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ABSTRACT

The last few years has witnessed considerable change in policy towards vertical restraints in Europe. The reform of EU policy, in particular, marks a fundamental shift in approach with a much greater emphasis on the economic effects of restraints rather than their contractual form. The UK has followed suit and has now adopted the same position in its assessment and treatment of vertical restraints at the national level as the EC has in regard to vertical restraints involving Community-wide aspects. These changes have important implications for trading relations, especially for firms with large market shares and perhaps industries that have previously received special treatment. The changes have a particular bearing on the way that exclusive and/or selective distribution systems may operate, with the EU's market integration objectives having a considerable bearing on policy. This article reviews the changes in EU and UK policy, appraises the economic arguments put forward by the EU and UK authorities in their vertical restraints guidelines, and discusses the likely effects on business of these changes.

Key Words: vertical restraints, policy reform, economic effects
JEL Codes: L41, L66, L13

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1. INTRODUCTION

The appropriate policy treatment for vertical restraints has long been a contentious subject. Vertical restraints are essentially restrictions on the freedom of behaviour for one or more undertakings resulting from a vertical agreement between trading parties. The central problem is that while vertical restraints may serve to prevent, restrict and/or distort competition, they may equally offer efficiency improvements (e.g. through reduced costs or improved quality), and thus the net economic effect is *a priori* ambiguous in most cases where market power is or might be an issue.[1]

Purely as an illustration, take so-called "exclusive dealing", whereby a distributor agrees to take its supplies from a single supplier and in the process prevents other suppliers from using this distributor. On the one hand, this arrangement may restrict or even prevent competition if access to the market (including final consumers) is difficult to achieve for these other suppliers. On the other hand, having an exclusive relationship may encourage the supplier to make (relationship-specific) investments in the arrangement (e.g. to improve distributor service quality), secure in the knowledge that other suppliers will not be able to free ride on this investment. The former aspect may be viewed as anti-competitive while the latter may be seen as pro-competitive, while if both effects are present the net outcome is not immediately obvious. The same problem arises with many other examples of vertical restraints.

Clearly, where the anti-competitive effects of a restraint outweigh any efficiency benefits, then social welfare[2] would be improved by the restraint being prohibited. Unfortunately, pinning down precisely the conditions where this is the case is far from straightforward and it is not possible to rely solely on the form of restraint as effectively every type can in principle exhibit both anti-competitive and efficiency-enhancing effects, indicating the need for case-by-case analysis.[3] However, economics has contributed some important insights into the effects of these practices and EC and UK policymakers have sought to draw on these insights in developing a new, essentially common, policy approach towards vertical restraints.

Indeed, the last few years have witnessed a fundamental reform of competition policy towards vertical restraints in both the European Union ("EU") and the United Kingdom ("UK"). In 2000, the European Commission ("EC") adopted a new general block

1 Where market power is absent it can usually be assumed that vertical restraints will have no significant detrimental effects on competition. However, competition authorities may still make exceptions and, as discussed in this chapter, they may adopt a tough stance to all vertical pricing fixing arrangements as well as other arrangements when they are industry-wide or at least very common, regardless of the industry's structural features (e.g. all firms having low market shares).

2 The term "societal welfare" is treated here as synonymous with *economic welfare*, which is generally taken as a weighted sum of *consumer surplus* (i.e. the amount above the actual price that a consumer would willingly pay if necessary to consume the units purchased) and *producer surplus* (i.e. the level of economic profit in the sense of the largest amount that could be subtracted from the supplier's revenue that would still induce the provider to offer the product). In practice, competition authorities may be expected to give greatest (if not all) weight to consumers' interests (e.g. adopt a "consumer welfare standard" as opposed to a "total welfare standard" when consumers' and firms' interests appear to be in conflict).

3 Specifically, a potential welfare trade-off is typical with most vertical restraints, if to differing degrees and usually depending on the circumstances.

exemption regulation, replacing the existing industry-specific (e.g. covering beer and petrol) or context-specific (e.g. covering franchising) exemption regulations.[4] At the same time, the European Commission issued very detailed guidelines on the proposed enforcement policy, explaining the “effects-based” approach underlying the new regime, with its emphasis on (economic effects-based) self-assessment rather than (form-based) notification (as was previously the case).

Meanwhile, in the UK, the passing of the Competition Act 1998 has moved the UK closer to the EU position on competition policy. Yet, for an interim period, following full implementation of the Competition Act, the UK adopted a “Vertical Agreement Exclusion Order”. This excluded non-price vertical restraints from the Chapter I provisions of the Act. However, from 1 May 2005, this is rescinded and instead the UK has fallen directly in line with the EU approach on vertical restraints.

As this article highlights, the reform in EU policy in particular, and in UK policy to a lesser extent, marks a fundamental shift in approach with a much greater emphasis on the economic effects of restraints rather than their contractual form. The change in policy has important implications for trading relations, particularly for firms with large market shares and perhaps industries that have previously received special treatment. This article reviews the changes in policy, appraises the economic arguments put forward by the EU and UK authorities in their vertical restraints guidelines, and discusses the likely effects on business of these changes.

2. EXAMPLES OF VERTICAL RESTRAINTS

It is not an exaggeration to suggest that most ongoing trading relationships involve one or more vertical restraints. For simple, one-off, arms-length transactions, it is quite possible that the terms and conditions of trade may be no more than a simple contract specifying the price, quantity, and timing/nature of exchange/provision of the traded goods/services. However, with ongoing or repeated exchanges, it is usual for contracts to have additional terms and conditions, in part to encourage compliance with the terms of the contract, as well as to counter potential opportunistic behaviour (i.e. to ensure parties keep within the intention or spirit of the contract). For example, there might be incentive and/or penalty clauses or detailed specification of behavioural requirements in order to avoid potential moral hazard problems, where one party’s behaviour is not fully observable by the other party (i.e. where monitoring becomes problematic).

[4] The notable exception has been in relation to the block exemption covering the supply and distribution of motor vehicles, which has subsequently been revised (Regulation No 1400/2002). The motor vehicle BER covers the distribution of motor vehicles and spare parts, as well as servicing agreements. In this context a wide range of vertical restraints are evident, including exclusive dealing, exclusive purchasing, exclusive supply, franchising, and selective distribution. The motor vehicle BER closely follows the approach taken by the general vertical restraints Block Exemption Regulation (Regulation No 2790/1999 [OJ L336, 29.12.99, p.21]), e.g. 30% market share test to benefit from the exemption and prohibition of hardcore restrictions. In addition, there is a list of provisions that must be included in the vertical agreements in order to benefit from the exemption. The mandatory stipulations include the right to transfer rights and obligations to another distributor or repairer within the distribution system, the supplier’s obligation to provide detailed reasons for terminating an agreement, a minimum termination period of two years on behalf of the supplier, and a provision that the parities may refer contract disputes to an independent third party or arbitrator.

In many instances, contracts may make extensive use of terms and conditions that collectively amount to several vertical restraints simultaneously applying. Moreover, not all the terms and conditions will necessarily be about ensuring compliance and overcoming potential problems in the supply or use of the traded goods or services. Some, whether intentionally or inadvertently, may affect the behaviour of one or both trading parties in a manner that adversely affects the economic outcomes of the markets they respectively operate in. However, this is only likely to arise where market power is an issue and where vertical restraints serve to magnify or exacerbate competition problems. It is with regard to tackling these instances, and distinguishing them from the vast bulk of cases where restraints do not harm competition, that competition policy towards vertical restraints policy has now been directed.

To provide an idea of the range of possible restraints, as well as indicate the scope of this topic, it might be useful to begin by highlighting some of the possible types of vertical restraints that might be employed by trading parties. The following list is far from exhaustive but provides ten commonly cited types:

- *non-linear pricing*: such as a volume related discount or a two-part tariff (with a lump-sum fee plus a constant per-unit charge as paid by a franchisee to the franchiser)

- *rebate schemes*: where a retailer is offered discounts depending on quantity sold or purchased (e.g. a progressive rebate) or on the number/range of products stocked (i.e. an aggregated rebate)

- *service requirements*: where the retailer is required to provide a specified level of pre- or post-sales service or promotional effort in support of the manufacturer's product

- *resale price maintenance*: where the supplier specifies the resale price of the product at a fixed or minimum level, thereby preventing the retailer undercutting this level (in contrast to the setting of maximum prices or recommended resale prices)

- *selective distribution*: where a manufacturer supplies only a limited number of dealers that are then restricted in their ability to re-sell products (e.g. they may not be allowed to sell on to unauthorised distributors)

- *exclusive distribution*: a particular form of selective distribution where the manufacturer supplies only one distributor or retailer in a particular territory or allows only one distributor/retailer to supply a particular class of customer (e.g. businesses or consumers)

- *exclusive purchasing or dealing*: where the retailer agrees to purchase, or deal in, goods from only one manufacturer

- *tie-in sales and bundling*: where the manufacturer makes the purchase of one product (the tying product) conditional on the purchase of a second product (the tied product) (where a set of tied products is commonly referred to as a bundle of products)

- *full-line forcing*: an extreme form of tie-in sale where, in order to obtain one product in the retailer's range, the retailer must stock all the products in that range

- *quantity forcing/fixing*: where the retailer is required to purchase a minimum or an exact quantity of a certain product or a substantial percentage of its annual requirements.

