Competition Competence Report

Economic Analyses of Vertical Restraints – A Self-Assessment

Since the EC Block Exemption Regulation (BER) went into force in June 2000, companies are required to undertake a self-assessment of the possible consequences of their vertical agreements that is, of agreements that arise in a channel of distribution between firms at different levels of trade or industry, i.e., between a manufacturer and wholesaler, between a supplier and customer, or between a licensor of technology and his licensee. Such an assessment can be extremely complex. Although the European Commission has issued regulatory guidelines to facilitate the self-assessment process, business people and their counsel face difficulties in the application of these guidelines.

Requirement for Self-Assessment

The new European competition rules on distribution and supply agreements - known as "vertical agreements" - embody a shift from the former legalistic approach towards the more economics based approach. Nowadays economics play a central role in the assessment of vertical agreements. In addition, due to Regulation 1/2003 companies are now required to do a self-assessment of the possible consequences of their vertical agreements.[1]

Companies performing a self-assessment have to make first an individual assessment under Article 101 (1) TFEU if their market share is above 30 %. The issue is to judge whether an agreement has an anti-competitive object or actual (or potential) anti-competitive effects. The second step, which only becomes relevant when an agreement is found to be restrictive

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[1] EC Commission, Regulation No. 1/2003 on the implementation of the rules of competition laid down in Article 101 and 82 of the TFEU.

of competition under Article 101(1), is to determine the pro-competitive benefits produced by that agreement and to assess whether these pro-competitive effects outweigh the anti-competitive effects. This kind of balancing of anti-competitive and pro-competitive effects is conducted within the framework laid down by Article 101(3).[2] Article 101 (3) applies if the exemption criteria are met. Therefore, companies have to apply the economic rationale developed by the EC Commission in a comprehensive set of guidelines. If this analysis is performed wrong or if the companies make a mistake, consequences are quite comprehensive: the vertical contracts or clauses are void and companies can face potential fines or damage claims.

This CCR familiarises you with the economics. The next CCR will provide guidance how to perform the self-assessment in short-form.

Economics of Vertical Restraints

Vertical agreements are those that arise in a channel of distribution between firms at different levels of trade or industry i.e. between a manufacturer and wholesaler, between a supplier and customer or between a licensor of technology and his licensee. Examples of vertical restraints include nonlinear pricing, quantity forcing, full-line forcing, resale price maintenance, territorial restrictions, exclusive dealing, partial exclusive dealing, tie-in sales, refusal to deal, etc..

In general, vertical restraints restrict competition to a considerable lower extent than horizontal agreements. Moreover, vertical restraints often have pro-competitive effects. Among other things, vertical restraints can be employed to reduce transaction costs or to achieve other efficiencies between firms at different levels of the production and distribution chain.[3]

In the Commission's guidelines on the application of Article 101 (3)[4], a broad range of efficiency gains from vertical agreements are highlighted. Efficiencies may create additional value by lowering the cost of producing an output, improving the quality of the product or creating a new product.

Another benefit consists in the elimination of double marginalization.[5] The intuition behind double marginalization is that if both producers and distributors add mark-ups over their costs, the resulting "double" mark-up leads to excessive prices.

2 EC Commission, Communication of the Commission, Notice, Guidelines on the application of Article 101(3) of the Treaty, OJ (C) 101/97, 27.4.2004

3 P.Rey from IDEI, Toulouse performed quite an extensive economic discussion on these aspects in various papers and speeches like on "The economics of vertical restraints", Speech at Cargese, May 2004

4 EC Commission, Guidelines Article 101(3), para. 33

5 L.Peeperkorn, "The Economics of Verticals", Competition Policy Newsletter 1998 – Number 2, l http://europa.eu.int/comm/competition/speeches/text/sp1998_020_en.html

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Another aspect is the externality which stems from the fact that each partner, when setting his price (the wholesale price for the producer and the retail price for the distributor), does not consider the effect of this price on the other partner's profit. For instance the distributor, when setting the retail price, does not take into account that an increase in his price, which decreases the final demand, also decreases the producer's profit.

