PRODUCTION AGREEMENTS: COMMISSION'S DRAFT GUIDELINES

Subject: Production agreements
Specialisation agreements

Industry: All industries

Source: Commission paper entitled *Draft Guidelines on the Applicability of Article 81 to horizontal co-operation*

(Note. This recently published paper provides the basis for a discussion between industrial interests and the Commission on the review of horizontal agreements: that is, agreements between traders at the same functional level, such as manufacturing and distribution. Apart from its value as a policy discussion paper, the draft guidelines provide a useful indicator of the Commission's categorisation and treatment of the various different types of horizontal agreements. Essentially, the Commission identifies the following six categories:

Research and Development Agreements
Production (including Specialisation) Agreements
Purchasing Agreements
Marketing Agreements
Standardisation Agreements
Environmental Agreements

At present there are block exemption regulations covering research and development agreements, specialisation (but not other types of production) agreements and certain types of purchasing agreements.

The purpose of the report which follows is to select production agreements in the first instance for examination. Reports in later issues will cover marketing, standardisation and environmental agreements, to the extent that space allows. A valuable part of the Commission document is in the examples of the types of agreement under discussion.)

[Chapter 3 of the Commission's draft Guidelines deals with production agreements (including specialisation agreements).]

3.1. Definition

74. Production agreements may vary in form and scope. They may take the form of joint production through a joint venture, i.e. a jointly controlled company that runs one or several production facilities, or can be carried out by means of specialisation or sub-contracting agreements whereby one party agrees to carry out the production of a certain product. (Joint ventures which fall under the Merger Regulation are not the subject of these guidelines. Full-function joint ventures below Community dimension will only be assessed as co-operation by the Commission if spill-over effects are likely to be caused. The assessment under Article 81 will then be limited to the spill-over effects.)

75. Generally, one can distinguish three categories of production agreements: joint production agreements, whereby the parties agree to produce certain products jointly; specialisation agreements, whereby the parties agree unilaterally or reciprocally to cease production of a product and to purchase it from the other party; and subcontracting agreements whereby one party (the contractor) entrusts to another party (the subcontractor) the production of a product.

76. Subcontracting agreements are vertical agreements. They are therefore, to the extent that they contain restrictions of competition, covered by the Block Exemption Regulation and the Guidelines on Vertical Restraints. There are however two exceptions to this rule: subcontracting agreements between competitors (Article 2, paragraph 4, of the Block Exemption Regulation on Vertical Restraints), and subcontracting agreements between non-competitors involving the transfer of know-how to the subcontractor. (Article 2 paragraph 3 of the Block Exemption Regulation on Vertical Restraints. See also Guidelines on Vertical Restraints, paragraph 28, which notes that subcontracting arrangements between non-competitors under which the buyer provides specifications to the supplier which merely describe the goods or services to be supplied are covered by the Block Exemption Regulation on Vertical Restraints.)

77. Subcontracting agreements between competitors are covered by these guidelines. (If a subcontracting agreement between competitors stipulates that the contractor will cease production of the product to which the agreement relates, the agreement constitutes a unilateral specialisation agreement which is covered, subject to certain conditions, by the Specialisation block exemption Regulation (see below).) Guidance for the assessment of subcontracting agreements between non-competitors involving the transfer of know-how to the subcontractor is given in a separate Notice. (Notice concerning the assessment of certain subcontracting agreements in relation to Article 85(1) of the EEC Treaty, OJ C 1. 3.1.1979, p.2.)

3.2. Relevant markets

78. To assess the competitive relationship between the co-operating parties, the relevant product and geographic market(s) directly concerned by the co-operation (that is, the market(s) to which products subject to the agreement belong) must first be defined. Secondly, a production agreement in one market may also affect the competitive behaviour of the parties in a market which is downstream or upstream or a neighbouring market closely related to the market directly concerned by the co-operation (so-called "spill-over markets", as also referred to in Article 2(4) of the Merger regulation). However, spill-over effects occur only if the co-operation in one market necessarily results in the co-ordination of competitive behaviour in another market, that is, if the markets are linked by interdependencies, and if the parties are in a strong position on the spill-over market.

3.3. Assessment under Article 81(1)

3.3.1. Nature of the agreement

79. The main source of competition problems that can possibly arise from production agreements is the co-ordination of the parties' competitive behaviour as suppliers. This type of competition problems arises where the co-operating parties are actual or potential competitors on at least one of these relevant market(s), that is, on the markets directly concerned by the co-operation and/or on possible spill-over markets. Foreclosure problems and other negative effects towards third parties may also arise, but are less frequent in the context of production agreements. (They are not caused by a competitive relationship between the parties, but by a very strong market position of at least one of the parties (e.g. on an upstream market for a key component, which enables the parties to raise the costs of their rivals in a downstream market) in the context of a more vertical or complementary relationship between the co-operating parties.)

