VERTICAL RESTRAINTS: COMMISSION COMMUNICATION

Subject: Vertical restraints
Block exemption

Industry: All industries

Source: Communication from the Commission on the application of the Community competition rules to vertical restraints; published in the Official Journal of the European Communities, C.365, 26.11.98

(Note. In our December, 1998, issue we reported on this Communication, commenting on its importance for the future of block exemption regulations, particularly in the field of distribution; and we reproduced Sections I and II of the Communication, with a promise to reproduce as much of the remainder as space permitted. In our view, what is important now is to have before us the Commission's policy proposals, which are set out in Section V, all of which, apart from the introductory paragraphs, repeating much of the material printed in December, is reproduced below. Sections III and IV of the Communication, on the "economics of verticals" and "market-share thresholds" have a great deal of economic interest. It is in fact the Commission's aim to reshape the law to reflect a more "economic based system". This will involve, among other things, a change in the principle enshrined in Regulation 17 of 1962, to the effect that the earliest date upon which an individual exemption can have effect, subject to certain limited exceptions, is the date of notification and not the date of the agreement. In the interests of legal certainty, and to avoid the use of procedural requirements as "strategic tools", instead of being used to promote competition, businesses need more latitude; and this is one of the objectives of the two proposed Council Regulations and the proposed Commission Regulation designed to give effect to the changes.)

SECTION I - INTRODUCTION [reproduced in our December issue]

SECTION II - SUMMARY OF REACTIONS TO THE GREEN PAPER [reproduced in our December issue]

SECTION III - ECONOMICS OF VERTICALS [omitted]

SECTION IV - MARKET-SHARE THRESHOLDS [omitted]

SECTION V - POLICY PROPOSAL [reproduced below]

SECTION VI - PROCEDURE [reproduced below]

1 Different Options [omitted]

2 The proposed new policy

As was explained in the introduction, future policy should avoid the three major shortcomings of current policy. The new policy should first and foremost

protect competition and market integration. It should also provide a reasonable level of legal certainty for business, result in acceptable enforcement costs for industry and the competition authorities and increase decentralisation.

In order to avoid the shortcomings and strike the right balance between these different objectives, a profound change of policy is necessary. The main characteristics of the proposed policy are the following.

First, the basis is one, very wide, Block-Exemption regulation ("the Block-Exemption") that covers all vertical restraints concerning intermediate and final goods and services, except for a limited number of hardcore restraints. This solves the shortcoming of block exemptions which are too narrow.

Second, it is based mainly on a black-clause approach, that is, defining what is not block-exempted instead of defining what is exempted. This removes the straitjacket effect.

Third, it makes use of market-share caps to link the exemption to market power. The issue of whether one or two market-share thresholds should be used has not yet been decided. A single-threshold system has advantages in terms of clarity and simplicity (In the course of consultation on this document a majority of the Member States expressed a preference for a single-threshold system.). A dual-threshold system allows an economically justified gradation in the treatment of vertical restraints reflecting differences in their likely anti-competitive effects. Below such thresholds it is assumed that vertical restraints have no significant net negative effects. This means that the agreements either fall outside Article 85(1) or, when falling within Article 85(1), with the exception of the hardcore restraints, may be block-exempted. The hardcore restraints are mainly related to resale price maintenance and to restrictions on resale which are deemed not to justify block-exemption in the light of the market integration objective.

Fourth, in the case of a single-threshold system the threshold would lie in the range of 25-35% market share, clearly below what is usually perceived as the level of dominance. In the case of a dual-threshold system the first and main market-share cap would be around 20%. Above the 20% threshold there is room to exempt certain vertical restraints up to a higher level of around 40%. Such an approach with market share(s) takes away the shortcoming of neglect of market power and, by eliminating the vast majority of notifications, probably 80 to 90% of all cases, it will allow the Commission and the national competition authorities to concentrate on the important cases.

