Green Paper

on

Vertical Restraints

in EC Competition Policy

GREEN PAPER ON VERTICAL RESTRAINTS IN EC COMPETITION POLICY

CONTENTS

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EXECUTIVE SUMMARY

Background and reasons for Green Paper[1]

1. The creation of a single market is one of the main objectives of the European Union's competition policy. Whilst great progress has been made further efforts are still necessary if the full economic advantages of integration are to be realised.

2. The single market represents an opportunity for EU firms to enter new markets that may have been previously closed to them because of government barriers. This penetration of new markets takes time and investment and is risky. The process is often facilitated by agreements between producers who want to break into a new market and local distributors. Efficient distribution with appropriate pre- and after-sales support is part of the competitive process that brings benefits to consumers.

However, arrangements between producers and distributors can also be used to continue the partitioning of the market and exclude new entrants who would intensify competition and lead to downward pressure on prices. Agreements between producers and distributors (vertical restraints) can therefore be used pro-competitively to promote market integration and efficient distribution or anti-competitively to block integration and competition. The price differences between Member States that are still found provide the incentive for companies to enter new markets as well as to erect barriers against new competition.

3. Because of their strong links to market integration that can be either positive or negative, vertical restraints have been of particular importance to the Union's competition policy. Whilst this policy has been successful in over 30 years of application a review is now necessary because

- the single market legislation for the free movement of products is now largely in place
- the Regulations governing vertical restraints expire, and
- there have been major changes in methods of distribution that may have implications for policy.

4. In addition, as the world's largest trading block, the Union is committed to the development of open and fair international trade. Just as vertical restraints can either promote or hinder the creation of a real single market, they can be either beneficial or detrimental to international trade. The Union's policy in this area is therefore of wider international importance. Our experience may be useful for analysing market access impediments in third countries.

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[1] Each heading in this executive summary corresponds to a chapter in this Green Paper.

5. The review of policy takes the form of a Green Paper, which sets out the relevant issues as understood by the Commission[2]. Several policy options (point VIII below) are set out which will form the basis for a wide reaching public consultation involving Parliament, Member States, the Economic and Social Committee and Committee of Regions as well as all interested parties (producers, distributors, workers representatives and consumers). This consultation will allow the Commission to decide on the direction and form of future policy in the full light of all the facts. This review and consultation also constitute the Commission's response to the exciting challenge of taking forward this key area of competition policy into the next millennium.

I. Structure of distribution

6. Making general statements about distribution or identifying trends is difficult because of its size, diversity and dynamism.

- Size. Distribution employs 22 m (15.6% of total employment), represents 12.9% of value added and accounts for 4,5 m enterprises (29.4% of total)(1994 figures EU 15).

- Diversity. The structure of distribution varies considerably from sector to sector, not only in the degree of concentration or lack of it at the distribution level but also in the organisation upstream to the manufacturer (sometimes via specialised intermediaries such as wholesalers or importers). In addition there are considerable differences in size and structure between Member States even in the same sector. Finally there are many different types of distribution systems (eg exclusive distributors dealing in one product or supermarkets stocking 30.000 lines).

- Dynamism. Distribution is a dynamic sector with a relatively high birth and death rate of small companies. New forms of distribution are constantly being tried out. In certain sectors there has been a trend towards concentration with the development of oligopolistic structures.

7. All industries need distribution and the level of service provided by, and efficiency of, distribution are important elements of the competitive process to reach customers. Very few producers distribute themselves to final customers; rather, they rely on specialised distributors. In some industries there are considerable economies to be gained from cooperation in the supply chain, which have been facilitated and accelerated by the introduction of Information Technology and modern Just-in-Time techniques. This has led to goods being pulled down the supply chain by final demand rather than pushed down from above according to the dictates of production needs. The result has been considerable savings in inventories and large reductions in volumes of unwanted goods. Competition between supply chains is growing in importance.

8. Whilst distribution is a dynamic sector, it is also characterised in the EU by barriers to entry particularly when compared to certain third countries (eg restrictions on opening hours

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[2]This Green Paper does not cover motor vehicles, commercial agents or licensing of intellectual property which have been or are the object of separate exercises. The focus is primarily on vertical restraints in the distribution chain. However, comments are also invited in relation to upstream linkages in the supply chain between producers and suppliers of intermediary inputs.

and zoning laws). This may have enhanced the market power of certain distributors in oligopolistic markets and have implications for competition policy.

9. Whilst there are examples of distributors moving outside their "home" market and there are some European wide chains emerging, distribution, particularly at the retail level, is still largely national. The Commission asks whether this national character of distribution coupled with the need for economic integration of supply chains driven by economies from Information Technology have implications for policy. The Commission has always insisted on the freedom for intermediaries to respond to price differences between Member States and engage in parallel trade as central to its policy of ensuring that distribution arrangements have a market integration and not a market partitioning effect. In view of structural and organisational changes in distribution, this freedom for intermediaries to conduct parallel trade may no longer be sufficient on its own to ensure a positive outcome for vertical restraints on competition and market integration in all cases. Similar conclusions were drawn from the fact-finding exercise for this Green Paper (see point VII). The Commission would welcome comments and evidence on this point and on the implications for the options (point VIII).

II. Economic analysis of vertical restraints and the single market

10. The heated debate among economists concerning vertical restraints has calmed somewhat and a consensus is emerging. Vertical restraints are no longer regarded as *per se* suspicious or *per se* pro-competitive. Economists are less willing to make sweeping statements. Rather, they rely more on the analysis of the facts of a case in question. However, one element stands out : the importance of market structure in determining the impact of vertical restraints. The fiercer is interbrand competition, the more likely are the pro-competitive and efficiency effects to outweigh any anti-competitive effects of vertical restraints. Anti-competitive effects are only likely where interbrand competition is weak and there are barriers to entry at either producer or distributor level. In addition it is recognised that contracts in the distribution chain reduce transaction costs, and can allow the potential efficiencies in distribution to be realised. In contrast, there are cases where vertical restraints raise barriers to entry or further dampen horizontal competition in oligopolistic markets.

11. The questions posed by vertical restrains are still highly significant in terms of potential economic gains. Figures showing price differences between Member States demonstrate that, although there has been some price convergence, the potential economic gains from further integration are by no means exhausted.

12. Other conclusions that can be drawn from recent economic analysis are that :

- Individual clauses in an agreement or different types of vertical restraints cannot be considered *per se* as having a negative or positive effect on competition or integration.

- The combination of several vertical restraints does not necessarily increase the probability of any anti-competitive outcome but in some circumstances may make the outcome more favourable.

- Analysis should concentrate on the impact on the market rather than the form of the agreement. For example, whether entry is foreclosed by a network of agreements or whether the vertical agreement coupled with market power permit producers or distributors to practice

price discrimination between different Member States.

- Given the risk associated with either entry into new markets or significant market expansion (ie creation of new trade flows that integrate the market), consideration should be given to a more favourable treatment of vertical restraints where this is accompanied by significant material or immaterial investment. This more favourable treatment should be limited in time.

- The nature of the products, the need for services and for investment to undertake efficient distribution and the needs and knowledge of consumers may all be important elements in determining both the objective efficiencies promoted by vertical restraints and any anti-competitive effects. A list of criteria that might be used to identify efficiencies in distribution and so help guide policy is given in the text (pt 85). Comments on the usefulness or otherwise of this table are requested.

13. It is clear that economic theory can not be the only factor in the design of policy. Firstly it is only one source of policy. Secondly a full evaluation of every individual case would be too costly in resource terms and may lead to legal insecurity. Its use is therefore primarily to help develop basic policy and rules.

III. Current procedures and institutional framework

14. The Treaty rules on competition applicable to undertakings are set out in Articles 85-90. Article 85 is of particular relevance for which vertical restraints. Article 85(1) provides for a ban on agreements which may affect trade and which have as their object or effect the prevention, restriction or distortion of competition. Agreements falling within its scope are void (Article 85(2)) unless exempted under Article 85(3). Amongst other conditions for exemption, the agreement must not eliminate competition and the efficiency gains or other objective advantages it promotes must outweigh the disadvantages from the loss of competition. Consumers must also obtain a fair share of the gains.

15. The Council, acting under Article 87 established the implementing rules for the basic Treaty provisions of Articles 85 and 86. These are set out in Regulation 17/62 which, *inter alia*, gave the Commission exclusive competence to grant exemptions under Article 85(3) and set up a system of notification to the Commission for agreements for which an exemption or negative clearance is sought. The entry into force of Regulation 17/62 resulted in a "mass" of notifications in excess of 30,000 in the early 1960's, the majority of which concerned vertical agreements. In view of the fact that, under the procedures laid down in Regulation 17/62, the Commission is unable to adopt many formal decisions (currently around 20 a year), and that its capacity to close cases by informal comfort letter is also limited (around 150 a year), in order to give legal certainty to companies with vertical agreements, an approach of "block exemptions" was adopted.

16. Under Council Regulation 19/65, the Commission is empowered to adopt "block exemption" Regulations which define certain categories of agreements which generally fulfil the conditions of Article 85(3) and so are exempted. Council Regulation 19/65 requires that Commission block exemption Regulations contain lists of conditions which must be fulfilled, the types of agreements covered, restrictive clauses which are exempted and clauses which must not be included.

17. The Commission has identified different types of distribution systems and acting under the powers granted to it by Council Regulation 19/65, has adopted block exemptions to cover them. These currently are :

- exclusive distribution, where a producer agrees to appoint only one distributor in a territory (Regulation 1983/83)

- exclusive purchasing including special provisions for beer and petrol, where the distributor agrees to purchase the goods in question only from one producer (Regulation 1984/83) and

- franchising, where a franchisee is allocated an exclusive territory in which to exploit the know-how and intellectual property rights of the franchiser and sell the product or service in a standardised format (Regulation 4087/88).

Where an exclusive distribution or purchasing agreement or a franchising agreement conforms to the block exemption, no notification is necessary for an exemption.

18. In addition the Commission identified a further type of distribution : selective distribution, whereby distributors are chosen on the basis of objective criteria necessary for the efficient distribution of the goods in question. Selected distributors normally provide some pre- or after-sales services and may only sell to final consumers or other selected dealers. Because no "mass" problem was perceived for selective distribution, Commission policy has been set out in individual decisions following the procedure of Regulation 17/62.

19. Although the Commission has a monopoly for applying Art 85(3), there is still room for a role by national courts and competition authorities.

- national courts may apply Articles 85(1) and (2) and 86. They may also interpret the provisions of the block exemptions to see if agreements are covered. They can therefore resolve many disputes about competition rules and vertical agreements. The Commission can decline to deal with complaints when they can be dealt with by national courts. Finally national courts can award damages, provisional remedies and injunctions, often more quickly than the Commission

- national competition authorities may apply Articles 85(1) and (2) and 86 as long as the Commission has not opened its own procedures in respect of the same agreements. Seven of the fifteen Member States have adopted enabling legislation permitting them to apply these powers. Unless the Commission has granted an Article 85(3) exemption or the agreements are covered by a block exemption, Member States can apply their own national law to an agreement.

IV. Current rules for vertical restraints

20. Because of concerns over threats they pose to market integration and the ambiguous nature of their impact on competition, Commission policy has been to apply Article 85(1) relatively widely to vertical restraints. It considers that both intrabrand and interbrand competition are important.

21. The rules on *de minimis* define categories of agreements that are too small to have an appreciable impact on trade or competition and are consequently outside the scope of Article 85(1). Above this level, Article 85(1) applies virtually automatically to certain vertical agreements which by their very nature can only distort competition, in particular to

- agreements which limit the freedom of distributors to set their resale prices (Resale Price Maintenance) and

- agreements which establish absolute territorial protection for exclusive distributors. This point is central to Commission policy. Not only is Article 85(1) applied, but an Art 85(3) exemption is unlikely to be granted. Whilst a distributor may be allocated an exclusive territory in order better to penetrate the market and make distribution more efficient and may be forbidden to sell or promote directly in the territory of other exclusive distributors, this protection must not be absolute. The possibility of some alternative sources of supply must always exist. Although exclusive distributors may be forbidden from actively promoting the product outside their allocated exclusive territory, they must be free to respond to orders coming from outside that territory (passive sales). Customers must be free to purchase from any distributor they wish in the EU, even outside their territory of residence, and make or arrange for personal imports. Intermediaries and other traders must be able to buy from any distributor and sell in any other market, particular in response to significant price differences between Member States (parallel trade).

22. If a vertical agreement is neither *de minimis* nor constitutes one of the two restraints automatically triggering the application of Art 85(1), a case by case analysis is necessary to see if Art 85(1) applies. This analysis takes account of the real economic context of the case to see if competition is appreciably restricted. Even if the individual agreement does not fall within the scope of Article 85(1), the cumulative impact of several similar agreements may appreciably restrict competition. This is particularly the case for networks of exclusive purchasing agreements where a large share of retail outlets are tied exclusively to existing producers. This can foreclose the market to new producers or prevent producers in other Member States from entering the market.

23. Because Article 85(1) has been applied widely to vertical agreements, the block exemptions must provide legal certainty for firms. They do this by setting out the types of distribution arrangements that are automatically exempted under Article 85(3). Firstly, the Regulations set out the reasons why the types of distribution agreements may restrict competition and fall under Article 85(1), along with the general reasons that permit the Commission to grant an exemption under Article 85(3) subject to certain conditions. A common thread through the three block exemptions (exclusive distribution and purchasing (including special arrangements for beer and petrol) and franchising) as well as the policy for selective distribution has been the overriding concern not to permit any form of absolute territorial protection[(3)].

[(3)]Any impediment to passive or parallel trade is a serious infringement of the competition rules. When such behaviour is detected it is normally punished by fines.

Rules are also set out for what is and is not permitted with respect to

- territorial restrictions
- purchasing obligations including tie-ins
- selling obligations
- non-compete clauses and permissable duration of the contract and
- customer restrictions.

Finally the block exemptions lay down the conditions that might lead the Commission to withdraw the benefit of the exemption.

V. Advantages of current system

24. The Commission believes that its competition policy towards vertical restraints has been largely successful. Its advantages can be characterised in terms of both substance and procedure. Its disadvantages and criticisms are outlined below in section VII.

- substantive advantages

25. In drawing Article 85(1) relatively widely, the analysis of vertical restraints is primarily focused on exemptions under Article 85(3) which allow a full economic assessment of the advantages of the agreements, the impact on the structure of competition and consumer welfare. This approach has allowed the Commission to strike a balance between intra- and interbrand competition. The need for this type of analysis is a reflection of the ambiguous nature of the impact of vertical restraints on competition.

26. Market integration has also been promoted by current policy which ensures that distribution systems can never establish absolute territorial protection. Thus, even though the pro-competitive gains from granting territorial exclusivity are permitted, vertical agreements must still leave open the possibility of alternative sources of supply. Markets cannot be sealed off to prevent intermediaries exploiting price differences.

27. The policy allows freedom to establish new and innovative forms of distribution, since agreements not already covered by block exemptions can be notified individually.

- procedural advantages

28. The notification system has been successful in providing the Commission with information about the many types of vertical arrangements. It provided the basic material for the Commission to decide on the need for and scope of block exemptions. These block exemptions provide basic legal certainty for the vast bulk of vertical agreements in the EU as well as the advantages of a one-stop-shop. Comfort letters have successfully dealt with any mass problem for cases not already covered by block exemptions. This combination of block exemptions plus comfort letters has freed scarce Commission resources to deal with cases that require individual attention,either to show what is permitted in new policy areas or to investigate and bring to an end serious infringements of the rules (eg block to parallel trade). Finally the role of national courts and authorities improves the efficiency and speed of enforcement in this area.

VI. Comparison of Community law with Member State and third country law and policy applicable to vertical restraints.

29. A comparison with other Member States and third country law and policy is useful. It provides experience of policies from which the Union can profit. It also shows the feasibility or otherwise of certain alternatives that may be considered as possible options.

30. However, it should always be remembered that the Commission is the only competition enforcement agency in the world that has a market integration objective in addition to that of maintaining a system of undistorted competition. Other models are therefore not necessarily appropriate for the EU.

31. For analytical purposes countries were divided into two groups :

- those with laws that resemble Article 85 with its two-part structure, containing a general prohibition and a separate exemption provision

- those with laws not resembling Community law in that a violation is generally based on the finding of some type of abuse.

32. Examination shows the diversity of arrangements for handling vertical arrangements. However certain major aspects in which these systems are consistent, and consistent in differing from the Community system, can be identified.

- First they hold that economic analysis should be employed in the first instance to determine whether a violation is present. This is true of at least some of the Member States with systems based on the Community system (most notably France and Italy), some of the Member States with systems which differ from the Community system (most notably Germany and the UK) and third countries (both the USA and Canada)

- Secondly neither the large Member States nor the USA, nor Canada, employ a notification system with respect to restrictive agreements. This is because they believe enforcement resources can be put to better use in other ways such as investigating complaints which involve vertical restraints. The absence of a notification system is also consistent with the premise that vertical agreements are *a priori* lawful

- Thirdly only a small number of cases involving vertical restraints are brought in these systems, which is again consistent with the notion that these restraints are *a priori* lawful.

VII. Results of fact finding

33. As part of the exercise to collect background information for the Green Paper, the Commission conducted a series of interviews with manufacturers, retailers, industry, trade and consumer associations and specialist academics. These interviews in no way change the need for, or prejudge, the open consultation that will follow the publication of the Green Paper, but merely helped the Commission to identify certain key issues.

34. The results of the fact finding confirm the findings on distribution gathered from basic source materials (section I above). In particular they emphasised the changes stemming from

the introduction of Information Technology (IT). Information is more concentrated in the hands of distributors, who now constitute a more credible countervailing power to producers.

35. Great emphasis was put on the internal market not yet being completed. This was due not only to natural barriers (eg differences in taste, language) and the time and risk it takes to overcome them, but also the incomplete nature or unsatisfactory working of the single market.

36. Many interviews also raised questions concerning private structural impediments to a single market and parallel trade. It became obvious during the interviews that many retailers do not take advantage of the opportunities to exploit price differences between Member States for fear of spoiling long-term relationships with manufacturers, or, of being faced with retaliatory actions such as boycotts or price discrimination. Cross-border purchasing groups do not yet seem to have had a significant impact on narrowing price differentials. In addition, the introduction of IT and the logistical savings from close cooperation in the supply chain mean that price differences have to become even greater before parallel trade becomes economic, particularly in view of the necessarily uncertain nature and randomness of supplies obtained from that source. IT made it easier for producers to trace and stop sources of parallel trade between national markets. Even when distributors did try to source in other (cheaper) Member States, they were usually refused and referred back to the national subsidiary of the producer or his exclusive dealer in the territory to which the distributor in question intended to import the goods. All these practices increase the uncertainty of parallel imports and make them less attractive, with the consequence that on their own their market integration function may be less effective.

37. Certain criticisms were made about the structure and application of current Commission policy for vertical restraints and block exemptions, as well as several requests for changes or adaptations[(4)]. The most commonly heard points were

- the current block exemptions lacked flexibility, have a strait-jacket effect and are over-regulatory;

- too much emphasis is put on analysis of clauses and not enough on the economic impact of the agreements. A more rigorous policy could be applied through a more active policy of withdrawal of block exemptions;

- one-stop-shopping is vital, as is legal certainty which might be lost if the block exemption approach were abandoned. Comfort letters did not provide a satisfactory solution;

- if the block exemption approach is maintained it should be more flexible, less dirigiste and

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[(4)]In many respects these remarks mirror those made by industry organisations : UNICE (Modernising EU competition policy UNICE 1995), BDI (Standortfaktor Wettbewerbspolitik - Reformbedarf auf deutscher under europäischer Ebene, BDI 1995) and CBI (Loosening the strait-jacket CBI proposals for reform of the scope and administration of Article 85. CBI 1995) as well as their legal advisers and academic lawyers (for example B. Hawk "System failure: Vertical Restraints and EC Competition Law", Common Market Law Review, Vol. 32, N° 4, 1995.). The thrust of these remarks is that Article 85(1) has been too widely drawn for vertical restraints, that block exemption Regulations have an over-regulatory straitjacket effect and that the current operation of individual notifications and comfort letters is both costly and does not provide adequate legal certainty.

wider in scope. For example, one non-exemptible clause should not cause nullity of the whole exemption, and block exemptions could include intermediate goods and not only goods for resale as at present;

- Commission policy should promote, not discriminate against, plurality of distribution systems. This can arise when buying groups and retail associations (or a group consisting of a mixture of integrated subsidiaries and non-integrated outlets such as franchisees) try to obtain the logistical economies obtainable from the full application of IT and the integration of the supply chain;

- some interviewees wondered whether it might be useful to have rules against price discrimination even for non-dominant companies to prevent integrated subsidiaries charging different prices in different Member States;

- the views on selective distribution were very varied. Some were satisfied with its operation and it was considered as necessary to distribute certain products. Others felt that it lead to price rigidities, that price discounters were excluded even though they fulfilled the criteria for admission to the system and that selective distribution was used for many products when it was no longer justified. Complaints were made about lack of transparency and objectivity in applying the criteria for admission to the system and arbitrariness on the part of producers.

VIII. Options

38. The Green Paper asks for comments on four options set out below. These options are not exhaustive and individual elements from the different options may be combined.

39. Some remarks or questions are common to several or all options

- while the Commission acknowledges that the case law of the Community Courts and its own policy in respect of vertical restraints have evolved over time and are likely to continue to do so, it envisages only options which remain within the bounds of Article 85 as interpreted by the European Courts, and

- absolute territorial protection and Resale Price Maintenance (RPM) which may affect trade between Member States will not only continue to fall *per se* within Article 85(1) but are unlikely to be exempted,

- the options apply only to vertical distribution agreements not agreements between competitors although the latter may be permitted for certain SMEs,

- the options apply principally to vertical arrangements for goods for resale. Comments are requested on whether the options can be extended to intermediate goods,

- non-opposition procedures are not an appropriate solution for dealing with a large number of cases,

- comments are requested on the use of market share thresholds either to define eligibility for exemption or as a guide to market structures when the Commission may withdraw the benefit

of this exemption, and

- a separate exercise is currently under way to increase the thresholds below which Article 85(1) does not apply (Notice on Agreements of Minor Importance - "de minimis"). As a working hypothesis for this exercise, this may be taken to be 10 %.

OPTION I - MAINTAIN CURRENT SYSTEM

40. The advantages of the current approach were set out at point V above. The special arrangements for beer and petrol would continue.

OPTION II - WIDER BLOCK EXEMPTIONS

41. This option consists of maintaining the current approach and the many advantages of block exemptions but responding to criticisms made by making them more flexible, cover more situations and be less regulatory. In addition this option raises the question of whether it is appropriate to adopt a block exemption Regulation for selective distribution or an independent arbitration procedure for disputes concerning admission to such distribution systems. The special arrangements for beer and petrol would also be made more flexible.

Suggestions as to the type of changes that could be made are requested.

OPTION III - MORE FOCUSED BLOCK EXEMPTIONS

42. Because considerable price differences still remain in the single market, because vertical restraints can be anti-competitive when coupled with market power and because intra-brand competition is important especially when interbrand competition is not fierce, this option proposes to limit the exemption given by current block exemptions to companies with market shares below a certain threshold [40%][(5)]. Suggestions as to how to limit any mass problem or legal insecurity that might arise for cases above the threshold include granting exemption only on condition that there is no price discrimination between different Member States. The special arrangements for beer and petrol would also limit the scope of the exemption above the [40%] market share threshold.

OPTION IV - REDUCE SCOPE OF ARTICLE 85(1)

43. As a response to the criticisms that block exemptions have had a strait-jacket effect and that Article 85(1) has been applied too widely to vertical restraints without reference to their economic and market context, this option proposes for parties with a market share less than [20 %] to introduce a rebuttable presumption of compatibility with Article 85(1) ("the negative clearance presumption"). This negative clearance presumption could be implemented by a Notice and subsequently in the light of experience acquired, within the framework of a negative clearance regulation. This approach would apply to beer and petrol supply sectors only in so far as the cumulative impact of parallel networks has no significant foreclosure effect. The presumption of negative clearance could be rebutted on the basis of a market analysis taking account of factors such as market structure (eg oligopoly), barriers to entry,

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[(5)]Below this threshold it is possible to introduce the suggestions for change in Option II.

the degree of integration of the single market or the cumulative impact of parallel networks.

44. Above the [20 %] threshold there are two variants :

- Variant I : wider block exemptions described in Option II.
- Variant II : follow option III with wider block exemptions up to 40 % market share but inapplicability or limited scope of block exemptions above this limit.

The variants for beer and petrol above [20%] would be that described in options II and III for these sectors.

GENERAL REMARKS ON OPTIONS

45. Although the Commission is willing to enter into consultation and discuss possible changes to policy, it should be understood that current policy and rules will be applied until such time as the Commission changes its policy or rules.

46. It would be useful for the Commission if comments on the options addressed the following issues, which must be taken into account in the choice of option.

- substantive concerns of competition policy

  - how efficiently does the option distinguish between the pro- and anti-competitive effects of agreements, how far does it facilitate market integration, how far does it permit new and innovative forms of distribution, do consumers get a fair share of the benefit and what is the attitude to the use of market share thresholds as a guide or rule in applying policy ?

- procedural and legal concerns

  - how far does the option provide legal certainty and speedy and efficient enforcement without creating a "mass" problem of many individual notifications and how far does it permit one-stop-shopping and decentralisation ?

  - how far can the option be implemented by changing current Commission practices (eg. comfort letters) or rules (eg. Commission Regulations), or how far would more substantive legal changes be needed (eg. Council Regulations) ?

The address to which comments should be sent is given pt 306.