Note that in all ten of these examples, the restraint is applied to the receiving (so-called "downstream") party – i.e. the distributor, retailer or franchisee – as determined by the providing or supplying (so-called "upstream") party – i.e. the supplier, manufacturer or franchiser.[5] In many of the above examples, the restraints are likely to arise by mutual agreement – e.g. the retailer agrees to the manufacturer's restraint as long as there is some reward, such as financial compensation for exclusive dealing or conferred monopoly privileges coming with exclusive distribution. However, in other cases, the restraint may be effectively imposed when one party has sufficient power over another trading party – e.g. an imposition of full-line forcing as a take-it-or-leave-it trading offer.

Yet, beyond the examples given above there may be other restraints that arise from neither contractual agreement nor contractual imposition on another trading party as they affect trade in other ways. A good example is "selective distribution" which may well arise through agreement between a manufacturer and selected retailers but affects those retailers outside of the selective distribution system who are deliberately refused supplies. In other words, there is a dual combination of restraints - selective distribution for "inside" retailers and refusal to supply to "outside" retailers. Nevertheless, for the sake of clarification, this chapter will take vertical restraints simply as contractual-based restrictions, unless otherwise stated.[6]

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[5] Here it is useful to think of the vertical relationship as goods flowing down a river, e.g. with an "upstream" producer supplying goods to a "downstream" distributor, who in turn re-sells the goods into a "sea" of consumers.

[6] Furthermore, the emphasis in this chapter will mainly be on formal/explicit contractual restrictions, as opposed to informal or implicit restrictions that arise through an "understanding" rather than being a contractual obligation. Nevertheless, it needs to be appreciated that the effect on competition may be the same whether it is explicit or implicit arrangement. An example is (fixed) resale price maintenance ("RPM") that might arise in the form of an explicit contract provision or, as an alternative, by a supplier recommending a retail price that the retailer is then obliged to follow in setting its retail price under the threat of being refused supply if it does not do so. In the effects-based approach that the EC and UK have now adopted, it is the resulting impact (on the market) that is critical, not the legal form of the restraint. Thus, for example, where RPM is strictly prohibited (i.e. per se illegal), the prohibition applies to both explicit fixed-RPM contracts as well as practices that give rise to the same outcome (i.e. where the retailer is induced – e.g. through a reward or fear of a penalty – to set prices as prescribed by the supplier).

The above examples are also in keeping with the emphasis by policymakers and competition authorities on restraints placed on downstream parties by upstream parties. This does not necessarily have to involve a producer supplying a distributor – as the above examples all indicated. It could instead involve a producer (of, say, components or raw materials) supplying another producer (e.g. an assembler of components or user of raw materials). Equally, it could involve a distributor, like a wholesaler, supplying another distributor, like a retailer. More generally, vertical restraints can, in principle, occur at any stage of the supply/distribution process for a product or service. Moreover, vertical restraints can work in both directions. Just as a producer might seek to impose restrictions on a retailer's behaviour, a retailer might seek to impose restrictions on its suppliers. For example, the retailer might impose on the supplier an obligation for exclusive supply or a requirement to use a third-party supplier nominated by the retailer (e.g. for packaging or transport), or deliberately shift risk (e.g. through enforced sale-or-return or delaying payments).[7]

With these examples and background in mind, we move on next to examine the respective changes to EU and UK vertical restraints policy, prior to considering the guidelines for assessing the economic impact of vertical restraints.

3. EU POLICY REFORM

The European Commission's "Green Paper on Vertical Restraints in EC Competition Policy" (published in January 1997), effectively began the vertical restraints reform process in Europe. The Green Paper highlighted the shortfalls in existing EU policy and offered suggested options for change.[8]

The Green Paper came at a time when there had been growing disquiet over policy and a widespread view that implementing some changes in policy direction and/or form might be desirable. At the time, the old Article 85, now Article 81, of the EU Treaty provided the basic policy framework. Article 85(1) prohibited agreements in fairly broad terms, but many or even most vertical agreements benefited from either block exemption or individual exemption under 85(3). Specific block exemptions existed for exclusive distribution, exclusive purchasing including special provisions for beer and petrol, motor vehicle distribution arrangements, franchise arrangements, and intellectual property licensing. These exemptions did not permit blanket approval, but rather allowed the practices subject to certain provisions. In addition, the old Article 86, now Article 82, could also be relevant where one firm clearly operated in a dominant position in the industry and imposed restraints, e.g. tie-ins or full-line forcing, on those it supplied. But in general, the legislation in the area was, and still is, largely framed in terms of agreements. Thus (service) franchising agreements, for example, were treated for the purposes of the block exemption as a generally benign method of business operation, even though distributors agreed to substantial restrictions in their

[7] *See*, for example, Competition Commission (2000) for details of 52 practices employed by supermarket retailers in the UK in regard to trading with suppliers.

[8] *See* European Commission (1997a). For details on the evolution of the EC's thinking on the subject of vertical restraints and the policy reform process see Peeperkorn (1999), Subiotto and Amato (2001), and Verouden (2003).

activities. Even if the restrictions included elements such as tying or full-line forcing, which would in other contexts have attracted opprobrium, these could be treated as acceptable if they were viewed as having been (freely) agreed to.

The Green Paper identified three major shortcomings in this policy approach. Firstly, the then existing Block Exemption Regulations comprised rather strict form-based requirements and as a result were generally considered too legalistic and tended to work as a straitjacket. Secondly, for those agreements that fell within the old block exemptions there was a real risk that the Commission could have exempted agreements that distorted competition (due to them being *form*-based rather than *effects*-based). Thirdly, as the old block exemptions only covered vertical agreements concerning the resale of final goods and not intermediate goods or services, a significant proportion of all vertical agreements were not covered by the then existing block exemptions, even when the parties involved had no market power.

Following a consultation period, the European Commission (1997b) issued a *Communication* setting out the European Commission's preferred course of action to remedy these three shortcomings and protect competition better. The approach advocated was to consider vertical agreements in their market context. A central tenet was that restraints do not pose problems unless inter-brand competition (i.e. rivalry between producers) is weak and market power exists. In the absence of market power, the advocated approach was to facilitate a relaxation of the form-based requirements, ensuring that fewer agreements were covered by the old Article 85(1) (now Article 81(1)). For those companies with substantial market power, the approach would ensure closer scrutiny, i.e. concentrate attention and resources on cases where anti-competitive effects were most likely to arise.

Subsequent to the *Communication* and the setting out of the Commission's economic thinking, two key regulations were amended in April 1999 that paved the way for the implementation of new policy rules as formalised by the Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices[9], the so-called EC Block Exemption Regulation.

This new regulation dispensed with the old form-based block exemptions and instead gave rise to a single broad-umbrella block-exemption approach, covering all vertical restraints for the distribution of all goods and services. This uses a market-share-threshold test to distinguish between agreements that are or are not block exempted, taking essentially a blacklisting approach, i.e. defining what is not block exempted as opposed to defining what is exempted. In this way, it is argued, it avoids the straitjacket effect and facilitates the simplification of the applicable rules.

The core element of the new EU policy approach is thus for one, very wide, Block Exemption Regulation ("BER") that covers all vertical restraints concerning intermediate and final goods and services except for a limited number of hardcore restraints. As a base premise, the Commission's line is that in the absence of market

[9] OJ L 336, 29.12.99, p.21.

power, a presumption of legality for vertical restraints can be made with the exception of what it terms "hardcore restrictions", but that when market power exists no such favourable presumption can be made. The level of market power required for vertical restraints to produce negative effects is below the level normally required to meet the dominance test under Article 82 of the Merger Regulation, which following case law is sometimes taken to be a market share exceeding 40% (although the ability to act independently of competitors, customers and suppliers is the more refined test). Rather the critical threshold the Commission has settled on is 30% market share. Below this level (other than for the hardcore restrictions) it is assumed that the practices have no significant net negative effects (at least, when operating in isolation and not part of parallel networks). Above the threshold there is no presumption of illegality. Instead, the threshold is intended to serve as a means of distinguishing the agreements that are presumed to be legal from those which may require individual examination. The latter must be assessed to determine whether they are caught by Article 81 and, if so, whether each of the four exemption criteria are met. In principle, this is a question of "self-assessment" although the Commission may provide assistance and, in appropriate cases, it may issue a "guidance letter".[10]

With the critical firm-level market share threshold set relatively high at 30%, the intention was that the vast majority of vertical agreements where no net negative effect could be expected would no longer require individual scrutiny, thereby leaving competition authorities to concentrate on perceived important cases.