80. The fact that the parties are competitors does not automatically cause the co-ordination of their behaviour. In addition, the parties normally need to co-operate with regard to a significant part of their activities in order to achieve a substantial degree of commonality of costs. The higher the degree of commonality of costs, the greater the potential for a limitation of price competition, especially in the case of homogenous products.

3.3.1.1. Agreements which do not fall under Article 81(1)

81. Production agreements between non-competitors are not normally caught by Article 81(1). (They may only fall under Article 81(1) if foreclosure problems arise). This is also true for agreements whereby inputs or components which have so far been manufactured for own consumption (captive production) are purchased from a third party, unless there are indications that the company which so far has only produced for own consumption could have entered the merchant market for sales to third parties without incurring significant additional costs or risks in response to small, permanent changes in relative market prices.

82. Even production agreements between competitors do not necessarily come under Article 81(1). First, co-operation between firms which compete on markets closely related to the market directly concerned by the co-operation, cannot be defined as restricting competition, if co-operation is the only commercially justifiable way of entering a new market, launching a new product or service or carrying out a specific project.

83. Secondly, an effect on the parties' competitive behaviour as market suppliers is highly unlikely if the parties have a small proportion of their total costs in common. For instance, a low degree of commonality in total costs can be assumed, where two or more companies agree to specialise or to jointly produce an intermediate product which only accounts for a small proportion of the production costs of the final product and, consequently, the total costs. A low degree of commonality of total costs can also be assumed where the parties jointly manufacture a final product, but only a small proportion as compared to the total output of the final product. Even if a significant proportion is jointly manufactured, the degree of commonality of total costs may nevertheless be low or moderate, if the co-operation concerns heterogeneous products which require costly marketing.

3.3.1.2. Agreements which almost always fall under Article 81(1)

84. Agreements which fix the prices for market supplies of the parties, limit output or share markets or customer groups have the object of restricting competition and almost always fall under Article 81(1). This does, however, not apply to cases where the parties agree on the output directly concerned by the production agreement (for example, the capacity and production volume of a joint venture or the agreed amount of outsourced products), or where a production joint venture sets the sales prices for the manufactured products when the joint venture also carries out the distribution of these products so that the price fixing by the joint venture is the effect of integrating the various functions. (A production joint venture which also carries out joint distribution is, however, in most of the cases a full-function joint venture.) In both scenarios the agreement on output or prices will be assessed together with the other effects of the joint venture on the market in order to determine the applicability of Article 81(1).

3.3.1.3. Agreements which may fall under Article 81(1)

85. Production agreements which cannot be characterised as clearly restrictive or non-restrictive on the basis of the above factors may fall under Article 81(1) and have to be analysed in their economic context. (Pursuant to Article 4, paragraph 2(3) of Council Regulation N°17/62, agreements which have as their sole object specialisation in the manufacture of products need not, under certain conditions, be notified to the Commission. They may, however, be notified.) This applies to co-operation agreements between competitors which create a significant degree of commonality of costs, but do not involve hard core restrictions as described above.

3.3.2. Market power and market structures

86. The starting point for the analysis is the position of the parties in the market(s) concerned. This is due to the fact that without market power the parties to a production agreement do not have an incentive to co-ordinate their competitive behaviour as suppliers. Secondly, there is no effect on competition in the market without market power of the parties, even if the parties co-ordinate their behaviour.

Block Exemption

87. Most common types of production agreements can be assumed to cause some economic benefits in the form of economies of scale or scope or better production technologies unless they are an instrument for price fixing, output restriction or market and customer allocation. These benefits outweigh a limited degree of market power. It is therefore reasonable to block exempt production agreements which result in a restriction of competition up to a certain market share threshold. Therefore, agreements concerning unilateral or reciprocal specialisation as well as joint production are block exempted (revised Regulation on specialisation) provided that they do not contain hard core restrictions (see Article 4) and that

they are concluded between parties with a combined market share not exceeding 20% in the relevant market(s). The block exemption also applies to related purchasing and distribution agreements (see Article 2).

Production agreements falling outside the Block Exemption

88. Agreements falling outside the block exemption require a more detailed analysis. The starting point again is the market position of the parties. This will normally be followed by the concentration ratio and the number of players as well as by other factors as described in Chapter 1.