INTRODUCTION TO GREEN PAPER AND INVITATION TO THIRD PARTIES TO COMMENT

I. Importance of vertical restraints for Community competition policy

1. Integration of the different economies of the Member States and the creation of a single market are fundamental political objectives of the European Union (Article 2). One of the instruments designed to bring about the integration of the single market has been the establishment of a system of undistorted competition (Article 3g). Such integration based on undistorted competition is now also widely recognised as one of keys to European industrial competitiveness in wider global markets and as a means of accelerating growth and creating jobs. Community competition policy therefore unlike competition policy of Member States or our trading partners has not only had to take account of the need for a system of undistorted competition but also the market integration objective.

2. Because of this integration objective, the relationship between producers and distributors and other vertical relationships in the distribution chain has been of particular concern for EU competition policy. Producers have vertical relationships with component or input suppliers in increasingly complex supply chains. Most producers also use a specialised distributor often with specialised intermediaries (eg wholesale) to reach their final consumers. These vertical and distribution relationships are needed both

- to distribute efficiently since producers do not always have the necessary skills or knowledge of distribution and specialised distributors can often gain economies of scale and scope by distributing several/many products simultaneously, and
- to penetrate new markets since a relationship with a local distributor with specialist knowledge of the markets in which the product is to be launched can increase the chance of success and reduce risks.

3. In addition to promoting efficiency and market integration, these vertical restraints can also give rise to concerns for competition policy, for example

- the organisation of a distribution system with exclusive distributors appointed on a Member State basis can facilitate the continued partitioning of the single market on a national basis, or
- if several competing manufacturers tie up all the existing distributors in a given territory by exclusive contracts, this can create barriers to entry for a new producer to enter the market as he does not have access to a system of distribution.

Therefore vertical restraints have been of special concern to Community competition policy.

II. Coverage of Green Paper

4. There are very many types of distribution systems and vertical relationships in a modern complex economy. In fact as companies increasingly both outsource and have recourse to specialist services such as distributors, the supply or logistic chain becomes longer. Consequently vertical relationships may be growing in importance. However for analytical purpose, the Commission has distinguished four types of distribution systems

- exclusive selling whereby a producer undertakes to sell only to a particular distributor in

a given territory
- exclusive buying whereby a distributor undertakes only to take supplies of the product in question from a single producer (found particular for beer and petrol)
- franchising, whereby a franchisee is allocated an exclusive territory in which to exploit the know-how and intellectual property rights of the franchiser and sell in a standardised format
- selective distribution whereby distributors are chosen on the basis of objective criteria necessary for the efficient distribution of the product in question and these distributors can only sell either to final consumers (to whom they normally provide a service in addition to the product), or to other selected distributors who fulfil the objective criteria. This system is found in particular for highly technical products - eg certain consumer electronics - or luxury goods - eg perfumes.

5. The Commission has developed a specific policy for these four types of distribution. These are set out in Commission Regulations for the first three[(1)] and individual Commission decisions and practice for the last.

6. The present Green Paper covers all vertical relationships in the distribution chain, although the main focus will be the four types of distribution listed above[(2)]. Because (nearly) all modern economic activity involves vertical relationships, Community competition policy in this area is possibly of interest to a greater number of companies than any other area of competition policy. This Green Paper will not cover directly questions of buying power. Although there is some overlap, the issues of buying power are best treated separately.

III. Aim of Green Paper

7. The aim of the Green Paper is to undertake a fundamental review of policy towards vertical restraints. Current policy has been developed and evolved to meet successfully changing circumstances over the last thirty years. However a review is now considered necessary because
- the three Regulations covering exclusive buying and selling (including the special arrangements for beer and service-stations) and franchising will expire and the review will help prepare their renewal with any changes considered necessary,
- the single market legislation is now largely in place. Therefore in the future private barriers (ie arrangements between undertakings) may gain in importance relative to public barriers as a cause of the partitioning of the single market, and
- there have been major changes both in the structure of final distribution and in the organisation of logistics (due largely to the application of Information Technology), that may have implications for Community policy towards vertical restraints.

[(1)]Commission Regulations (EEC) No 1983/83, 1984/83 (see also Commission Notice 84/c 101/02) and 4087/88. All Regulations and Notices and other basic legal texts can be found in "Competition law in the European Communities Vol. 1A Rules Applicable to undertakings". European Commission 1994.

[(2)]This Green Paper does not cover motor vehicles (which has been the subject of a recent Commission Regulation (1475/95) and any vertical relationship in the licensing of Intellectual Property Rights or commercial agents (which are the object of separate exercises). It should also be reminded that in general Article 85 applies to the production of and trade in agricultural products. However, Article 85 (1) does not apply to those arrangements which are an integral part of a common market organisation.

8. The Green Paper sets out the current economic and legal situation as regards vertical restraints as well as the results of a fact finding exercise. The focus will be on market integration as well as more purely competition related issues. This exercise has permitted the Commission to identify a number of possible options for the future thrust of policy towards vertical restraints. (see Executive Summary and Chapter VIII for options).

IV. Invitation to comment

9. The Commission is transmitting this Green Paper to Parliament, Member States, the Economic and Social Committee, and the Committee of Regions. The Commission will enter into dialogue with these partners and invites them to express an opinion on the Green Paper and the options.

10. By publishing the Green Paper the Commission also invites and welcomes all interested third parties - producers, distributors, consumer organisations and worker representatives - to submit comments. Third parties are particularly invited to submit comments on the different options, giving their reasons along with all supporting factual/quantitative evidence for their preferred option. They are also requested to submit their view on the means by which this option can be most efficiently implemented and what legislative changes this would imply. The Commission may decide to hold hearings once the period for written comments is finished if there is sufficient interest and if it considers the submissions show such hearings justified.

This consultation process with all interested socio-economic partners will then allow the Commission to decide on the direction and form of policy in this area in the full light of all the facts and views.

11. The address to which comments should be sent is given pt 306.

12. Although the Commission is willing to enter into consultation and discuss possible changes to policy, it should be understood that current policy and rules will continue to be applied until such time as the Commission changes its policy or rules.

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Chapter I

STRUCTURE OF DISTRIBUTION

I. Introduction

13. The purpose of this chapter is to give a brief overview of the distribution sector and to point out those changes and trends in the structure of distribution which may be relevant for European Union (EC) Competition policy on vertical restraints[3]. It must be acknowledged at the outset that there are major variations in the structure of distribution as between the Member States of the EC and that many of the changes and trends in distribution identified in this chapter are difficult to measure across the whole of the EC as they exist to varying degrees in the different Member States and sectors of distribution, nevertheless they are important if one is to understand the implications of vertical restrictions on competitive relationships between undertakings in the EC and the establishment and maintenance of a single market. In this chapter the term "distribution" is used in its widest sense to encompass all trade activities between producers and consumers, where the consumers may be processors, manufacturers or final consumers.

14. The distinction between manufacturing, wholesaling and retail sectors is becoming increasingly blurred. In many cases today, the function of the wholesale distribution sub-sector itself may be partially or fully undertaken by the manufacturer, while some retailers are active in both wholesale distribution and manufacturing. This makes it extremely difficult to analyze these sectors independently from each other or to interpret statistical data. Increasingly these sub-sectors are being viewed as activities which form part of a single supply chain from raw material sourcing through manufacturing and distribution to the end user. In this chapter the terms "manufacturer" and "supplier" are used synonymously to describe undertakings which constitute the first link in the supply chain for a particular product(suppliers further down the supply chain are referred to as wholesalers or retailers).

II. Importance of Distribution

15. Almost all goods, and many services, pass from producer to consumer by a process of trade and/or distribution. Distribution needs to be considered not only as a sector but as a process or function within the economy. It performs a value added function in its own right. At the beginning of the 1990s, about 4.5 million enterprises (29.4% of the total) in the European Community (EC) were involved in distributive trades, of which 3.4 million were in retailing and 1,1 million in wholesaling[4]. This percentage may vary considerably for

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[3]Directorate General XXIII of the Commission has published a tender for an economic study on "The structure of and trends in the distributive trades in the European Community" which is scheduled for completion in 1997 (OJ No C 228, 2.9.95, p.17) This and any other relevant studies which subsequently become available, will be taken into consideration during the consultation process which follows publication of this Green Paper.

[4] See the statistical annex of the Commission's "Green Paper on Commerce", COM (96)530 of 20.11.1996

different Member States ranging from about 20% in Denmark and Belgium to 40% in Greece[5]. Distributive trades employed approximately 22 million people in the EC in 1994 (15,6% of total employment). In 1991, 12,9% of all value-added in the EC was generated in the distributive trades sector, ranging on a national basis from 10% in Germany to 17% in Portugal.

16. The long-term viability of any individual member of a supply chain is becoming increasingly dependent on the ability of the entire chain to compete with the chains of other economic operators. For this reason, members of a chain may seek to influence its functioning. Complete control can be achieved by acquisition of the other members of the chain, i.e. vertical integration. While many producers lack the financial resources to sell direct to final consumers, wholesalers and/or retailers are used primarily because of their superior efficiency in making goods widely available and accessible to targeted customers. Where, as is the case for most distribution systems, there is no vertical integration for part of or the entire supply chain, relationships can be governed by vertical restrictions, the subject matter of this Green Paper.

III. Wholesale distribution

Description

17. Wholesaling is a difficult activity to define and seems to have different meanings within different Member States. Its function has evolved over time and different types of wholesale organisations still coexist in various phases of development. The NACE rev. 1 classification defines wholesale distribution as "units exclusively or primarily engaged in the resale of goods in their own name to retailers or other wholesalers, to manufacturers and others for further processing, to professional users, including craftsmen, or to other major users".

18. Wholesalers buy primarily from manufacturers and sell mostly to retailers, industrial users, and other wholesalers. Wholesalers perform many value added functions, including selling and promoting, buying and assortment building, bulk-breaking, warehousing, transporting, financing, risk bearing, supplying market information, and providing management services. Throughout the distribution chain the functions necessary for the economic process can either be found within independent wholesale businesses or upstream and downstream in the distribution chain with sales companies of suppliers or purchasing departments of buyers. Generally, wholesalers are only used by manufacturers or purchasers where they are more efficient at performing one or more of these value added functions.

19. Wholesale trade is described by some analysts as a function which bridges differences in the distribution chain between place, time period, quantities and price requirements. Generally speaking, wholesaling only requires scrutiny under EC competition rules on vertical restraints where these "bridges" are not open to all goods (e.g. exclusive distribution) or only under restrictive arrangements (e.g. exclusive purchasing and customer restrictions). The existence of wholesalers would also appear to be important for market access, particularly for small and medium sized enterprises. Wholesalers who are not acting on an exclusive basis

[5]Definitions and statistical methods for processing data on distribution for the national accounts vary considerably. A harmonised classification system (NACE Rev. 1) only entered into force in 1993.

may also play an important role in seeking cheaper prices, particularly in those sectors where retailers do not have sufficient resources to engage in imports and exports to any significant extent. The limited information on wholesalers tends to indicate that they are undertakings for whom foreign markets are more important for sourcing than sales, although they do facilitate exports.

Trends

20. The European economy is going through a process of change which is impacting on the distribution chain and the position of the wholesaler. Greater concentration and integration in retailing has altered the position of the wholesale trade, the traditional intermediaries between manufacturers and retail outlets. The trend has been for the wholesale functions to be absorbed by the retail chain and this trend is likely to continue. Developments in information technology and modern distribution systems have resulted in a shift in control over inventories from wholesalers to retailers (e.g. access to point of sale information enables the larger retail chains to forecast demand with a high level of accuracy, and thus to fine-tune their inventory levels and delivery schedules). Another trend has been the reduction in the number of independent national distributors, particularly in the food and drinks sectors, with manufacturers entrusting national distribution to wholly owned subsidiary companies.

21. In certain instances, wholesalers try to offer additional services to retailers in areas such as financial and stock control, setting up of new retail outlets, development of a common image etc. Some wholesalers have set up so-called voluntary chains which involve central purchasing on behalf of their members. These link separate legal undertakings (both wholesalers and retailers) in a manner which permits them to compete more efficiently with large integrated undertakings by common use of a single modern and efficient supply chain.

22. New entities have entered the market for distribution services such as specialists in warehousing and physical distribution to provide European distribution services to large manufacturers. These logistics service providers do not take part in the commercial process to the same extent as wholesalers do (i.e. they do not take title to the products concerned). These specialists can take over the logistics activities of industry and wholesalers because they have their information systems in place and have locations throughout Europe. They are often part of large transportation companies willing to invest in the creation of these services and their margins are substantially lower than those of the wholesale trade.

23. Faced with falling rates of return in wholesaling and integration by other members of the supply chain, many wholesalers have restructured their operations in an effort to increase purchasing power, economies of scale and value added, while reducing operating costs. Three strategies have been particularly significant. The first is the voluntary chain where the wholesaler has sought to play the leading role in grouping small buyers together in central purchasing, the provision of common services or even a single trade name. The second is where wholesalers have diversified their operations into other markets, particularly retailing. The third significant strategy is where wholesalers have moved from the delivered trade to "Cash and Carry" warehouses in which the small retailer assembles and pays for its goods, and from which it performs the transport function.

24. In some sectors, such as pharmaceuticals, the European wholesale trade holds a strong position while in others, its functions have been integrated with suppliers or buyers. Some

manufacturers are concentrating on their core business while leaving the other business processes, including distribution, to specialists with local, technical and logistics knowledge. It would appear that many wholesalers have increased, or are in the process of increasing, their purchasing power vis-a-vis producers by developing or extending distribution networks of independent traders. The development by the wholesaler of services which benefit their retailer clients will also enable them to "add value" to their business activities.

IV. Retail distribution

Description

25. Retailing is a dynamic and complex sector involving a range of company types of varying scale. Its structure reflects the cultural characteristics of the society it serves, and regulatory, sociological, economic and technological developments have an impact on retail trade. Prominent among these factors are population patterns and associated social trends (e.g. ageing, mobility, urban development and car ownership). There is a higher outlet density in Mediterranean countries (particularly Greece, Portugal and Italy) than in most of Northern Europe, due to the large proportion of family and other small retail enterprises. In 1992, 32% of the estimated 3.8 million retail outlets in the EC were mainly engaged in food retailing; the remaining 58% in non-food retailing and 10% in motor trades. In Mediterranean countries, which have a high percentage of sole proprietors, the number of local outlets is almost the same as that of retail enterprises. In Northern Europe, however, where there is greater concentration, the difference between the number of enterprises and that of outlets is increasing each year, as a small number of enterprises gain control of increasingly large networks of outlets. Retail turnover at constant prices rose by nearly 20% in the EC (excluding Spain, Italy and Portugal) from 1985 to 1991. Retailing is a major employer in the EC. In 1990 retail employment in the EC was approximately 13.3 million, representing 10% of total employment.

26. Household consumption is the most significant determining factor for retail trade activity. In 1990, tradable consumption, which equates to retail spending, represented nearly 53% of total household consumption in the EC. Tradable consumption exceeds the EC average in Portugal (66.1%) and Ireland (64.6%). In these countries, the share of food products is as high as 40%, compared with only 16.6% in Germany, 18.4% in the Netherlands, and slightly over 19% in Belgium and France. Sectoral analysis of household consumption indicates the persistence of wide diversity in standards of living, climate, culture and lifestyles. Markets for certain product categories (e.g. cosmetics, cars, luxury goods) are evolving towards a certain degree of homogeneity. Regional differences persist for products such as food, clothing, and footwear. Community-wide product standardisation is therefore a slow process; retailers need to be very responsive to local consumer needs and lifestyles.

27. Barriers to entry at retail level may in certain circumstances increase the anti-competitive aspects of vertical restraints. A 1994 Report on Employment Performance by the McKinsey Global Institute contains a case study on employment in retailing. The study identifies weak performance in job creation in Europe vis-a-vis the US and identifies a number of issues for policy makers. In respect of the retailing sector the study concludes that "product market restrictions represent the most obvious and easily correctable barriers to increased employment. Restrictions on opening hours, excessive zoning restrictions, and the veto power given existing retailers have both limited the creation of higher value, higher employment

retailing formats and restricted the shopping opportunities available to consumers. These restrictions have not saved the existing retailers they were designed to protect, as the rapid decline in individual stores in France, Germany and Japan indicates (.....). All they have done is limit the creation of new jobs, leading to lower employment, lower national income and lower value to the consumer." The tendency observed over the last few years in the Member States to relax restrictions without jeopardising objectives with a social, employment or spatial planning character, should be viewed positively.

28. Retailing is the final link in the distribution chain between the customer and the product manufacturer for the majority of consumer goods. Even so very few manufacturers have their own retail outlets. They leave this to specialist retailers because of either their economies of scale and scope, or their local knowledge and capital. In its simplest form, retailing is the activity which makes goods and services available for purchase and consumption by consumers. The role of retailers in the distribution chain varies according to the characteristics of the products and service concerned and the type and nature of business relationships with others involved in the chain. Traditionally, retailing does not in itself create goods and services, and consequently, the activities performed by retailers reflect this role. Increasingly, retail activity now "adds value" to products and services and enhances them in the eyes of consumers. More and more food retail chains offer a wide range of products under their own private labels. Some retail chains are also trying to create a brand out of their outlets. In Western European countries, one sees more upstream integration meaning that an increasing amount of fast moving products are delivered directly from suppliers to the retail outlets. This trend is motivated by decreased transport lead-times and improved information technology.

29. Although some manufacturers offer products that are available in all European countries under the same label, and retail chains are increasingly undertaking cross-border activities, retail activity is not a single homogeneous international entity. In spite of its growing importance, internationalisation is still limited to certain retail groups and countries. At the beginning of the 1990's, 75% of the EC's international food retailing operations were conducted by only three countries; Germany, France, and the United Kingdom. The saying "retailing is a local business" is still correct, not only because of its geographically determined cultural differences, but also because of its organisation and selling techniques. Many cross-border retailers have had to fine tune their offers to meet local consumer tastes and continue to source on national as opposed to pan-European terms and conditions of business.

Trends

30. Retailing is an extremely dynamic and changing sector with high birth and death rates particularly amongst smaller retailers. While independent shops supplied by wholesalers were the norm in many countries in the 1950s, the multiple chains have come to play a significant role in many countries. In most of Northern Europe large retailers account for over 50% of retail sales. With the possible exception of Sweden and Finland, where traders groups have ensured the survival of many small operators, Northern Europe generally has the most developed network of shops with larger outlets handling substantial volumes of trade. The trend towards concentration is more marked in the food than the non-food sector. In most of Northern Europe the top five food retailers in each Member State account for over 50% of food retailing. In Southern Europe the retail trade is less concentrated with smaller units prevailing. Concentration in distribution reflects a similar trend in manufacturing. This is also

evidenced by the growth of retailers' brands and the decline of secondary brands in certain Member States[6].

31. The retailer is the closest of all the institutions in the distribution chain to the consumer and is increasingly using the knowledge derived from this position to develop activities more suited to consumer demands. Companies in the sector have recognised that consumers' perceptions of organisations and store formats are central to the retailing business and have responded accordingly. On the one hand, for some retail segments there is a trend from a mass or generalist retail offer to a specialist retail offer, which is particularly visible in smaller store formats. The aim is to exploit specialist market segments, identify target customers, and provide a retail offer to meet these needs. On the other hand, for many customers a mass or generalist retail offer is still appropriate for certain needs. The growth and spread of the large scale food store (whether hypermarket or superstore) is testament to this. However, even in the large store sector, which is commonly associated with mass retailing, specialisation is taking place. Large store specialists are developing in most retail product line areas (furniture, DIY, garden centres, clothing, shoes, records and toys), and many department stores are adjusting their product ranges, effectively becoming large textile specialists.

32. Each type of outlet (e.g. department store, hypermarket and large scale specialist) can be compared to a product with a specific life cycle. In Germany, France, and the United Kingdom, variety stores and conventional self-service outlets (supermarkets and mini-markets) are experiencing a decline in growth. Large scale specialists in the suburbs and discount stores, specialist chains and convenience stores in the inner cities are in their growth stage. As certain traditional retail formats disappear, they are replaced by others. The new formats are usually more modern and better suited to local requirements. The stage reached by a given outlet format is not the same in all countries. The hypermarket format is expanding rapidly in Southern Europe (Spain, Italy, Greece and Portugal), but its growth has slowed down in Northern Europe.

33. Beside marketing as a main factor for increasing sales, retail management focuses on managing cost structures. For that reason great emphasis is placed upon maximising buying power benefits through scale and efficiency. Scale is related to the volume of products sold within a product range, sales growth via internal development, acquisition or collaboration. The breadth of product ranges and number of brands stocked also influences power as sales volume is concentrated or dispersed over the lines or brands. Efficiencies in decision-making, and centralisation or the coordination of purchasing also provide for greater buying power. From a competition policy perspective it is important to recognise that these efficiencies may be lost where a retailer engages in parallel trade or other sources outside its normal supply chain[7]. While purchase prices are important, no retailer looks at purchase prices in isolation from transport, storage and administrative costs, and the impact of sourcing on supply chain efficiency. Food retail outlets particularly optimise shelf-space management, which is a determining factor in buying decisions. Closely associated to the cost of buying, particularly for retailers with a high stock turnover, is management of the delivery and distribution of products to stores and customers. A clear trend in Europe is a move towards the

[6]On the issue of decline in secondary brands, see also Chapter VII.

[7] See points 41 and 45 of this chapter for other possible efficiency losses.

centralisation of physical distribution, where suppliers deliver to a central point for redistribution rather than direct to the store. Often this process may involve the subcontracting of this activity to specialist third party distribution companies.

34. Supply chain management is increasingly important in order to improve both marketing and control. Whilst buying terms and conditions are still the subject of negotiation between suppliers and retailers, the nature of these discussions becomes more and more collaborative. Coordination of the supply chain has grown, enhanced by improved information on product movement and the increasing power of retailers who regard their outlets as a brand. The combination of activities, products and services offered by retailers "adds value" to the basic product offering and provides a means of differentiation from competitors. The growth in retailer advertising reflects this trend, as does the development of retailer brand product ranges. The role of the retailer brand has changed, particularly in the food sector. The original market position of these food brands was a low price/lower quality alternative to manufacturer brands; but, as these brands carry the retailer's name and are unique to the store, they have been repositioned, their quality improved and are increasingly associated with new product launches. In some food retail chains, private labels already take 30% of the fast moving product assortment.

35. All of these operational issues have been aided by the introduction of technology in retailing and the development of management skills. Initially, technology investment was driven by the desire for better management of assets and associated productivity improvements. Increasingly, a number of retail businesses are appreciating the potential for information technology to aid marketing and strategic management decisions. The acceptance of universal standards that allow item identification, data transmission and electronic processing have been central to the adoption of technology in retailing. For example, without agreements on bar-code standards, investment in item identification equipment such as scanning could not take place. Investment in such technologies has provided the information infrastructure upon which application technologies such as electronic funds transfer at the point of sale (EFT-POS) and electronic data interchange (EDI) are based. These application technologies provide the information basis for improved management of retailers and facilitate direct contact between manufacturer, supplier, and public sales information systems. They have also enabled large-scale retailers to integrate wholesale functions and to develop alternative forms of distribution.

36. In the face of competition from large distribution undertakings, many small and medium sized undertakings have defended their market shares by associating together in a network which grants them access to efficient logistic structures and enables them to acquire the necessary critical mass and economies of scale. These network associations of independent businesses are primarily structured in the form of consumer or retailer co-operatives, purchasing groups, voluntary chains between a wholesaler and many retailers, or even as franchises. Franchising, which appeared more recently than the other networks, is developing rapidly, particularly in non-food sectors as manufacturers endeavour to influence their distribution networks. It is most developed in France accounting for approximately 8% of total retail turnover in 1991. The primary advantage of franchising over the other network formats is its greater emphasis on transfer of business know-how and the marketing of a more unified image. In grouping together under a common trade name independent undertakings of different sizes, these network formats offer small and medium sized undertakings the possibility of competing more efficiently with large distribution undertakings. In Germany

trade through such networks is showing an upward trend, accounting for almost 50% of food sales in 1992. In terms of turnover, some of these networks are comparable with large scale distribution undertakings (the two principal networks of independents in France are amongst the top 10 retail groups in Europe).

37. Large retailers have increasingly developed strategies to maintain growth and service within the market place. Some of the strategies that re-occur in literature, include;

- Seeking product market dominance. Growth is sought within the existing 'core' product market as companies seek to increase their share of sales through new outlet development, or through cooperation with, or acquisition of, others operating in the market.
- Diversification beyond the original activities of the business into related or new product markets.
- Vertical integration, which may include activities such as wholesale functions, the development of private label products, and brand advertising.
- Geographical diversification outside the domestic market. More retailers are trading internationally and are using a wide range of market entry strategies. Large retailers generate a significant proportion of sales from overseas activities. The management involvement in international operations will range from a financial stake in existing companies, to franchising and everyday management control.

In addition, food retailers are entering into cross-border alliances. While these alliances do not appear to have engaged in collective purchasing to any great extent, they often facilitate the exchange of information on producers and their prices, which puts pressure on producers to justify price differences between Member States. All of these strategies have enabled retailers to obtain some influence over the supply chain, to become more balanced negotiating partners for suppliers and in some cases to act as competitors to suppliers.

38. Trends in retailing are not uniform throughout the EC and are influenced not only by competitive forces within the industry in each Member State but also by differing national customs and differing national measures regulating the size, location, labour costs, opening hours and trading practices of retail formats. There are major variations in the structure of distribution as between the Member States of the EC. These variations arrive not only from the fact that the industry is at different stages of development in the Member States but also from cultural and regulatory differences. While regulatory differences can be removed over time, cultural differences are likely to persist and will continue to restrict the organic expansion of retail distributors outside their national territories. Nevertheless, as retail internationalisation in its various forms increases from its low base over the next decade, similarities in the retail formats and management techniques seen in different countries may grow. Despite these trends, retailing will however retain distinct national characteristics. In most countries and retail product markets, the purchasing power of large organisations is growing.

