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Consultation on review of the competition rules for vertical agreements

INTRODUCTION

1. Steptoe & Johnson LLP is grateful to the Commission for the opportunity to comment on its proposals with respect to a revised block exemption and guidelines on vertical agreements. The proposals show that the Commission is of the opinion that the present rules are working reasonably well and do not need to be fundamentally changed. Steptoe & Johnson shares this view. The proposals appear to be mainly intended to respond to two important market developments since the adoption of the current block exemption regulation, namely the enhanced purchasing power of large retailers and the growth in sales over the Internet. Steptoe & Johnson's comments will be largely limited to the Commission's proposals in these two areas. It will also touch on its suggested approach of "resale price maintenance" ("RPM").

2. The Commission's current approach with respect to vertical restraints is certainly not free from criticism. In the literature, attention has in particular been drawn to two systemic problems. In the first place, it has been pointed out that the main reason for the establishment of the block exemption was to facilitate the assessment by the Commission of notified distribution agreements. As notification since the entry into force of Regulation 1/2003 is no longer required, the block exemption has become obsolete and is now an obvious anomaly in European competition law. Secondly, Regulation 2790/1999 should have become the first concrete example of the shift from the legalistic to a more economic-based approach. The Commission had not long before its adoption promised that it would found its competition policy on a more solid economic basis. Many felt however that the new regulation and guidelines did not live up to the expectations.

3. Although market power was taken as the main reference point many commentators, including prominent economists, were of the view that the market share threshold of 30% was too low, and probably unnecessary in the first place, and that it was uncalled for in any event to bluntly blacklist certain fairly innocent vertical restraints. In a true economic approach, one would expect that first of all the circumstances in which restrictive clauses might produce negative effects on competition would be defined and that they would only be prohibited where such

circumstances actually occur. The block exemption was described as a less than brilliant compromise between a more, but not sufficiently, economics-based approach and the apparently felt need to pursue a competition policy based on strict rules.

4. Even though Steptoe & Johnson considers this criticism not entirely unfounded, we believe that the block exemption regulation has served its purpose and remains necessary for two main reasons. First of all, the block exemption and its guidelines are a useful tool for companies when self-assessing the compatibility of their vertical agreements with competition law. Secondly, the block exemption is a binding instrument, not only for the European Commission but also for the NCAs and the national and Community courts. The block exemption regulation includes a common frame of reference for these NCAs and courts which obviously contributes to harmonisation and an EU-wide level playing field.

MARKET SHARE THRESHOLD

5. Back in 1999, one of the main points of criticism was the Commission's introduction of market share ceilings. Many people pointed to the existing consensus among economists that market shares are often not a reliable indicator of a company's market power. Others argued that with such low market share thresholds, the Commission should have allowed wider exemptions for most forms of vertical restraints.

6. To this criticism can be added that in practice it is extremely difficult to determine the actual level of a particular market share with, as a logical consequence, legal uncertainty for businesses. It also should be noted that the market share of a company will obviously fluctuate with the passage of time. Distribution agreements are almost always concluded for a number of years and, therefore, it is almost certain that the original estimate of the market share will be different from the market share at the end of the contract. In cases where a company's market share rises after the conclusion of the agreement, the block exemption remains applicable for a period of only one, and maximum two years. This places parties in a difficult situation; they continuously need to verify whether the market share limit has not been exceeded. In fact, parties continually run the risk of losing the protection of the block exemption. In our view, it would be better if the next regulation did not contain a market share threshold.

7. Perhaps the most important proposed amendment to the existing regulation concerns the application of the current market share threshold not only to the vendor but also to the buyer. The Commission wishes to take into account the further strengthening of the market power of major distributors during the last ten

years, and therefore proposes that a vertical agreement should only qualify for the block exemption if not only the market share of the vendor, but also the market share of the buyer does not exceed 30%. Steptoe & Johnson does not believe that such a change would be a good idea.

