DISTRIBUTION AGREEMENTS: PROPOSED COMMISSION REGULATION

Subject: Distribution agreements
Selective distribution
Exclusive supply
Franchising agreements
Vertical restraints
Intellectual property
Know-how
Non-competition] obligations
Block exemption

Industry: All industries concerned with industrial supply and distribution

Sources: (a) Commission Statement IP/99/699 of 24.09.1999
(b) Official Journal No C.270 of 24.09.1999

(Note. All the discussions which followed the publication of the Commission's Green Paper on Vertical Restraints have now assumed concrete form as a draft Regulation on the application of Article 81(3) of the EC Treaty to categories of vertical agreements and concerted practices. Like the Green Paper, the draft Regulation concentrates on distribution agreements, including franchising. The draft is based on an over-riding economic assumption that, where the share of the relevant market accounted for by the supplier does not exceed 30%, vertical agreements generally lead to an improvement in production or distribution and allow consumers a fair share of the resulting benefits. For some years, the Commission has been emphasising the importance of market share in the context of vertical agreements, though it did not fully succeed in gaining acceptance of the market share criterion for the block exemption regulation on technology transfer agreements, in which the percentage proposed was a more generous 40%. Unless there is any last-minute opposition to the Commission's present draft, the Regulation is likely to be adopted well before the end of the year and to come into force in general on 1 June, 2000, except for the provision extending the existing regulations until that date.

The draft Guidelines accompanying the draft Regulation will be covered in a forthcoming issue, if space permits.)

The Commission has published draft rules and accompanying guidelines on vertical agreements between producers and distributors. These two legislative proposals aim at achieving an important reform in a key area of competition policy. They follow an in-depth policy review launched in 1997 with the publication of a Green Paper; this review is now entering its final phase of public consultation. The proposals concern virtually all arrangements between

companies operating at different levels of the supply chain, spanning from industrial supply to distribution agreements. The new competition rules applicable to vertical restraints are designed to come into force in the year 2000.

The proposed Commission Regulation on the application of Article 81(3) of the EC Treaty to vertical agreements is designed to replace the existing block exemption regulations applicable to exclusive distribution, exclusive purchasing and franchising agreements, which will expire on 31 December 1999.

The aim of the proposed new rules is to allow a shift from the formalistic approach underlying the current legislation towards a more economic approach in the assessment of vertical restraints under the EU competition rules. The new policy is based on a single Commission Regulation, with a wide scope of application, which gives block exemption to all vertical restraints (agreements between producers and distributors) concerning final or intermediary products as well as services, with the exception of a limited number of hard-core restrictions. These restrictions include the imposition of resale prices and certain types of territorial protection leading to a partitioning of geographical markets.

The principal objective of the draft block exemption Regulation is to allow companies which do not have market power to benefit from a safe haven within which they are no longer obliged to assess the validity of their agreements with Community competition rules. Hence, the draft Regulation limits the benefit of the block exemption to companies whose market share is below 30%. Above this threshold, agreements would not be presumed to be illegal but may require an individual examination under Article 81. The draft Guidelines are designed to assist undertakings in carrying out such an examination.

With the publication of its draft Regulation and Guidelines, the Commission has invited all interested parties to comment upon the new rules before their final adoption. Interested parties are granted one month to present their comments in respect of the block exemption Regulation, which is due to be adopted by the end of 1999 when the existing block exemptions will expire. As regards the Guidelines, interested parties will have two months to react as the Commission envisages adopting this text during the first six months of the year 2000.

On the occasion of publication of the new draft legislation, Commissioner Mario Monti stated that this important reform project was well advanced and confirmed the Commission's commitment to review and modernise Community rules on competition. "The aim is to simplify our rules and reduce the regulatory burden for companies, while ensuring a more effective control of vertical restraints implemented by companies holding sign ificant marker power. This will allow the Commission to concentrate in the future on important cases, in co-operation with the Member States, who will play an

increased role in the application of Community competition rules."