39. While it may be too early to judge the full impact of these trends and changes for EC Competition policy on vertical restraints, it would appear that parallel trade and arbitrage are still important issues given that distribution in retailing is still primarily operated along national lines, with goods being sourced on national terms and conditions.

V. Changes in distribution

Management and technology

40. Traditional distribution channels consisting of independent manufacturers, wholesalers and retailers are in decline. These traditional channels consist of independent operators acting at arms' length and seeking to maximize their own profit rather than those of the channel as a whole.

41. The whole nature of distribution has been changed by the information technology revolution. Information systems have forced companies to re-evaluate and adapt their commercial relationships with both customers and suppliers and have enabled them to adopt more tightly managed and efficient business practices. The adoption of Just-in-time (JIT) principles by manufacturing industry and their extension to traditional distribution systems has had a profound effect on the whole distribution chain. JIT is based upon the principle that no products should be made, no components ordered, until there is downstream demand. Combined with modern technology (i.e. computers, automation, laser scanning, etc.) JIT has facilitated a shift from "push" (i.e. where products are manufactured and stored in anticipation of demand) to "pull" (i.e. where consumer demand pulls products towards the market and behind those products the flow of components is also determined by that same demand) in the supply chain. The disadvantage of the "push" system is that it frequently results in stock levels being higher or lower than necessary. The adoption of JIT techniques reduces stock holdings and forces companies to address inefficiencies or bottlenecks in the supply chain. JIT also involves a shift from large shipments towards smaller and more frequent shipments, a factor which forces both suppliers and customers to search for consolidation (i.e. JIT deliveries from a number of supplies are consolidated into one delivery, thus cutting down on transport and other costs arising from smaller and more frequent nature of batches).

42. Quick response logistics (QR) a further refinement of JIT, is a concept used to describe the capturing of demand in as close to real time as possible and as close to the final consumer as possible. The implementation of QR has been facilitated by electronic data interchange (EDI), efficient replenishment (ER), bar coding, laser scanners, etc. The most recent evolution of these concepts in retailing is called efficient consumer response (ECR), the aim of which is to provide consumers with the best possible value, service and variety of products through a collaborative approach to improving the supply chain.

43. The adoption of JIT, QR and ECR systems in distribution involve a shift from the traditional arms' length relationship between manufacturers, wholesalers and retailers towards a relationship of co-operation, particularly in the area of logistics[(8)]. Although well advanced in the U.S. it has been suggested that co-operation between product manufacturers and retailers in the supply chain is still in its infancy in the EC due to a number of obstacles, including the traditional conflict between branded manufacturers and large multiples who

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[(8)] It is also important to recognise the importance of logistical integration as a competitive tool, particularly in global markets. This is clearly illustrated by the 1993 study commissioned by the European Commission on "The Evolving Competitive Challenge for the European Automotive Components Industry". This study reveals that in both productivity and stock turns the EC components industry only achieves one third of the Japanese level. One of the principal reasons advanced for this competitive disadvantage is the lack of "true partnership relationships along the value chain".

would rather sell their own branded goods, and differing national terms and conditions of business. One of the most commonly quoted examples of co-operation involving a branded manufacturer and a retailer is the "partnership" in the US between Procter & Gamble (P&G) and Wal-Mart, one of North America's largest retailers, whereby the former receives sales data directly from the check-out counters of the latter. P & G uses this information to match its production to Wal-Mart's demand. The benefits of such a system for both manufacturers and retailers is that they can reduce the levels of stocks while improving consumer availability. While the fully integrated "partnership" concept as between P & G and Wal-Mart may still be in its infancy in Europe, we are now starting to see the emergence of integrated logistics systems that link the operations of the entire supply chain.

Structure

44. Distribution in the EC is undergoing considerable restructuring. Changes include concentration, reduction in the number of traditional wholesalers, transformations in the retail sector and a tendency towards diversification and internationalisation.

This change can be summarised as :

- concentration, expressed in terms of a reduced number of larger operators, and closer vertical links between manufacturers, wholesalers and retailers;
- development of networks of independent traders, primarily in reaction to trends towards concentration and the growth of large integrated groups. In general terms, retailers without dedicated distribution facilities and the capacity to bypass the wholesaler are unable to compete with the major retail groups in terms of price and service.
- a general reduction in the number of independent national distributors/traditional wholesalers, bearing in mind the fact that the concept of wholesaling seems to have different meanings within different Member States;
- a series of transformations in the retail sector, with significant differences between Member States. Overall a slower increase than before in hypermarkets, a rise in franchising and a proliferation of forms of distance selling are prominent features;
- a tendency towards diversification of activities into other service areas. In addition some specific moves towards internationalisation, although from a low base, such that retailing is still essentially national.

45. The changes in management and technology described above have major implications for EC competition policy on vertical restraints. Vertical restraints can be used to isolate national markets, particularly where there are price differences between Member States. To counteract this isolation the Commission has relied upon the operation of "parallel trade" and arbitrage. It has long been recognised that operation of "parallel trade" has been hindered by public measures (e.g. different currencies, tax systems, technical regulations and administrative formalities), private measures (e.g. agreements not to supply across frontiers) and social issues (e.g. differing cultural, linguistic and consumer preferences[(9)]). However, it now appears that even where "parallel trade" is theoretically possible, the inherent nature of modern distribution systems may have reduced the scope for the operation of this mechanism. While price is still important, the relative importance of certainty and efficiency of supply has increased. When

[(9)]See also Chapter II on the Single Market.

considering whether to engage in parallel trade, a wholesaler or retailer who forms part of an efficient supply chain must not only take into account immediate financial considerations such as transport, storage, capital and administrative costs, but also short to medium term financial considerations arising from the disruptive impact of such a transaction on its supply chain. For example the immediate financial gain on a parallel trade transaction or series of transactions could be wiped out where the wholesaler or retailer subsequently has to revert to its original channel of supply (e.g. national importer or manufacturer) and experiences delays in replenishing stocks. Such delays could occur simply from the reduction of its stocks in accordance with JIT principles (i.e. stocks are no longer manufactured and stored in anticipation of demand). The adoption of such principles and the decline in the number of independent wholesalers are also likely to reduce the level of stocks entering the parallel trade market in the first place.

VI. Petrol and beer

46. There have been major changes in the distribution of petrol and beer although generalisations are difficult. These are not discussed here in detail because the situation varies between Member States. In some Member States the impact of liberalising State monopolies is being worked out (Spain and Portugal for petrol) and in some new Member States there are still monopolies (Sweden, Finland and Austria for alcohol). The Commission would welcome evidence in these sectors, and particularly for beer, on the ease or otherwise in which producers in one Member State can penetrate a new market. In particular it would be useful to analyze whether the widespread system of exclusive purchasing contracts facilitated or hindered this process. Despite these caveats some general remarks can be made.

Petrol

47. The number of petrol stations is in decline with an increase in the average size of each outlet. Super/hyper markets have also entered with aggressive pricing. They now represent a relatively large share in some markets (up to 33%). There has been the emergence of no brand or own brand petrol. In addition other branded entrants have managed to break into national markets. The investment needed for a petrol station has increased considerably (increased size, environmental protection and increased facilities). The relative importance of the non-petrol aspect of outlets has increased with the development of convenience shops selling a range of consumer goods in addition to car related accessories and lubricants[(10)]. In fact a much smaller percentage of off-sale lubricants is sold via petrol stations due to the growth of special car accessory store/chains. With the exception of supermarkets, the petrol stations themselves continue to be owned/leased/managed by small (often one-man) businesses linked to the major petrol producers by exclusive purchase contracts. In addition, the station and equipment are often financed by loans from the producers.

Beer

48. The structure of brewing varies greatly between Member States, going from highly atomistic, to tight oligopoly and even dominance. Local producers tend to account for the bulk of sales in each Member State although there is an increase in intermarket penetration.

[(10)]Each petrol company is developing a separate standardised format for its chain of convenience stores.

This is being accomplished in various ways - direct import, though own subsidiary, brewing under licence, purchase of or joint venture with local brewers, purchase of retail outlets, via wholesalers, construct new brewery or distribution arrangement with local brewers.

49. Sending standard beers long distance to keep supplies available and fresh is not economic. There is a tendency, quite strong in some Member States, for the proportion of off-sales (eg. via supermarkets for consumption off the premises) to grow relative to on-sales (ie for consumption on premises). The outlets for on-sales tend to be owned/leased/managed by small often one-man businesses. They are often but not always linked to brewers by exclusive purchasing contracts. In addition these on-sale retail outlets can be financed by loans from brewers. This finance is increasingly important as the level of amenity (value added) in the outlet has tended to increase with the subsequent increase in investment costs. Recently there has been the emergence of specialist retail outlet management companies that own many outlets. These management companies negotiate with brewers for supplies.

VII. Conclusions and Questions

50. With information technology acting as the catalyst, there is a movement towards the replacement of conventional supply-driven distribution channels by planned, professionally managed, demand-driven supply chains in which suppliers, manufacturers, wholesalers and retailers act as an integrated system and compete against other integrated systems to maximize efficiencies and consumer response. However, it should be noted that "partnership" between manufacturers and retailers in the management of the supply chain has so far been limited by a number of obstacles, including differing national terms and conditions of business and business practices.

51. From a competition perspective it is important to note that the shift from traditional arms' length relationships towards relationships based on cooperation may weaken positive competitive forces within the supply chain, such as intra-brand competition. In addition, there is a greater potential for the domination of such a supply chain by one of its members than a traditional distribution channel, resulting in the imposition of functions and costs on the other operators in the chain (as opposed to the situation where all independent operators freely assign and integrate their functions on the basis of arms' length negotiation). This is an important factor for EC Competition policy, particularly where the party responsible for the management of the supply chain is a large undertaking and the other parties are small and medium sized enterprises who are economically dependent on that supply chain, given that it may result in a substantial weakening of intra-brand competition and/or foreclosure of the supply chain to other producers in the same or related markets.

52. The unified systems have together with information technology facilitated a shift from "push" to "pull" in the supply chain for many sectors of distribution. Moreover, in many sectors there is now a concentration at either end of the supply chain, with the disappearance of independent intermediaries. Both of these factors appear to have considerably reduced the scope for parallel trade or arbitrage even where there are substantial price differences between Member States. The principal implication of these changes for EC Competition policy on vertical restraints is that modern distribution systems could "copperfasten" the isolation of national markets, given that distribution in retailing is still nationally orientated. This could have major implications for the market integration goals of the EC.

53. We have been unable to find any useful statistics on the relative size and importance of the various distribution channels used by manufacturers, namely exclusive distribution, exclusive purchasing, selective distribution, open distribution and franchising. Nor have we been able to get useful information on the decline in independent wholesalers/distributors across Europe. The Commission would particularly welcome the views (backed up by statistics) of interested parties on the relative size and importance and accessibility of distribution channels in Europe, and the decline in independent wholesalers/ distributors. We would also welcome views on the extent to which new distribution formats/systems and any of the other factors identified in this chapter may reinforce the isolation of national markets by vertical restraints.

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Chapter II

ECONOMIC ANALYSIS OF VERTICAL RESTRAINTS AND THE SINGLE MARKET

I. Background

54. The economic analysis of vertical restraints has in the past been the subject of heated debate between economists. By the early 1980's the position had swung from regarding them as suspect for competition, to a generalised perception that they were innocuous for competition (the Chicago school). Nowadays there is a new emerging consensus and economists are becoming more cautious in their assessment of vertical restraints with respect to competition policy and less willing to make sweeping generalisations, and vertical restraints cannot all be regarded as per se beneficial for competition[(11)]. However one element does stand out. Current economic thinking stresses the importance of market structure in determining the impact of vertical restraints on competition. The fiercer is interbrand competition the more likely are the pro-competitive and efficiency effects to outweigh any anti-competitive effects of vertical restraints. The inverse is true when interbrand competition is weak and there are significant barriers to entry.

To further the interest of the consumer is at the heart of competition policy. Effective competition is the best guarantee for consumers to be able to buy good quality products at the lowest possible prices. Whenever in this green paper the introduction or protection of effective competition is mentioned, the protection of the consumer's interest by ensuring low prices is implied.

55. This chapter will give some of the conclusions from recent economic thinking on vertical restraints that may be useful in policy formulation[(12)]. It will also examine the relationship between the state of play of integration in the single market and vertical restraints. Even though many of the administrative and other public barriers to trade have been removed, we do not yet have a real single market in some sectors and there remain significant price differences between Member States. This suggests there are still significant unexploited economic advantages to be had from further integration and that the importance of private agreements (eg. vertical restraints) to promote or hinder economic integration has increased relative to that of public barriers.

II. The economic interpretation of vertical restraints

56. As the relationship between a producer and a distributor progresses beyond a mere arm's length one-off sale, and regular and closer contacts are necessary, contracts and vertical

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[(11)]In particular a key assumption for the Chicago school conclusions was perfect competition at the distribution level. The McKinsey study (op cit) suggests this not to be so for Europe and identified significant barriers to entry.

[(12)]This is based on P. Rey and F. Caballero "The implications of the Economic Analysis of Vertical Restraints" forthcoming as an Economic paper of the European Commission, DG II, Brussels. The reader is also referred to Dobson and Waterson "Vertical Restraints and Competition Policy", London 1996 and "Competition Policy and Vertical Restraints", OECD, Paris 1994.

restraints can, for instance, reduce transaction costs between them. This is particularly so when distribution requires longer term relationships involving division of tasks in selling and promotion activities and the transfer of intangibles such as good will and know-how. Neither party has complete knowledge of the other parties' activities. Each has different interests, the pursuit of which on an independent basis does not regularly take account of the impact on the interests of the other party. Furthermore producers and distributors have independent and individual powers of decision over the different elements in the production and distribution chain. Given such a general background there is scope for vertical restraints to help obtain more efficient outcomes not only for producers and distributors but also for consumers and efficiency. Co-ordination between producers and distributors formalised through vertical restraints can help firms to increase their profits and under certain circumstances, those efficiency gains may be passed on to consumers. Some examples are given below.

Vertical restraints as a means to improve economic efficiency through a better co-ordination between producers and distributors[13]

57. From the point of view of competition policy, it is best to distinguish cases in which vertical restraints have an overall positive effect from those where they bring about a negative effect. Vertical restraints normally have an unambiguous positive effect when they are properly introduced to solve co-ordination problems, while their negative effects tend to prevail in the presence of weak upstream and/or downstream competition.

a) Vertical co-ordination in pricing.

58. In the absence of co-ordination, vertical structures may produce prices that are too high, not just from the point of view of consumers, but also from the point of view of producers and distributors. When there is some market power, producers and distributors will charge "mark ups" to their respective costs[14]. This "double" mark up, known as double marginalisation, results from the fact that each firm takes its pricing decision independently, without taking into consideration the impact of its decision on its partner in the vertical structure. As a result, the price is likely to be too high, that is higher than the price that would maximise the joint profits of producer and distributor(s). Setting maximum retail prices by producers can help overcome this situation. Other types of vertical restraints can help solve the double marginalisation problem. For instance, a two-part tariff with a fixed fee and a wholesale price are usually found in franchise agreements. Minimum purchase obligations can also solve the double marginalisation problem. However, these alternative solutions may not have the same effect from a competition viewpoint.

b) Co-ordination for the provision of services

59. The distribution of goods and services usually requires the provision of additional services by distributors. These may take the form of after-sales services such as guarantees or maintenance or pre-sales services such as information or technical assistance to potential

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[13] There are other efficiency gains that can be obtained by vertical restraints that are also taken into account for Commission policy in this field. They are listed in Chapter IV and not repeated here.

[14] Market power means that producer and distributor face downward sloping demand curves i.e. not the horizontal demand curve they would face in perfect competition.

buyers. This raises two different types of problems for economic efficiency[15].

i) Appropriation problems. If a distributor spends on pre-sales information to customers or improves his facilities, the demand for his product will grow and he will benefit from this. But the manufacturer supplying the products he sells will benefit too, as he will sell more to the distributor. In these situations, the distributors' sales efforts will be below the level that they might reach if he could get all the benefits resulting from his extra-efforts. Vertical restraints can help achieve the optimal outcome for the vertical structure. Consumers will also benefit from this outcome if there is active interbrand competition. Once again, a franchise system with a franchise fee and a lower wholesale price can ensure that the level of sales effort is improved.

ii) Free-rider problems. When several retailers sell the same brand of a given product in a given area, all retailers will benefit from the sales efforts of one of them. For example, if one retailer invests in information to customers in that area, or advertises that brand, all other retailers can save in advertising and "free ride" on the services provided by the first one. In such a situation, all retailers will tend to under-invest in those activities. Free-riding can be solved by the imposition of exclusive territories by the producer. If the distributor is allocated an exclusive territory where he will be the only supplier of a given brand, transportation and transaction costs will minimise the effects of "free-riding".

Vertical restraints to harm competition.

60. To examine the impact of vertical restraints on competition we have to take into account competition not just at the level of distribution, i. e. intrabrand competition, but also at the level of competition between manufacturers or interbrand competition. Introducing vertical restraints can be a means to dilute competition upstream between manufacturers that do not compete directly face to face but through their retailers. In that case we can talk about competition between "vertical structures". There are at least three different ways in which vertical restraints can restrict competition.

a) Distribution or manufacturing cartels.

61. Vertical restraints such as resale price maintenance or territorial exclusivity have the direct effect of restricting or even eliminating intrabrand competition under certain circumstances. For that reason, distributors may be interested in the enforcement of agreements with their suppliers to restrict competition at the retailers' level. When distributors have market power, this interest is particularly likely to emerge if entry in distribution is difficult. Vertical restraints can also be used to help enforce collusive price agreements between manufacturers. For instance, resale price maintenance can facilitate collusion as price cuts at the retail level are easier to detect. If all multibrand retailers maintain the prices established by the producers, cartel-breaking cuts in wholesale prices could not be reflected at the retail level without a risk of being rapidly detected. The impossibility of passing on those cuts and the risk of retaliation by other cartel members make cartel agreements more stable in the presence of resale price maintenance.

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[15]In fact economists would consider other problems such as risk shifting or moral hazard problems. For simplicity, these issues will not be considered here. See Rey and Caballero op. cit. for a discussion of these issues.

b) Vertical restraints as instruments of foreclosure

62. Vertical restraints can be introduced with the effect of hindering entry by other potentially more efficient competing manufacturers. This may clearly be the case if existing producers reach exclusive agreements with the distributors of a certain product available in a given area. The existence of some sort of barrier to entry or any other factor limiting the number of retailers is a necessary condition for this foreclosure to occur. However, this is also possible if economies of scale or of scope are important in retailing, when signing exclusive agreements with existing retailers would make entry harder for entrants at the level of production, because they would have to face higher distribution costs than incumbent firms[(16)].

63. Nevertheless, vertical restraints can also stimulate entry in the long run under certain circumstances. In so far as vertical restraints such as territorial exclusivity tend to increase the profits obtained by vertical structures, they will also stimulate entry by other potential distributors and producers and this will promote efficiency in the long run.

c) Vertical restraints as a means to dilute competition among producers.

64. In oligopolistic markets the introduction of vertical restraints within vertical structures can reduce the degree of interbrand competition even further. For instance, exclusive dealing sometimes allows manufacturers to raise their margins by increasing wholesale prices. In that case, if retailing takes place under non-competitive conditions and there are barriers to entry, retailers will tend to respond to those higher wholesale prices by increasing final prices to consumers too. Alternatively, apart from reducing intrabrand competition, exclusive territories implemented by more than one producer can also dilute interbrand competition by reducing the incentives that manufacturers have to undercut each other's prices. Thus, besides reducing intrabrand competition in oligopoly markets, vertical restraints can dampen interbrand competition too.[(17)]

III. Developing workable rules: Intrabrand and interbrand competition

65. For policy purposes, it is necessary to translate the conclusions from economic analysis into workable tools that are both consistent with EC competition rules and relatively easy to implement with the necessary legal certainty for undertakings. One element has emerged as crucial in analysing the impact of vertical restraints : the degree of interbrand competition. The existence of a market structure permitting a sufficient level of competition in distribution and/or production will be determinant of the net effect of vertical restraints on competition. This element can assist in the development of policy consistent with economic analysis and taking into account the trade off between full market analysis of every case and the costs of such a mechanism of enforcement.

66. If vertical restraints such as exclusive territories or franchising are introduced to avoid the consequences of free-riding, competition between retailers of the same brand may also be

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[(16)] A similar argument can be made about the foreclosure of producers by distributors when the latter are strong enough.

[(17)]See for instance, Besanko and Perry "Exclusive dealing in a spatial model of retail competition", International Journal of Industrial Organisation, vol. 12, 1994 pp. 297-329 and Rey and Stiglitz "The role of exclusive territories in Producers' competition", Rand Journal of Economics, vol. 26, n° 3, Autumn 1995, pp. 431-51.

restricted. The efficiencies that result from the introduction of those restraints will increase profits for the vertical structure. Consumers are much more likely to benefit from the efficiency gains if the vertical structure faces strong competition from other suppliers of goods that can be considered close substitutes of the product in question. If the vertical structure has sufficient market power, it will have less incentive to reduce prices and will tend to absorb any efficiency gains in the form of extra profits. However, a relatively competitive market structure can dampen the potentially negative effects of the vertical restraint on competition.

67. The question of agreements with multiple vertical restraints also arises. The combination of different clauses in the same contract can significantly complicate the economic assessment of the competitive impact of vertical restraints. The addition of vertical restraints does not necessarily imply a proportional worsening of their impact on competition. For instance, the introduction of exclusive territories - to avoid *free rider* problems for instance- would tend to reduce intrabrand competition and retailers may be inclined to raise prices. Moreover, double marginalisation problems are aggravated by territorial exclusivity as it gives more market power to distributors. To avoid this reaction, which would result in smaller output levels sold, manufacturers may combine the introduction of exclusive territories with an additional vertical restraint such as price ceilings or two-part tariffs to avoid double mark-up problems. In this case, the combination of two vertical restraints could be positive for competition.

68. However, the bundling of vertical restraints might also be the reflection of a combination of motives which might have adverse effects for competition. If a given vertical restraint is introduced to solve problems of co-ordination, along with another one aiming deliberately to restrict competition, for example the creation of a cartel, there might not be any compensatory effect and one would not see any improvement in the outcome from a competitive point of view.

69. For these reasons, the assessment of the effects of agreements presenting a combination of vertical restraints has to be carried out taking into account the joint effect of all the vertical restraints included in the agreement in their market context. A one-by-one consideration of the different vertical restraints may be insufficient to reach a correct evaluation of the agreement.

IV. Vertical restraints and the Single Market

70. The ongoing integration process of the Single Market adds an extra dimension to the analysis of vertical restraints. The 1992 programme was the result of a widely held conviction that the failure to achieve a single market has been costing European industry millions in unnecessary costs and lost opportunities. The exact title of the Cecchini Report, "The cost of Non-Europe"[(18)] is a clear reflection of this. The efforts made since the entry into force of the EEC Treaty in 1958 had not exhausted by the mid-1980's all the potential gains to be expected from the full economic integration of the economies of the Member States. Now that more steps have been taken to eliminate the remaining obstacles to the free movement of goods, services and factors of production, it is still apparent that further efforts are necessary to achieve the maximum possible level of integration. This integration has taken on wider

[(18)]See summary in "The European Challenge - 1992. The Benefits of a single market". Paolo Cecchini Wildwood House 1988.

significance, since a successful single market giving European companies the possibility of economies of scale and scope whilst still being subject to effective competition, is seen as the springboard for competitiveness in increasingly global and competitive world markets.

71. Competition is vital to obtain the economic gains from the single market. These gains will only come if firms compete more with each other and enter each other's market. The gains come from:

- static efficiencies, where competitive pressures reduce the price in high price Member States to levels nearer those in lower priced Member States. Prices may be lower because of "natural" cost advantages or greater competitive pressures.
- dynamic efficiencies where the process of increasing competitive pressures will spur firms to greater efficiencies. The simplest to explain is perhaps economies of scale from having a larger market, but many gains are likely from the simple increase in competition especially in markets previously sheltered by barriers or not subject to effective pressure from competitors.

72. Of course not all markets will become European. Some will stay local (e.g. hairdressers) and some are already global (e.g. civil aero-engines). But for many products, Europe will increasingly become the relevant geographic market. Even though there is some evidence of convergence of prices of certain traded goods, there is still room for further gains from increased competition and integration.

73. The Single Market Programme was based on the assumption that the removal of non-tariff barriers should lead to increased competition which would in turn put pressure on prices. Competitive pressures were expected to take price reductions beyond the limits allowed by economies of scale, which would imply a reduction in price-cost margins throughout the economy and in particular, in those sectors more directly affected by the Single Market. The final result from these competitive pressures on prices was expected to be a process of price convergence for goods across different Member States, to the advantage of consumers. These predictions were supported by empirical evidence showing the existence of important price dispersion for a selected group of goods and services throughout the Community. Final prices to consumers diverged substantially from country to country in 1985.

74. Price differentials remain at present substantial, in particular for certain goods. More importantly, there seems to be significant price differences across Member States in the net purchasing prices of distributors. For consumer electronics for instance, differences can attain up to 35% for the same product/model bought from the same manufacturer. Despite the persistence of important price differentials between Member States, a recent study carried out in the framework of the evaluation of the Single Market shows the existence of a tendency towards price convergence. Table 1 shows dispersion indexes for prices of different groups of products[(19)]. Indices have been calculated including and excluding taxes to isolate the effects of indirect taxation. The results show that for traded goods and services for which the single market has had a real impact, price dispersion has been reduced. However, for construction and energy, where the impact of the Single Market is very limited, there has been no price convergence. Indeed, in some cases price dispersion has increased. With all the

[(19)] The prices in the table are retail. Wholesale prices would be a better indicator for the purposes of this report but were not available. However the retail prices are probably sufficient to show both any trends towards price convergence and serve as an indicator albeit imperfect of differences in price still existing at wholesale level.

methodological caveats that comparisons of this type require, this seems to support the evidence of a real impact of the Single Market programme in terms of price convergence. Nonetheless, substantial price differences were still present in 1993.