However, in the case of hardcore restraints, the view taken is that, irrespective of the market shares held by the trading parties, these should not be exempted.[11] Here, the prohibited hardcore ("blacklisted") restraints identified by the Commission are:

(i) resale price maintenance (except maximum or recommended resale prices provided that these do not amount to fixed or minimum resale prices)

(ii) restrictions concerning the territory into which, or the customers to whom, the buyer may sell (other than for certain trade used in exclusive or selective distribution[12])

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[10] At the time of writing, no such guidance letters have yet been issued. They are provided for in the Commission's "Notice on informal guidance relating to novel questions concerning Articles 81 and 82 of the Treaty that arise in individual cases (guidance letter)" [OJ 2004 C101/78 of 27/4/04].

[11] Moreover, it should be noted that, for the other (i.e. non-hardcore) vertical restraints, where the parties have a small market share, say less than 10%, the '*de minimis*' notice usually applies (e.g. Notice on agreements of minor importance of 9 December 1997, OJ C372, 9.12.1997, p. 13). In such instances, the view taken is that vertical agreements entered into by undertakings are generally considered to fall outside the scope of Article 81(1), while the Block Exemption Regulation applies only to agreements falling within the scope of application of Article 81(1). The previous threshold level was 10%, but in the latest revision, of 2001, the market share figure was further increased to 15% (Commission Notice on Agreements of Minor Importance, OJ C368, 22.12.2001, p.13). Yet, regarding the hardcore restrictions, Article 81(1) may still apply below the threshold when there is an appreciable effect on trade between Member States and on competition. Accordingly, it is by no means certain that hardcore restraints even when used by firms with small market shares will be permitted. This appears especially so in the case of restrictions on parallel imports and resale price maintenance, which are normally subject to *per se* prohibitions.

[12] Specifically, there are exceptions in so far as the supplier can restrict a buyer from making "active sales" into a territory allocated to another buyer or which the supplier has reserved to itself; the supplier

(iii) restrictions on active or passive selling[13] to end-users by authorised retail distributors in a selective distribution system (as long as the distributor sells only from a given location)

(iv) restrictions on authorised distributors in a selective distribution system selling or purchasing from other members of the network (i.e. relating to cross-supplies amongst distributors)

(v) restrictions on the sale of components as spare parts by the manufacturer of the component to end-users, independent repairers and service providers (i.e. relating to after-market sales)

For each of these cases it is argued that the anti-competitive effects are likely to be high and the efficiency benefits relatively weak (or at least not significantly greater than could be attained from using other arrangements). In regard to possible anti-competitive effects it is important to distinguish between those arising at the upstream level and those arising at the downstream level. If we take the upstream level to be suppliers of brands selling to distributors/retailers at the downstream level, then an important distinction is between what is termed "inter-brand competition" (i.e. rivalry between different supplier brands) and "intra-brand competition" (i.e. rivalry between distributors/retailers selling the same brand). In this context, a vertical restraint would necessarily be directed at influencing one or other of these two types of competition, but through knock-on consequences both might be affected.[14]

Now in respect of the five hardcore restrictions, we can note that the first of these relates to vertical price fixing, something that is *per se* prohibited in most developed countries on the basis that it completely bars intra-brand price competition and can facilitate supplier collusion (i.e. weaken inter-brand competition by making it more straightforward to identify and move towards "focal prices" and assist in monitoring collusion through increased price transparency). Thus resale price maintenance has the effect of potentially preventing both intra-brand and inter-brand competition.

The other four restrictions, though, relate to various aspects of selective and exclusive distribution, but again where there are restrictions on intra-brand competition. However, rather than a concern about diminished inter-brand competition (which could only be expected to arise indirectly, say from the deliberate separation of downstream markets), the prime concern with these four restraints appears to be that they can lead to segmented markets (particularly for consumers) and increased scope for price discrimination – something very much at odds with the European Commission's policy desire for integrated markets (preferably Community-wide) and an absence of barriers to trade across territories within the EU. In other words, while there may be

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can restrict sales by a wholesaler to end-users; the supplier can restrict distributors in a selective distribution system from selling to unauthorised distributors in markets where such a system is operated; and the supplier can restrict a buyer of components supplied for incorporation from re-selling them to competitors of the suppliers (Article 4(b) of the Block Exemption Regulation).

[13] The distinction between "active" and "passive" selling is that with active selling a distributor for a producer directly approaches or makes itself directly amenable to customers in another distributor's territory or market segment, whereas with passive selling the distributor merely responds to unsolicited requests for supply, i.e. it does not go out of its way to deliberately compete head to head with another distributor but if approached can offer to supply (from its own location).

[14] Further explanation of the competition effects of vertical restraints is given below in section 5.

competition concerns, there appears also to be a strong political motive behind the special treatment afforded these four restrictions – certainly compared to much more benign view taken towards other non-price vertical restraints.

In addition to the prohibited hardcore restrictions, there are some rules governing the use of other restraints. For example, exemption does not apply to any non-compete obligation, like exclusive dealing or tying, if its duration is indefinite or exceeds 5 years. Furthermore, the Commission may withdraw the benefit of the Block Exemption when cumulative effects are observed as applying widely to a sector (i.e. where there is a network of similar agreements or concerted practices).

A central element to this new effects-based approach was also to view different forms of vertical agreements having similar effects in a similar way – as reviewed below in section 5. Specifically, the new policy is intended to prevent unjustified differentiation between forms or sectors and avoid a policy bias in the choice companies make concerning their formats of distribution (i.e. similar policy treatment for similar effects so avoiding the problem of firms "form shopping", that is choosing the form of agreement that creates the least competition concerns).

To go with the new block exemption regulation, the European Commission (2000) issued *Guidelines on Vertical Restraints* detailing the Commission's enforcement policy. The *Guidelines* set out the general rules to be adopted when evaluating the effects of vertical restraints, the relevant factors for the assessment of Article 81(1) and Article 81(3), and analysis of specific vertical restraints with examples. The *Guidelines* also provide insights on policy towards individual exemption above the market share threshold and possible withdrawal of the Block Exemption below the thresholds (e.g. where blacklisted practices are used or where cumulative effects from parallel networks are a concern[15]).[16]

4. UK POLICY REFORM

The UK has taken its lead from the EC in this area of competition policy.[17] Where previously the legal position was complicated by different elements of vertical restraints falling under different Acts and associated procedures, the Competition Act 1998 paved the way for simplification and alignment with the EC approach.

[15] With parallel networks where a common restraint is employed, such as exclusive dealing or exclusive distribution, then the likelihood of intra-brand and/or inter-brand competition being dampened increases. This is because there will likely be fewer full-range distributors operating, e.g. retailers carrying all producers' goods, so that consumers will face less in-store choice and have to undertake greater search activity to find and compare all or a range of available substitutable goods.

[16] The Modernization Regulation (EC Regulation 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty, OJ L1, 4.1.03, p.1) also has an important bearing since this regulation allows national competition authorities and the courts of Member States to apply and enforce Articles 81 and 82.

[17] For more on the antecedents of the recent UK and EC policy shifts, and relations with the US approach, see Kunzlik (2003).

In the old regime, the need to register vertical agreements was governed by the Restrictive Trade Practices Act 1976. Here, registration was dependent on the form of the agreement. Some forms were exempted while others were not, thus opening up the prospect of firms adopting *form shopping* to avoid the need to register agreements. For example, Schedule 3 to the Act exempted some exclusive dealing arrangements. Moreover, whereas multipartite agreements regarding exclusivity might typically have required registration, an equivalent set of bipartite agreements (e.g. covering exclusive territories) might not have, even though the economic effect may have been the same.[18]

In contrast to the case-by-case treatment generally afforded to most vertical restraints, resale price maintenance has for a long time been treated more harshly in the UK. The Resale Prices Act 1976 made the imposition of vertical resale price maintenance illegal in most cases. Subsequent to the passing of the Act, all outstanding instances of fixed or minimum RPM were made illegal through successful challenges by the authorities in the Restrictive Practices Court. The Office of Fair Trading was finally able to remove the last two vestiges of RPM, for books and non-prescription medicaments, respectively in 1998 and 2001.[19]

For all other vertical restraints, including exclusive purchasing, selective and exclusive distribution, franchise arrangements, tie-in sales, and full-line forcing, the legal framework used to be driven primarily by the Fair Trading Act 1973 and the Competition Act 1980. However, these Acts did not proscribe activities. Rather, they simply provided for investigation in appropriate cases. Thus, for example, the anticompetitive provisions of the Competition Act 1980 enabled the Office of Fair Trading to investigate particular practices and produce a report which may have then led to a Monopolies and Mergers Commission (subsequently, a Competition Commission) reference. However, of greater significance were the monopoly investigations that could be initiated under the Fair Trading Act. In the 1990s, in particular, a number of highly significant industries, often involving particular exclusivity arrangements, were subjected to such investigations. In several notable cases, no action was taken.[20] However, in some cases, structural remedies (e.g. the enforced divestitures in the beer industry) or behavioural remedies (e.g. applying to carbonated drinks, new motor cars, national newspapers, and films) were applied.[21]

[18] *See* Waterson (1993, p.42).

