

TECHNICAL ANNEX 2

THE ECONOMICS OF VERTICAL RESTRAINTS

1. Vertical agreements are agreements for the sale and purchase of goods or services which are entered into between companies operating at different levels of the production or distribution chain. Typical examples are distribution agreements between manufacturers and distributors, - such as between car manufacturers and authorised car dealers - or supply agreements between a manufacturer of a component and a producer of a product using that component.
2. Vertical agreements are often designed to protect relationship specific investment made in connection with the agreement; they typically aim to avoid free-rider effects. As a consequence they can be an effective against underinvestment and therefore beneficial for competition. On the downside, vertical agreements can reduce competition either by restricting competition between distributors or by foreclosing access to the market by competing suppliers, although they are in general regarded as less harmful than horizontal agreements involving price fixing or market sharing between direct competitors.
3. In order to determine the final impact of vertical agreements on competition, it is crucial to evaluate their nature and the market structure the contract parties are operating in. In general, vertical restraints may create competition problems only if there is insufficient inter-brand competition on the relevant market, i.e. in case the supplier enjoys a significant degree of market power. The more intense inter-brand competition is, the less likely vertical agreements create a negative impact on competition. Moreover, should a vertical agreement be liable to appreciably restrict competition, such negative effects have to be balanced against their potential positive effects. Both effects are discussed in the following.

Positive effects

4. Vertical agreements can generate a number of positive, welfare – enhancing effects, as contracts between producers and distributors that specify only the price and quantity of a good may lead to less investments and sales than optimal. Certain restrictive vertical agreements that appear to reduce competition at first sight may have a beneficial effect in encouraging investment in the market and thus enhancing competition. Other vertical agreements enhance competition directly. Amongst the possible efficiency-enhancing effects, the following main arguments are often mentioned in economic literature..
5. Firstly, vertical agreements may often help to solve 'free-rider' problems. A distributor may free-ride on the promotion efforts or technical advice given on a product by another distributor. In particular for technically more complex products, this may blunt the incentive for distributors to invest in technical information, if the client is susceptible to collect information with one distributor but finally buys the product elsewhere. Restraints such as quantitative selective distribution, with limits the

number of distributors in an area may alleviate this problem and encourage investment.

6. Secondly, the limited number of distributors imposed by a restrictive distribution agreement may help to allow the manufacturer to exploit scale economies and thereby achieve a lower retail price for his product. Similarly, when a manufacturer wants to enter a new geographic market, for instance by exporting to another country for the first time, this may involve special "first time investments" by the distributor to establish the brand in the market. In order to persuade a local distributor to make these investments it may be necessary to provide protection to the distributor in limiting the number of distributors geographically, so that the distributor can recoup these investments by temporarily charging a higher price. Although the agreement may impose an immediate restriction on intra-brand competition, in the end, the agreement has furthered the market entry of a new competitor, thus benefiting competition.
7. Thirdly, free-riding can also occur between manufacturers, for instance where one manufacturer invests in promotion at the buyer's premises at the retail level that may also attract customers for its competitors. Another example is the client-specific investment, such as special equipment and training. (Temporary) non-compete type restraints in vertical agreements can help to overcome or limit this situation of free-riding.
8. Finally, in some circumstances a vertical agreement may directly enhance the competitive pressure on the market. A manufacturer which realized efficiency gains may want to ensure that his sales volume is increased by lower prices. In order to pass efficiency gains and price decrease through the end customers, he may conclude a vertical agreement which imposes maximum prices on the retail level.

Negative effects

9. On the downside, vertical agreements may not only reduce intra-brand competition but also competition between brands. In particular non-compete obligations, which imply that other suppliers cannot sell to particular distributors are likely to have more negative effects on competition than distribution agreements which are not combined with non-compete obligations. Non-compete obligations reduce inter-brand competition twofold: Apart from the foreclosure effect on other suppliers, there is no in-store competition within the shops of the distributor.
10. In the absence of sufficient inter-brand competition, restrictions on intra-brand competition may significantly restrict the choice available to consumers as well. Distribution systems that limit the number of distributors may reduce the available number of dealers for a specific customer and weaken intra-brand competition. In the case of customer allocation the result may eliminate intra-brand competition altogether. Other restrictions on competition within a brand are agreements on the retail price between the manufacturer and distributors, which can eliminate price competition within the brand completely.
11. Negative anti-competitive effects of vertical restraints can be reinforced when several suppliers organise their distribution on the same market in a similar way (parallel networks of similar agreements). In particular, single branding (non-compete obligations) or selective distribution can create a cumulative foreclosure effect.