Table 1

Coefficients of price variation between countries for selected groupings

	1980		1985		1990		1993	
	Incl. taxes	Excl taxes	Incl. taxes	Excl. taxes	Incl taxes	Excl taxes	Incl taxes	Excl. taxes
EC-6								
Consumer goods	15.9	15.7	14.2	14.2	13.5	13.4	12.4	12.6
Services	22.7	23.1	23.9	24.6	20.0	20.2	21.3	21.7
Energy	18.4	17.2	12.5	10.4	19.4	18.8	24.3	23.4
Capital goods	10.5	10.5	9.7	9.7	11.6	11.6	12.5	12.5
Construction	15.7	15.7	11.0	11.0	14.0	14.0	19.1	19.1
EC-9								
Consumer goods	19.9	18.8	19.1	17.7	20.3	18.5	18.0	16.6
Services	25.2	25.7	25.6	25.2	24.6	23.7	23.4	23.3
Energy	22.1	20.5	16.1	13.3	24.7	22.6	30.6	27.4
Capital goods	13.1	13.1	12.5	12.5	12.2	12.2	12.9	12.9
Construction	20.1	20.1	14.4	14.4	16.5	16.5	22.4	22.4
EC-12								
Consumer goods	26.0	24.2	22.5	21.4	22.8	21.5	19.6	18.4
Services	33.0	31.9	33.7	31.5	31.8	30.4	28.6	28.3
Energy	30.8	28.0	21.1	16.9	28.0	26.0	31.7	29.7
Capital goods	18.0	18.0	14.0	14.0	13.1	13.1	14.5	14.5
Construction	24.4	24.4	22.1	22.1	23.5	23.5	27.4	27.4

Source DRI, E de Ghellinck and Horack, Adler and Associates, "Study on the Emergence of Pan European Markets". Draft Final Report february 1996.

75. However the full possibilities for increased competition offered by remaining price differences will not be eroded overnight even for goods or services where the relevant geographic market might eventually be expected to be wider than a Member State. This is because :

- there are still some regulatory or administrative obstacles to eliminate, and
- there are other "natural" frictions (language, tastes, local customs) which will continue to create costs (and therefore barriers) to market integration as well as less natural frictions (eg. different and fluctuating currencies).

76. Even in the absence of natural or other friction costs, bringing about effective competition at the European level often requires penetrating new markets or increasing sales efforts even where a producer is present in the market of another Member State. This process often requires considerable investment to build up distribution networks and break down the entrenched position of incumbents.

77. Moreover, the success of the Single Market requires substantial changes in distribution in Europe. Two issues have to be mentioned in this regard.

- The fact finding carried out for this Green Paper suggests that modern distribution techniques may reduce the possibilities for independent arbitrageurs to influence significantly markets. The Commission would welcome any evidence on this point.
- The Commission also has no evidence on how the integration process is hindered by the fact that very few European-wide distributors have expanded outside their "home" territory compared with the number of producers who sell regularly and significantly outside their "home" markets. Even where distributors have expanded into other markets, they have often taken over existing local distributors (and kept the original names, style, etc.). In addition, such distributors seem on the whole to source locally either because of the inherent efficiencies of local logistic supply chains or of the insistence of manufacturers on supplying only through their local subsidiary or dealer in that Member State. Prima facie, price discrimination by producers between Member States would be more difficult if they were confronted with some European wide distributors. The Commission would welcome any evidence on this point.

78. The EC experience shows that the removal of non-tariff barriers is not sufficient for the full development of parallel trade, arbitrage and changes in distribution across Europe. For the complete success of economic integration it is necessary that producers, distributors and consumers, find it profitable to move towards the new market situation and do not take actions to avoid or counteract the effects of the Single Market measures. The elimination of barriers to trade may not achieve its objectives if producers and/or distributors introduce practices contrary to integration. Unfortunately in many cases it is likely that they have strong incentives to do so.

79. Producers of goods and services with market power can take advantage of the market segmentation resulting from the pre-1992 scenario and use language or other differences to price discriminate across countries. This will let them maximise their profits. On the other hand, distributors with market power in their "home" country may take measures to avoid market integration as this could weaken their market position. Moreover, under certain circumstances, price discrimination can be maintained after the elimination of non-tariff barriers to trade, even if either manufacturers or distributors make less profit after the elimination of those barriers. This may occur if the sum of manufacturers' and distributors' profits is higher under the price discriminating scenario than under *arbitrage* and market integration. For instance, the extra profits obtained through price discrimination by the manufacturer can be so high that he may find ways to reach an agreement with his distributors to pass on to them part of those extra profits, on the condition that no parallel trade take place. In those cases, both will have incentives to maintain the pre-integration outcome and not become involved in parallel trade. Thus, there are reasons to believe that firms may try to introduce practices whenever they can to block or hinder parallel trade and *arbitrage*.

Vertical restraints to facilitate integration.

80. After the removal of administrative and other barriers to integration, market entry does not occur automatically. The creation of new distribution channels or the modification of existing networks is costly in terms of investment. Moreover, the introduction of new products or brands in foreign markets requires investments in marketing research efforts, advertising and infrastructure, both by the producers and local retailers, which are often subject to uncertainties. In the context of economic integration, the existence of different

currencies and possibilities of fluctuations will add more uncertainty to the outcome of the investment. These factors have one element in common: the investment required for the introduction of new goods and services in a "foreign" market are product and brand specific. In that sense, the investor will not be able to recover the amounts invested if he does not succeed in developing a new market. In economic terms, the necessary investments to open new distribution channels are considered "sunk" costs ie. costs that firms cannot recover if they fail and want to withdraw.

81. This irreversibility coupled with the highly uncertain nature of investment decisions for both producers and distributors will mean that some decisions to enter new markets will be postponed or even that entry may not occur. Firms will effectively enter and thereby realise market integration only if their expected profits are well above the irreversible costs of entry. However, the introduction of vertical restraints can effectively increase the number of circumstances under which entry can occur. For example exclusivity can reduce risks for distributors or facilitate information flows. Therefore in the circumstances identified here of high investment and risk, there may be a case at least temporarily for treating more favourably vertical restraints designed to facilitate new entry or expand existing market positions significantly.

Vertical restraints to hinder integration.

82. As well as facilitating and speeding up market integration, vertical restraints can also hinder the process. It must be stressed that such a negative outcome is likely only when market power is high and there are barriers to entry - in competitive markets vertical restraints are unlikely to hinder integration[(20)].

83. There are nevertheless circumstances where vertical restraints can hinder market integration, in particular

- where market access is foreclosed by a wide-ranging system of exclusive purchasing or distribution agreements restricting the distributor's freedom to market competing products.
- where interbrand competition is already weak, some vertical restraints can have the effect of diminishing both intra- and interbrand competition and so hinder the integration process. This is particularly the case where there are significant price differences, giving producers the incentive to continue to price discriminate and keep markets separate. Vertical restraints in coordination with some market power facilitate producers ability to maintain price discrimination.

84. Market integration can also be hindered by distributors with significant market power. If such distributors can either create their own production facilities or constitute a significant share of the sales of a producer, they can insist on vertical restraints with the effect of obliging producers not to supply newcomers. This power to oblige producers to refuse to supply is particularly pernicious when it is practised against newcomers who might use a discount format. In these circumstances such practices serve to keep prices high.

[(20)]The threat of entry can have a beneficial effect even if actual entry does not take place. If this threat of entry is credible and potentially quick, it will suffice to attenuate the potentially negative effects of exclusive territories on consumers. Producers and distributors with territorial exclusivity will refrain from exercising any market power in full to avoid entry.

V. Conclusions

85. This chapter presented a sketch of the findings of the recent economic analysis about vertical restraints. There are a number of conclusions that may be made:

i. Anti-competitive effects of vertical restraints are likely to be insignificant in competitive markets. Rather their efficiency enhancing effect and benefit to consumers is likely to dominate. Anti-competitive effects are only likely where interbrand competition is weak and there are barriers to entry.
ii. Individual clauses or different types of vertical restraints cannot be considered per se as having a negative or positive effect on competition or integration.
iii. The combination of several vertical restraints does not necessarily increase any anti-competitive effects but may in fact make the outcome more favourable.
iv. Analysis should concentrate on the impact on the market, rather than the form of the agreements, for example whether entry is foreclosed by a network of agreements or whether the vertical agreement coupled with market power permits producers or distributors to practise price discrimination between different Member States.
v. Given the risks associated with either entry into new markets or significant market expansions (ie. creation of new trade flows that integrate the market) consideration should be given to a more favourable treatment towards vertical restraints where this is accompanied by significant material or immaterial investment. This more favourable treatment should be limited in time.
vi. The nature of the products, the need for services and investment to undertake efficient distribution and the needs and knowledge of consumers may be all important elements in determining both the objective efficiencies promoted by vertical restraints and any anti-competitive effects. The following Table 2 taken from Dobson and Waterson (op cit) provides a guide to the likely effect of vertical restraints and whether they are justified. Comments on this table would be welcome as to how useful it would be if incorporated into Guidelines by the Commission.

86. Although the policy options presented in Chapter VIII take account of these conclusions, it should be made clear that economic theory can not be the only factor in the design of policy for several reasons. Firstly, strict economic theory is just one of the sources of policy. In practice, the application of economic theory must take place in the context of the existing legal texts and jurisprudence. Secondly, economic theories are necessarily based on simplifying assumptions often obtained in the context of stylised theoretical models that cannot take into account all the complexities of real life cases. Only an individual analysis of each case would allow the impact of vertical restraints to be assessed with any degree of certainty. Finally, a full economic analysis of every case would be very costly and might not be justified by gains in identifying market situations and vertical restraints that were detrimental to competition. In those circumstances, competition policy may have to resort to relatively simple rules of thumb and do without a full economic analysis of every case. The costs in terms of uncertainty for enterprises and resources needed to do this analysis would not be justified by the expected economic gains of this approach.

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Table 2

The Strength of the Efficiency Argument for Vertical Restraints Across Different Product/Distribution Conditions

Product/ Distribution Nature	*More likelihood of restraints having efficiency gains*	*Less likelihood of restraints having efficiency gains*
Product complexity	Highly complex or technical	Simple or non-technical
Cost for consumer	Expensive - large part of budget	Inexpensive
Consumer buying habits	One-off purchases	Repeat purchases
Shopping format	Non-convenience outlet	Convenience outlet
Consumers' product information	Limited knowledge	Details/features widely known
Price/quality comparability	Experience or credence goods	Search goods
Perceived product differentiation	Unclear - weak branding	Clear - strong branding
Position in product life cycle	New	Established or mature
Entry barriers in retailing	Low	High
Economies of scope in retailing	Insignificant	Substantial

Chapter III

PROCEDURES AND INSTITUTIONAL FRAMEWORK

I. Article 85 and the system instituted by Regulation 17/62

87. Article 85 has two-part structure, containing a general prohibition and an exemption provision.

Article 85(1) imposes a general prohibition against agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States, and which have "as their object or effect the prevention, restriction or distortion of competition within the common market". It applies at and between all levels in the production and distribution chain, from research and development to retailing.

In order to hold an agreement, decision or concerted practice in violation of Article 85(1), the Commission must establish that (1) a restriction of competition exists, (2) it is appreciable, and (3) it affects trade between the Member States.

The far-reaching ban on restrictive agreements is softened by the exemption rule of Article 85(3), which allows the Commission to exempt agreements which violate Article 85(1) but which meet requirements specified therein. Article 85(3) provides the grounds upon which an exemption can be granted. To qualify, an agreement, decision or concerted practice must contribute to improving the production or distribution of goods or to promoting technical or economic progress while allowing consumers a fair share of the benefit; at the same time it must not impose restrictions on the undertakings concerned which are not indispensable to the attainment of these objectives, nor afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

88. Pursuant to the requirements of Article 87, the Commission submitted a proposal to the Council consisting of the procedural rules to implement Articles 85 and 86. These rules were adopted as Regulation 17/62 by the Council by qualified majority. Regulation 17/62 provides that a party may apply for a certification by the Commission that the transaction described in the application does not constitute a violation of Article 85(1), known as a "negative clearance". (Art. 2). Moreover, it requires notification of agreements, decisions and concerted practices prohibited by Article 85(1) of the Treaty, and for which the party seeks an exemption pursuant to Article 85(3). Applications for negative clearance or notifications for exemption must be made in accordance with the rules laid down in Commission Regulation 3385/94.

89. Under Regulation 17/62, the Commission has sole power to declare Article 85(1) inapplicable by granting an exemption pursuant to Article 85(3), subject only to review by the Community Courts (Art. 9(1)).

90. Regulation 17/62 attempted to limit the number of agreements subject to the notification requirement. Art. 4(2) provides that the notification requirement shall not apply to transactions where

(1) the only parties are from a single Member State and no imports or exports are involved;
(2) not more than two undertakings are involved and the terms of the agreement meet certain requirements specified in the article; or
(3) the agreement is limited to certain specified objectives[21]. This provision is designed to relieve the parties concerned of the obligation to notify, the Commission remaining free to apply Article 85(1) to these agreements. The practical advantage for these enterprises is that the Commission may examine these agreements *ex officio* to determine whether the requirements of Article 85(3) are satisfied. If so, it can issue a decision to that effect retroactive to the date the agreement was entered. Moreover, Art. 4(2) provides that these agreements may be notified. The advantage of making such a notification is that, in conformance with Art. 15(5) of Regulation 17/62, it provides immunity from fines. Art. 4(2) does not stop the Commission, in the absence of notification, from imposing a fine for agreements falling within this provision.

91. With respect to applications for negative clearance or individual exemption, the Commission conducts a case by case examination. Regulation 17/62 identifies the circumstances giving rise to the opening of an investigation by the Commission, which may follow from an application for negative clearance (Art. 2), a notification for individual exemption (Art. 4), a complaint or an ex officio initiative (Art. 3), as well as a sectoral investigation (Art. 12). It also specifies the Commission's powers of investigation, including information requests (Art. 11), and on-site inspections (Art. 14) or to obtain the assistance of Member States in conducting investigations (Art. 13). Art. 19 sets forth the rights of defence of the enterprise during the course of these proceedings (including protection of business secrets), as well as the rights of third parties to be heard; Art. 20 provides for the non-disclosure of professional secrets.

92. Following an investigation, the Commission may decide to grant a negative clearance or exemption if it finds the activities in question qualify. On the other hand, it may conclude that the activities constitute a violation of Article 85(1), and issue a statement of objections. The statement of objections consists of a letter addressed to the enterprises engaged in the activities which the Commission believes to violate Article 85(1) and not to qualify for an exemption. In the letter, the Commission must clearly set forth the essential facts on which

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[21]Specifically, Art. 4(2) states that notification is optional where:
(1) the only parties thereto are undertakings from one Member State and the agreements, decisions or practices do not relate either to imports or exports between Member States;
(2) not more than two undertakings are party thereto, and the agreements only:
(a)restrict the freedom of one party to the contract in determining the prices or conditions of business upon which the goods which he has obtained from the other party to the contract may be resold; or
(b)impose restrictions on the exercise of the rights of the assignee or user of industrial property rights - in particular patents, utility models, designs or trade marks - or of the person entitled under a contract to the assignment, or grant, of the right to use a method of manufacture or knowledge relating to the use and to the application of industrial processes;
(3) they have as their sole object:
(a)the development or uniform application of standards or types; or
(b)joint research and development;
(c)specialization in the manufacture of products, including agreements necessary for achieving this,
- where the products which are the subject of specialization do not, in a substantial part of the single market, represent more than 15% of the volume of business done in identical products or those considered by consumers to be similar by reason of their characteristics, price and use, and
- where the total annual turnover of the participating undertakings does not exceed 200 million units of account.

the objection is based. Moreover, it must indicate the documents in the Commission's possession which constitute the proof of the alleged infraction. The Commission must supply its assessment of the facts and specify the measures it envisages to adopt as remedies, including fines. The Commission allows the undertakings to inspect all documents with the exception of internal documents, documents containing business secrets of other companies and other confidential documents. Regulation 99/63 requires the Commission to specify in the statement of objections a deadline within which the concerned undertakings or association of undertakings may submit a reply. The reply may consist of written comments with relevant documents attached. Interested third parties must also be afforded the opportunity to make known their views within a given time limit. Regulation 17/62 and Regulation 99/63 require the Commission to afford to all persons who have requested in their written comments the opportunity to put forward their views in an oral hearing, and the persons to be heard shall be sent a written summary. Regulation 17/62 requires that an Advisory Committee of the Member States shall be consulted prior to the taking of any decision on an application or notification. The Commission may then issue its final decision, which is published in all official Community languages, specifying the date from which it will take effect.

93. Prior to issuing a negative clearance or exemption, the Commission is required to publish a summary of the relevant application or notice in all official Community languages and to invite interested third parties to submit their observations. (Art. 19(3)). Regulation 17/62 requires that prior to issuing any decision on an application or notification, an Advisory Committee of the Member States shall be consulted. The Commission must publish its final decision granting a negative clearance or exemption in all official Community languages (Art. 21(1)).

94. When the Commission takes a decision to grant an exemption, Regulation 17/62 requires it to specify the effective date (Art 6(1)), the duration of the exemption and any specific conditions or obligations (Art. 8(1). Fines may not be imposed with respect to acts falling within the limits of the activity in the notification and taking place after the date the notification was filed but before the Commission renders its decision with regard to Article 85(3). (Art. 15.(5)(a)).

95. Only a limited number of formal decisions can be rendered each year for cases under Articles 85 and 86. Formal decisions allow the Commission to set forth its position with respect to certain questions and/or certain sectors, and to clarify the criteria that may be applied thereafter with respect to similar agreements. Negative decisions are also taken in order to compel companies to comply with Community competition rules and, in particular to impose fines.

96. In most cases of application for negative clearances or individual exemption, the Commission declares by simple letter, known as a "comfort letter," (i) that it sees no grounds for action against an agreement under Article 85 (1)(negative clearance), or (ii) that the agreement appears to fulfil the conditions for granting an exemption under Article 85(3). For vertical cases this is on average accomplished within 18 months of receiving a notification. Comfort letters carry considerable authority although they do not provide complete legal certainty. They confine themselves to indicating the Commission's prima facie favourable approach in respect of the case under examination.

97. An exemption, once granted, may be renewed (Art. 8.2). It also may be revoked or amended with retroactive effect, if the facts upon which it was based have changed, the parties have committed a breach of their obligations, it is based on incorrect information, was induced by deceit or where it has been abused by the parties. (Art. 8.3)

II. Block exemptions relating to vertical restraints

Regulation 19/65 and the adoption of block exemptions

98. Article 87 of the Treaty of Rome provides that the Council, acting on a proposal from the Commission, shall adopt regulations to give effect to Articles 85 and 86, including regulations "to lay down detailed rules for the application of Article 85(3), taking into account the need to ensure effective supervision on the one hand, and to simplify administration to the greatest possible extent on the other," and "to define, if need be, in the various branches of the economy, the scope of the provisions of Articles 85 and 86."

99. Following entry into force of Regulation 17/62, the Commission was faced with a "mass" problem of a large number of notifications, many of which concerned vertical restraints (nearly 30,000 notified agreements). Accordingly, to facilitate the task of the Commission in handling the large number of notifications submitted, the Council passed by qualified majority Regulation 19/65 based on a proposal from the Commission, which it made based on its powers under Article 87 of the Treaty. Council Regulation 19/65 enabled the Commission "to declare by way of regulation that the provisions of Article 85(1) do not apply to certain categories of agreements and concerted practices." Regulation 19/65 specified that such regulations shall apply only to categories of agreements to which two undertakings are party, and involve exclusive distribution agreements and exclusive purchase agreements involving goods for resale, and restrictions imposed in relation to the assignment of industrial property rights. (Art. 1.(1)). The regulation must specify the restrictions or clauses which must not be contained in the agreements, and the clauses which must be contained, or other conditions which must be satisfied. (Art. 1(2)) Block exemption regulations are made for a specified period (Art. 2), and may be repealed or modified if circumstances on which they are based have changed. They may also be revoked with respect to a particular case where effects incompatible with Article 85(3)'s conditions are present (Art. 7). In order to withdraw the benefit of a block exemption, the Commission must follow the full procedure leading to adoption of a decision under Article 85(1). No mechanism is currently in place with respect to withdrawal of the benefits of a block exemption which would eliminate the benefit of suspension of fines, similar to the procedure set forth in Art. 15(6) of Regulation 17/62.

100. Accordingly, the instrument of the "block exemption" regulation allows the Commission to exempt a class of similar agreements whose procompetitive benefits are considered to outweigh their anticompetitive effects. An agreement of the relevant type which complies with the terms established in such a regulation is automatically exempt from the application of Article 85(1), and need not be notified. Agreements that meet the requirements of a block exemption enjoy the same legal status and advantages as those which have been granted an individual exemption.

Specific Commission block exemptions related to vertical restraints

101. Commission Block exemptions cover most vertical agreements, i.e. exclusive distribution (Regulation 1983/83), exclusive purchasing, with specific provisions for beer and petrol (Regulation 1984/83), franchising (Regulation 4087/88)[(22)].

102. All of the block exemptions for vertical restraints apply without regard to market shares or sales.[(23)] The exclusive distribution and exclusive purchasing regulations contain the following provisions: an exhaustive list of the restrictive clauses that are exempted under the regulation (the so-called 'white list'); a non-exhaustive list of other provisions that are normally not restrictive of competition and may appear in exempted agreements; a list of the restrictive clauses that are deemed anticompetitive and disqualify the agreements concerned from qualifying under the block exemption (the so-called 'black list').

103. Non-opposition procedure

Certain block exemptions (including, with respect to vertical agreements, the franchising block exemption) contain a non-opposition procedure, which may be employed with respect to restrictions not clearly exempted and not black-listed, and is designed to improve the efficiency with which notifications are handled. Under this procedure, if the Commission does not oppose an agreement within six months of receiving a complete notification, the agreement is deemed exempted.[(24)] If the Commission opposes an agreement, the effects of notification are governed by the provisions of Regulation 17/62. Delays may, however, result from an incomplete notification. In 1995, the non-opposition procedure was used only twice with regard to the franchising block exemption. The Commission welcomes comments on why the non-opposition procedures have not been used more extensively.

III. Treatment of cases concerning selective distribution agreements

104. Selective distribution occurs when a supplier limits sale of his products to dealers that he has chosen according to specified criteria. This distribution method is generally employed only in certain sectors primarily involving luxury or high-technology products.

105. No block exemption applies to selective distribution agreements. Instead, Commission practice is reflected in approximately 20 formal decisions taken over the course of a number of years, statements published in the Commission's annual competition reports of the Commission, and judgments of the Community Courts.

IV. Role of national courts

106. Member State courts hold concurrent power with the Commission to apply Articles 85(1), 85(2) and 86 through the doctrine of direct effect. The Courts themselves may not

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[(22)]Others include motor vehicle distribution and servicing (Regulation 1475/95) and transfer of technology (Regulation 240/96).

[(23)]The applicability of some block exemptions, including those governing specialization agreements and research and development, is limited by market share thresholds.

[(24)]See, e.g., Regulation 4087/88 of 30 November 1988, Art. 6(1).

grant exemptions for restrictive practices that meet the requirement set forth in Article 85(3). Only the Commission can grant Article 85(3) exemptions (Regulation 17/62, Art. 9(1)).

107. Parties who bring actions in national courts for breaches of Community competition law have access to all procedural rules and remedies provided for by national law. The remedies and procedural rules applied by national courts for breaches of Community law can be no less favourable than those for a comparable breach of national law, including provisional remedies, injunctions, and, in many Member States, damages.

108. In 1992, the Court of First Instance affirmed the right of the Commission to reject complaints that raise no significant Community interest and where adequate redress is available through national courts. Pursuant to this judgment, the Commission will reject such complaints, which it expects will lead to significant increase in the number of Community competition law actions filed in national courts.

109. In 1993, the Commission issued its "Notice on Cooperation Between National Courts and the Commission in Applying Articles 85 and 86 of the EEC Treaty,"[(25)] to aid national courts in dealing with such cases. It sets forth a procedure to guide national courts in applying Community competition law. It provides that national courts are required to respect the exemption decision taken by the Commission (para. 25) and suggests that national courts may determine whether agreements, decisions or concerted practices fall within the scope of block exemptions (para. 26).

V. Role of national competition authorities

Enforcement of Community competition rules by national authorities

110. Each of the Member States has established a national authority. Article 88 of the Treaty empowers national authorities to apply Community competition law. As long as the Commission has not initiated a procedure under Article 85[(26)], Member State authorities are competent to apply Article 85(1) in accordance with Article 88 of the Treaty of Rome. (Regulation 17/62, Art. 9(3)). However, they may not grant an exemption pursuant to Article 85(3) nor withdraw the benefits of a block exemption. As discussed above, only the Commission has power to grant such an exemption. Block exemptions are, as noted above, directly applicable and thus may be applied by national authorities.

111. National enabling legislation is required to allow national authorities to apply Articles 85 and 86, and to establish that national remedies apply. Eight Member States have adopted such enabling legislation;[(27)] seven have not.[(28)] Remedies vary considerably among the Member States, based on differences in law and traditions. Thus, the position of parties vary

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[(25)]O.J. C39/05 (Feb. 13, 1993).