[19] For example, see Utton (2000) on the formal ending of RPM on books. Interestingly, while the UK has now managed to prohibit all overt RPM situations, some member states still allow certain exceptions – e.g. RPM on books in Germany.

[20] These included reviews of the supply of petrol (1990), new car parts (1992), fine fragrances (1993), ice cream (1994), and recorded music (1994). However, with the exception of fine fragrances, these industries have been subject to further OFT reviews and MMC/CC inquiries. For example, the supply of ice cream featured in two further MMC inquiries (1998 and 2000), leading ultimately to behavioural remedies being imposed.

[21] *See* Dobson and Waterson (1996a) for some details. In addition, there were other industry investigations involving other vertical restraints (i.e. other than exclusivity arrangements) that led to behavioural remedies being proposed – e.g. prohibition on recommended retail prices for domestic electrical goods, prohibition of most favoured customer clauses for foreign package holidays, and removal of rental restrictions in the supply of video games to retailers.

These industry investigations effectively reflected the policy approach towards (non-price) vertical restraints, but such a piecemeal approach naturally raised concerns about consistency in treatment both across industries and over time. Indeed, a good example relates to the successive inquiries into the ice cream market by the Monopolies and Mergers Commission in 1979, 1994, 1998 and 2000 concerning freezer exclusivity, i.e. manufacturers that supplied freezers requiring shops to stock them exclusively with their own ice creams.[22] In 1979 and 1994, it was concluded that freezer exclusivity did not restrict competition. Yet, in 1998 and 2000, and with little change in the market circumstances, it was concluded that the practice did restrict competition.[23]

The key reform towards a more integrated policy approach in the UK emanated from the Competition Act 1998, with the intention to bring the UK into line with EU competition policy. Specifically, the prohibitions contained in Article 81 of the EU Treaty and section 2 of the Competition Act 1998 (the so-called Chapter I prohibition) prohibit agreements between undertakings which have as their object or effect the prevention, restriction or distortion of competition. While Article 82 of the EU Treaty and section 18 of the Act (the Chapter II prohibition) prohibit conduct by one or more undertakings that amounts to an abuse of a dominant position.

In regard to vertical restraints, the Competition Act 1998 signalled the intention to shift the UK policy position away from a reliance on *ex post* redress (to block any abuse of market power arising or exacerbated by vertical restraints) to the EC's *ex ante* approach where vertical agreements should not be exempted from the general prohibition of anti-competitive agreements when one or more parties has significant market power.[24]

However, the move to the ex ante approach was not immediate. At the time, the changes to EC vertical restraints policy were still to be resolved and the prevailing view in the UK was that vertical agreements which did not include a restraint on prices would not usually have an appreciable adverse effect on competition. Instead of adopting the ex ante approach applicable to other agreements (notably horizontal ones), the ex post redress approach towards vertical restraints was essentially retained under the Competition Act 1998 (Land and Vertical Agreements) Order 2000, the so-called "UK Exclusion Order".[25] The UK Exclusion Order, made under section 50 of the Act, excluded non-price fixing vertical agreements from the application of the Chapter I prohibition.

The Exclusion Order did not mean that all non-price-fixing vertical agreements could operate without restriction. First, the UK Exclusion Order offered protection from the Chapter I provision but did not preclude the application of EU Article 81 where there was an effect on trade between Member States.[26] Second, agreements giving rise to an

[22] *See* Monopolies and Mergers Commission (1979; 1994; 1998; 2000).

[23] *See* the comments and suggestions by Hutchings (2004).

[24] *See* Glynn and Howe (2003).

[25] Competition Act 1998 (Land and Vertical Agreements) Order 2000 (SI 2000 No 310).

[26] The issue about whether agreements *might* affect trade between member states has an important bearing in regard to exemptions, since agreements exempt under EC law can obtain a parallel Competition Act exemption.

abuse of a dominant position could be challenged under Chapter II of the Competition Act 1998.

To an extent, the UK Exclusion Order covered similar agreements as the EC Block Exemption covers, given its intention to follow closely the treatment of vertical agreements in the European Union. Nevertheless, there were two fundamental differences:

- The UK Exclusion Order was not subject to a market share threshold test - although, like the Block Exemption, the OFT could withdraw the benefit of the exclusion in certain cases and where one party is dominant it did not preclude the application of Article 82 and/or the Chapter II prohibition.
- The UK Exclusion Order had only one "hardcore" restriction, which related to vertical price fixing (i.e. fixed or minimum resale price maintenance). An agreement that included a price fixing restriction could not benefit from the exclusion.

From EU case law, though, the likelihood of challenge under Article 82 or the Chapter II prohibition would seem unlikely if each party had less than about a 40% market share of its respective economic market, though in the past the UK authorities have seen 25% market share as a critical level (viewing this level as a "scale monopoly" threshold). Accordingly, if EU case law were followed on market share thresholds for "economic dominance" this would suggest that about a 40% level has been the relevant UK threshold while the Exclusion Order had been in operation, compared to the 30% market share level adopted by the EC.

In contrast to the one "hardcore" restriction, the EC approach, as explained above in section 4, has four other "hardcore" restrictions relating to restrictions on re-sales, after-market sales, cross-territory sales and cross-supplies in a selective distribution system. These hardcore restrictions distinguish the EU from other systems of competition policy as they reflect the fact that one of the historical goals of EU competition policy was and still is the creation of the single European market, with no national barriers to trade.

Thus there are significant differences between these two approaches, giving rise to the prospect that particular agreements could be (or, at least, could have been) treated very differently under these two regimes.

Indeed, this is to be put to the test as the UK is now set to align fully with the EC position. This change in stance follows the EU's adoption of the "modernisation regulation" (Regulation 1/2003) in December 2002, "decentralising" the enforcement of Article 81 to national competition authorities and courts as from 1 May 2004.

This regulation prompted the UK government to reconsider the way that vertical agreements are dealt with in UK law. After a period of consultation, the government announced the decision in January 2004 to repeal the Exclusion Order and apply the EC Block Exemption Regulation for all vertical agreements whether they affect interstate trade or only trade within the UK.[27] Formally, the Exclusion Order is repealed with effect from 1 May 2005 upon entry into force of the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order (SI 2004 No 1260).

This change will potentially have a considerable impact on those parties either caught by the difference in implied market share thresholds (down from a dominance threshold usually taken at around 40% to the Block Exemption threshold of 30%) or where one or more of the EC's other four hardcore restrictions are used.[28] An example of just such an industry caught in this manner is the supply and distribution of national newspapers and consumer magazines. Here, there are parties with slightly over 30% (but less than 40%) market share.[29] The products are also distributed through an exclusive territory system that operates with a prohibition on cross-territory passive sales – amounting to a hardcore restriction under the EC interpretation, but a practice that has been approved (due to its considerable efficiency benefits) by UK competition authorities in the past (notably the MMC (1993)). It remains to be seen what, if any, support the UK authorities will be willing and able to offer this industry in order for this distribution system to be maintained.

On a more general level, the repealing of the Exclusion Order opens up the question of whether it is always appropriate for practices operating at the national level to be treated the same as Community-wide practices. Certainly, not all members of the European Union share this view – for example, the French and German authorities have allowed instances of RPM to continue. Yet, by falling completely in line with EU policy, it would appear that UK policymakers do not see the need to distinguish between national and community objectives, where the latter embrace not only the desire for effective competition but also for pan-European market integration or at least prevention of market segmentation. However, from a competition perspective, it is far from clear that the latter aspect is always supportive of the former. For example, it is conceivable that instances of deliberate market segmentation serve to enhance effective competition – exclusive territories for wholesaling newspapers and magazines being a prime example – while at the EU level, separation of national markets on this basis would be seen as anathema, regardless of the economic merits or otherwise. In particular, a concern must be that the move by the UK to repeal the Exclusion Order and blacklist additional restraints, i.e. beyond RPM, may mean that the UK is embracing an EC perspective which is not solely about economic effects, but in part politically motivated by the desire for integrating markets within the European Union.[30]

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[27] The DTI issued a press release on 21st January 2004 announcing the Government's proposal to remove the UK Exclusion Order but with the removal not taking effect until 1st May 2005. For more details on the arguments for the change, see the consultation paper by DTI (2003).

[28] *See* OFT (2004) for further details of the changes and guidelines offered to businesses.

[29] Specifically, there is one newspaper publisher, one magazine distributor and one wholesaler with a share of their respective economic markets greater than 30% but less than 40%.

