the RPM is widely put into effect. Moreover, economic analysis shows that, in certain circumstances an RPM provision can enhance consumer welfare. For example:

- In the case of a monopoly (upstream and downstream levels), RPM suppresses the double marginalisation inefficiency.

- RPM may increase inter-brand competition between manufacturers.

- RPM may increase intra-brand competition other than on the ground of pricing, for example where the distributor provides higher quality and valuable services. This can in particular be demonstrated where sales increase notwithstanding an increase in price.

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6 Leegin Creative Products v PSKS, Supreme Court of the United States, 28 June 2007.
7 OECD Roundtable on resale price maintenance, note by the European Commission OECD DAF/COMP/WD(2008)64, 13 October 2008.

- In sectors in which the consumer is required to make a quick choice, such as the fast food sector, in which customers value the guarantee of uniformity of quality and price throughout a chain of restaurants[8], RPM may help that choice to be made efficiently.

- A supplier could choose an alternative distribution model, such as proprietary networks or an exclusive distribution network which have the effect of limiting downstream competition, but could be less efficient and consequently decrease consumer welfare. The fact that a supplier that imposes an RPM saves itself the cost of maintaining a proprietary distribution network is irrelevant in assessing economic welfare.

- Price competition may encourage free riding, in particular regarding complex products and new products:

  <u>Complex products</u>: there are no real incentives to provide pre-purchase services if the consumer is able to take advantage of those services and then purchase the product at a low price from a retailer who does not provide them. The logical consequence would be that each retailer would provide low level services and, as a result, consumer welfare is reduced.

  <u>New products:</u> in certain circumstances, subsequent distributors could free ride on investments made by the first distributor of a new product that that are specific to its launch. As a result, a first distributor may limit the scope of its initial investments, to the detriment of the product launch and consequently to consumer welfare.

  In both cases, RPM can be used to impede free-riding and encourage distributors to provide high quality services.

We note that the draft Guidelines do not expressly provide that an agreement including a minimum resale price provision could fulfil the conditions of Article 81(3). We believe that the European Commission should explicitly address the point. In our view, and in particular in relation to luxury products, the competition authorities should put an end to the "judgmental" assessment of minimum prices and recognise the fact that a high price may be necessary to the brand image of a product[9].

We believe that, since the welfare effects of RPM are similar to the effects of other vertical restraints, such provisions should benefit from similar treatment. To that end, an assessment of RPM provisions under Article 81(3) is highly relevant in appropriate cases. Perhaps there is an argument for reintroducing the concept of a “grey” category of restriction for RPM, which would underscore the fact that such restrictions are not exempted, but must be assessed individually in appropriate cases.

Conclusion

Whilst we welcome aspects of the changes (in particular in relation to efficiencies, both in the approach to RPM, and the inclusion of the vertical externality/double marginalisation issue) we have two principal reservations about the proposed changes. The first is the hardening of the approach to analysing essentially benign agreements and a narrowing of the safe harbour – essentially what we have described as “regulatory creep”. We regret the deletion from paragraph 3 of the 1999 Guidelines the statement that the Commission “*will apply the Guidelines reasonably*

8 See, for example, the discussion by David Spector in ‘Minimum resale prices: Is a ban justified?’, Concurrences n° 3 – 2007.

9 As is the case in EC merger control practice, see M.1534, Pinault-Printemps-Redoute/Gucci; M.1780, LVMH/Prada/Fendi.

and flexibly" – which could awaken the unwelcome prospect that, going forward, the Commission intends to do the opposite. Overall, for a set of "*rules [that] have worked well in practice*", the extent of the proposed changes to the regime go beyond what in our view is necessary. Our second reservation is the lack of assistance provided in the draft Guidelines to parties faced with self assessing their agreements, for example in the lack of actual guidance provided in the new sections on supply chain practices in the draft Guidelines. In that respect, we would encourage the European Commission to go further, and provide guidance of real assistance not only to enforcers across the Member States, but also to companies so that enforcement (and subsequent litigation) can be avoided in the first place.

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