[(26)]Regulation 17/62, Article 9(3)provides that the Member States remain competent to apply Article 85(1) so long as the Commission has not initiated any procedure under Articles 2 (issuance of negative clearant), 3 (termination of infringements) or 6 (issuance of decision pursuant to Article 85(3)).

[(27)]Germany, France, Italy, Spain, Belgium, Greece, Portugal and Austria.

[(28)]Denmark, Finland, Ireland, Luxembourg, the Netherlands, Sweden and the United Kingdom.

depending on the remedies offered by the Member State in which the action is brought.

112. The Commission has recently published a draft Notice regarding the application of Articles 85(1) (and 86) by national authorities[29]. Like the notice with respect to national courts, this notice will provide for information and consultation between the Commission and the national authorities when the latter apply these articles or national competition law in cross-border cases.

Concurrent application of national competition laws by national authorities

113. In the years between entry into force of the Treaty of Rome in 1958 and the present, each Member State enacted some form of competition law, or modified already existing laws, with respect to restrictions of competition and abuses of dominant position. Chapter VI discusses the Member States' laws on vertical restraints.

114. National competition rules usually apply in situations where the primary effects of a vertical practice are felt in markets within the boundaries of a single Member State.

115. National competition authorities are empowered to enforce their national competition laws. In general, they have powers to investigate, make decisions, and impose sanctions. Administrative decisions of the competition authorities are subject in some circumstances to review by a national court. The investigatory powers in some Member States are generally more extensive than those of the Commission in two important respects: many of them may direct their investigatory efforts against individuals and sanction them for failure to cooperate, including imprisonment for failure to obey a court order; and they have police powers, including the possibility to obtain search warrants, which they may use to support their efforts to make on-site inspections.

116. Member State laws may not be applied in conflict with Community law. If the Commission has made a decision that Article 85(1) does not apply, the national authority is free to decide that national competition law has been violated. However, if the Commission grants an exemption pursuant to Article 85(3), the national authority cannot reach a contrary result, under Community law or national law.

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[29] OJ C 262 of 10.9.1996

Chapter IV

CURRENT RULES GOVERNING VERTICAL RESTRAINTS

I. The scope of Article 85

117. As we have already seen, distribution agreements raise special difficulties because they are usually something of a two-edged sword. They can be a useful way for a firm to penetrate a new market and to sell its products effectively. But they can also be used to prevent outsiders from entering a market, and so perpetuate the compartmentalization of the Community. This equivocal character has given rise to considerable discussion, particularly regarding the extent to which vertical restrictions are caught by Article 85.

118. In *Consten and Grundig*, one of its earliest judgments on the subject, the Court of Justice found that Article 85 applied both to horizontal and to vertical agreements; regarding vertical agreements the Court had this to say:

> Although competition between producers is generally more noticeable than that between distributors of the same make, it does not thereby follow that an agreement tending to restrict the latter kind of competition should escape the prohibition of Article 85(1) merely because it might increase the former.[30]

For a proper understanding of this approach the competition rules of the EC Treaty have to be seen in context. Interpreting their purpose in the light of the general principles in Articles 2 and 3(g) of the Treaty, we can say that they are intended not only to safeguard the efficiency of the economic system but also to promote the integration of the national economies so as to establish a single market. This means, on the one hand, that competition in goods traded under the same brand has to be looked at on its own merits. On the other hand, however, given the market integration objective, any system of absolute territorial protection will normally be judged contrary to what is a fundamental objective of the Treaty, and will consequently be held incompatible with the competition rules. We will see in more detail below that this aspect is of particular importance in the competition policy pursued by the Commission, which has consistently sought to prevent agreements which might impede parallel trade inside a dealer's authorized territory and passive sales outside it.

119. This chapter looks at the rules laid down in the distribution block exemption regulations and at the principles applied to selective distribution agreements. Given the complexity of the subject-matter it has not been possible to carry out a detailed analysis of cases in which Article 85(3) has been applied to individual agreements outside the block exemption regulations. Nor has any attempt been made to provide an exhaustive description of the Commission's practice with regard to the general applicability of the ban in Article 85(1); the following observations are intended as a rough outline.

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[30] Joined Cases 56 and 58/64 [1966] ECR 299.

II. Types of distribution agreement

120. Commission practice distinguishes four main types of vertical agreement: exclusive distribution, exclusive purchasing, selective distribution and franchising.

Exclusive distribution agreements

121. Regulation 1983/83 is concerned with a specific type of exclusive distribution agreement which is very common in practice. Article 1 defines the type of agreement covered as "agreements to which only two undertakings are party and whereby one party agrees with the other to supply certain goods for resale within the whole or a defined area of the common market only to that other." Regulation 1983/83 can be said to cover all bilateral exclusive distribution agreements which relate to finished goods and which have cross-border implications. It does not cover agreements by which the supplier appoints more than one approved dealer in the contract territory; agreements of that kind have to be vetted individually. Agreements for the supply of services also fall outside the scope of the Regulation. And the Regulation applies only to agreements concluded with a view to resale.[31] The practice the Commission has followed with regard to agreements which are not covered by the Regulation has been based on a fairly generous interpretation of Article 85(3).

122. According to recitals 5 to 7 to the Regulation, these exclusive distribution agreements "lead in general to an improvement in distribution because the undertaking... does not need to maintain numerous business relations with a larger number of dealers and is able, by dealing with only one dealer, to overcome more easily distribution difficulties in international trade resulting from linguistic, legal and other differences". They "facilitate the promotion of sales of a product and lead to intensive marketing and to continuity of supplies while at the same time rationalizing distribution... they stimulate competition between the products of different manufacturers"; such an agreement is "often the most effective way, and sometimes indeed the only way, for the manufacturer to enter a market... this is particularly so in the case of small and medium-sized undertakings". As a result consumers "can obtain products manufactured in particular in other countries more quickly and more easily".

123. The same advantages do not automatically arise where an exclusive distribution agreement is concluded between competitors, whether reciprocally or non-reciprocally. The Regulation does not apply to such agreements, which have to be notified individually. The only exception is for non-reciprocal agreements where either party has a turnover not exceeding ECU 100 million. Otherwise exclusive distribution agreements between competitors have to be vetted on a case-by-case basis; individual exemption can be granted on certain conditions.[32]

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[31] In Commission practice "resale" is taken to include cases where the dealer breaks bulk or packages or repackages the article supplied. If he performs additional operations to improve the quality, durability, appearance or taste of the goods, the question whether the agreement is concerned with goods for resale will be determined by the value the operation adds to the goods. .

[32] For an example see the *Moosehead/Whitbread* decision, OJ No L 100, 20.4.1990, p. 15. In *Carlsberg/Interbrew* the Commission allowed the agreement on condition that price determination, advertising and strategic marketing were not to be left to the discretion of the concessionaire: Twenty-fourth Report on Competition Policy, p. 351.

Exclusive purchasing agreements

124. Regulation 1984/83 applies only to agreements providing for exclusive purchasing with a view to resale. The dealer agrees not to buy the goods in question from suppliers other than the other party to the agreement or a person designated by him. The supplier may supply to other dealers in the same area at the same level of distribution, and there is no territorial restriction on the dealer's efforts to market the goods. But the main exclusive purchasing obligation is often accompanied by a no-competition clause by which the dealer undertakes not to manufacture or distribute goods which compete with the contract goods. Recital 3 to the Regulation states that "exclusive purchasing agreements of the categories defined in this Regulation may fall within the prohibition contained in Article 85(1)... this is in particular the case where [the agreement] is one of a number of similar agreements which together may affect trade between Member States". Agreements of this kind have the effect of tying the dealer to a single supplier, and in some cases may form a substantial barrier to entry to the market by outsiders. The restrictions involved are consequently of great importance from the point of view of competition law, particularly because of their implications for interbrand competition.

125. But exclusive purchasing agreements which meet the conditions set out in Regulation 1984/83 produce economic benefits that justify a positive assessment under Article 85(3). Recitals 5 to 7 to the Regulation point out that they can improve the production and distribution of goods because they enable the parties to plan production and sale with greater precision and for a longer period, to limit the risk to them of variations in market conditions, and to lower the costs of production, stocks and marketing. For small and medium-sized enterprises such agreements are often the only way of entering the market and thus stimulating competition. They facilitate sales promotion and intensive marketing, because the supplier will generally help to improve the distribution network. Consumers benefit, because they can obtain the goods regularly and more easily. But this positive assessment is subject to the condition that the agreements must not significantly impede entry to the market by outsiders. In the *Langnese-Iglo* case, for example, the Commission had to withdraw the benefit of the block exemption; it did so especially because of the exclusionary effect of the agreements at issue.[(33)]

Exclusive purchasing agreements, like exclusive distribution agreements, do not automatically produce the anticipated benefits if the agreement, whether reciprocal or non-reciprocal, is between competitors. The Regulation covers only non-reciprocal agreements where either party has a turnover not exceeding ECU 100 million. All other agreements between competitors have to be vetted on a case-by-case basis.

Beer supply and service-station agreements

126. In addition to the general rules on exclusive purchasing the Regulation also makes specific provision for what it calls beer supply agreements and service-station agreements. Here, as a general rule, "the supplier confers on the reseller special commercial or financial advantages by contributing to his financing, granting him or obtaining for him a loan on favourable terms, equipping him with a site or premises for conducting his business, providing him with equipment or fittings, or undertaking other investments for his benefit" (recital 13);

[(33)]OJ No L 183, 26.7.1993, p.19.

"the commercial and financial advantages conferred by the supplier on the reseller make it significantly easier to establish, maintain and operate premises used for the sale and consumption of drinks and service stations... the exclusive purchasing obligation and the ban on dealing in competing products imposed on the reseller incite the reseller to devote all the resources at his disposal to the sale of the contract goods... such agreements lead to durable cooperation between the parties allowing them to improve or maintain the quality of the contract goods and of the services to the customer and sales efforts of the reseller... they allow long-term planning of sales and consequently a cost effective organization of production and distribution... the pressure of competition between products of different makes obliges the undertakings involved to determine the number and character of premises used for the sale and consumption of drinks and service stations, in accordance with the wishes of customers" (recital 15). To obtain these objective advantages the exclusive distribution of beer and petroleum products must be confined to designated premises. This distinguishes beer supply and service-station agreements from other exclusive purchasing agreements, where there is no limitation to designated premises. In order to preserve the dealer's commercial freedom and to ensure access to the retail trade for other suppliers, therefore, the Regulation limits the duration of the agreement, and strictly defines the range of products that may be covered. Beer supply agreements concluded by small brewers fall outside the prohibition in Article 85(1).[34]

Selective distribution agreements

127. In selective distribution a manufacturer usually agrees to supply only to dealers satisfying certain professional or technical requirements, while the approved dealers undertake not to purchase or sell the contract goods from wholesalers or retailers outside the official network. As a general rule the establishment of a selective distribution system is motivated by the nature of the product.

128. On the basis of the Commission's administrative practice and the case-law of the Court of Justice we can distinguish three types of selective distribution characterized by the stringency of the approval requirements applied.[35]

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[34] *Commission Notice concerning Commission Regulations (EEC) No 1983/83 and (EEC) No 1984/83*, paragraph 40: OJ No C 121, 13.5.1992.

[35] Selective distribution is not covered by a block exemption, and this account is based on the case-law of the Court of Justice and the Court of First Instance and the practice followed by the Commission in its decisions. The most significant cases decided by the Community lawcourts are: Case 26/76 *Metro I* [1977] ECR 1875; Case 31/80 *L'Oréal* [1980] ECR 3775; Case 99/79 *Lancôme* [1980] ECR 2511; Case 126/80 *Salonia* [1981] ECR 1574; Case 210/81 *Demo-Studio Schmidt* [1983] ECR 3045; Case 107/82 *AEG/Telefunken* [1983] ECR 3151; Case 243/83 *Binon* [1985] ECR 2034; Joined Cases 25 and 26/84 *Ford Werke II* [1985] ECR 2725; Case 31/85 *ETA v DK Investment* [1985] ECR 3933; Case 75/84 *Metro II* [1986] ECR 3076; and Case T-19/91 *Vichy* [1992] ECR II-415. The main Commission decisions are: *Kodak*, OJ No L 147, 7.7.1970, p. 24; *Omega*, OJ No L 242, 5.11.1970, p. 22; *Bayerische Motoren Werke*, OJ No L 29, 3.2.1975, p. 1; *SABA I*, OJ No L 28, 3.2.1976, p. 19; *Junghans*, OJ No L 30, 2.2.1977, p. 10; *Krups*, OJ No L 120, 13.5.1980, p.26; *Hasselblad*, OJ No L 161, 12.6.1982, p. 18; *AEG/Telefunken*, OJ No L 117, 30.4.1982, p. 15; *Ford Werke*, OJ No L 327, 24.11.1983, p. 31; *Murat*, OJ No L 348, 10.12.1983, p. 15; *SABA II*, OJ No L 376, 31.12.1983, p. 41; *IBM Personal Computer*, OJ No L 118, 5.4.1984, p. 24; *Grohe*, OJ No L 19, 23.1.1985, p. 17; *Ideal Standard*, OJ No L 20, 24.1.1985, p. 38; *Grundig*, OJ No L 233, 30.8.1985, p. 1; *Ivoclar*, OJ No L 369, 31.12.1985, p. 1; *Villeroy & Boch*, OJ No L 376, 31.12.1985, p. 15; *Vichy*, OJ No L 75, 21.3.1991, p. 57; *Yves Saint Laurent Parfums*, OJ No L 12, 18.1.1992, p. 24; and *Givenchy*, OJ No L 236, 19.8.1992, p. 11.

(i) The approval requirements may be purely *qualitative*. Here selection is by objective criteria which define the professional qualifications to be held by the dealer or his staff and the technical and operational requirements that must be met by sales outlets. From its earliest decisions on the subject the Commission has followed a "rule of reason" approach under which it considers that such distribution systems generally fall outside the ban in Article 85(1) provided the approval of dealers complies with three conditions.[36] First, the requirements must be related to the nature of the goods (the "principle of necessity").[37] Second, the requirements must not be excessive, bearing in mind the objective, which is to maintain a specialized trade offering the best possible conditions for the sale of the goods (the "principle of proportionality"). And third, the requirements must be the same for all potential dealers, and must be applied without discrimination (the "principle of non-discrimination").

(ii) Entry to the network may be confined to dealers who as well as meeting qualitative conditions are also prepared to enter into additional commitments of a *promotional* nature; such systems are not covered by the rule of reason, and are caught by the prohibition in Article 85(1). But as these additional obligations allow distribution to be concentrated on the most effective sales outlets, with the costs of distributing the goods and providing assistance to the sales outlets being rationalized, such networks will in general qualify for exemption under Article 85(3).

(iii) Networks in which the manufacturer limits the number of dealers on purely quantitative grounds (on the basis of the purchasing potential of the region, for example) are in principle caught by Article 85(1). At present the Commission accepts the possibility of exemption only in quite exceptional cases.[38]

Franchising agreements

129. Commission Regulation (EEC) No 4087/88 exempts agreements "whereby one undertaking, the franchiser, grants the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified types of goods and/or services". A "franchise" is "a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users". There are three features which distinguish a franchising network: (i) "the use of a common name or shop sign and a uniform presentation of contract premises", (ii) "the communication by the franchiser to the franchisee of know-how", and (iii) "the continuing provision by the franchiser to the franchisee of commercial or technical assistance".

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[36]This general rule needs to be qualified in certain particular cases where the market is considered to be so rigid and structured, especially because of the cumulative effect of a plurality of selective distribution networks, that the element of competition which is inherent in such systems is not enough to maintain effective competition. In such cases the system may be caught by Article 85(1), and would then have to be looked at under Article 85(3).

[37]So far the Commission has generally been sympathetic to networks for the distribution of technically complex items, certain specialized goods (such as newspapers), and certain luxury articles.

[38]See for example Regulation 1475/95 on motor vehicle distribution and servicing agreements.

130. The Regulation starts from the principle that "clauses which are essential either to preserve the common identity and reputation of the network or to prevent the know-how made available and the assistance given by the franchiser from benefiting competitors" fall outside Article 85(1) (recital 11). Article 3(2) of the Regulation lists a number of obligations which are not caught by Article 85(1). These include the obligation (i) to attend training courses arranged by the franchiser; (ii) to apply the commercial methods devised by the franchiser; (iii) to comply with the franchiser standards for the equipment and presentation of the contract premises and/or means of transport; (iv) to allow the franchiser to carry out checks of the contract premises and/or means of transport to ensure that these standards are in fact complied with; (v) not to change the location of the contract premises without the franchiser consent; (vi) not to assign the rights and obligations covered by the franchise agreement without the franchiser consent; (vii) not to disclose the know-how to third parties, even after termination of the agreement, unless it has entered the public domain; (viii) to communicate to the franchiser any experience gained in exploiting the franchise and to grant the franchiser a non-exclusive licence for improvements resulting from the exploitation of the know-how; (ix) not to use the know-how licensed by the franchiser for purposes other than the exploitation of the franchise; and (x) to inform the franchiser of infringements of licensed industrial or intellectual property rights and to take any legal actions necessary.

131. But agreements of this kind may contain clauses which do restrict competition, such as the grant of an exclusive territory to the franchisee or an obligation on the franchisee not to sell competing goods or to use them in the course of the provision of services. These restrictions would as a rule be caught by the ban in Article 85(1), but they may qualify for exemption on certain conditions. The Regulation weighs the disadvantages of these restrictions against the positive effects they can produce. It accepts that they can improve distribution "as they give franchisers the possibility of establishing a uniform network with limited investments, which may assist the entry of new competitors on the market, particularly in the case of small and medium-sized undertakings, thus increasing interbrand competition. They also allow independent traders to set up outlets more rapidly and with higher chance of success than if they had to do so without the franchiser experience and assistance. They have therefore the possibility of competing more efficiently with large distribution undertakings" (recital 7). From the point of view of consumers franchise agreements combine the advantage of a uniform and homogeneous network, which ensures a constant quality of the products and services, with the existence of traders personally interested in the efficient operation of their business (recital 8).

132. The Regulation does not cover agreements to which there are more than two parties, franchising agreements at industrial or wholesale level, or agreements between competitors.[(39)]

III. Assessment of the main vertical restrictions

133. The main types of vertical restriction will now be examined systematically for each class of agreement, in the following order: (a) clauses conferring territorial protection on a party; (b) purchasing obligations entered into by the dealer, including tie-in clauses; (c) sales obligations entered into by the dealer, including clauses affecting his pricing policy;

[(39)]It does cover "master franchising agreements", whereby the franchiser gives a "master franchisee" the right, for consideration, to exploit a franchise for the purposes of concluding franchise agreements with third parties, the "franchisees".

(d) no-competition clauses entered into by the dealer; and (e) obligations restricting the dealer's choice of customers.

Territorial restrictions

Exclusive distribution agreements

134. The territorial protection conferred on an exclusive dealer varies from case to case with the stringency of the clauses intended to protect his exclusive rights. In order to arrive at an assessment of the territorial protection which is the object or effect of such clauses, the Commission and the courts have consistently sought to determine whether the protection conferred is absolute or merely relative.

135. Regulation 1983/83 identifies two situations in which territorial protection is absolute. One arises where "users can obtain the contract goods in the contract territory only from the exclusive distributor and have no alternative source of supply outside the contract territory" (Article 3(c)). The other arises where one of the parties impedes parallel imports into the contract territory (Article 3(d)). A classic example is the exercise of industrial property rights to obstruct imports of "properly marked or otherwise properly marketed contract goods" (Article 3(d)(1)). In its decisions the Commission has identified other restrictions which have the effect of obstructing parallel trading, such as those which affect the validity of the manufacturer's guarantee[40] or the "essential services" associated with the supply of the product.[41]

There are some forms of differentiation of products or prices on the basis of the geographic market of destination which can have the same effect.[42] Territorial restrictions of this kind will usually be caught by Article 85(1), and will not qualify for exemption under Article 85(3). In the same way, the Commission systematically acts against exclusive distribution agreements which contain bans on reexport to EU Member States.[43] It has taken the view, for example, that Article 85 prevents the grant of a rebate which is subject to the condition that the goods are not reexported to other Member States.[44] The Commission has

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[40]See in particular the *Zanussi* decision (OJ No L 322, 16.11.1978), and the positions taken by the Commission in *Matsushita Electrical Trading Company* (Twelfth Report on Competition Policy (1982), point 77), *Ford Garantie Deutschland* (Thirteenth Report on Competition Policy (1983), points 104 to 106), *Fiat* (Fourteenth Report on Competition Policy(1984), point 70), and more generally the considerations set out in the Sixteenth Report on Competition Policy (1986), point 56.

[41]See Nineteenth Report on Competition Policy, point 45, on the *AKZO Coatings* case.

[42]A practice of this kind was considered in the decision in *Zera/Montedison* (OJ No L 272, 4.11.1993, p. 28).

[43]There is a large body of precedent here. Among recent cases, see in particular the banning decision in *Sandoz* (OJ No L 222, 10.8.1987, p. 28), subsequently upheld in full by the Court of Justice (Case C-277/87 [1990] ECR 45); the fining decision in *Tipp-Ex* (OJ No L 222, 10.8.1987, p. 1), also upheld by the Court (Case C-279/87 [1990] ECR 261); and the fining decisions in *Viho/Toshiba* (OJ No L 287, 17.10.1991, p. 39), *Gosme/Martel* (OJ No L 185, 11.7.1991, p. 23), *Newitt/Dunlop Slazenger International* (OJ No L 131, 16.5.1992, p. 32), *Viho/Parker Pen* (OJ No L 233, 15.8.1992, p. 27), and *Ford Agricultural* (OJ No L 20, 28.1.1993, p. 1).

[44]See *Pittsburgh Corning Europe/Formica Belgium/Hertel* (OJ No L 72, 5.12.1972, p. 35) and *Sperry New Holland* (OJ No L 376, 31.12.1985, p. 26).

likewise held that certain measures aimed at providing additional protection for an exclusive dealer by means of a price differentiation policy which operates to the disadvantage of parallel exporters do not satisfy the tests of Article 85(3).[45] In the same way the Commission considers that terms of sale under which buyers must pay the price of the country of destination of the goods rather than that which applies in the country of the seller can infringe Article 85.[46]

136. Where the territorial protection conferred is only relative, whatever the degree of intensity of protection conferred, consumers are still able to obtain the contract goods from sources other than the exclusive dealer, and middlemen can import the goods into the contract territory on a parallel basis. More precisely, an exclusive dealer is said to enjoy relative territorial protection if the agreement confines itself to

- an obligation on the supplier to supply certain products to the exclusive dealer distributor only (Regulation 1983/83, Article 1) and "not to supply the contract goods to users in the contract territory" (Article 2(1)); and
- an obligation on the dealer "to refrain, outside the contract territory and in relation to the contract goods, from seeking customers, from establishing any branch and from maintaining any distribution depot" (Article 2(2)(c)).

137. In this case the supplier is entitled only to prevent his dealers from carrying on an active sales policy outside their territories. They are consequently subject to indirect competitive pressure from the other exclusive dealers, who remain free to supply users or intermediaries outside their own territories provided they do not solicit orders ("passive sales"). Such a system of relative territorial protection does qualify for the block exemption declared by Regulation 1983/83.

Exclusive purchasing agreements

138. Regulation 1984/83 grants exemption, for a limited time, only for an exclusive purchasing obligation (and that for a limited time), and not for the allocation of an exclusive sales territory. Article 2(1) specifies that "No other restriction of competition shall be imposed on the supplier than the obligation not to distribute the contract goods or goods which compete with the contract goods in the reseller's principal sales area and at the reseller's level of distribution." This means that if the agreement is caught by Article 85(1) the supplier must remain free to supply to other dealers in the exclusive purchaser's principal sales area, and himself to operate at another level of distribution in the same area. And in order to qualify for the block exemption an exclusive purchasing agreement must not place any territorial restriction on the exclusive purchaser's sales efforts. The dealer thus retains his freedom actively to seek custom outside his principal sales area.

139. Article 16 of the Regulation states that if the supplier allocates an exclusive sales territory to the dealer the Regulation ceases to be applicable, so that the agreement has to be

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[45]See in particular the *Distillers* decision (OJ No L 50, 22.2.1978, p. 16), subsequently upheld by the Court (Case 30/78 [1980] ECR 2229); though that decision ruled out the applicability of Article 85(3) on the ground that the agreement had not been notified as required by Regulation 17. See also the *Johnny Walker Red Label* case (Seventeenth Report on Competition Policy (1987), point 65).

[46]See the decision in *Kodak* (OJ No L 147, 7.7.1970, p. 24).

considered under Regulation 1983/83.

Beer supply and service-station agreements

Whilst no territorial restrictions can be imposed on the reseller's sales efforts, the agreement must clearly indicate the premises in respect of which the agreement is to apply. The reseller is free to conduct competing businesses from other premises.

Selective distribution agreements

140. If admission to a selective distribution network is dependent on quantitative criteria, the system has the effect of giving each dealer a form of territorial protection similar to that provided by an exclusive sales territory. As we have already seen, such a system will certainly be caught by the ban in Article 85(1), and will not as a rule satisfy the tests for exemption set out in Article 85(3).

141. In addition, a supplier cannot prevent his approved dealers from supplying contract goods to final users inside the common market by reason of the users' place of residence. Nor may he impose on his approved dealers obligations which might have the effect of partitioning markets. In particular, the manufacturer must allow his approved dealers to obtain supplies from any member of his distribution network in the common market (exclusive agents or approved wholesalers or retailers). He must leave his approved dealers free to sell the contract goods to any other member of the distribution network in any Community country. To put it another way, if negative clearance or exemption is to be granted the Commission requires that the selective distribution contracts must not obstruct cross-deliveries between approved dealers, who may be established on the territory of the same Member State or in other Community countries.[47]

Franchising agreements

142. A franchising network involving territorial restrictions will usually be caught by Article 85(1), and will qualify for the block exemption declared by Regulation 4087/88 only on condition that these restrictions do not have the effect of conferring absolute territorial protection.