Fifth, it will create a safe harbour to distinguish the agreements that are presumed to be legal from those which may require individual examination. Vertical restraints falling outside the safe harbour will not be presumed to be illegal but may need individual examination. In respect of agreements which fall outside the Block Exemption, the Commission will continue to bear the burden of proof that the agreement in question does infringe Article 85(1) and will have to examine whether the agreement does fulfil the conditions of Article 85(3). This is the normal situation for an agreement not covered by a block-exemption regulation. Above the threshold, three situations may arise:

negative clearance, individual exemption or prohibition if the conditions of Article 85(3) are not fulfilled. The proposed policy will provide for guidelines detailing the Commission's policy concerning individual negative clearance, exemption or prohibition above the market-share thresholds and possible withdrawal of the Block Exemption below the thresholds.

Sixth, there will be a number of flanking measures as outlined in the previous section. The most important one is the extension of Article 4(2) of Regulation 17 to all vertical distribution agreements. Taken together as a package with the other elements of the proposal (namely, the fact that this very wide Block Exemption will cover many agreements that are not presently covered by a block exemption, the possible gradation in exemption, and guidelines), the overall level of legal certainty for industry will be improved.

Seventh, it will be compatible with improved decentralisation. National courts and national competition authorities will be able to apply the Block Exemption, and, with the help of guidelines, apply Article 85(1) above the market-share thresholds. Furthermore, if Article 85(1) is not applicable because there is no appreciable effect on trade between the Member States or on competition, the Block Exemption will not apply. It is also proposed that the national competition authorities, on the basis of clear and well specified criteria, would have the power to withdraw the benefit of the Block Exemption Regulation in respect of their territory.

This more economic approach is based upon the investigations made for the Green Paper, a careful analysis of all the comments received on the Green Paper, the Commission's experience in past vertical cases, Court judgments and study of the relevant economic and legal literature.

3 Specific points

The following specific points can be made about the proposed new policy.

The proposal will contain a list of hardcore restrictions that always fall outside the Block Exemption. This list will in any event include agreements concerning minimum and fixed resale prices and absolute territorial protection. In addition, the Commission proposes to protect the possibility of arbitrage by intermediate and final purchasers to a greater extent and therefore to blacklist more generally resale restrictions in so far as these restrictions result from factors under the control of the parties. The following may then be defined as hardcore restrictions that would fall outside the Block Exemption:

(a) fixed resale prices or minimum resale prices;

(b) maximum resale prices or recommended resale prices which in reality amount to fixed or minimum resale prices as a result of a pressure exercised by any of the parties;

(c) the prevention or restriction of active or passive resales, imports or exports to final or non-final buyers, other than (i) the restriction on active sales in the territory of an exclusive distributor, (ii) the restriction on active sales to

exclusively allocated customers, (iii) the restriction on members of a selective distribution system from selling to unauthorised distributors and (iv) the restriction on the buyer of intermediate goods and/or services from selling these to other direct or indirect buyers of the supplier;

(d) the prevention or restriction of cross-supplies between distributors at the same or different levels of distribution in an exclusive or selective distribution system or between distributors of these different systems of distribution: that is, exclusive or selective distribution combined with exclusive purchasing;

(e) the combination, at the same level of distribution, of selective distribution and exclusive distribution containing a prohibition or restriction on active selling;

(f) the combination, at the same level of distribution, of selective distribution and exclusive customer allocation;

(g) an obligation on the supplier of an intermediate good not to sell the same good as a repair or replacement good to the independent aftermarket.

Where a *single-threshold* system is chosen, all the non-hardcore vertical restraints are covered below this threshold.

Where a *dual-threshold* system is chosen, the non-hardcore vertical restraints including the more serious ones are subject to the first and main threshold of 20% market share. These include the restraints that lead to a form of exclusivity like exclusive supply, exclusive customer allocation and non-compete. As explained in section III, exclusive vertical restraints are in general more likely to have significant anti-competitive effects than non-exclusive restraints, while the latter may often achieve the same efficiencies. To the extent that selective distribution falls within Article 85(1), it is also subject to this threshold in view of its considerable potential to reduce both intra- and inter-brand competition. Tying also falls under this threshold. The first threshold covers all possible vertical restraints and combinations of vertical restraints unless otherwise stated.