Background

In January 1997 the Commission adopted a Green Paper on vertical restraints in EU competition policy (COM(96) 721 final, IP/97/35), the purpose of which was to initiate a wide ranging consultation to help the Commission in the formulation of future policy in this area. The Commission subsequently set out the main lines for a policy reform in its *Communication on the application of EC competition rules to vertical restraints* of 30 September 1998 (COM(98) 544 final IP/98/853).

To obtain the necessary powers to carry out its envisaged reform, on 30 September 1998, the Commission submitted to the Council two proposals for Regulations, designed to amend Council Regulation No 19/65/EEC, with a view to extending the Commission's delegated legislative powers, and Council Regulation No 17, with a view to dispensing all vertical agreements from the requirement of prior notification provided for by Article 4(2). The Council then adopted the two new Council Regulations on 10 June 1999 (Regulations 1215/99/EC and 1216/99/EC). On 14 July 1999 the Commission approved the draft Commission Regulation on the application of Article 81(3) to vertical agreements, as well as the draft of the accompanying Guidelines, and authorised the Commissioner in charge of Competition to take the necessary procedural steps towards their final adoption. Member States were consulted on these two drafts on 2 and 3 September.

Draft COMMISSION REGULATION on the application of Article 81(3) of the EC Treaty to categories of vertical agreements and concerted practices

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation No 19/65 of 2 March 1965 on the application of Article 81(3) of the Treaty to certain categories of agreements and concerted practices as last amended by Council Regulation No 1215/99 of 10 June 1999, and in particular Article 1 thereof,

Having published a draft of this Regulation,

Having consulted the Advisory Committee on Restrictive Practices and Dominant Positions,

(1) Whereas Council Regulation no 19/65 as amended empowers the Commission to apply Article 81(3) by regulation to certain categories of vertical agreements and corresponding concerted practices falling within Article 81(1) (hereinafter referred to as "vertical agreements");

(2) Whereas experience acquired to date makes it possible to define a category of vertical agreements which can be regarded as normally satisfying the conditions laid down in Article 81(3);

(3) Whereas it is appropriate to include in this category all vertical agreements for the purchase and sales of goods and services, certain vertical agreements between competitors and vertical agreements concluded by associations of retailers; whereas vertical agreements concluded by an association of retailers are covered without prejudice to the application of Article 81(1) to horizontal agreements entered into between its members, or decisions adopted by such an association;

(4) Whereas it is also appropriate to include certain ancillary agreements on the assignment or use of intellectual property rights related to vertical agreements;

(5) Whereas it is not necessary, for the purposes of the application of Article 81(3) of the Treaty by regulation, to define expressly those vertical agreements which are capable of falling within Article 81(1);

(6) Whereas the benefit of the block exemption must be limited to vertical agreements for which it can be assumed with sufficient certainty that they satisfy the conditions of Article 81(3) of the Treaty;

(7) Whereas vertical agreements of the category defined in Article 1 of this Regulation can improve economic efficiency within a chain of production or distribution through a better co-ordination between the participating undertakings; whereas they can lead to a reduction in the transaction and distribution costs of the parties and to an optimal level of their investments and sales;

(8) Whereas the likelihood that such efficiency enhancing effects outweigh possible anti-competitive effects resulting from restrictions contained in vertical agreements (hereinafter referred to as "vertical restraints") depends on the degree of market power of the undertakings concerned and, therefore, on the extent to which these undertakings face competition from other suppliers of goods or services regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use;

(9) Whereas it can be assumed that, where the share of the relevant market accounted for by the supplier does not exceed 30%, vertical agreements generally lead to an improvement in production or distribution and allow

consumers a fair share of the resulting benefits; whereas in the case of vertical agreements including exclusive supply obligations, it is the market power of the buyer which is relevant for determining the overall effects of such agreements on the market;

(10) Whereas it is not possible to presume that, above the aforesaid market share threshold, vertical agreements give rise in general to objective advantages of such character and size as to compensate for the disadvantages which they may cause for competition;