[30] On this matter, Motta (2004, pp. 32-33) is extremely forthright in his view that the list of hardcore practices "are justified more by the desire to promote identical prices and sales conditions in the EU than by an economic rationale", adding (p.377-8) that "there is no economic justification for a policy that treats restraints in a different way" and that "an efficient policy towards vertical restraints would grant exemption to all the vertical restraints and mergers of firms which do not have large market power". In a similar vein, see Bishop and Walker (2002, point 5.50).

5. ECONOMIC ASSESSMENT OF VERTICAL RESTRAINTS

In order to consider more fully the merits or otherwise of the policy reforms outlined above, particularly the EC effects-based approach and the guidelines offered, it appears appropriate to start by considering in more detail the economic role played by vertical restraints and their effects on the economic performance of markets.[31]

As observed above in section 2, vertical restraints can, in principle, occur at any stage of the supply/distribution process for a product or service. They are essentially agreements between trading parties that restrict the actions or place an obligation on the behaviour of one or both of them in some way. For example, this could be the seller obliging the buyer not to trade with any rival supplier (i.e. exclusive dealing), the seller agreeing to exclude sales to some or all other buyers (i.e. respectively, selective or exclusive distribution), or the supplier dictating the buyer's resale price (resale price maintenance - RPM). The purpose of such restraints is to tackle distribution and/or supply problems that in some way damage the joint profits of the parties (even though they may favour one party over another) – e.g. problems arising from sub-optimal investment, effort or sales, excessive transaction costs, or excessive competition. Moreover, given the multiplicity of distribution/supply problems that can arise, vertical restraints can occur on their own or in combination with others, apply to one trading relationship, several relationships, or be generally applicable in a market (i.e. where they are operated in parallel by different parties).

The view traditionally held in the economic analysis of vertical restraints is that they are motivated by the desire for vertical control within a principal-agent relationship, where the principal (e.g. a manufacturer) imposes contractual obligations on its agent (e.g. a retailer) when delegating responsibility for selling its good.[32] In this framework, vertical restraints are viewed as responses to supply and distribution problems facing the principal. The problems stem from a divergence of the parties' interests, typically over the level and type of retail service. The notion is then that the principal uses vertical restraints in order to bring the agent's interests into line with its own interests.

The key problems for which a manufacturer as a "principal" may wish to control are summarised in Table 1 (shown below). These fall into two groups. Firstly, problems may arise for a manufacturer, independently of concerns about competition with other manufacturers, from retailers taking actions designed to maximise their own profits, but which act against the manufacturer's interest, i.e. concerns about intra-brand competition. These are represented by the first four problems in the table. Secondly, problems may stem from the actions of rival manufacturers that have an adverse impact on the firm's profits, i.e. concerns about inter-brand competition. In this case a firm

[31] For more detailed technical accounts on the economics of vertical restraints see Dobson and Waterson (1996a), Irmen (1998), Motta (2004, chapter 6), Rey (2003), Rey and Tirole (forthcoming) and Secrieru (2004). For a good non-technical introduction to the subject, relating theory to policy, see Bishop and Walker (2002, points 5.32-5.44).

[32] As examples of this vertical control principal-agent perspective, see Mathewson and Winter (1984), Rey and Tirole (1986a,b), and the survey by Katz (1989).

may wish to use particular vertical arrangements to deal with the other two problems listed in the table, i.e. concerning competition at the same level as the firm.

Table 1 - Vertical Restraints as Responses to Supply and Distribution Problems

	Problems in supply and distribution	*Contractual solutions*
1.	Successive (manufacturer then retailer) mark ups which result in prices being set higher than the optimal level (attained by setting a single mark up)[33]	Two-part tariffs Quantity requirements Retail price ceilings
2.	Damaging price competition between retailers which may dissuade retailers from stocking the firm's products[34]	Resale price maintenance Exclusive distribution
3.	Free riding by retail price discounters on the pre-sales services and/or reputation of full price dealers leading to under-investment by retailers[35]	Service requirements Resale price maintenance Exclusive distribution Selective distribution
4.	Providing the optimal number and density of dealers and capturing economies of scale in distribution[36]	Resale price maintenance Selective distribution
5.	Free riding by rival manufacturers on product's image, advertising, and customer drawing power or on investment in dealers leading to under-investment by manufacturers[37]	Exclusive dealing Fidelity rebates/discounts
6.	Profit damaging price competition between rival manufacturers offering similar (i.e. substitutable) products[38]	Exclusive dealing Tie-in sales Exclusive distribution

Source: Adapted from Dobson and Waterson (1996a)

As shown by Table 1, it is apparent that different restraints may serve the same basic purpose. Though, in practice they may vary in their effectiveness, which along with legal and practical considerations is likely to determine the firm's choice. For instance, with a form-based policy, where a particular restraint is prohibited, e.g. minimum resale price maintenance (RPM), then a problem, say dealer free-riding, could be tackled by implementing an alternative restraint.[39] Accordingly, with this policy framework firms

[33] The classic reference for an explanation of the problem is Spengler (1950).
[34] See Rey and Tirole (1986b) for consideration of this problem in the presence of market uncertainty and risk averse retailers.
[35] Telser (1960) explains why too little promotional and demonstration activity may arise if free riding on pre-sales service is allowed. Marvel and McCafferty (1984) consider the effects of free riding on the reputation of high-quality stores as providing "certification" of the quality of a good.
[36] The problem of sub-optimal density of retailers when sunk costs are involved in establishing retail outlets is examined by Dixit (1983), Gallini and Winter (1983) and Waterson (1988).
[37] See Marvel (1982) and Steuer (1983).
[38] Clearly the resolution here is to lessen competition – either by restricting it or preventing it. On dampening competition, see Lin (1990), O'Brien and Shaffer (1993), Besanko and Perry (1994), Rey and Stiglitz (1995) and Dobson and Waterson (1996b). On exclusion and foreclosure, see Comanor and Frech (1985), Mathewson and Winter (1987), Rasmusen, Ramseyer and Wiley (1991), and Whinston (1990).
[39] For instance, a dealer free-riding problem might occur when sales are maximised when dealers invest in demonstration services but they individually or collectively would not be prepared to undertake such

may be tempted to adopt "form shopping", i.e. use permissible restraints which have the same economic effects as prohibited restraints. On the other hand, it might be argued that such a policy approach may be preferable where the prohibited restraint has potentially multiple anti-competitive effects.

From the perspective of tackling distribution and supply problems, vertical restraints are imposed in order to increase the firm's profits. However, the problem for the policy maker is that the net economic effect of a restraint on society (i.e. taking account of the interests of the consumers and the firms operating in the market or sector) is not immediately obvious. For while vertical restraints may benefit society when they increase efficiency, say by allowing for improved investment decisions, reduced costs, and improved product/service quality, they may equally have a detrimental effect by restricting and distorting competition.

More specifically, an anti-competitive effect can arise through a restraint serving one or more of the following:

(i) raising barriers to entry or expansion (i.e. a so-called "foreclosure effect"),
(ii) reducing the intensity of competition between existing firms (either for one particular brand with reduced intra-brand competition or between different brands with reduced inter-brand competition), or
(iii) facilitating collusion (including tacit collusion through conscious parallel behaviour).

Accordingly, each case needs to be examined on its merits and the market circumstances and other features will be particularly important in determining which effect (pro- or anti-competitive) is likely to dominate. Here, economics has contributed some important insights into the effects of these practices, from which the EU and UK competition authorities have sought to draw on in developing new guidelines.

The *Guidelines on Vertical Restraints*, issued by the European Commission in 2000, for instance, consider the negative and positive welfare effects of vertical restraints in turn. In regard to possible negative effects[40], vertical agreements are divided into four

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action, instead choosing not to provide such services. In this situation a "market failure" problem could arise when each dealer under-invests in these services and this leads to sub-optimal sales. In order to overcome the problem, all dealers would have to be sure that (a) all other dealers would undertake similar investments and (b) they themselves were obliged to undertake such investment. One of several different restraints might resolve this problem: (i) a service-level requirement (but which might be difficult for the supplier to monitor and enforce), (ii) a selective or exclusive distribution system which only allowed "full service" dealers to act as distributors (thus deliberately excluding low-service "discounters"), or (iii) (minimum) resale price maintenance (as this would mean that dealers would have to compete for customers through their service offer rather than through their retail prices). Clearly, each of these is different in respect of its directness – the first being the most direct, the third being the least direct. However, it should not be taken for granted that such vertical restraints will necessarily increase social welfare. For example, Comanor and Kirkwood (1985) and Scherer (1983) show that consumers (especially informed ones) might be better off in aggregate without these pre-sales services when this results in intra-brand price competition and lower prices compared to high prices arising under RPM.