143. The Regulation does provide that the franchiser may grant an exclusive sales territory, and to this end it exempts a series of obligations aimed at limiting the activities of the franchiser inside the contract territory and the activities of the franchisee outside that territory.[48]

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[47]The Commission also requires that cross-deliveries be possible between approved members of networks in the EU and members established in countries in a free trade area, or other non-Community countries, if there may be an effect on trade between Member States.

[48]Most notably "an obligation on the franchiser, in a defined area of the common market, the contract territory, not to:

- grant the right to exploit all or part of the franchise to third parties,
- itself exploit the franchise, or itself market the goods or services which are the subject-matter of the franchise under a similar formula;
- itself supply the franchiser goods to third parties" (Article 2(a)).

144. But if the parties either directly or indirectly prevent end users from obtaining the contract goods or services by reason of their place of residence,[49] or take advantage of differences in the specifications for the goods or services between Member States so as to partition the market, the Regulation no longer applies. Likewise in order to prevent the partitioning of the market, the Regulation stipulates that the agreements must not restrict cross-deliveries among the members of the network and between them and the members of any parallel networks the franchiser may have established.[50]

Purchasing obligations

Exclusive distribution agreements

145. Regulation 1983/83 exempts an exclusive purchasing obligation, that is to say "the obligation to obtain the contract goods for resale only from the other party" (Article 2(2)(b)), provided it is "agreed only for the duration of the agreement" (recital 8).

146. Tie-in clauses are not considered incompatible with Article 85(3).

147. Article 2(3)(a) of the Regulation gives an indication of other purchasing obligations which may be imposed on an exclusive dealer. It refers to clauses requiring the dealer to purchase complete ranges of goods or minimum quantities. As a general rule such obligations are not considered restrictions within the scope of Article 85(1). But they must not be "formulated or applied in such a way as to take on the character of restrictions of competition that are not permitted."[51] An obligation to purchase minimum quantities might for example have the same effect in practice as a no-competition clause, and it would then have to be considered whether, given the economic context in which it was to operate, the agreement might form a substantial obstacle in the way of competing suppliers seeking to enter the market. If there is such an obstacle the agreement no longer meets the requirements for exemption, even on an individual basis.

Exclusive purchasing agreements

148. An exclusive purchasing obligation is the vital component in the agreements covered by the block exemption declared by Regulation 1984/83. Article 1 makes it clear that "The Regulation only covers agreements whereby the reseller agrees to purchase all his

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The franchisee may be obliged "to exploit the franchise only from the contract premises" (Article 2(c)). He may also be obliged "to refrain, outside the contract territory, from seeking customers for the goods or the services which are the subject-matter of the franchise" (Article 2(d)). A master franchisee may be obliged "not to conclude franchise agreements with third parties outside its contract territory" (Article 2(b)).

[49] As far as indirect restrictions are concerned it is worth drawing attention to Article 4(b) of the Regulation, which states that an obligation on the franchisee to honour guarantees for the franchiser goods may qualify for the block exemption on condition that it includes goods sold in the common market by other members of the franchised network or other distributors which give a similar guarantee.

[50] Article 4(a). An example of parallel networks would be the existence of a franchised network alongside a network of approved dealers. See the *Charles Jourdan* decision: OJ No L 35, 7.2.1989. p. 11.

[51] See the *Commission Notice concerning Commission Regulations (EEC) No 1983/83 and (EEC) No 1984/83*, paragraph 19 (OJ No C 101, 13.4.1984, p. 2).

requirements for the contract goods from the other party."[52] It can happen that an agreement to purchase part of the purchaser's requirements needs to be exempted on an individual basis; if there are no other restrictions incompatible with Article 85(1) exemption is not usually refused. The Regulation does cover agreements containing an "English clause", which allows the purchaser to buy from other suppliers if they are offering the goods on more favourable terms than the other party.[53] The dealer may also be released from his exclusive purchasing obligation if the other party is unable to supply.

149. The block exemption does not apply where there is a tie-in clause, that is to say where "the exclusive purchasing obligation is agreed for more than one type of goods where these are neither by their nature nor according to commercial usage connected to each other" (Article 3(c)). This means that in order to qualify for the block exemption the agreement must be concluded "for a specified product or assortment of products" (recital 11), which must be specified "by brand or denomination".[54] For the goods to belong to the same range there must be a link between them, which may be of a technical nature (as in the case of accessories and spare parts), of a commercial nature (as with goods used for the same purpose), or just a matter of commercial usage (as with goods customarily offered for sale on the same premises). In its decisions the Commission has taken the view that if an agreement appreciably affects competition in trade between Member States tie-in clauses will not usually qualify for individual exemption.

150. As regards the duration of the obligation, the Regulation provides that the exemption does not apply if the agreement is "concluded for an indefinite duration or for a period of more than five years" (Article 3(d)). The Commission has been strict in dealing with such agreements.

151. The Regulation gives an indication of other purchasing obligations which will generally be compatible with Article 85(1). It refers to clauses requiring the dealer to purchase complete ranges of goods or minimum quantities. The assessment of such clauses in exclusive purchasing agreements is not substantially different from that of similar clauses in exclusive distribution agreements.

Beer supply and service-station agreements

The exclusive purchasing obligation imposed by a beer supply agreement has to be confined to "certain beers, or certain beers and certain other drinks, specified in the agreement". The publican must be free to sell other beers in bottles, cans or other small packages. The publican must also be free in his choice of goods and services other than the drinks specified in the agreement. In the case of a service-station agreement the exclusive purchasing obligation has

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[52] *Notice concerning Commission Regulations (EEC) No 1983/83 and (EEC) No 1984/83*, paragraph 35. In other words, "If the purchasing obligation relates to only part of such requirements, the block exemption does not apply", and the agreement would have to be vetted individually.

[53] *Notice concerning Commission Regulations (EEC) No 1983/83 and (EEC) No 1984/83*, paragraph 35. The Commission's decision in *BP Kemi/DDSF* (OJ No L 286, 14.11.1979, p. 32), in which the Commission held that an English clause did restrict competition, has to be looked at in the light of the circumstances of the case, and does not appear to contradict the general rule in the *Notice*.

[54] *Notice*, paragraph 36.

to be confined to "certain petroleum-based motor-vehicle fuels or certain petroleum-based motor-vehicle and other fuels specified in the agreement". The service-station operator may also be obliged to use the supplier's lubricants where the supplier has helped finance a lubrication bay or other lubrication equipment. No other tie-ins are covered.

Selective distribution agreements

152. If it is to be compatible with Article 85(1) or to qualify for exemption under Article 85(3) an agreement establishing a selective distribution network may not contain any exclusive purchasing clause. An exclusive purchasing obligation would prevent cross-deliveries between members of the network, and would consequently partition the market..

153. The Commission accepts that the supplier may require approved dealers to buy minimum quantities of contract goods from him directly, provided the volume stays below a reasonable threshold; the supplier could otherwise use an obligation of this kind to secure the same result as an exclusive purchasing obligation would. With that proviso selective distribution agreements including such an obligation, while they do fall within the scope of Article 85(1), can qualify for exemption under Article 85(3).

154. An approved dealer may be required to buy and to maintain representative stocks of the range of products covered by the contract: depending on the circumstances this obligation may fall outside the ban in Article 85(1) (for example where it is not combined with other obligations of a promotional nature), or may qualify for exemption.

Franchise agreements

155. Franchise agreements must not impose exclusive purchasing obligations on the franchisee. Regulation 4087/88 stipulates that the block exemption applies on condition that "the franchisee is free to obtain the goods that are the subject-matter of the franchise from the other franchisees; where such goods are also distributed through another network of authorized distributors, the franchisee must be free to obtain the goods from the latter" (Article 4(a)).

156. But obligations on the franchisee to buy minimum volumes, to plan orders in advance, and to keep a minimum stock of a minimum range of goods are not regarded as restrictions of competition, provided they do not go beyond what is necessary to maintain the common identity and reputation of the network (Article 3(1)(f)).

Sales obligations

Exclusive distribution and exclusive purchasing agreements

157. To impose a resale price on a dealer is an infringement of Article 85(1), and as the case-law stands at present it will not as a rule qualify for exemption (see recital 8 to Regulations Nos 1983/83 and 1984/83). It is immaterial whether the price is a fixed price or a maximum or minimum price. In the Commission's decisions any limitation of the dealer's freedom with regard to discounts or advertising of sales promotions has been treated the same way. The only pricing practice generally allowed is that whereby the supplier provides the dealer with lists of recommended prices; provided these are not followed up with instructions

or other binding measures they fall outside the ban in Article 85(1).

158. Article 85 also catches agreements by which an exclusive dealer undertakes to apply differentiated prices to certain categories of purchaser (such as parallel importers or users outside the allotted territory).

159. Agreements of this kind usually impose several obligations of a promotional nature on the dealer. An exclusive dealer may for example be required to achieve a minimum turnover, to advertise, to maintain a sales network, to comply with certain minimum requirements as with respect to stocks, to provide customer and guarantee services, to employ staff having specialized or technical training, or to sell the goods only under trade marks or packed and presented as specified by the supplier. These obligations will not as a rule be caught by Article 85(1).[55]

Beer supply and service-station agreements

No obligation can be imposed on the reseller either with respect to his resale price or any special sales efforts. He may be required to sell only from designated premises, but he is free to promote his business without territorial or other restrictions.

Selective distribution agreements

160. The supplier may not seek to have his dealers observe a certain level of prices by any means whatever, whether fixed, minimum or maximum prices. In the same way, the Commission cannot as a rule exempt restrictions which limit an approved dealer's freedom to determine the level of discount he allows his customers. Article 85 also prohibits a supplier from refusing to approve dealers who are qualified but who are suspected of charging low prices.

161. The Commission accepts that a supplier may provide his approved dealers with lists of recommended prices, provided these are not followed up with instructions or other binding measures obliging or inducing retailers not to depart from those prices. On that condition recommended prices are not considered to restrict competition.

162. As we have already seen, obligations of a promotional nature are usually regarded as compatible with Article 85(3); these would include clauses requiring the dealer to achieve a reasonable level of business and stock turnover, and to play his part in promotion campaigns organized by the supplier.

Franchise agreements

163. Regulation 4087/88 denies the benefit of the block exemption "where the franchisee is restricted in determining its prices."[56] This rules out any form of resale price maintenance (fixed prices, minimum prices or maximum prices). But the franchiser "should be free to

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[55]See Regulation 1983/83, Article 2(3). But this assessment is subject to the condition that "the obligations may not be formulated or applied in such a way as to take on the character of restrictions of competition that are not permitted" (*Notice*, paragraph 19)

[56]Recital 13; see also Article 5(e).

recommend prices to the franchisees... to the extent that it does not lead to concerted practices for the effective application of these prices" (recital 13); such illicit practices might be concerted between the franchiser and the franchisee or between the franchisees themselves. It is worth noting here that in *Pronuptia* the Commission insisted on the removal of a clause according to which the franchisee was not to charge prices that might damage the brand image of the contract goods. That obligation was replaced by a maximum price which the franchisee was recommended not to exceed in advertising and promotions.[57]

164. The Regulation takes the approach that promotional obligations imposed on the franchisees are usually outside the scope of Article 85(1) provided they are confined to what is necessary in order to maintain the common identity and reputation of the franchised network. Article 3(1)(f) refers expressly to clauses whereby the franchisee agrees to achieve a minimum turnover, to keep a sufficiently representative stock and to provide customer and warranty services.

165. Other obligations specific to franchised networks which limit the freedom of the franchisee in order to protect the know-how provided by the franchiser also fall outside the ban in Article 85(1). But the block exemption ceases to apply where the franchiser prohibits the franchisee from challenging the validity of the industrial or intellectual property rights which form part of the franchise (Article 5(f)).

No-competition clauses

Exclusive distribution agreements

166. The block exemption covers agreements whereby the dealer undertakes "not to manufacture or distribute goods which compete with the contract goods" (Article 2(2)(a)). But the obligation may not be entered into for a period longer than the duration of the agreement itself.[58] The Commission must also seek to ensure that in the economic context in which the agreement operates the no-competition clause does not give it a significant exclusionary effect.

Exclusive purchasing agreements

167. Regulation 1984/83 states that apart from the exclusive purchasing obligation "no other restriction of competition shall be imposed on the reseller than the obligation not to manufacture or distribute goods which compete with the contract goods." (Article 2(2)). That restriction will be covered by the block exemption only provided the agreement is for a period of no more than five years (Article 3(d)), "so that access by other undertakings to the different stages of distribution can be ensured" (recital 11). The Commission's practice confirms that a no-competition clause in an exclusive purchasing agreement which is concluded for a long time or for an indefinite period will normally prevent exemption on an individual basis too.[59]

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[57]OJ No L 13, 15.1.1987, p.39. On resale price maintenance and recommended prices see also the decisions in *Yves Rocher* (OJ No L 8, 10.1.1987, p. 49), *Computerland* (OJ No L 222, 10.2.1987, p. 12), and *ServiceMaster* (OJ No L 332, 3.12.1988, p. 38).

[58]*Notice*, paragraph 18.

[59]See the *Schöller* decision, OJ No L 183, 26.7.1993, p. 1.

Beer supply and service-station agreements

A publican can be obliged not to sell beers and other drinks which are supplied by other undertakings and which are of the same type as those supplied under his agreement. If the agreement relates only to specified beers it may not run for more than ten years; if it relates to specified beers and other drinks it may not run for more than five years. A service-station operator can likewise be obliged not to sell fuels supplied by other undertakings. The agreement may not run for more than ten years. If the supplier owns the premises exploited by the reseller, however, a beer supply agreement or a service-station agreement can run for as long as the reseller operates the premises. Under a beer supply agreement with a supplier who owns the premises, the publican must also be entitled to turn to other firms for his supplies of drinks other than the beer supplied under the agreement if they are offered on more favourable terms or if they carry other trade marks.

Selective distribution agreements

168. A selective distribution agreement may not contain a no-competition clause if it is to be compatible with Article 85.

Franchising agreements

169. There are two kinds of no-competition obligation which may be imposed on a franchisee: one is concerned with competing goods, and the other with competing business.

170. As regards competing goods, Regulation 4087/88 distinguishes between the goods covered by the franchise and spare parts or accessories for them. It exempts "an obligation on the franchisee not to manufacture, sell or use in the course of the provision of services, goods competing with the franchiser goods which are the subject-matter of the franchise" (Article 2(e)), but the exemption does not extend to spare parts and accessories manufactured by the franchiser competitors. It also distinguishes between goods covered by the franchise and other goods. For goods outside the scope of the franchise the franchiser may require the franchisee "to sell, or use in the course of the provision of services, exclusively goods matching minimum objective quality specifications laid down by the franchiser" (Article 3(1)(a)), in order to maintain the common identity and reputation of the franchised network. He may restrict the franchisee to goods manufactured by himself, or by third parties he designates, "where it is impracticable, owing to the nature of the goods which are the subject-matter of the franchise, to apply objective quality specifications" (Article 3(1)(b)).

171. As regards competing business, the Regulation provides that an obligation on the franchisee "not to engage, directly or indirectly, in any similar business in a territory where it would compete with a member of the franchised network, including the franchiser" is no obstacle to the block exemption in so far as that obligation is necessary to protect the franchiser industrial or intellectual property rights or the common identity and reputation of the network. The obligation may not run for more than one year after termination of the contract (Article 3(c)).

Restrictions on choice of customers

Exclusive distribution agreements

172. Regulation 1983/83 states that clauses "which limit the exclusive distributor's choice of customers... cannot be exempted under this Regulation" (recital 8). As regards restrictions on territorial grounds, based on the customer's place of residence, we have seen that the block exemption applies only provided the dealer is free to meet unsolicited orders from buyers outside his allocated territory ("passive sales"). As regards restrictions based on other criteria, the Regulation allows clauses which require the dealer to sell only to dealers who are members of a selective distribution network admission to which is based solely on objective criteria of a qualitative nature.[60] Outside this general exemption restrictions on choice of customers can be exempted only on an individual basis and in special circumstances.[61]

Exclusive purchasing agreements

173. What has been said with regard to exclusive distribution agreements applies *mutatis mutandis* to exclusive purchasing agreements too, including beer supply and service-station agreements. But as exclusive purchasing agreements are not in fact normally used in selective distribution networks, the exception we have described for an obligation to sell only to approved retailers is of negligible practical importance here.

Selective distribution agreements

174. As we have seen, the integrity of a system of selective distribution requires that approved dealers agree to sell the contract goods only to final consumers or to other members of the supplier's network. With that proviso, selective distribution agreements are incompatible with Article 85 if they contain clauses restricting the approved dealer's choice of customers on territorial grounds, for example on the basis of the customer's place of residence, or without an objective requirement of a qualitative nature.[62]

Franchising agreements

175. The need for cohesion in a franchised network justifies an obligation on the dealer to sell the goods covered by the franchise only to end users, to other franchisees and to resellers within other channels of distribution supplied by the manufacturer, such as a parallel selective distribution network. The restriction is outside the ban in Article 85(1) provided it does not go beyond what is necessary to protect the licensed know-how or the common identity and

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[60] *Notice*, paragraph 20.

[61] In *SABA I*, for example, the Commission considered that a ban on wholesalers supplying to end users was compatible with Article 85 because it was in line with the requirements of domestic legislation separating the functions of wholesaler and retailer (OJ No L 28, 3.2.1976, p. 19). In *Distillers* the Commission took the view that Article 85 did not stand in the way of an obligation on dealers supplied duty- and tax-free to sell only to buyers operating on a duty- and tax-free basis (*The Distillers Company Ltd/Victuallers*, OJ No L 233, 4.9.1980, p. 43).

[62] See the decisions in *Grohe* (OJ No L 19, 23.1.1985, p. 17) and *Ideal Standard* (OJ No L 20, 24.1.1985, p. 38).

reputation of the franchised network (Regulation 4087/88, Article 3(1)(e)). Any further restriction on the choice of customers is caught by Article 85(1) and is not exempted by the Regulation (recital 13).

IV. Withdrawal of the benefit of a block exemption

176. All three of the block exemption regulations we have been considering specify conditions under which the Commission may withdraw the benefit of the block exemption from agreements which formally comply with the requirements laid down.

177. Regulation 1983/83, on exclusive distribution, provides for withdrawal where "(a) the contract goods are not subject, in the contract territory, to effective competition from identical goods or goods considered by users as equivalent in view of their characteristics, price and intended use; (b) access by other suppliers to the different stages of distribution within the contract territory is made difficult to a significant extent; (c) for reasons other than those referred to in Article 3(c) and (d) it is not possible for intermediaries or users to obtain supplies of the contract goods from dealers outside the contract territory on the terms there customary; (d) the exclusive distributor: 1. without any objectively justified reason refuses to supply in the contract territory categories of purchasers who cannot obtain contract goods elsewhere on suitable terms or applies to them differing prices or conditions of sale; 2. sells the contract goods at excessively high prices" (Article 6). Regulation 1984/83, on exclusive purchasing, contains similar rules. There are provisions identical to those in points (a) and (b) just mentioned, followed by the stipulation that the Commission may withdraw the benefit of the block exemption where "the supplier without any objectively valid reason: 1. refuses to supply categories of resellers who cannot obtain the contract goods elsewhere on suitable terms or applies to them differing prices or conditions of sale; 2. applies less favourable prices or conditions of sale to resellers bound by an exclusive purchasing obligation as compared with other resellers at the same level of distribution" (Article 14). Under Regulation 4087/88, on franchise agreements, withdrawal may be justified where access to the market is restricted "by the cumulative effect of parallel networks of similar agreements" or where the goods or services do not face effective competition in a substantial part of the common market. The Commission may also withdraw the benefit of the block exemption where either party prevents end users from obtaining the goods or services, directly or through intermediaries, because of their place of residence, or takes advantage of differences in the specifications for the goods or services to isolate markets. The same applies, lastly, where franchisees engage in concerted practices relating to sale prices, or where the franchiser misuses his right to inspect the franchisee's premises or means of transport or his right to refuse a request by the franchisee to move the contract premises.

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Chapter V

ADVANTAGES OF THE PRESENT SYSTEM

178. This chapter is devoted to the advantages of the present system. Its disadvantages and criticisms are outlined below in Chapter VII (Results of Fact Finding).

179. Community competition policy has two fundamental goals: the promotion of integration of the economies of the Member States into a single internal market; and the establishment and protection of effective competition throughout the Community. In many cases, these aims are promoted by certain types of agreement between undertakings which improve the efficiency of distribution and do not harm the Community's market integration goal. Where such agreements are covered by Article 85(1)'s prohibition, they may qualify for either an individual exemption or fall within a block exemption under Article 85(3).

I. Questions of substance

180. Protecting competition and promoting agreements beneficial to competition
In order to constitute a violation of Article 85(1), an agreement, decision or concerted practice must have an "appreciable" effect on trade between the Member States. The Court of Justice has held that an assessment of appreciability requires assessment of the economic and legal context of the arrangement and of the cumulative effect of other similar arrangements.

The appreciability requirement is designed to exclude economically insignificant cases from the coverage of Article 85(1). However, the Notice on agreements of minor importance is careful to exclude from its coverage agreements where, "in a relevant market competition is restricted by the cumulative effect of parallel networks of similar agreements established by several manufacturers or dealers."

In assessing possible restrictive practices, the notion that the competitive structure of markets must not suffer should always be the foremost consideration. In its decisions, the Commission has consistently demonstrated a willingness to consider economic factors such as efficiency and consumer welfare. It seeks to protect competition at all levels of the production/distribution chain and both interbrand and intrabrand competition. The Commission makes this analysis under Article 85(3), which provides that an agreement which results in the elimination of competition may not be exempted.

Economic analysis plays an important role in the application of Community competition law to vertical restraints. This has been stressed in several recent decisions of the Community Courts which require consideration of the cumulative effect of parallel networks.[63]
In the *Langnese* case the Court of First Instance found that

> ... it is appropriate, according to the case-law, to consider whether, taken together, all the similar agreements entered into in the relevant market and the other features of the economic and legal context of the agreements at issue show that those agreements cumulatively have the effect of denying access to that market for new domestic and

[63] Delimitis v. Henninger Brau AG, [1991] ECR I-935, and Langnese-Iglo GmbH v. Comm'n, T-7/93 (8.6.1995).

foreign competitors. If, on examination, that is found not to be the case, the individual agreements making up the bundle of agreements as a whole cannot undermine competition within the meaning of Article 85(1) of the Treaty. If, on the other hand, such examination reveals that it is difficult to gain access to the market, it is necessary to assess the extent to which the contested agreements contribute to the cumulative effect produced, on the basis that only agreements which make a significant contribution to any partitioning of the market are prohibited.[64]

181. Market integration

Under the present system, exclusive distribution agreements containing bans on passive sales by the distributor outside its allotted territory are not exemptible. This protects the market integration goal and maintains the freedom of parties to a distribution agreement to respond to third party traders who engage in parallel trade, thereby contributing to the elimination of significant price differences between Member States.

182. Consumer Benefits

Article 85(3) requires that consumers obtain a fair share of the benefits of a restrictive practice if it is to qualify for exemption. The block exemptions take specific notice of the benefits which consumers are likely to realize from the various exempted activities. Exclusive distribution agreements in general allow consumers a fair share of the resulting benefit as they gain directly from the improvement in distribution, and their economic and supply position is improved as they can obtain products manufactured in particular in other countries more quickly and more easily. However, it is clear that in individual cases the benefit to consumers has to be demonstrated in a concrete manner before an exemption can be granted.

Parties who believe they have been injured by an anticompetitive agreement are protected under the current system. The Court of Justice held that "as the prohibitions of Articles 85(1) and 86 tend by their very nature to produce direct effects in relations between individuals, these Articles create direct rights in respect of the individuals concerned which the national courts must safeguard."[65] Since Article 85(1) has direct effect, individuals may bring an action before a national court. They may also raise issues under Article 85(1) in a national court action based chiefly on some other claim, for instance under contract law or franchise law. They may file a complaint with the Commission[66].

183. Other goals (Promotion/protection of SMEs)

The Commission's Notice on agreements of minor importance (C368 23/12/94 p. 20) is designed to provide small and medium sized enterprises with legal certainty without needing to notify agreements. Moreover, many provisions in the block exemptions are designed to benefit SME's. For instance, block exemption 1983/83 provides that it does not apply to exclusive distribution arrangements between competitors, unless "one of them has a total annual turnover of no more than ECU 100 million."

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[64] Case T-7/93 [1995] ECR II-1539.

[65] BRT v. Sabam, [1974] ECR 51, para. 16.

[66] Automec v. Comm'n, 1992 ECR II-2223 however confirmed that the Commission has discretion to reject a complaint on the ground that it lacks significant Community interest, provided adequate redress is available at national level.

184. Freedom to establish type and detail of distribution system

Parties have the choice of seeking an individual exemption or structuring their agreements to meet the requirements of a block exemption. Parties who prefer not to follow the parameters established by the block exemption may draw up agreements as they wish, and may still qualify for an individual exemption.

II. Questions of procedure

185. Regulation 17/62 (Article 4(1)) establishes a system of notification for agreements for which the parties want negative clearance or an exemption under Article 85(3). Regulation 17/62 itself attempted to restrict the number of agreements subject to the notification requirement through Article 4(2), which sets forth limitations on the types of transactions subject to the notification requirement. Nevertheless, after the adoption of Regulation 17/62 the Commission was faced with a "mass" problem of a large number of notifications, many of which concerned vertical restraints (nearly 30,000 notified agreements). The Commission responded to the challenge in two ways. Firstly, for many cases, the Commission has adopted block exemption Regulations which exempt a class of similar agreements whose pro-competitive benefits are considered to outweigh their anti-competitive effects. Secondly it has dealt with the remaining cases by individual decision or comfort letter. This policy has been successfully applied so that the large backlog of notified cases has been substantially reduced.