(11) Whereas this Regulation must not exempt restrictions which are not indispensable to attain the positive effects mentioned hereabove; whereas, certain severe anti-competitive vertical restraints like minimum and fixed resale prices and certain types of territorial protection are to be excluded from the benefit of the present block exemption irrespective of the market share of the undertakings concerned;

(12) Whereas certain conditions are to be attached to the block exemption with a view to ensuring access to the market by competing undertakings or to preventing collusion between competing suppliers; whereas, to this end, a time limit must be set for the exemption of non-compete obligations in view of possible foreclosure effects connected with such obligations; whereas any direct or indirect obligation imposed on the members of a selective distribution system to sell or not to sell specified brands of competing suppliers may facilitate collusion among the suppliers concerned or restrict access to the market by other competing suppliers;

(13) Whereas the market share limitation, the non-exemption of certain vertical agreements and the imposition of conditions provided for in this Regulation are such as to in general ensure effective competition on the relevant markets; whereas, therefore, the agreements to which the block exemption applies do not normally enable the participating undertakings to eliminate competition for a substantial part of the products in question;

(14) Whereas in particular cases in which the agreements satisfying the conditions of this Regulation nevertheless have effects incompatible with Article 81(3) of the Treaty, the Commission may withdraw the benefit of the block exemption from the undertakings party thereto;

(15) Whereas Council Regulation 1215/99 has granted the competent authorities of Member States the power to withdraw the benefit of the block exemption in respect of vertical agreements having certain effects incompatible with the conditions laid down in Article 81(3) of the Treaty, where such effects are felt in their respective territory, or in a part thereof and where such a territory has the characteristics of a distinct geographic market; whereas Member States must ensure that the exercise of this power of withdrawal does not prejudice the uniform application throughout the common market of the Community competition rules and the full effect of the measures adopted in

implementation of those rules;

(16) Whereas, in order to strengthen supervision of parallel networks of vertical agreements which have similar restrictive effects and which cover more than 50% of a given market, the Commission may declare this Regulation inapplicable to certain restraints operated on the market concerned, with a view to restoring the full application of Article 81(1) and (3) in their respect;

(17) Whereas this Regulation does not exclude the application of Article 82 of the Treaty;

(18) Whereas, in accordance with the principle of primacy of Community law, this Regulation prevails over any decision taken in application of national laws on competition; whereas this Regulation does not however preclude Member States from applying national laws on competition to vertical agreements to which Article 81(1) is not applicable;

HAS ADOPTED THIS REGULATION:

Article 1

1 Pursuant to Article 81(3) of the Treaty and subject to the provisions of this Regulation, it is hereby declared that Article 81(1) of the Treaty shall not apply to agreements or concerted practices entered into between two or more undertakings each operating, for the purposes of the agreement, at a different level of the production or distribution chain and which relate to the conditions under which the parties may purchase, sell or resell certain goods or services (hereafter referred to as "vertical agreements"), to the extent that these conditions constitute restrictions of competition falling within the scope of Article 81(1) of the Treaty (hereafter referred to as "vertical restraints").

2 This Regulation applies to vertical agreements entered into between an association of distributors selling to final consumers and its members, or between such an association and its suppliers, provided that no individual member of the association, together with its connected undertakings, has a total annual turnover exceeding €50 million.

3 This Regulation applies to provisions contained in vertical agreements concerning the assignment or use of intellectual property rights for the purpose of using or reselling the goods or services supplied, on condition that these provisions do not constitute the primary object of, but are directly related to and necessary for, the implementation of such agreements and do not contain restrictions of competition having the same object or effect as vertical restraints not exempted under the present Regulation.

4 This Regulation does not apply to vertical agreements entered into between competing undertakings; however it does apply where competing undertakings enter into a non-reciprocal vertical agreement and:

(a) the buyer has a total annual turnover not exceeding €100 million or

(b) the buyer is a distributor and not also a manufacturer of goods or services competing with the contract goods or services.