8. First of all, we foresee major practical problems. As mentioned, it is already extremely difficult for a supplier to determine with any degree of certainty the actual level of his own market share. It will be even more difficult for a supplier to determine how high the market shares of his (in many cases numerous) buyers are, particularly since the buyer will often be very reluctant to share such information. And where the purchaser is active in different local markets, this exercise becomes almost impossible. In addition to the difficulty of the assessment of market shares, anticompetitive effects may equally arise in cases where the market share is less than 30%. The existence of buyer power depends on a number of factors and a significant market share is only one of those factors. Should the combination of supplier and buyer power prove to be problematic in an individual case, the Commission can always withdraw the benefit of the block exemption. The presumption of legality conferred by the regulation may be withdrawn if a vertical agreement, considered either in isolation or in conjunction with similar agreements enforced by competing suppliers or buyers, comes within the scope of Article 81(1) and does not fulfil the conditions of Article 81(3). For these reasons, Steptoe & Johnson suggests that the Commission rethink its proposal to apply the market share threshold to both vendor and buyer.

INTERNET SALES

9. In the past decade, the sale of goods over the Internet has become a popular form of distribution. The Commission proposes to distinguish clearly between sales as a result of active marketing and sales on the initiative of the consumer (that is, between active and passive sales). The inclusion of a clear definition in the revised guidelines is useful, because in practice many companies have great difficulties distinguishing between the two. Furthermore, the Commission's proposals explain how the revised regulation would deal with conditions imposed in relation to Internet sales, such as the requirement imposed by a supplier that the distributor should have a "brick and mortar" shop before engaging in online sales.

10. When the block exemption regulations and guidelines were adopted in 1999 the phenomenon of sales over the Internet was still relatively new. Since it lacked practical experience in this area, the Commission decided to follow the basic approach that any additional form of distribution means more competition and would therefore be good for consumers. In addition, it saw the Internet as an additional tool in its continuous struggle to achieve a truly single European

internal market. Restrictions on sales over the Internet should therefore *prima facie* be viewed as anticompetitive. The Commission did also realize however that the Internet harbours dangers for consumers, and that its great potential was no justification for ignoring the existing case law on exclusive and selective distribution. The last ten years have made abundantly clear that the Internet indeed has both positive and negative aspects. It is both an ideal place for consumers to compare prices and quickly order products, particularly products such as books and CDs, and an ideal place for those inclined to engage in piracy and fraud or free-ride on the efforts and investments of others.

11. Steptoe & Johnson is of the opinion that the current proposals with regard to online sales strike the right balance between, on the one hand, the legitimate demands of suppliers and distributors and, on the other hand, the Commission's own legitimate policy objective of stimulating the sale of goods through the Internet. Of course, for the obvious reasons the ability of European consumers to make intra-European cross-border purchases should be encouraged as much as possible and it is undeniable that this is greatly enhanced by the Internet. It is also indisputable, however, that at least limited sales restrictions are necessary in order to prevent certain traders from taking advantage of the investments of their competitors in marketing and brand promotion. That too is in the interest of the consumer.

12. European competition law has long recognized that certain vendors, in particular those of luxury and high-tech products, are permitted to organise protected distribution networks within which distributors may be selected on the basis of specific qualitative criteria in order to protect the image of the products sold. These criteria vary from requirements as regards the store's interior, the presence of trained personnel and the availability of after-sale services. This policy has been reflected in Regulation 2790/1999 and its accompanying guidelines which are currently the subject of review but had already been recognised in the case-law of the European and national courts long before that.

13. Producers of luxury products are rightly concerned that a bad presentation of their products on websites of inferior quality (for example, by means of low-resolution photos) is detrimental to the brand. For these reasons, they generally restrict the online sale of their products, require their authorized distributors to maintain a physical outlet and put high demands on their websites. These requirements equally aim to prevent the free-riding of traders on the investments of authorised distributors in their physical outlets. An online store that does not need to invest in a physical outlet, or in the training of staff, obviously has lower costs which may lead to lower consumer prices. Consumers can make use of the services offered in real shops to make their choices, and can then elsewhere order

the product online. This obviously takes away the incentive for physical distributors to invest in their shop and services.