186. Formal decisions are not an appropriate way to deal with a large number of individual cases. The procedures laid down in Regulation 17 and Commission resources do not permit the Commission to make a large number of decisions[67]. Decisions lay down policy, establish procedure, bring to an end serious violations of the rules (e.g. interference with parallel trade) and punish (fine) their perpetration. Block exemptions[68] and comfort letters are the "instruments" the Commission uses for the bulk of cases.

187. The benefits of a block exemption may be withdrawn by the Commission, thereby providing it with great flexibility. In order to withdraw the benefit of a block exemption, the Commission must follow the full procedure leading to adoption of a decision under Article 85(1). In practice, this is a very rare occurrence.

188. Effectiveness of notification system

The notification system provides the Commission with a steady source of information about transactions, including vertical agreements. A substantial portion of the Commission's decisions are triggered by notifications. This indicates that many contractual provisions deserving careful scrutiny have been brought to the Commission's attention through notifications. They also provide the basic material for the Commission to determine the necessity and scope of block exemptions.

The Commission is aided in its decision-making on individual notifications by a provision which allows interested third parties to submit comments following publication of an obligatory notice in the Official Journal.

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[67] The Commission currently makes on average 20 decisions a year and receives 250 notifications.

[68] Including non-opposition provisions.

The exemption system is flexible since exemption must be limited in time and may be renewed. The renewal process allows the Commission to reconsider the competitive structure of the market at issue. The benefits of an individual exemption may be withdrawn by the Commission if conditions change or new facts are revealed.

189. Speedy and Efficient Enforcement

Despite the fact that formal decisions are feasible only in a limited number of cases the Commission has various tools to ensure that procedures are speedy and efficient

- Regulation 17 (Art. 4(2)) limits the number of cases that need to be notified
- block exemptions cover the bulk of vertical agreements, with, where appropriate, non-opposition procedures
- comfort letters are a crucial instrument which helps the Commission cope with the large number of notifications it receives.

190. Legal certainty

Individual exemption decisions provide complete legal certainty throughout the Community. Block exemptions also provide complete legal certainty for those agreements which squarely fall within their terms. Negative clearances provide legal certainty, but a national authority or national court may reach the conclusion that an agreement which has received a negative clearance nonetheless violates national law, although this is an extremely rare occurrence. This is not possible with respect to an exemption.

The opposition procedure in some block exemptions is a tool which provides the greatest degree of legal certainty for the minimum administrative time and effort.

Comfort letters carry considerable authority although they do not provide complete legal certainty. Companies can reasonably rely upon comfort letters for several reasons. First, they indicate the Commission's prima facie favourable opinion and its lack of interest to pursue the case further, at least in the immediate future. The Commission would not revoke a comfort letter or take a decision at odds with one unless a major change in the facts or circumstances were to occur. These are the same conditions under which the Commission might withdraw the benefit of a formally granted exemption decision.[(69)]

Second, a comfort letter demonstrates an informal commitment by the Commission that if it were to become necessary, a formal decision would be issued.

Third, a comfort letter discourages third parties from challenging an agreement, although in several instances they have done so when in possession of new evidence. For example, the Court of First Instance concluded that since the Commission's provisional analysis of market conditions on which a comfort letter had been based changed sufficiently due to the entry of new competitors, and barriers to market access existed which the Commission had not been aware of at the time it issued the comfort letter, the Commission's reopening of a procedure

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[(69)] Art 8 of Regulation 17/62 enables the Commission to withdraw the benefit of an exemption decision where:
"(a)where there has been a change in any of the facts which were fundamental in the making of the decision,
(b)where the parties commit a breach of any obligation attached to the decision,
(c)where the decision is based on incorrect information or was induced by deceit,
(d)where the parties abuse the exemption from the provisions of Article 85(1) of the Treaty granted to them by the decision."

after it had issued a comfort letter was justified.[70]

Finally, although not bound by a comfort letter, no national court or national authority has ever issued a decision at odds with the position expressed in one. These comfort letters are highly persuasive because they indicate the Commission's assessment of the agreement. Thus, a national court may be confronted with the question of the legality of an agreement for which the Commission had granted a comfort letter stating that the agreement merits exemption. In such a case, the court "may take account of these letters as factual elements."[71]

The legal certainty provided by a comfort letter is even stronger if a notice has been published pursuant to Regulation 17, Article 19(3), which has not elicited adverse comments from third parties.

191. Consistency

The current system promotes consistent and uniform application of Article 85 throughout the Community for vertical restraints. Regulation 17 confers on the Commission the function of central antitrust authority, granting it sole power to declare Article 85(1) inapplicable by granting an exemption pursuant to Article 85(3), subject only to review by the Court of First Instance and the Court of Justice. Once an exemption has been granted, it is binding throughout the Community, and national Courts and competition authorities may not thereafter decide that the agreement violates Community competition law. In this way, decisions which involve complex evaluations of economic matters or balancing competition policy against other policies of the Community and which may have far-reaching consequences throughout the Community are taken by competent Community-level authorities.

192. One Stop Shopping/decentralisation

The current system creates for vertical restraints a "one stop shop" for business with respect to obtaining an exemption under Article 85(3). National authorities and courts can play an appropriate role determining whether the block exemptions apply, dealing both with complaints and with restrictions of competition that cannot be exempted.

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[70] Langnese-Iglo GmbH v. Comm'n, T-7/93 (8.6.1995), paras. 38-40.

[71] Notice on cooperation between national courts and the Commission in applying Articles 85 and 86 of the EEC Treaty, 93/C 39/05, 13.2.1993, para. 25(a).

Chapter VI

COMPARISON OF COMMUNITY LAW WITH MEMBER STATE AND SOME THIRD COUNTRY LAWS APPLICABLE TO VERTICAL RESTRAINTS

193. This chapter compares Community law and policy with Member State and some third country laws, both substantive and procedural, as they apply to vertical restraints[(72)]. It demonstrates that in general, the Member States and third countries surveyed place greater emphasis than the Commission on economic analysis of the market in determining whether a vertical restraint constitutes a violation. Moreover, since none of these jurisdictions is concerned with market integration, they do not provide for protection of parallel imports, as the Community system does.

I.SUBSTANTIVE LAW

Member States With Laws Similar to Article 85

194. The laws of 9 Member States (Belgium, France, Greece, Ireland, Italy, Luxembourg, Portugal, Spain and Sweden) follow the approach of the Community, with national laws which resemble Article 85 with its two-part structure, containing a general prohibition and an exemption provision. They follow the Community's classification scheme for vertical restraints, including both territorial and non-territorial restraints, and they apply similar criteria to analyze whether a violation exists (e.g., market position of parties, foreclosure effect, effects on intrabrand and interbrand competition). In cases which have been decided to date by national courts or authorities under these laws, the influence of Community law is often apparent. Resale Price Maintenance (RPM) is per se prohibited in France and Spain, although recommended prices are allowed. In Italy, RPM is not per se illegal, but is analyzed on a case-by case basis. National block exemptions have been adopted by 3 of the Member States with laws similar to Article 85 (Ireland, Spain and Sweden). In all instances, national block exemptions correspond, to a greater or lesser extent, to Community block exemptions. Only two of these Member States (Spain and Sweden) have adopted a de minimis rule. France and

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(72) The information in this chapter is based on three sources.

The first ("Survey of the Member State National Laws Governing Vertical Distribution Agreements") was prepared by DG IV in 1995, and published in 1996 by the Office of Official Publications of the European Communities. It contains basic information about the national systems concerning vertical distribution agreements.

The second ("Proceedings of the European Competition Forum") concerns the Forum organized by DG IV in the spring of 1995, which was attended by representatives of each of the Member State national authorities, among others. It consisted of three panels: exclusive distribution, selective distribution, and suppliers' economic dependence on large distribution groups. The proceedings, copublished in 1996 by John Wiley and Sons Ltd and the Office for Official Publications of the European Communities. A summary was published in DG IV Newsletter No. 5 Vol. I Summer 1995 by Larraine Laudati.

The third ("Surveys of the Member States' Powers to Investigate and Sanction Violations of National Competition Laws") prepared in 1994, and published in 1996 by the Office of Official Publications of the European Communities, was used with respect to certain procedural issues pertaining to notifications. Whilst every case has been taken to check the accuracy of the information given in this chapter relating to Member States and third countries it represents the opinion of the Commission and does not necessarily reflect the views of Member States or third countries.

Italy have indicated that they do not have such a rule because they prefer to carry out a full analysis of the market and the market position of the parties.

195. Several Member States which have laws similar to Article 85 indicated that their application of national law governing restrictive agreements differs from the Commission's application of Article 85. For instance, the Italian authority carries out a rule of reason analysis both to determine whether a restriction exists and whether an exemption should be granted, relying heavily on economic analysis, especially the economic impact of the agreement in the relevant market. Market access, market position of the parties, duration of the agreement, and cumulative effect of the network of distribution systems are considered. The Italian authority stated in its comments:

> [W]hat is to be considered a restriction of competition under Article 85 of the Treaty as well as under the corresponding national provisions is in no way a self-evident issue.
>
> Under a traditional, legalistic approach one may consider Article 85 to prohibit *some clauses* in vertical agreements. Nevertheless, an increasingly shared view is that Article 85(1) should be interpreted as prohibiting vertical agreements only in so far as they have an economic impact restricting competition on the market. Notably, in many judgments the European Court of Justice has held that the restrictive nature of a vertical agreement within the meaning of Article 85(1) can be considered only by reference to its economic and legal context. On an economic appraisal, there is ample support for the view that an examination of the potentially restrictive nature (in terms of competition) of a vertical agreement should not be confined to its formal aspects.

196. In France, the lawfulness of distribution agreements is assessed with reference to the clauses in the contracts and the way in which they are applied in the economic context in which the distribution system operates. This method is utilized irrespective of whether the exclusivity clauses are in an isolated contract or a network of contracts.

The French authority believes that its interpretation differs from the Commission's, because under French practice exclusivity in sales or purchasing does not in itself restrict competition. Thus, it takes a favourable view of distribution systems, believing that they contribute to economic efficiency and generally comply with Article 85(1) or the national law equivalent, except where they are accompanied by clauses which may be injurious to competition. The authority decides whether a restriction exists on the basis of an economic analysis, taking account of the increased competition that, more often than not, is generated by this type of system. Foreclosure and the cumulative effect of a network of agreements constitute principal criteria for assessing whether a restriction of competition is present. The French authority views the presence of a degree of permanent competition as a justification for not finding a restriction, which it contrasts with the Commission's approach, which considers it as a condition for granting an exemption.

197. If, after this initial assessment, the French competition authority concludes that an appreciable restriction of competition is present, it considers whether an exemption is justified. Its analysis is more strict than the Commission's at this point. The authority explained:

> [R]ecent exchanges among Member State authorities, notably that held in Brussels last spring, [at the European Competition Forum] showed that several countries [with laws similar to Article 85] consider that vertical agreements may have, in certain cases, a favourable effect on competition.
>
> It is only when vertical agreements have a potentially anticompetitive object or effect that they are prohibited under the 1986 competition law, unless they result in a sufficient economic benefit. The provision on abuse of dominant position is based on the same conditions.

Member States With Laws Not Similar to Article 85

198. The laws applicable to restrictions of competition in the remaining 6 Member States (Austria, Denmark, Finland, Germany, the Netherlands and the UK) do not resemble Community law. A violation is generally based on the finding of some type of abuse:

- in Austria;
- in Denmark, where a "dominant influence" may be exerted;
- in Finland, the agreement affects price formation, decreases efficiency, prevents or complicates the practising of trade by another party, or is incompatible with a binding international agreement in a manner incompatible with sound and effective competition;
- in Germany, the restraints have an adverse effect on competition (for exclusive distribution agreements, exclusive purchasing agreements, and selective distribution systems), or the restraints exceed the scope of licensed rights (for license agreements);
- in the Netherlands, the restraints are contrary to the general interest;
- in the UK, contrary to the public interest.

199. The classification scheme for violations varies considerably among these countries, but all of them have per se rules against RPM. Austria is the only country in this group which has adopted block exemptions, which are similar to Community block exemptions.

200. Five of these countries (all but Finland) are currently considering reforms of national competition law which may bring them more into line with Community law.

201. The German authority takes the view that a restrictive organization of distribution does not as a rule endanger workable competition, but can do so when combined with a degree of market power. Thus, under German law, exclusive distribution agreements and exclusive purchasing agreements are permissible in principle but subject to supervision by the competition authorities in order to prevent abuse.

202. In the UK, exclusive distribution and exclusive purchasing agreements are not covered by the law dealing with agreements, but rather by the law which allows the authorities to investigate on a case-by-case basis if a market share threshold of 25% is reached either by one firm or a group of firms through a network of vertical arrangements. A rule of reason analysis is followed, which involves a balancing of the effect that vertical restraints have on competitive rivalry at both manufacturing and retailing level against the benefits arising from efficiency gains. In making this analysis, two main structural conditions are considered relevant:

- market imperfections upstream or downstream, giving rise to significant individual or collective market power in the short to medium term;
- widespread use of vertical restraints in a given product market, affecting a significant proportion of total market sales, with no history of significant entry.

Efficiency gains are considered by UK authorities as least likely to be strong when the product is simple or non-technical, inexpensive, subject to repeat purchases, sold in convenience outlets, and when consumer information is widely available, strong branding is present, the product is mature, entry barriers in retailing are high, and economies of scale in retailing are substantial. RPM is illegal, but allowed if the Restrictive Practices Court rules that failure to apply minimum RPM would cause a net detriment to the public. Several in-depth studies have been carried out recently which involve issues of vertical restraints in the beer, petrol, carbonated drinks, cars and ice cream sectors.

<u>Third Countries</u> (USA and Canada)

- United States

203. The goal of US antitrust law is to promote consumer welfare; it has no goal to promote market integration. Vertical restraints are mainly governed by Section 1 of the Sherman Act,[(73)] which provides that every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is illegal.

204. In 1977, the Supreme Court ruled in *GTE Sylvania*[(74)] that non-price vertical restraints are to be subjected to analysis under the rule of reason, recognizing that such restraints may "promote inter-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products". In the absence of market power by the manufacturer, distribution arrangements which contain non-price vertical restraints are generally considered to be legal because they promote efficient delivery and a stable supply of goods and services for the consumer, and to increase interbrand competition by enhancing the ability of manufacturers within an industry to compete for customers. Moreover, the anticompetitive risks of such restraints is generally believed to be low, as the manufacturer's interest is in developing effective distribution in order to maximize sales to consumers, and thus it has every incentive to encourage intrabrand competition among distributors in order to keep prices low.

205. Rule of reason analysis involves identification of the relevant market, establishing the defendant's market power as well as a multitude of other factors used to analyze whether the restraint adversely affects competition in the inter-brand market, and the justifications establishing a legitimate objective and the necessity of the restraint to achieve that objective. The defendant has the burden of establishing justifications to rebut the plaintiff's claim, but the ultimate burden rests with the plaintiff to convince the court that the restraint, on balance, has an anticompetitive effect. Whether there are less restrictive alternatives to the restraint in question in order to achieve the legitimate objective must also be considered.

[(73)] In certain circumstances, Section 2 of the Sherman Act and Section 3 of the Clayton Act may be applicable to vertical restraints.

[(74)] Continental T v. GTE Sylvania, 433 U.S. 36 (1977).

206. US courts tend to be more cautious about the anticompetitive effects of interbrand restraints, and may demand a thorough market analysis including inquiry into "both the extent of the foreclosure and the buyer's and seller's business justifications."[(75)] The degree to which competing manufacturers are deprived of outlets for their products, or distributors are prohibited from using alternative suppliers, is a threshold factor in analysis of such restraints.

207. There is no de minimis rule in the US. RPM is per se illegal under US law. Retail price suggestions, however, do not fall within the per se prohibition.

- Canada

208. Exclusive dealing and tying arrangements which are likely to have exclusionary effects on the market because they are engaged in by a major supplier of a product or widespread in a market, with the result that competition is likely to be lessened substantially, may be prohibited by the Competition Tribunal. A "market restriction" is defined as a requirement imposed by the supplier on the customer, requiring that a customer supply any product only in a defined market. If such a restriction is likely substantially to lessen competition in relation to the product, such as when it is engaged in by a major supplier of a product or because it is widespread in relation to the product, it may be prohibited by the Tribunal. Finally, a supplier may be ordered by the Tribunal to sell to a given customer who may be substantially affected in his business due to his inability to obtain adequate supplies, provided he is willing and able to meet usual trade terms. Restrictions on interbrand competition are viewed more strictly than restrictions on intrabrand competition. No de minimis rule applies, but authorities place low priority on cases of low economic impact.

II. NOTIFICATION SYSTEM

Member States With Laws Similar to Article 85

209. A notification requirement for restrictive agreements which is similar to that of the Community's - that is, requiring notification only when an exemption and/or negative clearance is sought - exists in 6 of the Member States with laws similar to Article 85 (Belgium, Greece, Ireland, Portugal, Spain and Sweden). However, of these, only Belgium and Sweden have the same rules regarding immunity from fines after notification. No immunity from fines is available in Greece or Portugal; Irish law does not provide for imposition of fines.

210. France and Italy do not require notification of restrictive agreements. In Italy, a voluntary notification system exists. In France, no notification system exists for restrictive agreements; enforcement authorities rely on other means to learn of violations:

> French law is based on a postulate opposite to that which holds that agreements or commercial cooperation in vertical relations are prohibited a priori. This is why we do not have an obligatory notification system. Such a system does not seem to us necessary since we consider vertical agreements to be a priori lawful.

[(75)] Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 236-37 (1st Cir. 1983).

Member States With Laws Not Similar to Article 85

211. A notification system similar to the Community's exists in Finland, but no immunity from fines is provided for.

In Germany, vertical restraints are generally subject to abuse control, and need not be notified; notification is required only of those restrictions which limit freedom to set prices or terms of business, which are generally prohibited but may qualify for exemption.

Notification of restrictive agreements is required in Austria, Denmark, the Netherlands and the UK, without regard to whether an exemption or negative clearance is either available or sought. Notifications are required to provide authorities with the information needed to determine whether an abuse exists.

In Luxembourg, no notification system exists for restrictive agreements.

Third Countries

212. Neither the United States nor Canada has a notification system with respect to restrictive agreements.

III. NUMBER OF CASES BROUGHT

213. Member States in both groups have, in general, brought a moderate number of cases annually for violations of vertical restraints laws. Data, however, are not available in several Member States or may not be comparable due to differences in the national systems or record keeping practices. A rough indication of the range of activity is from 0 cases brought in some Member States (Belgium and Austria) to approximately 25 a year in Germany.

214. In the US, vertical restraints were virtually ignored by federal enforcers during the 1980's. However, state enforcers brought some actions for RPM violations. In more recent years, RPM cases have been prosecuted by both federal and state enforcers, sometimes jointly. However, few actions are brought with respect to other types of vertical restraints. In recent years, some have been brought in the health care sector, a political priority, which involve primarily local markets and when significant market power is more likely to be found.

215. Enforcement appears to be light with respect to vertical restraints in Canada.

IV. CONCLUSIONS

216. There is considerable diversity in the arrangements for handling vertical agreements employed in the Member States and third countries discussed here. However, certain major aspects in which these systems are consistent, and consistent in differing from the Community system, can be identified. First, they hold that economic analysis should be employed in the first instance to determine whether a violation is present. This is true of at least some of the Member States with systems based on the Community system (most notably France and Italy), some of the Member States with systems which differ from the Community system (most notably Germany and the UK) and third countries (both the US and Canada).

217. Second, neither several Member States, nor the US and Canada, employ a notification system with respect to restrictive agreements. This is because they believe enforcement resources can be put to better use in other ways, such as investigating complaints which involve vertical restraints. The absence of a notification system is also consistent with the premise that vertical agreements are a priori lawful.

218. Third, only a small number of cases involving vertical restraints are brought in these systems, which is again consistent with the notion that these restraints are a priori lawful.

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Chapter VII

RESULTS OF FACT FINDING

I. Purpose and methodology

219. As part of the preparation of the Green Paper, it was decided to carry out a fact-finding exercise in the form of interviews. Several dozen manufacturers, retailers (also wholesale, import-export) and associations, both at European and national level, were contacted. In addition, a number of interviews were held with research institutions or individuals with specific knowledge about marketing or distribution techniques in the various industry sectors. The majority of the interviews concerned the area of consumer goods, both food and non-food. This list of interviews was not fully representative: for logistical reasons the Benelux, plus the neighbouring areas of Northern France, Western Germany and the South of the United Kingdom were over represented.

220. The overwhelming majority responded favourably to our invitations. Meetings were held between June and August 1994. Discussions scheduled with some of the industry associations turned out to be full-fledged round-table discussions, involving a large number of managers and other business representatives from a whole range of industry sectors. Although the Commission tried to achieve a maximum balance between the various groups and parties in order to get the broadest range of existing views, it is obvious that the results of these interviews cannot be held to be representative for any statistical purpose. The Commission would appreciate comments on the results of these interviews, particularly if it is felt that the geographic or sector sample is not representative.

221. Many points raised by the interlocutors were industry- or sector-specific. Others, such as the issue of the power relation between manufacturers and retailers, or the problem of parallel trade, were discussed at virtually every meeting. All meetings were held informally, and off the record. Therefore, most interlocutors were prepared to use clear language, to reveal sensitive facts and to support their views with anecdotal evidence based on their experience, or even involving confidential information. The following pages contain a summary of the basic findings without mention, however, of any company specific data.

II.Changes in society and customer demand

222. Customer dynamics have changed remarkably, with greater polarization in terms of income and a population which is growing older. Market saturation has triggered new and more complex demand structures of the individual customers. Demographic changes affect patterns in shopping which have essentially led to a concentration in terms of ownership and outlets. For fast moving customer goods (fmcg) customers shop less frequently, and like to make all their purchases at one go rather than in several different outlets. The increasing differentiation in customer demand is said to be one of the major reasons of success for the new specialised discounters. As an example, furniture makers are expanding into decoration and other accessory items. The print sector was quoted as a prototype sector where proliferation and specialization of the products offered to the customers could be observed.

III. Technological changes

223. Information Technology (IT) and in particular electronic point-of-sale scanning, more and more used for stock control, have boosted the just-in-time systems and changed the balance of information. These new technologies, together with retail loyalty cards, allow retailers nowadays to define the old marketing strategies without having to rely on manufacturers' information. Management of information will allow to control just-in-time deliveries even when a large product range is involved (hypermarkets), to lower stocking costs and to improve productivity through automatic re-ordering of goods. Possible cost reductions through the introduction of IT technology are generally said to be of limited scope. However, since margins in distribution are very low, any reduction in cost may have significant effect on profitability.

224. Mail order and distance selling companies are increasingly using audio- and video-text, CDI, CD-Rom as well as interactive television for the distribution of their products. Teleshopping is said to have the potential to become an extremely important tool in the distribution of retail goods. Some interlocutors were quite optimistic about present trial projects concerning distribution via interactive television without being able, however, to determine the main beneficiary of IT technology among the big retailers, manufacturers, or even television channels and media undertakings. Some voiced concerns that IT tools might become monopolised by either manufacturers or retailers. Developments in interactive television were said to be no major danger to the well established business of mail-order companies, since the former was essentially targeting upmarket segments, while the latter was said to be a relatively downmarket-oriented business.

225. Another recent trend concerns the development of in-house transport and logistic infrastructures. Use of own transport facilities allowed large distributors to rationalize their deliveries and intra-networks supplies, while reducing costs. These new developments have also triggered important changes in the way products are being marketed. For instance, products are often packaged only at the last minute so that specific marketing promotions can be incorporated into the labels.

IV. Structure of distribution

226. Many interlocutors described the distribution of the 60's and 70's as being fragmented and unorganised, totally dependent on industry and often confronted with compulsory sale prices and/or boycotts. Progressively, the distribution function has emancipated itself from the manufacturing industry, and is now constituting an industry in its own rights. Distributors gather and own information on how and where which products are sold, and have the capability of advising suppliers on consumer demand.

227. In the past, distribution, and in particular food distribution, has followed a volume-oriented strategy. The introduction of IT and just-in-time distribution will gradually bring about the emergence of new logistical functions, such as order-grouping. A number of small companies are already specializing on home deliveries, especially in the area of beverages and frozen foods.

228. There has been a fragmentation of retail format and a proliferation of the variety of store types. In addition to traditional grocery retail, normally supermarkets, new discount stores, club stores and cash and carry stores are emerging. The main groups to be

distinguished are the 'classic', small retail, the urban warehouses, the discounters, the special multiples and new forms of distribution, such as direct marketing companies (mail-order, telemarketing fulfilment houses, printers and publishers, teleshopping and small specialized agencies). For example, telemarketing companies are already well established in the field of computers, books, and records. Banking is an area of growth. The success of direct marketing techniques seems to depend on the product. For instance, while 75 % of car-insurance sold in the Netherlands are sold through the phone, pension schemes still require face to face interviews.

229. Fulfilment houses process and carry out actual fulfilment of an order on behalf of the manufacturer. They do not purchase the goods, do not handle stocks and do not fix the price for the end-consumer. Mail order companies usually carry out the fulfilment of orders in-house. Specialised agencies offer the service to smaller companies. This new industry offers the possibility of test sales of new products in a much cheaper way than having to distribute the products to retail outlets. This is important since roughly two thirds of all new product introductions failed.

230. In some sectors, the classic separation between producer, agent, wholesaler and retailer no longer exists. Large retailers nowadays source directly from producers. To take beverages as an example, in some Member States more than 60 % of wines are purchased in supermarkets.