89. Usually the analysis will involve only the relevant market(s) directly concerned by the co-operation. In certain circumstances, for example, if the parties have a very strong combined position on up- or down-stream markets or on markets otherwise closely related to the markets directly concerned by the co-operation, these spill-over markets may however have to be analysed as well. This applies in particular to co-operation in upstream markets by firms which also enjoy a strong combined market position further downstream. Market position of the parties, concentration ratio, number of players and other structural effects.

90. If the parties' combined market share is larger than 20%, the likely impact of the production agreement on the market must be assessed. In this respect market concentration as well as market shares will be a significant factor. The higher the combined market share of the parties, the higher the concentration in the market concerned. However, a moderately higher market share than allowed for in the block exemption does not necessarily imply a high concentration ratio. For instance, a combined market share of the parties of slightly more than 20% may occur in a market with a moderate concentration (HHI below 1800). In such a scenario a restrictive effect is unlikely. In a more concentrated market, however, a market share of more than 20% is likely to cause a competition restriction (see also example 1 below). The picture may nevertheless change, if the market is very dynamic with new participants entering the market and market positions changing permanently.

91. For joint production, network effects, that is, links between a significant number of competitors, can also play an important role. In a concentrated market the creation of an additional link may tip the balance and make collusion in this market likely, even if the parties have a significant, but still moderate combined market share (see example 2 below).

92. In specific circumstances co-operation between potential competitors may also raise competition concerns. This is, however, limited to cases where a strong player in one market co-operates with a realistic potential entrant, for instance, with a strong supplier of the same product or service in a neighbouring geographic market. The reduction of potential competition creates particular problems if actual competition is already weak and threat of entry is a major source of competition.

Co-operation in upstream markets

93. Joint production of an important component or other input to the parties' final product can cause negative market effects in certain circumstances:
- Foreclosure problems (see example 3 below), provided that the parties have a strong position on the relevant input market (non-captive use) and that switching between captive and non-captive use would not occur in the presence of a small but permanent relative price increase for the product in question;
- Spill-over effects (see example 4 below), provided that the input is an important component of costs and that the parties have a strong position in the downstream market for the final product.

Specialisation agreements

94. Reciprocal specialisation agreements with market shares beyond the threshold of the block exemption will almost always fall under Article 81 (1) and have to be examined carefully because of the risk of market partitioning (see example 5 below).

3.4. Assessment under Article 81(3)

3.4.1. Economic Benefits

95. For agreements falling under the block exemption, the existence of economic benefits can be assumed. For those agreements not covered by the block exemption the parties have to demonstrate improvements of production or other efficiencies. Efficiencies that only benefit the parties or cost savings that are caused by output reduction or market allocation cannot be taken into account.

3.4.2. Indispensability

96. Restrictions that go beyond what is necessary to achieve the economic benefits described above will not be accepted. For instance, parties should not be restricted in their competitive behaviour on output outside the co-operation.

3.4.3. No elimination of competition

97. The effects on competition have to be analysed on the market to which the products subject to the co-operation belong and on possible spill-over markets. Production agreements which bring about efficiencies, but involve parties with significant market power require a detailed analysis as to the assessment of whether or not effective competition is likely to be eliminated in the market. The analysis has to include the factors described under the point "market power and market structures". Efficiencies and other relevant benefits can justify even a significant restriction of competition in the market provided that effective competition is not eliminated and the creation or strengthening of a dominant position is excluded.

3.5. Examples

Joint production

98. The following two examples concern hypothetical cases causing competition problems on the relevant market to which the jointly manufactured products belong.

99. Example 1

Situation: Two suppliers, A and B, of the basic chemical product X decide to build a new production plant controlled by a joint venture. This plant will produce roughly 50% of their total output. X is a homogeneous product and is not substitutable for other products: it forms a relevant market on its own. The market is rather stagnant. The parties will not significantly increase total output, but close down two old factories and shift capacity to the new plant. A and B each have a market share of 20%. There are three other significant suppliers each with a 10-15% market share and several smaller players.

Analysis: It is likely that this joint venture would have an effect on the competitive behaviour of the parties because co-ordination would give them considerable market power, if not even a dominant position. Severe restrictive effects in the market are probable. High efficiency gains which may outweigh these effects are unlikely in such a scenario where a significant increase in output cannot be expected.

100. Example 2

Situation: Two suppliers, A and B, form a production joint venture on the same relevant market as in example 1. The joint venture also produces 50% of the parties' total output. A and B each have 15% market share. There are 3 other players: C with a market share of 30%, D with 25% and E with 15%. B has already a joint production plant with E.

Analysis: Here the market is characterised by very few players and rather symmetric structures. The joint venture creates an additional link between the players. Co-ordination between A and B de facto would further increase concentration and also link E to A and B. This co-operation is likely to cause a severe restrictive effect, and – as in example 1 – high efficiency gains cannot be expected.