Furthermore, a benefit based on vertical restraints may rely in the solution for the free-rider-problem.[6] Distributors might be unwilling to invest in the marketing of new products or services unless the manufacturer imposes a territorial restraint that ensures that late-entering distributors will not "free ride" on the earlier distributors' initial efforts and investments to establish the manufacturer's position in the marketplace.

Another issue which raises benefits is the so-called "hold-up" problem. The risk of hold-up might arise when a firm needs to make an important long-term investment involving substantial sunk costs and that is particular to one purchaser or supplier. In such a case, after the investments have been made, the bargaining position of the firm is weakened. The fear is that free riding on investments is a possibility. Vertical restraints may solve this problem.

Vertical restraints can also increase sales and create brand image by imposing certain standards of quality on the distributors. In such cases exclusive or selective distribution can be justified when introducing a new product into the market for a limited period of time. To conclude, the beneficial effects are quite comprehensive.

Nevertheless, vertical restraints can also lead to anti-competitive effects. Negative anti-competitive effects, which may result from vertical restraints, are: foreclosure by raising barriers to entry, reduction of inter-brand competition (including facilitation of collusion, both explicit and tacit), reduction of intra-brand competition, and creation of obstacles to market integration.[7]

Regarding market integration, vertical restraints are viewed ambivalent. They either may restrict competition in a harmful way or may introduce competition by the opening up of new markets. By imposing restrictions to competition, vertical agreements having the purpose or effect of protecting Member State markets contravene clearly with the Community's goal of market integration. They directly or indirectly impair the free flow of

[6] See for example the work done by D.Boyd, "Vertical Restraints and the Retail Free Riding Problem: An Austrian Perspective", in: The Review of Austrian Economics, Vol. 9, No. 1 pp. 119-134,(1996)

[7] M.Hughes/C.Foss/K.Ross, "The Economic Assessment of Vertical Restraints Under U.K. and E.C: Competition Law", (2001) ECLR p. 427

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goods between Member States and help to maintain different price levels. On the other hand, parallel imports may give rise to free rides from one exporting dealer on the promotional or servicing efforts of one local dealer. Thus, vertical agreements can be beneficial to competition since they enable a producer to be present on a market for less than it would cost him to set up a subsidiary. At the same time, however, agreements of this kind can prove an extremely effective tool for establishing price differentials within a particular territory or for deterring new competitors from entering the market. Exclusive agreements backed by measures aimed at restricting imports can protect a distributor's territory, enabling him to keep his prices high. In addition, when most or all of the manufacturers/suppliers apply exclusive distribution this may facilitate collusion, both at the suppliers and distributors level.

Negative effects traced back to vertical restraints are likely to emerge, if the undertakings hold a certain degree of market power. The main reason is that the profits of the vertical structure resulting from an efficiency-enhancing vertical restraint are more likely to benefit consumers in the form of reduced prices or better quality, if strong competition from other suppliers of goods exists. If, however, the vertical structure holds a sufficient degree of market power, it will tend to absorb those efficiency gains in the form of extra profits.

To conclude, vertical restraints generally have both: pro- and anti-competitive effects. In fact, the same vertical restraint can have very different effects depending on the context. Thus no per-se rules are appropriate to handle vertical restraints. A substantiated economic case-by-case analysis is required. An economic expert opinion may facilitate the self-assessment of companies as required by EC competition law. In any case, in absence of significant market power at the manufacturer’s and/ or retailer’s level, it is unlikely that vertical restraints are socially undesirable.

Practical Application and Conclusion

Due to the self-assessment required by the new more economics based approach, companies might need assistance in the assessment of the competitive effects of their vertical restraints. By means of expert testimonies economists support the finding process whether an agreement infringes Article 101(1) and, if the answer is a positive one, whether an exemption based on Article 101(3) can be applied. A substantiated economic expert testimony is accepted by Courts in any (future) proceedings and therefore provides more legal certainty for companies.

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Project times for such expert testimonies are about 2-3 months. Costs related are straightforward due to experiences gained with similar projects. Those experiences enable us also to reduce data requirements to a minimum. It is quality and experience that count's in this respect.

In the following CCR, the concrete applicability of Article 101 will be discussed from an economist's perspective.

Link to order the book on the "Economic Analyses of Vertical Agreements – A Self-assessment" written by Dr.Dr.Doris Hildebrand, Managing Partner EE&MC:
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