14. Selective distribution is not incompatible with the development of Internet sales. Most luxury products can be purchased online by consumers on websites owned by the manufacturer or the distributor of the product. Many distributors have no difficulty complying with the rules for selective distribution. It is certainly possible to find an acceptable balance between the protection of the consumer and his interest in low prices on the one hand and the preservation of legitimate distribution networks on the other hand by recognising that suppliers may require from distributors who want to sell luxury products online that they already have a serious outlet that meets objective quality criteria and, like the other distributors network, make the necessary investments in their websites to protect the brand image.

15. Steptoe & Johnson agrees with the Commission, however, that some of the more serious restrictions on passive sales over the Internet should be considered hardcore restrictions. There are vertical restrictions that simply entail unnecessary distortions of competition. The revised guidelines give a few examples. Requiring a distributor to terminate consumers' transactions over the Internet once their credit card data reveal an address that is not within the distributor's territory, is a good example of an unnecessary restriction.

16. The Commission further proposes to offer a certain protection to start up activities of distributors. A distributor which will be the first to sell a new brand or the first to sell an existing brand on a new market, may have to commit substantial investments to start up and/or develop the new market where there was previously no demand for that type of product. Such expenses are often sunk costs and in such circumstances the distributor probably would not enter into the distribution agreement without protection for a certain period of time against passive sales into its territory or to its customer group by other distributors. Steptoe & Johnson supports the Commission's proposal to provide a protection of two years in such cases. However, we believe that since this exception is of considerable practical importance, in particular to suppliers with a large cross-border network of distributors, it belongs in the text of the block exemption and should not just be mentioned in the guidelines as is currently the case.

RPM

17. In the Commission's current proposal, resale price maintenance continues to be a hardcore restriction. Including a hardcore restriction in an agreement gives rise to the presumption that the agreement falls within Article 81(1) and is

unlikely to fulfil the conditions of Article 81(3), for which reason the block exemption does not apply. The Commission states that situations do exist in which RPM could lead to efficiency gains that should be taken into account in the assessment under Article 81(3). It is, however, extremely doubtful whether the Commission will take these potential efficiencies seriously given its strong aversion to RPM. The Commission has made it very clear that it finds it hard to identify cases where RPM leads to efficiency gains. It is perhaps for this reason that since the entry into force of the current block exemption regulation the Commission in all RPM cases which it has dealt with has concluded that the arrangements did not fulfil the conditions of Article 81(3).

18. Economic literature makes clear that RPM can have procompetitive as well as anticompetitive effects. In the most cynical view, RPM is primarily used to facilitate cartels at the retail or production level and never produces any efficiencies. However, most of the explanations for RPM are based on the assumption that RPM is a legitimate practice designed for the benefit of a single producer (acting alone) and his distributors. These explanations describe the benefits that they can obtain from the establishment of minimum retail prices.

19. At first sight, RPM may seem a rather strange phenomenon. For any given wholesale price it must be assumed that the lower the markup for the retailer, the lower the retail price, the higher the sales, and therefore the higher the profit for the manufacturer. The establishment of a minimum retail price is tantamount to an increase of these prices and this reduces the total sales of the product and thus the income of the manufacturer. It is in the economic interest of the manufacturer that the retailer sells against the lowest possible price. What can be then a plausible explanation for the imposition of a minimum retail price?

20. There are in fact several plausible explanations. To give just one example, a higher margin between the wholesale price and the retail price can stimulate investments in various point of sale-specific types of services which consumers value above their actual costs. This may include investments in qualified sales people or store interior. Retailers will be less inclined to invest in staff and store amenities without a restriction on price competition, simply out of fear that their competitors will free-ride on their efforts and will be able to sell at lower prices. Consumers appreciate good service and an enjoyable shopping experience and are prepared to pay for it. That is why these shops exist and look the way they look. An increase in demand caused by a better service and luxurious stores can increase consumer welfare even if accompanied by higher prices.