Again assuming a dual-threshold system, the second threshold of 40% would cover vertical restraints which, on the basis of the economic thinking or past policy experience, lead to less serious restrictions of competition. First, one finds here the non-exclusive type of agreements such as quantity forcing on buyer or supplier. As they leave room for dealing with others, they are less serious than their exclusive counterparts. Two exclusive types of agreement are also subject to this threshold: (i) exclusive distribution, as it does not directly harm inter-brand competition and often has efficiencies, and (ii) exclusive purchasing, as it does not lead to foreclosure or a direct reduction of inter-brand competition. Lastly, this threshold would also apply to agreements between SMEs.

It is proposed to impose a duration limit on non-compete agreements in view of the possible serious foreclosure effects connected with non-compete obligations. The Commission is also considering imposing a duration limit for

exclusive purchasing combined with quantity forcing on the buyer. The Commission is further considering dispensing with the duration limits in the particular cases where the supplier owns the premises from which the buyer operates or in equivalent situations. The guidelines will take account of the particular relationship between long term investments and duration limits.

There are a number of vertical agreements that are generally considered or would in the future be considered to fall outside Article 85. These include qualitative selective distribution, service requirements and maximum and recommended resale prices if they do not amount to fixed RPM.

As was indicated at the end of Section III, the possible negative effects of vertical restraints are reinforced when a number of suppliers and their buyers practise a certain vertical restraint. These cumulative effects may be a problem in a number of sectors. Making a valid assessment of the effects of such a cumulation of vertical agreements may require a sector-wide investigation and overview. In general only a competition authority can be expected to gather such sector-wide information, as it may not be readily available to individual companies. It also seems fair to treat all companies the same if they add significantly to the total effect. Such cases of cumulative effect, where the individual suppliers are covered by the Block Exemption, will be addressed by withdrawal of the Block Exemption with effect for the future. It is proposed that not only the Commission but also the national competition authorities will have the power to withdraw the benefits of the Block Exemption.

The Commission will indicate when withdrawal is unlikely and when withdrawal is likely. It is proposed that withdrawal would be unlikely when less than a certain proportion of the market is foreclosed through similar agreements and would also be unlikely when the individual firm's market share is below a certain level.

According to the Commission's experience, the possible negative outcome resulting from the cumulative effect of the same type of vertical restraints are especially at issue in the field of selective distribution. To address this problem, it is proposed that the Block Exemption may be declared inapplicable to companies operating a selective distribution system on a market where more than two-thirds of the total sales are channeled through parallel networks of selective distribution. As the companies concerned may not be in possession of such a sector-wide information, it is proposed that this condition would not operate automatically. The future Block Exemption Regulation would provide that the Commission would, on its own initiative, establish that the aforesaid condition is fulfilled in respect of a specific market and fix a transition period at the expiry of which the Block Exemption would no longer be applicable to selective distribution agreements relating to that market. Such a transitional period should not be shorter than six months. The Commission will publish a decision to this effect in the *Official Journal of the European Communities*.

The choice has been made to propose one wide block exemption regulation instead of different regulations for specific forms of vertical restraints or sectors. It thus treats different forms of vertical restraints having similar effects in a similar way, preventing unjustified differentiation between forms or sectors. In

this way it is avoided, to the greatest extent possible, to have a policy bias in the choice companies make concerning their formats of distribution. The company's choice should be based on commercial merit and not on unjustified differences in exemptability. This has a number of consequences that are spelled out in the next points.

It is proposed to cover selective distribution in the Block Exemption regulation. Care has been taken to stay as close as possible to the current policy as formulated in past Commission decisions and Court judgments. This means that the supplier, in order to be covered by the Block Exemption, may not exclude *a priori* certain forms of distribution and may apply selective distribution only on condition that the nature of the good or service requires such a type of distribution and the selection criteria are implemented objectively and in a non-discriminatory manner. The supplier may also not specify the identity of competing brands to be sold by the authorised distributor.