101. Example 3 also concerns the relevant market to which the jointly manufactured products belong, but demonstrates the importance of criteria other than market share (here: switching between captive and non-captive production).

102. Example 3

Situation: A and B set up a production joint venture for an intermediate product X through restructuring current plants. The joint venture sells X exclusively to A and B. It produces 40% of A's total output of X and 50% of B's total output. A and B are captive users of X and are also suppliers of the non-captive market. A's share of total industry output of X is 10%, B's share amounts to 20% and the share of the joint venture to 14%. On the non-captive market, however, A and B have respectively 25% and 35% market share.

Analysis: Despite the parties' strong position on the non-captive market, the co-operation may not eliminate effective competition in the market for X, if switching costs between captive and non-captive use are small. However, only very rapid switching would counteract the high market share of 60 %. Otherwise this production venture raises serious competition concerns which cannot even be outweighed by significant economic benefits.

103. Example 4 concerns co-operation regarding an important intermediate product with spill-over effects on a downstream market.

104. Example 4

Situation: A and B set up a production joint venture for an intermediate product X. They will close their own factories, which have been manufacturing X and will cover their needs of X exclusively from the joint venture. The intermediate product accounts for 50% of the total costs of the final product Y. A and B have each a share of 20% in the market for Y. There are two other significant suppliers of Y each with a 15% market share and several smaller competitors.

Analysis: Here the commonality of costs is high; furthermore the parties would gain market power through co-ordination of their behaviour on the market Y. The case raises competition problems, and the assessment is almost identical with example 1, though here the co-operation is taking place in an upstream market.

Specialisation

105. Example 5

Situation: A and B each manufacture and supply the homogeneous products X and Y which belong to different markets. A's market share of X is 28%, of Y it is 10%. B's share of X is 10%, of Y it is 30%. Because of economies of scale they agree to specialise, that is, A will in future produce only X and B will produce only Y. Both agree on cross-supplies so that they will both stay as suppliers in the markets. Due to the homogeneous nature of the products, distribution costs are minor. There are two other manufacturing suppliers of X and Y with market shares of roughly 15%, the remaining suppliers have 5-10% shares.

Analysis: The degree of commonality of costs is extremely high, only the relatively minor distribution costs remain separate. Consequently, there is very little room for competition left. The parties would gain market power through co-ordination of their behaviour on the markets for X and Y. Furthermore, it is rather likely that the market supplies of Y from A and X from B will diminish over time. The case raises competition problems which the economies of scale can hardly outweigh. The scenario may change if X and Y were heterogeneous products with a very high proportion of marketing and distributing costs (for example, 65-70% of total costs). If furthermore the offer of a complete range of the differentiated products were a condition for competing
successfully, the withdrawal of one or more parties as suppliers of X and/or Y would be rather unlikely. In such a scenario the criteria for exemption may be

fulfilled (provided that the economies are significant), despite the high market shares. ■

German system of fixed prices for books

After a first examination, the Commission has reached the preliminary conclusion that the new agreements between publishers and booksellers in Germany on fixed book prices at national level do not fall within the scope of application of the EC competition rules. The condition for this, however, is that the rules on re-imports of German books and direct cross-border sales to end consumers at free prices are respected. With the publication of a notice pursuant to Article 19 (3) of Council Regulation No. 17(1) the Commission has announced its intention to give clearance to the agreements notified. At the same time it has invited comments from interested third parties.

The pending case concerning the German-Austrian system of fixed book prices has recently seen some new developments. In spring of this year, the publishers submitted a new version of their agreements for retail price maintenance for books in Germany and Austria (as well as Switzerland). By virtue of the new agreements, on 1 July 2000 all cross-border agreements for price fixing between Austrian publishers and German booksellers and between German publishers and Austrian booksellers will be abolished. The new German system of fixed book prices is limited in the European Union to agreements between German publishers and German booksellers.

German books and printing products re-imported into Germany from another Member State are in principle not subject to retail price maintenance. The system applies to them only if it is clear that the books and similar products were exported from Germany solely for the purpose of being re-imported in order to circumvent the retail price maintenance arrangements. Cross-border sales of books to final consumers in Member States other than the Member State in which the seller is established are not subject to the price maintenance arrangements. This also applies to direct cross-border sales to final consumers via the Internet.

The Commission has come to the preliminary conclusion that the new German system of fixed book prices does not have an appreciable effect on trade between Member States and, therefore, does not fall under Art. 81 (1) of the EC Treaty. Interested third parties may now submit their observations to the Commission. Even if the Commission's preliminary conclusion stands, it monitor closely the application of the system in practice.

Source: Commission Statement IP/00/651, dated 22 June 2000.