5. This Regulation does not apply to vertical agreements the subject matter of which is regulated by other block exemption regulations.

Article 2

1 Subject to paragraph 2, the exemption of Article 1 shall apply on condition that the market share held on the relevant market by the supplier and by undertakings connected with the supplier does not exceed 30%.

2 In the case of exclusive supply obligations, the threshold of 30 % shall apply to the market share held by the buyer and by undertakings connected with the buyer on the market on which it purchases the contract goods or services.

Article 3

The exemption of Article 1 does not apply to vertical agreements which directly or indirectly, in isolation or in combination with other factors under control of the parties, have the following object:

(a) the restriction on the buyer in determining its resale price, without prejudice to the possibility for the supplier to impose a maximum resale price or to recommend a resale price provided that these do not amount to a fixed or minimum resale price as a result of pressure or incentives created by any of the parties;

(b) the restriction of resales except:
- restrictions on active resales into the exclusive territory or exclusive customer group allocated by the supplier to another buyer, where such restrictions are imposed by the supplier on its direct buyers
- restrictions on resales to unauthorised distributors by the members of a selective distribution system, and
- restrictions on resales of goods or services which are supplied for the purposes of incorporation;

(c) the restriction of active or passive resales to users by members of a selective distribution system;

(d) the restriction of cross-supplies between distributors within a selective distribution system;

(e) the restriction of sales of spare parts to independent repairers and service providers agreed between the supplier of these spare parts and a buyer

which incorporates and resells these parts.

Article 4

The exemption of Article 1 does not apply to any of the following specific obligations contained in vertical agreements:

(a) any direct or indirect non-compete obligation if its duration is indefinite or exceeds 5 years ; however, this time limitation does not apply where the goods or services to which a vertical agreement relates are resold by the buyer from premises owned or leased by the supplier, provided that the duration of such non-compete obligations does not exceed the period of occupancy of the premises by the buyer;

(b) any direct or indirect obligation causing the buyer, after termination of the agreement, not to manufacture, purchase or distribute goods or services, unless such an obligation

- relates to goods or services which compete with the contract goods or services,
- is indispensable to protect know-how transferred by the supplier to the buyer

and its duration is limited to a period of one year after termination of the agreement; this condition is without prejudice to the possibility of imposing a restriction which is unlimited in time on the use and disclosure of know-how which has not fallen in the public domain.

(c) any direct or indirect obligation imposed on the members of a selective distribution system to sell or not to sell specified brands of competing suppliers.

Article 5

The Commission may withdraw the benefit of this Regulation, pursuant to Article 7(1) of Council Regulation No 19/65, where it finds in a particular case that vertical agreements to which this Regulation applies have nevertheless certain effects which are incompatible with the conditions laid down in Article 81(3) of the Treaty, and in particular where access to the relevant market or competition therein is significantly restricted by the cumulative effect of parallel networks of similar vertical restraints practised by competing suppliers or buyers.

Article 6

Where in any particular case vertical agreements to which Article 1 applies have certain effects incompatible with Article 81(3) in the territory of a Member State, or in a part thereof, which has all the characteristics of a distinct geographic market, the competent authority in that Member State may withdraw the benefit of application of this Regulation in respect of its territory under the same conditions as provided for in Article 5.

Article 7

1 Pursuant to Article 1a of Council Regulation No 19/65, the Commission may by regulation declare that, where parallel networks of similar vertical restraints cover more than 50% of a relevant market, this Regulation shall not apply to vertical agreements containing specific restraints and relating to that market.

2 A regulation pursuant to paragraph 1 shall not enter into force earlier than six months following its adoption.

Article 8

1 For the purposes of Article 2(1), the market share shall be calculated on the basis of market sales value of the contract goods or services and other goods or services sold by the supplier or by an undertaking connected with the supplier and which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use ; if market sales value data are not available, estimates based on other reliable market information, including market sales volumes, can be used to establish the market share of the undertaking concerned. This rule applies *mutatis mutandis* for the purposes of Article 2(2).