[40] In addition to the three anti-competitive effects listed above, the European Commission also explicitly includes in its consideration of "negative effects on the market" the EC competition law aim at preventing "the creation of obstacles to market integration, including, above all, limitations on the

groups: a single branding group, a limited distribution group, a retail price maintenance group and a market partitioning group. It is argued that the division is appropriate since the "vertical restraints within each group have largely similar negative effects on competition" (EC 2000, point 104).

The single branding group comprises non-compete obligations and quantity forcing on the buyer as well as tying. The common element is that the buyer is induced to concentrate his orders for a particular type of good with one supplier. The chief competition effect is through reduced *inter-brand* competition as a consequence of foreclosure of certain suppliers and no in-store competition when retailers sell only one brand.

The limited distribution group covers exclusive distribution, exclusive customer allocation, exclusive supply, quantity forcing on the supplier, qualitative and quantitative selective distribution, and after-market sales restrictions. The common element is that the producer is selling only to one or a limited number of buyers.[41] The chief effect on competition is that it leads to foreclosure of certain buyers, which consequently may directly reduce *intra-brand* competition, which in turn may have the effect of reducing in-store *inter-brand* competition, particularly if the restraint is widely practised.[42]

The resale price maintenance group covers minimum, fixed, maximum and recommended resale prices. Concern about maximum and recommended resale prices is that they may work as fixed RPM. The competition effects of (fixed) RPM are that *intra-brand* price competition is totally eliminated and the increased transparency on price and responsibility for price changes make horizontal collusion between manufacturers easier, at least in concentrated markets. The absence of intra-brand competition may also have the indirect effect of reducing inter-brand competition.[43]

freedom of consumers to purchase goods or services in any Member State they may choose" (European Commission, 2000, point 103).

[41] Note, the term buyer here relates to an "intermediate" buyer such as a producer who uses the product or a wholesaler, distributor or retailer who sells on the product – i.e. not a "final" buyer like a consumer.

[42] The direct effect will be to reduce intra-brand competition when there are fewer distributors handling a particular good. If, though, the practice is widespread so that other producers use the same restraint and they tend to appoint separate exclusive distributors, say, and not rely totally on common distributors (which handle all producers' goods), then in-store choice for consumers will tend to be more limited compared to unrestricted distributor supply. This would then result in a reduced in-store inter-brand competition, serving to affect detrimentally overall inter-brand competition if consumers were reluctant to shop around. In contrast, though, where common distributors are used on an exclusive basis then this can enhance inter-brand competition, since the common distributor can act as an efficient sharable platform for producers. In fact, this is something, for example, which is very apparent with newspaper and magazine distribution in the UK through wholesalers being allocated exclusive territories and then being used by all publishers, so that the wholesaler can offer an efficient "one-stop shop" service to retailers as it would be able to supply all titles while taking advantage of its scale, scope and network economies from being the sole wholesaler in its territory to supply at least cost.

[43] This may be because it facilitates collusion in the market as it may allow for "focal prices" to emerge, making it easier for rival suppliers to match each others' prices, while making monitoring prices more straightforward (given that all retailers set the same price for the same product).

The market partitioning group is made up of exclusive purchasing, territorial resale restrictions, customer resale restrictions, and prohibitions of resale. The common element is that the buyer is restricted in where it either sources or resells a particular good, leading to a reduction in intra-brand competition that may aid the supplier or buyer to partition the market and thus hinder market integration and facilitate price discrimination.[44]

In regard to the positive effects of vertical restraints, the *Guidelines* note these as arising from a number of sources that can solve a variety of distribution/supply problems giving rise to sub-optimal investment and sales.[45] For example, vertical restraints may (in the absence of strong anti-competitive effects) be justified on the grounds of (i) solving a free-rider problem (causing under-investment), (ii) encouraging new investment, (iii) facilitating new entry into markets, (iv) allowing for a different promotional strategy in different markets, (v) achieving economies of scale in distribution, (vi) alleviating capital market imperfections, or (vii) allowing for uniformity and quality standardisation.

In evaluating the overall effects of restraints, i.e. weighing the negative and positive effects, the *Guidelines* propose some general rules. Firstly, competition effects can only arise if market power is present, i.e. where there is insufficient inter-brand competition. Secondly, it suggests that vertical restraints that reduce inter-brand competition are generally more harmful than restraints that only reduce intra-brand competition.[46] For example, non-compete obligations, by foreclosing other brands, may prevent these brands from reaching the market, but exclusive distribution, which instead forecloses certain buyers, does not in general prevent the good from reaching the final consumer. A further general rule claimed is that exclusive agreements are generally worse for competition than non-exclusive agreements as the degree of

[44] In themselves, these effects may not necessarily be detrimental to competition – and clearly there is a political aspect here about the perceived social desirability of having a common market with no price discrimination. Even so, there would be an adverse effect where these restraints lead to market segmentation which allows firms to avoid or reduce competition in sub-markets and as a consequence soften competition in the overall market (leading to reduced consumer choice, convenience or accessibility and/or higher prices).

[45] In other words, efficiency benefits are possible which correct for or help avoid situations of "market failure" in which sub-optimal outcomes would otherwise arise. These should also be seen as pro-competitive benefits since with increased efficiency firms will be better placed to compete more effectively and thereby pass on a portion of these benefits in the form of increased choice, improved quality and/or lower prices.

[46] However, there is little basis for this distinction from economic theory (e.g. Steiner (1991)). The EC's position really relies on the view that the variety and range of goods offered are significantly more economically important than the variety and range of distribution services offered to consumers, when in fact both are likely to take on importance to consumers. Indeed, in one sense they are equally important in that goods and distribution services are perfect complements – i.e. consumers need both to make purchases. However, it is not necessarily the case that the decision over what to purchase and where to purchase it from are made simultaneously or in a particular sequence, or that one is prioritised over another. For instance, consumers may be encouraged to make purchases by the knowledge that a good is available in advance of their decision to use a specific retail service (e.g. through an advertisement) or only upon using a distribution service (and as such the purchase may be "impulse" in nature rather than "planned"). Furthermore, it is just as possible for retailers to "brand" their distribution services as it is for suppliers to "brand" their products to build up consumer loyalty and have a differentiation advantage over rivals.

foreclosure is likely to be higher. Also, negative effects are likely to be compounded when the practice is common within a sector. Moreover, vertical restraints at the intermediate level are likely to be less harmful than restraints affecting the distribution of final, especially branded, goods and services.

Concerning differentiation of vertical restraints between groups, the view taken in the *Guidelines* is that RPM and market partitioning are likely to be more restrictive and offer fewer efficiency benefits than the other two groups. In addition, single branding (non-compete obligations) is generally considered to be more restrictive than limited distribution, reflecting the European Commission's view that inter-brand competition is more critical than intra-brand competition.

In terms of assessing the impact of a vertical restraint, the *Guidelines* propose the following four-step procedure:

1. Define the relevant markets for the supplier and buyer and calculate their respective market shares.
2. Check to see that neither market share exceeds 30%, in which case the vertical agreement is covered by the Block Exemption Regulation, subject to the hardcore restrictions and conditions set out in the regulation.
3. When a relevant market share exceeds 30%, assess whether the vertical agreement falls within Article 81(1).
4. If the vertical agreement falls within Article 81(1), examine whether it fulfils the conditions for exemption under Article 81(3).

For a restraint where the 30% market share threshold is met, the procedure effectively calls for a full competition analysis for assessing whether the vertical restraint fulfils the conditions for exemption. For restraints involving a Community dimension (i.e. potentially affecting trade between Member States), this analysis is with respect to Article 81(3) of the EU Treaty. For restraints that have no possible impact on trade between Member States, then the UK authorities (specifically, the Office of Fair Trading) would make an assessment with respect to Section 9 of the UK Competition Act.[47] In both cases, given the full alignment of UK policy with that of the EC, the assessment would be with regard to the same four economic tests:[48]

i. *Economic efficiencies*: Does the vertical agreement contribute to improving production or distribution or promoting technical or economic progress (i.e. offer efficiency benefits)?
ii. *Consumer benefits*: Does it allow consumers a fair share of these benefits (e.g. by increasing choice, quality or accessibility and/or lowering prices)?

[47] Of course, under the modernisation regulation, the OFT can now also undertake Article 81 and 82 investigations.

[48] These four tests are derived directly from Article 81(3) which states that a prohibition (in respect of Article 81(1)) does not apply to any agreement, decision or concerted practice "which contributes 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, and which does not: (a) impose on the undertakings concerted restrictions which are not indispensable to the attainment of these objectives; (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question".

iii. *Absence of any unnecessary restrictions*: Does the arrangement constitute the minimum necessary restriction to yield these benefits?
iv. *Continuing effective competition*: Does it operate in a manner that does not eliminate competition in respect of a substantial part of the market?

Only with all four tests satisfied would the restraint meet the conditions for exemption.[49]

The EC's *Guidelines* offer a range of hypothetical examples covering each group of restraints to illustrate the relevant factors that would be considered in such an analysis.