Vertical agreements relating to the manufacture of goods, in particular when they involve the use of know-how or patents, are not covered. Licence agreements covered by Regulation (EEC) No 240/96 on the transfer of technology will be outside the scope of the future Block Exemption regulation.

The subject matter of the 1979 Notice on sub-contracting also remains outside the scope of the Block Exemption regulation. However, vertical agreements relating to the supply of goods, produced on the basis of specifications given by the buyer to the supplier, but not involving the use of know-how or patent rights of the buyer for the manufacture of these goods, will be covered.

As regards vertical agreements relating to the distribution or supply of goods or services, it is proposed that the Block Exemption regulation cover intellectual property rights to the extent that these do not relate to the manufacture of goods and are (i) indispensable for and complementary to those agreements which are exempted, and (ii) contain obligations which are not more restrictive of competition than those vertical restraints which are exempted under the draft Block Exemption Regulation. This relates to restrictions on the use and application of intellectual property rights in the context of vertical agreements covered by the future block exemption regulation.

Agreements where the buyer of software on-sells this software to the final consumer without obtaining any copyright over it are considered as agreements for the supply of goods for resale for the purposes of this Block Exemption. The treatment of software agreements beyond this requires further consideration.

Franchising, while being covered, will not be given any preferential treatment in the Block Exemption regulation as it is a combination of vertical restraints. Usually franchising is a combination of selective distribution and non-compete obligations in relation to goods which are the subject matter of the franchise. Sometimes, other elements like a location clause or territorial exclusivity are added. These combinations will be treated according to the general criteria set forth in the Block Exemption.

Certain distribution forms - in particular franchising - involve the licensing of

Intellectual Property Rights. In franchising, the transfer of intellectual property rights is an essential element of this distribution format and is used to assimilate the commercial practices of the franchisee as closely as possible to those of the franchisor. This licensing may include restrictions which are necessary or complementary to the vertical restraints placed on the sale of the goods or services. While vertical restraints on the goods or services are important from a competition perspective and may result in a franchise agreement falling within the scope of Article 85(i), these necessary or complementary restraints must be examined in the light of the need to protect the know-how provided or the maintenance of the network's identity and reputation (see Case 161/84, *Pronuptia v Schillgalis*).

The Block Exemption Regulation will not cover vertical agreements between actual or potential competitors except where the agreement is a non-reciprocal one and no party has an annual turnover exceeding 100m ECUs.

It is further proposed that the Block Exemption Regulation will cover the vertical agreements of associations of independent retailers when the individual members of the association are SMEs as defined in the Annex to Commission Recommendation 96/280/EC. In the case of a dual-threshold system these agreements would fall under the lower threshold. What is contemplated here are retailers who associate themselves under a common format to sell to final consumers. It is recognised that there are horizontal aspects to these associations and the coverage by the Block Exemption is subject to the proviso that these horizontal aspects do not infringe Article 85.

For reasons of coherence and unity of policy it is proposed not to retain sector-specific rules for beer and petrol (the block exemption regulation on car distribution, which expires in 2002, is not covered by the current proposal). There are insufficient economic or legal reasons to continue to have a special regime for these sectors. In as far as sector specific treatment is justified this will be taken into account in the guidelines.

It is proposed not to apply the role of severability but to make the exemption of agreements dependent on all the provisions in the Block Exemption being complied with.

A transitional period for the adaptation of existing agreements to the Block Exemption is anticipated but remains to be determined.

4 Conclusions

The proposed new policy will create a more efficient protection of competition by allowing the competition authorities to concentrate their efforts on those cases involving market power. It will do away with the straitjacket effect of current regulation and will reduce the enforcement costs imposed on industry. The smaller operators, especially, will benefit from this and from the enhanced level of legal certainty.

There are four pillars on which this new policy is based:

- one broad umbrella Block Exemption Regulation applying to both goods and services with
market-share threshold(s) and a black-list approach;

- guidelines detailing the policy above the thresholds and possible withdrawal of the Block Exemption;

- the adjustment of Article 4(2) of Regulation 17 to reduce the number of notifications, to stop artificial litigation before national courts and strengthen the civil enforceability of contracts;
- an increase in the role of national competition authorities and national courts in the application of Article 85(1) above the market-share thresholds and the withdrawal of the Block Exemption below the thresholds.