2 For the purposes of applying the market share threshold provided for in Article 2 the following rules shall apply:

(a) the relevant market share shall be calculated on the basis of data relating to the preceding calendar year;

(b) if the relevant market share exceeds 30% but does not exceed 35%, the exemption of Article 1 shall continue to apply during a period of two consecutive calendar years.

(c) if the relevant market share exceeds 35% the exemption of Article 1 shall continue to apply for one calendar year;

(d) the benefit of letters (b) and (c) may not be combined so as to exceed a period of two calendar years.

Article 9

1 For the purpose of applying the turnover thresholds used in the present Regulation, the exemption of Article 1 shall remain applicable where during any period of two consecutive financial years the total annual turnover is exceeded by no more than 10%.

2 For the purpose of calculating total annual turnover within the meaning of Article 1, the turnovers achieved during the last financial year by the relevant

party to the agreement and connected undertakings in respect of all goods and services, excluding all taxes and other duties, shall be added together. For this purpose, no account shall be taken of dealings between the party to the vertical agreement and its connected undertakings or between its connected undertakings.

Article 10

1 Connected undertakings within the meaning of Articles 1(2), 2, 8(1), 9(2) and 11 are:

(a) undertakings in which a party to the agreement, directly or indirectly:

- has the power to exercise more than half the voting rights, or

- has the power to appoint more than half the members of the supervisory board, board of management or bodies legally representing the undertaking, or

- has the right to manage the undertaking's affairs;

(b) undertakings which directly or indirectly have over a party to the agreement the rights or powers listed in (a);

(c) undertakings in which an undertaking referred to in (b) has, directly or indirectly, the rights or powers listed in (a);

(d) undertakings in which one of the parties to the agreement or one of the undertakings as referred to in (a) to (c) jointly have the rights or the powers listed in (a).

2 For the purposes of Article 2, the market share held by the undertakings referred to in paragraph 1(d) shall be apportioned equally to each undertaking having the rights or the powers listed in paragraph 1(a).

Article 11

For the purposes of this Regulation the following terms have the following meaning:

- "Competing undertakings" are actual or potential suppliers of contract goods or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use ; the same applies where the goods or services referred to are supplied by an undertaking connected with a party to the agreement.

- "Non-compete obligation" means any direct or indirect obligation causing the buyer not to manufacture, purchase, sell or resell goods or services

which compete with the contract goods or services, or any direct or indirect obligation on the buyer to purchase from the supplier or a third party designated by the supplier more than 80% of the buyer's total purchases of the contract goods or services and their substitutes, calculated on the basis of its purchases in the previous year.

- "Exclusive supply obligation" means any direct or indirect obligation causing the supplier to sell certain goods or services only to one buyer for the purposes of a specific use or for resale.

- "Selective distribution system" means a distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly , only to distributors selected on the basis of certain predefined criteria and where these distributors undertake not to sell such goods or services to unauthorised dealers.

- "Know-how" means a package of non-patented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified; in this context, "secret" means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; "substantial" means that the know-how includes information which is necessary for the sale of the contract goods or services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services or methods of dealing with customers; "identified" means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality.

Article 12

The exemption provided for in Regulations (EEC) 1983/83, 1984/83 and 4087/88 shall continue to apply until the entry into force of the present Regulation.

The prohibition laid down in article 81(1) of the Treaty shall not apply during the period from 1 June 2000 to 31 December 2001 in respect of agreements already in force on 31 May 2000 which satisfy the conditions for exemption provided for in Commission Regulations (EEC) 1983/83,1984/83 or 4087/88.

Article 13

This Regulation shall enter into force on 1 June 2000 except for Article 12 which shall enter into force on 1 January 2000.

It shall expire on 1 June 2010.

This regulation shall be binding in its entirety and directly applicable in all Member States. □