6. SOME REMARKS ABOUT THE POLICY REFORMS

In principle, Article 81 provides an appropriate legal framework for a balanced assessment of vertical restraints, recognising the distinction between welfare-reducing and welfare-enhancing effects. Specifically, Article 81(1) restricts the scope of Article 81 to agreements that appreciably restrict or distort competition, while Article 81(3) allows agreements caught by Article 81(1) to be exempted (from the consequences of 81(2)[50]) if they provide sufficient efficiency benefits.

While it may be ideal to assess the balance of effects on a case-by-case basis, in practice it may be argued that the sheer number of cases involved means that some simple, formal rules are required for the application of Article 81 to limit what would otherwise be a very resource-intensive activity.[51] The new approach using a market share test is clearly designed to allow for resources to be devoted to those cases where social welfare losses may be most apparent (i.e. where anti-competitive effects are likely to significantly outweigh efficiency benefits of restraints).

Unlike the previous policy with its sector-specific rules (e.g. exclusive purchasing arrangements for petrol and beer) and special cases (e.g. franchising), the new policy is a blanket one, intended not to favour or discriminate against particular sectors and/or particular distribution systems (other than by the thresholds).

The new approach indicates a marked change with the past in terms of moving from a central focus on market behaviour to a more formalistic, mechanistic approach, at least for screening, with rules based on market structure.

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[49] It should be emphasised that a competition authority is not obliged to grant a formal exemption even if these tests are passed. While an exemption might offer the parties a high degree of legal certainty, and thus be much desired by them, the authority may decide to offer only informal guidance or at most a written opinion, which might at least be expected to carry some weight if the restraint is legally challenged, e.g. by potential competitors or customers.

[50] Specifically, Article 81(2) states that "any agreements or decisions prohibited pursuant to this article shall be automatically void".

[51] Here, it should be made clear that the burden has largely shifted to the private sector, i.e. companies and their advisers must generally reach their own judgment on whether or not their agreements and practices fall foul of the competition rules; thus public resources are at least in theory released.

Nevertheless, this move can be seen as placing a serious regulatory burden on firms, given that the new approach relies primarily on self-assessment rather than notification.[52] This means that firms (large or small) will need to define markets and assess market shares, which will add considerable legal uncertainty. Given the difficulties inherent in market definition, the potential for divergences of opinion over what constitutes the "relevant market" (especially in the context of differentiated goods and the interpretation of close or not closesubstitutes) is considerable. This may lead to a firm having a very low market share under one plausible market definition, but a high market share under an alternative, equally plausible, market definition. Added uncertainty is created by the risk of block exemption removal hinging on the actions of other firms and by the uncertainty over exactly how the European Commission (or OFT for UK cases) will assess the competitive nature of the market (for example, covering market structure, barriers to entry, the degree of integration of the single market and the cumulative impact of parallel networks).

However, it is not just the regulatory burden on firms and the general legal uncertainty that may be entailed in a system reliant on self-assessment that may be costly. There are also economic issues that suggest possible weaknesses and limitations of the new approach and the guidelines offered.

First, an important message from economic theory is that the effects of vertical restraints are entirely dependent upon market conditions and market behaviour. The new policy approach adopts a structural rule, based on market share alone - as a proxy for market power. This may be regarded as a crude way of capturing or releasing vertical agreements from regulation and, notwithstanding the comments in the EC's *Communication* and subsequent *Guidelines*, economics has yet to provide clear guidance on what might be appropriate levels of market share for thresholds, or even whether a sufficiently strong relationship exists between market share and the likelihood of anti-competitive effects outweighing efficiency effects to allow for thresholds to be used with any degree of confidence. Thus the 30% market share rule appears to be somewhat of an arbitrary level. Even with high market shares in evidence, it is of course entirely possible that the market may be acting in a competitive manner, particularly if market shares are highly unstable (i.e. volatility of market shares needs to be taken into account as well as the absolute levels). Equally, it is conceivable that firms with low market shares may be able to exert market power[53], where perhaps the vertical restraints may be market-wide and act to strengthen market segmentation and allow firms to avoid intense (e.g. head-to-head) competition (i.e. the extent of coverage of the restraint in the market may be crucial). Nevertheless, a market-share threshold test does at least offer an important degree of simplification (if not quite

[52] As of 1st May 2004, the system of clearance for individual agreements under Article 81(3) has been abolished. Instead, agreements, decisions and concerted practices caught by Article 81(1) which satisfy the conditions for exemption under Article 81(3) shall not be prohibited, with no prior decision to that effect being required (Article 1(2) Council Regulation 1/2003, 16.12.2002, OJ 2003 L 1/1). Rather, the undertakings, themselves, have to assess whether a vertical agreement within the scope of Article 81(1) may be nonetheless admissible pursuant to Article 81(3).

[53] For instance, this might arise where customers lack information about prices, choice and/or availability and are reluctant to "shop around" because search costs are high relative to the perceived value of the product.

certainty) in undertaking self-assessment, and in principle allows competition authorities to direct their resources to focusing on cases where market power is most likely to arise.[54]

Second, while the *Guidelines* offer perspectives on a good number of vertical restraints, the coverage is far from comprehensive. Specifically, certain restraints are not mentioned in the *Guidelines*, and it might not be immediately obvious where they fit into the EC's scheme. Perhaps the principal class that is largely ignored concerns non-linear pricing and incentive arrangements, such as two-part tariffs and discount schemes. For example, a manufacturer-induced restraint might be in the form of a distributor paying an up-front lump sum fee (e.g. a franchise fee) and a per unit charge. More complicated pricing procedures might be in the form of aggregated rebate schemes, e.g. with end-of-year lump sum payments to distributors based on sales' levels and/or for taking the producer's full product range. This topic raises important issues about the difference between vertical restraints that provide formal obligations and those that provide financial inducements. In practice, the economic effects may be the same, even though competition authorities may take a more favourable view of the latter, given that these, in theory, allow for discretion on the subjected party.[55]

Third, a more fundamental issue is that most of the concerns expressed in the *Guidelines*, and indeed going back to the Green Paper, are, at least by inference, to do with producers placing restraints on distributors. Indeed, this is reflected in the analysis and discussion set out in the *Guidelines*. This begs some important questions. Are restraints symmetric in effect when buyers rather than sellers induce them? Is buyer power seen as a problem equivalent to seller power in the context of vertical restraints? Unfortunately, the Green Paper was silent on these questions since issues of buying power were explicitly excluded from discussion, and the *Guidelines* offers little insight here into the Commission's new thinking except for the discussion on exclusive supply obligations, but here this relates to a manufacturer (as a buyer) imposing restraints on

[54] There is clearly a trade-off involved here between making the system as simple, transparent and as least burdensome as possible while trying to make sure that arrangements that allow for or exacerbate market power abuse are prohibited. If the threshold level is set "too high" then cases where market power is a problem may slip through the net, while if the threshold is "too low" then too many harmless arrangements will needlessly be caught and not automatically exempted. In statistical parlance, the choice of threshold is about trying to minimise Type I errors (false positives) and Type II errors (false negatives), whilst recognising any choice inevitably entails a trade-off between the likelihood of each error type occurring.

[55] An example of how the matter has been controversial when it concerns firms with high market shares has been the supply of impulse ice cream in the context of "freezer exclusivity" as a surrogate for "outlet exclusivity". Here, as investigations in the UK, Ireland and Germany have shown, the potential for incentive-based restraints to detrimentally affect competition can be particularly pronounced when operated alongside other restraints – see Hutchings (2004). However, in isolation, a practice that offers financial inducements, say to retailers to provide a supplier with additional in-store selling space or even to exclude rivals, may be just a manifestation of natural competition, especially when it allows for retailers to pass on lower prices and so long as it does not amount to predatory behaviour and the exclusion of rival suppliers from the market (as opposed to individual outlets). Indeed, in this specific context, the view generally taken is that "refusal to buy" is not as potentially detrimental as "refusal to supply". Yet this view rests on the perception that it is the supplier rather than the buyer (e.g. retailer) that is most likely to have market power – which may not in fact be the case, e.g. the distortion to supplier markets when powerful supermarket retailers delist suppliers (see, for example, Competition Commission (2000), Clarke *et al* (2002), and Dobson (2005)).

its component suppliers (EC, 2000, point 213). Yet, it is apparent that in practice retailers often employ a variety of restraints on manufacturers, other than the mentioned case of exclusive supply arrangements, e.g. the UK Competition Commission's (2000) inquiry into supermarkets identifying 52 different buyer-led practices. In this regard, the European Commission's views on suitable treatment for slotting allowances ("shelf-space fees"), listing fees, retroactive discounts, buyer forced application of most favoured nation (MFN) clauses, and reciprocal dealing, amongst other retailer-induced restraints, would have been a welcome inclusion in the *Guidelines*.[56]