Trade off between positive and negative effects

12. As noted above, in general for vertical restraints competition concerns can only arise if there is insufficient inter-brand competition, i.e. if there is a certain degree of market power at the level of the supplier or the buyer or both. Once there is a high degree of inter-brand competition, the positive effects of vertical restraints are more likely to outweigh the negative effects. The following example may illustrate the interaction between inter-brand and intra-brand competition.
13. The quantitative selective distribution system is a form of limited distribution that is widespread in the European car industry. Under this system the car manufacturer concludes distribution contracts with limited number of dealers that agree not to re-sell the car to non-authorized re-sellers but only to end customers or other authorized dealers. In return the car manufacturer agrees to distribute cars only via authorized outlets. The number of available dealers is not only limited but possibly geographically dispersed, so the competition between dealers of the same brand is limited to a certain degree. This approach allows for some positive economic effects mentioned above; such as limiting the free-rider effect of a dealer taking advantage of promotional efforts of another dealer, such as technical advice in sales contacts. Another example is the prohibition of selling the car to an independent reseller that helps the manufacturer to build a brand image by upholding qualitative standards in sales.
14. If these restrictions were not allowed, clients may collect free information from one dealer and buy the car easily from another (unauthorized) distributor. Dealers may therefore not have a sufficient incentive in informing clients on product, fearing a free-rider effect and manufacturer would be discouraged to build up a brand image; underinvestment would be the consequence. The vertical restriction in the form of a selective distribution system helps to avoid this underinvestment.
15. However, a dealer may be tempted to charge uncompetitive prices or offer uncompetitive services, wishing to take advantage of the fact that the distribution system reduces the competition within the brand by limiting the number of dealers and forbidding sales to independent resellers. In case there is weak competition between brands, he may succeed to do so, as the distribution agreement has eliminated or reduced the competition from other dealers of the same brand. In this case the vertical agreement would eliminate most competition; its negative effects would outweigh the positive ones. However, in case the competition between brands is strong, a dealer tempting to charge non-competitive prices would fail, as consumers would turn to a competing brand. The agreement's overall effect would be positive, as the agreement would assure the optimal level of investment and competition on quality by eliminating free-rider effects without harming price competition in the end.

Creating a safe heaven

16. Whether a vertical agreement actually restricts competition and whether in that case the benefits outweigh the anti-competitive effects will depend on the market structure and should therefore require an assessment.
17. The European law allows to balance the positive impact and the downside of vertical agreements. Whereas 81(1) of the EC Treaty prohibits agreements which appreciably restrict or distort competition, the Treaty allows in Article 81(3) to take the positive effects of vertical agreements into account and renders this prohibition inapplicable for those agreements which create sufficient benefits to outweigh the anti-competitive effects. In particular, once the positive effects of the agreement prevail, the agreement can be exempted under Article 81(3), if it "contribute[s] to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit (...)".
18. Whether a vertical agreement actually restricts competition to the degree that anti-competitive effects outweigh the benefits will often depend on the market structure. In principle, this should require an individual assessment. However the individual assessment of a vertical agreement implies inevitably a certain degree of legal uncertainty for the contracting parties. Contract partners may not be sure whether their agreement violates Article 81 (3). Moreover, the individual assessment creates an administrative burden for competition authorities and the legal branch. Therefore the EC treaty allows in Article 81 (3) for exempting not just single agreements, but categories of agreements. Once an agreement is covered by such a category, it is under a safe heaven. Contract partners may take advantage to draft an agreement in a way that that it is exempted, so that they can be sure that their agreement complies with Article 81.
19. The Commission has defined these exempted categories of vertical agreements in 'Block Exemption Regulations' (BER). A BER defines the conditions under which it can be safely assumed that positive effects of vertical agreements outweigh the negative effects. The BER No 2790/1999 entered into force on 1 June 2000 and provides a safe harbour for most vertical agreements. Agreements that concern the motor vehicle sector are dealt with the BER 1400/2002, the regulation which is discussed in the following chapters.
20. It should be noted that vertical agreements that are not covered by a BER, are not necessarily violating Article 81, unless they involve an infringement qualified as "hardcore" restriction. They are simply subject to an individual assessment where both the potential anti-competitive and efficiency-enhancing effects are to be balanced on the basis of a case by case analysis. For example, a manufacturer's market share may be higher than the threshold defined in the BER that allows the manufacturer's agreements to be covered by the BER. In this case the vertical agreement can technically not be covered by the BER and is subject to an individual assessment which should take into account the restrictions upon to in the agreement in conjunction with a competitive analysis of the market, which includes, among other things the degree of inter – brand competition. However, a contract may also be covered by the BER because parties may for some reason want to conclude a vertical agreement that contains clauses which are not exempt by the BER. In this case, the agreement has to be assessed individually as well.