21. The danger of free-riding is often underestimated, which is a serious mistake. Consumers can only benefit in the short term from the free-riding of distributors

outside the network. A well known example of free-riding relates to high-quality audio equipment where pre-sale assistance by an expert seller is required to inform the consumer and to convince him of the merits of the product. After having obtained the required information from the expert salesperson, the satisfied customer leaves the shop without however having completed the sale. He goes straight to the discount store around the corner, goes directly to the cash register and purchases the product for a lower price. The discount store, which can offer the lower price because it only employs part-time students without any relevant experience, takes a free ride on the investments of the full service retailer who faces much higher costs in order to bring his products to the market. To give another example: many manufacturers of high-end TVs or audio equipment usually develop different models and require their distributors to put all of these models on display in their shops. These distributors must invest, e.g., to obtain knowledge about the technical specifications of these different models. After some time it becomes clear which model is the most popular among consumers and the other models disappear from the market. Discount stores simply wait until it has become clear which model comes out on top. They don't invest in knowledge or fancy displays. They free-ride on the investment of the authorized distributors.

22. Evidently, the situations which we have just described are untenable in the long term for the full service retailer. He cannot both employ expert sellers and at the same time continue to compete with the discount stores in his area. The retailer will have to limit its service in order to be able to survive. Many will not survive. Consumers must decide which brand to buy with less than complete information. Products for which pre-sale assistance is required become less available. The consequences are bad for consumers. Ultimately, free riders prevent consumer access to retail services for which they are perfectly willing to pay. The end result is sub-optimal.

23. As stated above, it is sometimes argued that RPM can be a deliberate stabilizing measure for a cartel among retailers. These retailers are well aware that each of them separately has good reason to defect and charge lower prices in order to stimulate his sales at the expense of the other members of the cartel. They realise that it is therefore better to jointly approach the common producer and ask him to impose RMP, and take rigorous action against members who ignore it. Another explanation points out that RPM can be used as an information tool for producers cartels. The theory states that RPM is of great value in sectors where retail prices are more visible than wholesale prices. The establishment of minimum retail prices facilitates the detection of foul play in relation to wholesale prices. None of these explanations seem particularly convincing. Fixed minimum prices do stabilize prices, but if this leads to better service it would seem to be a

legitimate restriction on competition. Facilitation of producer cartels through RPM seems somewhat unlikely, in particular since a disparate retail price does not necessarily indicate a disparate wholesale price.

24. The Commission has quite rightly been criticised for its *de facto per se* approach of RPM. This is particularly worrying because the European courts have never confirmed this strict approach. Quite to the contrary, it is clear from the ECJ's judgment in Binon that RPM is not *per se* unlawful under Article 81 EC. The criticism increased after the Leegin judgment of the U.S. Supreme Court. In Leegin, the Supreme Court overturned nearly a hundred years of antitrust precedent in a landmark 5-4 decision. The decision overturned Dr. Miles Medical Co. v. John D. Park & Sons (1911), which made it per se illegal for a manufacturer and its distributor to agree on a minimum price. The majority emphasized that the rule of reason, which distinguishes between restraints with anticompetitive effects that are harmful to the consumer and those with procompetitive effects that are in the consumer's interest, is the accepted standard for determining whether agreements violate Section 1 of the Sherman Act, and that per se rules should be reserved only for those agreements that almost always would be found unreasonable after a rule of reason analysis. "Economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance, and the few recent studies on the subject also cast doubt on the conclusion that the practice meets the criteria for a per se rule," the Supreme Court held.

25. The Commission has claimed that EC competition law applies a similar standard because a party can always argue that the conditions of Article 81(3) are met. Since it is clear however that the Commission is not prepared to change its strict approach to RPM, any recourse to Article 81(3) will almost certainly prove to be in vain. Steptoe & Johnson is in favour of a more open approach to RPM, not in the least because this would be more in line with a genuine economics-based approach to European competition law in general and vertical restraints in particular.

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