Fourth, and partly related to the previous point, the emphasis in the *Guidelines* on the primary importance of protecting inter-brand competition (e.g. European Commission, 2000, point 119) is somewhat at variance to the categorisation of hardcore practices that are directly concerned with intra-brand competition. In particular, vertical restraints that directly affect inter-brand competition (e.g. from the non-compete group) are given a relatively more lenient treatment than the hardcore restraints that directly affect intra-brand competition (i.e. those from within the resale price maintenance and market partitioning group). Indeed, this perspective is markedly different from the policy approach in the US where tying (as from the non-compete group) has traditionally received harsher treatment than most other restraints, with the notable exception of RPM. Yet, the apparent contradiction within the EC approach is evident in the *Guidelines* where it is stated that: "Vertical restraints which reduce inter-brand competition are generally more harmful than vertical restraints that reduce intra-brand competition. For instance, non-compete obligations are likely to have more negative effects than exclusive distribution" (EC 2000, point 119 (2)).[57]

In fact, economic theory does not lend support to either of the Commission's stances. Specifically, protecting intra-brand competition can be just as important as protecting inter-brand competition and the negative effects of restraints that impede inter-brand competition can be just as damaging as those that impede intra-brand competition, and vice versa – e.g. Steiner (1991) and Dobson and Waterson (1996a). This observation serves to reinforce the view that the hardcore treatment of aspects of exclusive and selective distribution, in particular, is really more about the political motivation to see markets integrated within the European Union rather than about the competition and economic welfare effects of these restraints. Indeed, this view is further reinforced by the somewhat arbitrary pigeon-holing of vertical restraints into four different groups when most economists would probably just think of there being two groups: those restraints that directly affect intra-brand competition and those that directly affect inter-brand competition – e.g. Motta (2004).[58]

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[56] Of course, the same point applies to other situations where buyer power arises in the supply chain, such as a powerful manufacturer imposing restraints on an input supplier. Here, for example, vertical restraints might extend beyond a simple contemporaneous exclusive supply obligation. For example, a manufacturer might wish to impose a long post-term non-compete obligation on some of its suppliers. This would have the effect of prohibiting these suppliers providing their products to any other manufacturer beyond the existing contract period, i.e. potential foreclosure for the future as well as the present.

[57] This is particularly the case given the absence of a limitation on post-term non-compete obligations imposed on suppliers (unlike those imposed on buyers).

[58] Moreover, the EC's classification of restraints is not always clear-cut. For example, a series of resale restrictions that amount to territorial exclusivity (in the market portioning group) is really just an

Finally, apart from the form of restraint, whether induced by sellers or buyers and whether affecting inter- or intra-brand competition, another issue that may prove contentious concerns contract duration. Specifically, how long is it appropriate for a restraint to last, both in the sense of present commitments (and their possible renewal) and also their absolute duration? In the case of non-compete obligations on a buyer a five-year duration limit is applicable (EC 2000, point 58). However, like market share thresholds, this level seems somewhat arbitrary. In practice, each case may be expected to differ as different trade-offs and market conditions may be involved. Specifically, firms should be able to recoup investments made in developing highly specific trading relationships that offer efficiency benefits, but equally they should not be allowed to foreclose a significant part of a market for a considerable amount of time and thereby protect themselves from the rigours of competition. Similarly, there may be less need on efficiency grounds for lengthy contracts when markets are well established. More general guidance on this matter, applicable to each restraint (but notably ones involving exclusivity), in the form of official guidelines, appears warranted as this may be a critical point if firms with high market shares are required to self-assess.

7. CONCLUSION

Change of any sort in the regulatory environment throws up opportunities and threats for firms. The new policy approach on vertical restraints certainly offers some benefits but it also offers some costs for firms. The same applies for the authorities left to apply and enforce the new approach.

In its fact-finding exercise for the Green Paper, the European Commission found many industry associations calling for wider block exemptions, allowing their members greater freedom in developing vertical arrangements, tailored to their specific needs. This, indeed, is what the new approach delivers – i.e. a less restrictive policy compared to the previous form-driven system. This allows firms greater flexibility in how they conduct business and agree terms and conditions with trading parties without necessarily losing the protection of a market-wide block exemption.

However, the cost to firms of the new broad block exemption approach is the regulatory burden associated with self-assessment and the lack of legal certainty (given that there is no guarantee that authorities will not challenge self-assessed agreements). The difficulties associated with self-assessment start with the need to determine market shares, which in turn begs the question of how the market should be appropriately defined. Defining the relevant market requires both an understanding and a broad agreement on the extent of the market in both geographic and product terms. The latter aspect requires determining the appropriate set of (substitute) products constituting a singly defined market, which can prove notoriously difficult and contentious when goods are differentiated in a variety of ways. Also, even if there were full agreement on the market definition and all the relevant individual market shares were below 30%, there would remain the possibility that vertical agreements could be challenged. This

example of exclusive distribution (in the limited distribution group). Similarly, exclusive purchasing (in the market portioning group) is really just a non-compete obligation (in the single branding group).

could arise when vertical agreements involve elements that were interpreted (perhaps mistakenly) as amounting to "blacklisted" practices (e.g. price ceilings as *de facto* RPM). It could also arise where there are perceived (again, possibly mistakenly) to be network effects, giving rise to concerns about the cumulative impact of restraints commonly practised in a market.

The new approach is neither more nor less restrictive than the old regime. Economics tells us that all vertical restraints can have negative and positive competition effects. This applies to the prohibited practices under the new EC regime, just as it does to all the other types of vertical restraints. In practice, firms employ vertical restraints for a variety of motives, generally as responses to supply and distribution problems. To some extent, the control of a particular problem may be facilitated by more than one restraint – leaving firms with a choice between alternatives when policy treats restraints equally. Of course, in practice, there may be particular reasons why one form of restraint is favoured over another, e.g. if one offers greater efficiency benefits such as reduced transaction costs. However, the new policy prohibits the use of certain restraints, some of which may not have suitable replacements. For example, it is not immediately evident how the efficiency benefits will be preserved in the distribution of UK newspapers and magazines if the UK authorities do not continue to support adequately the current exclusive territory wholesaling system following the repeal of the UK Exclusion Order.

For some industries, though, releasing firms from the straitjacket of the previous block exemptions may encourage experimentation and yield efficiency benefits, while also possibly stimulating competition. Alternatively, it could of course exacerbate any anti-competitive effects, when combinations of restraints are employed, further adversely affect social welfare. In this regard, it will be interesting to see the developments in the years to come for the petrol, beer and motor vehicle markets.

The major impact of the policy changes, though, can be expected to fall on firms with large market shares. They are now faced with the prospect of a detailed case examination to determine whether they should receive the same benefits of exemption as their smaller rivals. If exemption is seen as crucial to financial success, then they will be under pressure to justify the efficiency benefits of their existing restraints and perhaps make concessions to the authorities on business practices (e.g. on closing price differences across different Member States) or alternatively undertake voluntary divestments to ensure that they fall below the critical upper market share threshold. Either way, large firms' positions may be compromised, and their business performance may suffer. This may be good for consumers if it is the result of large firms having to end anti-competitive practices. Equally, it may be bad for consumers if it reduces the ability of large firms to take advantage of potential economic efficiencies.

While there remain some shortcomings and unresolved issues in the new policy approach, these need to be put into the context of the considerable benefits offered by the recent changes. In particular, from an EU perspective, the new approach should broadly be seen as a considerable step forward in developing a sensible and reasonable means of treating vertical restraints for public policy purposes. The change for the EU is particularly marked as the emphasis is now firmly on consideration of vertical restraints on grounds of their economic effects on markets, rather than merely their legal form. In this respect, the approach should be seen as a very welcome change that will serve to protect competition and enhance economic efficiency better.

Nevertheless, this assessment is qualified in view of the EC approach conflating justifiable competition policy objectives with the political objective of increasing market integration. Even if one accepts the worthiness of the EC's market integration objective, it is questionable whether it should still feature as strongly today in influencing vertical restraints policy, and perhaps other aspects of competition policy, as it has done previously. Despite the recent accessions (and presumably more to come), it might not seem unreasonable to ask whether the market integration aim is or should be a permanent aspect of vertical restraints policy. In particular, will there ever come a time when we can consider the EU market sufficiently integrated so that parties do not have to be constrained in their commercial dealing because of this policy?

For the UK, the last few years has seen a near blanket exclusion of vertical arrangements from UK competition law, essentially with an unused "claw-back" provision and only prohibition of resale price maintenance. However, the decision to repeal the Exclusion Order brings UK policy fully into line with that of the EU. This move gives greater recognition to the both positive and negative effects of vertical restraints. Noticeably, it corrects a widely held perception that having a largely unqualified exclusion order meant that policy was too skewed towards the view that vertical restraints are benign. Nevertheless, it also means that the UK has implicitly taken on board the EC's market integration objectives and its tough stance against exclusive and selective distribution arrangements even though this might not be so relevant or appropriate at the national level.

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