SECTION VI - PROCEDURE

1 Legislative changes

Implementation of the policy proposal outlined in Section V will require three new legislative texts, namely, two Council amending regulations extending the Commission's powers under Regulation No 19/65/EEC and amending Article 4(2) of Regulation No 17, and a Commission Block Exemption regulation covering all vertical restraints in almost all sectors of distribution.

The first Council amending regulation is required to grant the Commission the power to declare by way of a Block Exemption regulation that Article 85(1) shall not apply to certain categories of vertical agreements entered into between economic operators. This is because the current enabling regulation (Regulation No 19/65/EEC) is restricted to a limited number of vertical restraints, namely, exclusive distribution of goods for resale, exclusive purchase of goods for resale, obligations in respect of exclusive supply and exclusive purchase for resale, and restrictions imposed in relation to the assignment or use of industrial property rights. It is also limited to agreements entered into between two parties.

The second Council amending regulation relates to the amendment of Article 4(2) of Regulation No 17, the First Regulation implementing Articles 85 and 86 of the Treaty. This is necessary because under the current system the date upon which an exemption can enter into effect cannot precede the date of notification. The Commission wants to change that system so as not to punish those companies which under the new more economic based system working with market-share thresholds may make mistakes in the assessment of their market position. Section IV.5 of this policy paper outlines a number of measures which are necessary to create a reasonable level of legal certainty for economic operators. The proposed amendment to Article 4(2) of Regulation No 17 is the most important of the measures identified. This is because under Regulation No 17, as currently worded, the earliest date upon which an individual exemption can have effect, subject to certain limited exceptions, is the date of notification and not the date of the agreement. This has the effect that many vertical agreements falling under Article 85(1), despite fulfilling the requirements for exemption under Article 85(3), are automatically void under

Article 85(2) until they have been notified to the Commission. The fact that such agreements are automatically void, pending notification, has two negative effects. First, it results in an unnecessarily high number of notifications and secondly, it results in the competition rules being used as a strategic tool to avoid the enforcement of contracts, rather than as a means to address competition problems. The objective of the draft amending text is to enable the Commission to exempt retroactively when the notification takes place at a later date. The practical effect of such a legislative amendment is that companies would no longer have to notify vertical agreements which they do not believe to cause competition concerns, simply to ensure legal certainty. Instead, companies will place greater weight on their own analysis of the economic effects of the vertical restraints at issue, knowing that in the event of subsequent litigation it would not be too late to apply for an exemption under Article 85(3).

The current Commission Block Exemption regulations in the field of distribution, adopted pursuant to Council Regulation No 19/65/EEC, are limited to exclusive distribution (Commission Regulation 1983/83), exclusive purchasing (Commission Regulation 1984/83), franchising (Commission Regulation 4087/88), and motor vehicle distribution (Commission Regulation 1475/95). These regulations, with the exception of the Block Exemption on motor vehicle distribution, which has been excluded from the scope of the current review, cannot be satisfactorily amended to provide for the change in policy proposed in this Communication. Therefore, subject to the adoption of the two Council Regulations outlined above, a new Commission Regulation will be proposed. The Regulation will extend to all vertical restraints in all sectors of distribution other than motor vehicles, covering, *inter alia*, selective distribution, services, intermediate goods and agreements between more than two parties each operating at different levels in the distribution chain. In the light of the new regulation the *de minimis* notice may need to be reviewed.

2 Procedural steps and timing

The first procedural step will be the adoption by the Council of the two new Council Regulations. It is only following adoption of these two Regulations that work can commence on the procedural steps leading to the adoption by the Commission of a new group exemption regulation and a set of guidelines in the field of vertical restraints. The Commission will submit these two documents together for consultation with Member States, industry and other third parties. This being the case, all the legislative changes required to implement the policy proposals outlined in this Communication are envisaged to be in place by the year 2000. □

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