231. Some industry sectors, such as pharmaceuticals, have not yet witnessed any sizable vertical integration. In other sectors, such as beverages, producers have pursued a policy of vertical integration and have taken over exclusive national importers.

232. It was generally acknowledged that information technology has resulted in goods being pulled down the supply chain by retailers rather than pushed down the supply chain by manufacturers. It was also recognised that there is now a concentration at either end of the supply chain and that many intermediaries/wholesalers have disappeared, a factor which may increase barriers to producer entry. There was no mainstream opinion on the question on whether the disappearance of wholesalers had resulted in the decline of exclusivity. Some interlocutors pointed out that concentration in the retailing sector had forced the producers to look for new outlets, e.g. sales through service station shops.

V. Relations between manufacturers and retailers

233. Although the balance of power has clearly shifted towards retailers in the course of the last years, the question of whether it is the manufacturer or the retailer who can determine the terms and conditions of their mutual relation seems to depend very much on the position of a specific brand in a given market segment. Manufacturers are more and more dependent on distributors and grocery retail for getting their products to the consumers. Since the shelve space for new products is limited, conflicts arise between the increasing number of new product launches and the retailers' objective for profit optimization. This conflict has resulted in retailers asking for listing fees (key money) or for discounts schemes which sometimes go beyond possible cost savings of the manufacturers. Given the pressure on shelve space, products which are not in a number one or two position increasingly run the risk of being delisted and replaced by large retailers' own brands. As a consequence, in many market segments, the position of the number one and two suppliers, has in many instances been copperfastened. Market access for other suppliers is becoming increasingly difficult.

234. Some interlocutors were of the opinion that basically three types of companies have a chance to survive in the long run : large manufacturers with a broad area of products who invest in R&D and new launches of product leaders, 'own label producers' (i.e. manufacturers who produce products for sale by retailers under their respective brand names), and niche operators. On the other hand, second tier manufacturers (i.e. those with brands in third and fourth position) are increasingly 'sandwiched' between brand leaders and downmarket own brands of big retailers and often have no choice other than to become a subcontractor and to produce under a retailer's brand.

235. In the view of some independent research analysts, there are limits to the retailers' capability to develop their own brands. While manufacturers are able to concentrate research and development as well as marketing costs on product development and differentiation in their particular area of market presence, retailers need to assure a broad range of products available via their network. For those reasons, they can achieve only limited sales per product. As a consequence, most retailers are unlikely to have the necessary scale to invest in brands since research and development costs are too onerous and marketing costs with respect to each product need to be amortized over a wide geographic distribution network.

VI. Single market, parallel trade

236. Many interviewees stated that the legal framework set by the Community has not worked sufficiently well as a vehicle capable of leading to market integration in the form of price adjustments. The obstacles to parallel trading are still numerous and complex. Some interlocutors felt that competition policy made companies pay the price of European market integration. It was argued that companies should be allowed to charge what markets would bear. Some also felt that the distinction between active and passive sales was outdated, especially since the arrival of IT on the market place.

There are still very significant price differences within the European Union, and sometimes even for the same products manufactured by the same company. Transport costs, regulatory constraints and the relations between producers and distributors in the various Member States account for these differences. Distributors are very powerful in certain areas (France, Germany) and more fragmented in others (Greece, Southern Italy). Price differences are important in the non-food sector, but even more significant for food products. It became quite obvious, during the interviews, that many retailers do not take advantage of opportunities to exploit price differences between Member States, for fear of spoiling long-term relations with manufacturers or,possibly, being faced with retaliatory actions, such as boycotts or price discrimination. Cross-border purchasing groups do not yet seem to have had a significant impact.

Logistic and other 'natural' constraints

237. For some markets, transportation costs are simply too high to trigger a substantial amount of parallel trade and so prevent goods from being shipped cross-border. In addition, there are huge discrepancies as to national preferences and local tastes of the consumers which are unlikely to fade quickly. Because consumers have different attitudes and demand different qualities, there are also huge product differentiations and different distribution techniques to be observed.

Some of the price differences can be explained by the fact that manufacturers are operating on the basis of separate manufacturing facilities with their own specific costs structures. To the extent that manufacturers are moving towards sourcing on a European level, the cost structure of the respective industrial subsidiaries are moving closer. This, in turn, will contribute to the reduction in price differences. For some products where trade between Member States is easy, price convergence has occurred due to competitive pressures.

While many manufacturer markets can be said to have a unified European supply and demand structure, consumer good markets at retail level are very much segmented along national boundaries. Hugh differences can be observed in customer behaviour.

Regulatory constraints

238. Different national requirements still isolate markets and prevent parallel trade. For example, labelling requirements - often arising primarily from environmental considerations - are still very different. In addition, packaging and coding requirements are different. Reference was also made to the growing importance of national codes of practice on matters such as advertising and marketing.

Trademarks are sometimes used to partition a market nationally. On the other hand, it is said to be difficult to get the same trademark registration throughout Europe because of the existence of different prior rights on the different national registers and also because of differences in culture. Nonetheless, trademarks are of great value in dealing with counterfeiting and in preventing unfair competition.

239. Even for direct marketing and mail-order companies, barriers to trade are still important. Postal monopolies create problems of reliability in many countries. In addition, copyright issues, unclear fiscal regulations, exchange rates and charges associated with transfer of money are additional impediments. Advertising across frontiers is complicated, and consumer products need to be adapted to important local preferences. Demand is strongly national oriented. One product may be sold in one country for different reasons than in another.

In some industries, for instance pharmaceuticals, it is apparently difficult to get the same trademark recognised in different Member States. This in spite of the fact that many companies pursue the policy of worldwide trademarks.

Private constraints

240. Many manufacturers are not convinced that efficiency gains from a single product formulation and presentation for all Member States would outweigh losses arising from a reduction in the ability to price differentiate between national markets as a result of parallel trade. Therefore, many manufacturers are said to impede parallel trade wherever possible, according to many retailers. The quantities available through parallel exports have always been too small to become a reliable source of supply.

241. In many interviews, representatives from the distribution sector accused manufacturers of seeking to split market within the Community. Such strategies were said to be mainly pursued through an abusing exploitation of intellectual property rights and the operation of selective distribution systems. For example, in the consumer electronics sector, it was argued

that manufacturers/exclusive distributors do not apply the principle of the "European guarantee". Parallel sourcing of consumer electronics is relatively easy if the goods are designed to be sold under the distributor's brandname, whereas supplies are refused if the retailer - without being member of the selective distribution system - wishes to sell them under the manufacturer's brandname. It was further argued that, within the consumer electronics market, the customer advice/aftersale service inherent to the selective distribution system can only be justified in respect of the more sophisticated, top-of-the-range products.

In many instances cross-border purchase requests are referred back to the respective national subsidiary of the manufacturer. The vast majority of our interlocutors from the retail side indicated that they would not be interested in parallel trade, for fear of spoiling their long term relations with their manufacturers. Undertaking parallel trade without the knowledge of the manufacturer was increasingly difficult, if not impossible. Computer-controlled distribution networks with on-line connection to manufacturers made track-and-tracing easier, and distribution more transparent.

242. Some large retailers are sourcing worldwide and are able to surmount attempts to partition the market, without risking rebate losses or the uncertainty as to the continuity of supplies. Some interlocutors implicitly questioned the distinction between active and passive sales. Since most consumers did not yet have the confidence to shop crossborder because of the lack of after-sale service and the difficulties with pursuing legal actions against foreign retailers, the permissibility of passive sales was said to be mere window-dressing in the face of territorial exclusivity. In some sectors sellers seem to actively discourage crossborder sales solicited from individual customers.

Identification numbers can also be used by manufacturers to trace sources of parallel trade. Instances were reported in which suppliers had been forced to compensate exclusive national distributors who had been harmed by parallel trade.

243. In some cases, large multinational food groups maintain compartmentalized national markets. A manufacturer might have different pricing for its products in different countries, depending on, for instance, whether its brand is a leader or a second brand in that country. These price differences are maintained by forcing retailers to purchase from the local subsidiary of the manufacturer at local conditions. This seems to be a matter of concern for many distributors.

VII. Market expansion and globalization

244. Expansion into new territories seems to depend very much on the differential advantage that can be exploited by a distributor. There have been examples of failed attempts to enter the North American market for instance, whereas the same companies could successfully establish themselves in other parts of Europe, Latin America or South East Asia.

245. It was pointed out that, at present, large retailers found it extremely difficult to penetrate new markets by opening up new points of sale under their own trade-names. There seems to be, in each national market, a rather strong consumer loyalty to national distribution chains. Furthermore, national legislation regulating commerce can in some instances represent an obstacle for new entrants.

246. Acquisition of local retailers seems to be the main route for expanding distribution

networks beyond national boundaries. Concentration at the distribution level has forced many small specialised retailers out of the market. This trend has become particularly noticeable during the 80's. However, there is still room for new entrants, in particular in the area of distance selling (mail-order, video-sales). Furthermore, large and small scale distribution can coexist in certain specific markets (such as jewelry).

247. To the extent that distributors second-source products, it was observed that sourcing outside the Community is fast developing as supplies, namely for the Far East, become more reliable in terms of quality and of continuity. However, import-quotas into the Community especially in the area of textiles, still impede the full exploitation of such sources.

VIII. Legal issues

Overall regulatory framework

248. It was common ground among all interlocutors that governmental intervention, including control by competition authorities, should be kept at a strict minimum. Some interlocutors were afraid of a possible proliferation of competences which would trigger parallel control mechanisms by the various national competition authorities, in addition to the Commission control. On the other hand, some interlocutors wanted to see a more rigorous enforcement of the law, and, in particular, more cases in which the Commission would withdraw the benefit of a block exemption under certain circumstances.

According to some interlocutors the block exemptions constitute an appropriate response to the legal uncertainty caused by the lack of general rules as to the application of the principles of Article 85. Some voiced fears that the abandoning of the block exemption system might trigger a new area of uncertainty.

249. A number of interlocutors criticized the Commission emphasis on clause analysis. They argued that the effects on the market should be more on the forefront of competition analysis. It was suggested that all vertical agreements including all clauses should be considered valid. Only if important anticompetitive effects would be felt after some time the Commission should intervene. It was argued that only a minority of distribution systems were anticompetitive and that the vast majority was legitimate, since distribution agreements normally help to regulate relationship and would not normally lead to competition concerns. The United States Guidelines approach was felt useful although some interlocutors mentioned the lack of legal certainty.

250. Many of the interlocutors criticised the current block exemption regulations for a lack of flexibility. Notifications were said to be extremely burdensome for companies and to tie up a lot of internal resources. Especially small and medium sized enterprises without in-house legal departments had sometimes problems to interpret the block exemption regulations. It was requested that the Commission should draft new regulations in a more comprehensible manner, or publish a list of uniform interpretations incorporating the jurisprudence of the European Court of Justice.

251. Block exemptions are generally believed to have a straightjacket effect. In some industry sectors, the Commission is perceived as regarding block exemptions as constituting guidelines for clearance under Article 85(3), rather than looking at applications for individual clearance strictly on their merits. However, while the concerns with regard to the conformity

with the block exemptions seems to be rather limited, there is a more general concern with regard to the cost and time involved in applications for clearance and the impossibility of obtaining quick clearance where an agreement does not entirely fall within a block exemption. Comfort letters are perceived as being no satisfactory basis for the industry. If block exemptions had to exist, for reasons of administrative efficiency and legal certainty, they should have a more limited scope and contain clear criteria requiring evidence of consumer benefit.

252. Virtually all interlocutors with a legal background spoke out in favour of the principle of severability for clauses falling outside the scope of a block exemption. It was felt unacceptable that the existence of a provision not covered by the block exemption may result in the entire agreement loosing the benefit of the block exemption. It was suggested that new block exemptions should cover intermediate products, and that regulations 1983/83 and 1983/84 should be amended to cover distribution of products by competitors since, in many cases, the national subsidiaries of competing manufacturers are said to be the only viable way of getting access to a market. The introduction of market share thresholds could be useful in this context.

Buying groups / Retail associations

253. The single most prominent issue mentioned as a concern voiced by small and medium sized retailers was the question of how to enable a survival in the long term. Their main message was to request a level playing field with respect to their main competitors, the big integrated retail chains. In particular, the ability to take advantage of certain franchise concepts with the association acting as franchiser towards its members, was perceived to be essential. They called on the Commission as a competition authority to safeguard a plurality of distribution forms. A legal framework which would allow associations of independent retailers would be the only way to add some muscle to small and medium enterprises.

254. Is was recognised that many of the obligations contained in such cooperatives (purchase obligations for individual members, etc.) may be caught by Article 85(1). They argued, however, for an economics-based overall assessment, which would definitely be in favour of these forms of cooperation. A 85(3) type mechanism, ideally set down in a block exemption, would pave the way to legal certainty for such associations.

255. A competition policy in favour of such retail associations was said to be of great potential significance for the survival of small retailers in Southern Europe (Italy, Portugal, Greece) where the concentration process of the retail industry is less advanced. The present set-up of rules was said to contain important inconsistencies. Whereas certain obligations are perfectly acceptable in vertical relationship, similar clauses imposed by cooperatives on their members are prohibited due to their horizontal nature. Although the restrictions of competition are vertical in one case, and horizontal in the other, both forms of cooperation would seem to serve the same purpose.

256. The inability to have a uniform pricing strategy is perceived as the single most important disadvantage of retail associations compared to their main competitors, integrated retailers. While big retailers are able to publish leaflets and other marketing material with fixed prices, retail associations can only operate with non-binding price recommendations. However, the situation appears to be very different in each Member State. Some of our interlocutors, in particular in the food sector, held that the price component was much more

important for their business than other non-price aspects of their strategic planning. For example, it was felt essential to be able to enforce a chosen price on the market.

257. Another problem is the inability of retail associations to guarantee sales in their negotiations with manufacturers which put them at a competitive disadvantage vis-à-vis their integrated competitors. However, the need for a level playing field in this respect, i.e. the right for associations to impose fixed quantities of goods on their members, was less clear. Some interlocutors even signalled that many members would oppose such contractual systems.

Price restraints

258. Although resale price maintenance (RPM) is formally prohibited, many interlocutors were of the view that non-binding price recommendations would continue to serve the appropriate purpose. It was argued that in new innovative high-tech products, RPM should be allowed until the product was established and well known. A five years time-limit or the reach of a certain market share could serve as a useful threshold. Otherwise, dealers would not invest in pre-sale services and the launch of products would be slower.

259. Several interlocutors mentioned the example of the United States where not only RPM but also discriminatory pricing - for all companies, not only the dominant ones - was per se illegal. Some went so far as to argue for the need of a legal provision similar to the Robinson-Patman Act of the United States pursuant to which prices offered by manufacturers must be available to all customers. Others equalled the European attitude towards absolute territorial protection to the negative stance of the United States authorities to discriminatory pricing. Interlocutors advocated the publications of price-lists by manufacturers and retailers, with discounts directly related to efficiency and in-store marketing.

Exclusive distribution / Exclusive purchasing

260. Relatively few comments were made on the Commission's policy as to the exclusive dealing (Regulation 1983/83 and 1983/84), apart from the more general remarks described above. Some interlocutors voiced concerns that the current block exemptions regime was based on a system of wholesale distribution which no longer existed. Exclusivity was said to be no longer an issue which would deserve the same amount of concern on the part of the Commission. Others suggested a regular update of the accompanying communications.

Selective distribution

261. Selective distribution is generally said to be only of significance in a limited number of products. Cosmetics, clothes, liquor and champagne, but also pharmaceutical products are most commonly quoted. In many instances, manufactures have extended the criteria of their selective distribution network to include also flagship department stores ("Weltstadtwarenhaus"), but not other stores where the sales personnel was said to be equally qualified.

262. The range of views expressed on this issue was, however, extremely broad and varied. Interlocutors from the relevant industry sectors were generally satisfied with the criteria established by case-law (perfume cases). These criteria would help to guarantee product image, as well as after-sales and other technical service. Some interlocutors requested that these criteria should be incorporated in a special block exemption on selective distribution.

263. On the other hand, representatives from discounters and mail-order houses argued against the free-rider argument which, according to them, was frequently being invoked to justify selective distribution with respect to products which require little or no contact between purchaser and agent after that sale has taken place (e.g. bicycles). Also, the level of technical expertise required to install and operate many of the products sold through selective distribution networks has decreased. Therefore, selected distributors often are required to provide little or no service in respect of sales. Finally, discounters and mail-order houses generally claimed to be able to provide a level of service which is similar with the one offered by selective distribution networks.

264. Large distributors excluded from the selective distributor system seek in certain cases to obtain supplies from the main branch, and engage in legal battles in certain instances. The possibility to obtain legally these products in the parallel market and distribute them has often been enforced by national Courts. However, in some instances, once a retailer had obtained access through a Court decision to a product previously reserved for another distribution channel, producers had stopped manufacturing that particular product and replaced it through a similar product to which the Court decision was not applicable. Selective distribution is not seen as a problem when the market is truly competitive. However as long as objective criteria are followed to select distributors, without discrimination among different categories of distributors, most interlocutors do not seem to see major concerns at present. However it was fact that these conditions were not always fulfilled.

265. Some interlocutors however criticized selective distribution systems as a means of maintaining artificially high prices. According to interlocutors from consumer associations, the manufacturers' argument to guarantee more choice and better service for customers was in many cases a false pretence to control the flow of goods and shut out new entrants. The net result would be less consumer choice. Particular problems were identified with regard to perfumes, cars, electrical goods and microwave ovens.

Franchising

266. Ten years ago most franchise networks were "pure", in that the network was composed entirely of franchisees. Emerging "mixed systems" include both integrated subsidiaries and franchisees in the same systems. Often, pure integrated systems become mixed on expansion outside the home base, with the risks associated of entering new markets. These mixed systems were also said to be very efficient since they allowed expansion in more flexible formats, especially into other Member States. However, in certain mixed systems, for example supermarkets, the ability to compete inter-brand depended crucially on centralised IT. It appeared that whenever centralised computer systems (ordering/stocking/deliveries given by real-time bar code information) were used, the franchisees were no longer free to buy where they wanted or to charge whatever price they wanted. In some cases, franchisees were said to have been transformed into an agent-like status, with goods remaining the property of the franchiser.

267. More generally, franchising appears to be a very dynamic sector with new innovative forms constantly coming on the market. Interlocutors insisted that this innovation should not be stifled by an over-regulatory approach. The present block exemption does not appear to have hindered this process too much. But it was said to have occasionally created legal uncertainty.

IX **Beer and Petrol**

268. There was general satisfaction both from producers and distributors with the operation of the block exemptions for beer and petrol. They stressed the efficiencies from vertical restraints in these sectors. For beer it was also stressed that agreements with local brewers was often the most efficient way to break into the market of another Member State and distribute and compete efficiently. All sides stressed the absolute need for legal certainty and continuity with minimum changes, in view of the very many contracts found in the industry (in the hundreds of thousands). However several more detailed aspects of the Regulation called for comment, which on certain aspects showed a divergence between producers and distributors.

269. These comments included

- Article 85(1) was drawn too widely.

- Regulations and Guidelines should be simpler and more flexible with less regulatory/strait-jacket effect.

- Longer period agreements should be allowed.

- Retailers called for greater protection from producers and from the arbitrary ending of leases and contracts. Criticisms concerning the imposition of over ambitious sales targets by producers were made.

- In one Member State all producers had been told by the Commission services that they were not covered by the Regulation on grounds of what they claimed was a technicality. They had however received a comfort letter which they interpreted as meaning these agreements merited an Article 85(3) exemption. Unfortunately this comfort letter had proved unenforceable in courts and led to legal insecurity.

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CHAPTER VIII

OPTIONS

I. INTRODUCTION TO THE OPTIONS

270. This chapter sets out a number of options drawing on the analysis contained in the Green Paper.

271. The Commission's overriding concern is to promote and preserve integrated and competitive markets in the European Community and to implement an efficient and effective competition policy in order to serve the consumer interest and foster the competitiveness of industry, with special regard for SMEs.

272. Those wishing to submit observations should not consider themselves limited by the options set out below in section II. The options may be combined in different ways and other ideas may be submitted.

273. It should be borne in mind throughout that Article 86 remains applicable and that the Commission does not contemplate any solutions which go beyond the bounds of Article 85 as interpreted by the Community Courts. Treaty amendment is not an option.

274. Section III sets out a number of matters on which the Commission *would particularly welcome comments*.

II. DESCRIPTION OF OPTIONS

Common observations and questions

275. The following observations and questions are relevant to all or several of the options.

276. The policy of treating resale price maintenance and impediments to parallel trade as serious violations of the competition rules would continue. It is proposed that they be treated as *per se* contrary to Article 85(1), as long as the agreement, concerted practice or decision concerned may affect trade between Member States. They are also unlikely to benefit from an exemption under Article 85(3).

277. The different options relate only to vertical distribution agreements and do not cover horizontal agreements between competitors. Nevertheless, the current block exemptions allow an exception for non-reciprocal agreements between competitors where one party has a turnover not exceeding 100 MECU. It is proposed to maintain this exception. *Comments would be welcome* on the appropriateness of this figure.

278. The question arises whether a non-opposition procedure similar to that contained in the franchising Regulation (4087/88) should be included in other Regulations. *Comments would be welcome* on how this issue and on how the procedure might be improved. The Commission does not have the resources to investigate a large number of cases under a non-opposition procedure. The Commission is aware that notifications, even under non-opposition

procedures, may be costly for companies. Consequently non-opposition procedures are not an appropriate solution for a large number of notifications.

279. Although the main focus of the Green Paper is on vertical restraints for distribution, it has been suggested that attention should also be paid to other vertical relationships in the supply chain (e.g. relating to intermediate goods not for resale). These non-distribution vertical relationships often raise different issues from those relating to distribution. *Comments would be welcome* on competition policy aspects of vertical arrangements not related to distribution, particularly:

- whether they are already effectively dealt with by the Notice on subcontracting[(76)]
- whether such agreements, in so far as they fall within the scope of Article 85(1), are infrequent enough to enable the Commission to deal with them on an individual basis, and

- whether and, if so, to what extent the different options set out below can be usefully applied to such agreements.

280. The Commission is preparing a revision of its Notice on Agreements of Minor Importance to which Article 85(1) does not usually apply. This is commonly known as the *de minimis* notice. As a working hypothesis, Article 85(1) may be taken not to apply to vertical restraints between parties whose share of the relevant market is less than 10 % except as regards resale price maintenance and absolute territorial protection, in respect of which no market share threshold may be envisaged.

OPTION I - **Maintain current system**

281. Option I consists of maintaining the current system (including the special arrangements for beer and petrol).

OPTION II - **Wider block exemptions**

282. It is sometimes suggested that current block exemptions are too limited. Option II would maintain the current system, with some changes in the provisions of the block exemption Regulations. There would be no significant procedural changes. The block exemptions would apply more widely than hitherto by an extension of their coverage to different clauses set out below thus broadening legal certainty. Fewer individual cases would require notification. Some of these changes may be made by the Commission acting under the powers already granted to it under Council Regulation 19/65. Others would require amendment of that Council Regulation. Some suggested changes are listed below and comments on their appropriateness and on other possible changes are welcome.

283. Measures to increase flexibility in general could include one or more of the following :

- the block exemptions would cover not only the precise clauses listed, but also clauses which are similar or less restrictive;
- the inclusion of prohibited clauses might not deny the benefit of the exemption for the rest of the agreement;

[(76)] Notice concerning the Commission's assessment of certain subcontracting agreements in relation to Article 85(1). (OJ C 1, 3.1.1979)

- the block exemption could apply to agreements involving more than two parties;
- a block exemption or a Commission notice for selective distribution could be enacted.

284. Specific measures to increase flexibility could include one or more of the following :
- the block exemptions for exclusive distribution and exclusive purchasing could be extended to cover services or to permit the distributor to transform or process the contract goods. Distributors could be allowed to add significant value by changing the economic identity of the goods without losing the benefit of the block exemption;
- the block exemption for exclusive purchasing agreements could be extended to cover partial as well as exclusive supply;
- the block exemption for franchising agreement could be extended to cover maximum resale price maintenance as an exception to the general principle that resale price maintenance will not be exempted;
- associations of independent retailers could be permitted to benefit from block exemption regulations, provided that the independent retailers are small and medium-sized enterprises[77] and that the market share of the association remains below a certain threshold;
- an arbitration procedure could be set up for distributors denied admission to a selective distribution network.

285. Under this option the special provisions in Regulation N° 1984/83 for beer and petrol would remain in force with certain changes to increase the flexibility of the application of the Regulation. One possibility could be to limit the requirement to specify the 'tied' beers to the type of beer concerned, instead of identifying the individual brands as required under the current Regulation. This gives the brewer the possibility of adding or replacing brands of a type of beer for which the tenant is already tied, instead of requiring an additional agreement with the tenant for such changes, as required by the Regulation. As regards petrol one could consider how to deal with forms of distribution other than exclusive purchase in relation to goods sold in convenience stores that form part of the service station business. Additionally,one could consider whether it is justified to maintain the requirement that the supplier should make available or finance lubrication equipment in order to benefit from an exemption for exclusivity of supply of lubricants.

OPTION III - <u>More focused block exemptions</u>

286. This option stresses Community competition policy's market integration objectives. Territorial protection and vertical restraints are seen as a significant contributory factor to the maintenance of considerable price differentials between Member States. It is certainly the case that many markets are becoming more concentrated at the production and distribution level, while vertical restraints can foreclose markets and raise barriers to entry. The value added by distribution is an important element in its own right. Intrabrand competition can play an important role in promoting competition in markets where interbrand competition is not fierce.

287. The current block exemptions apply without any market share limits. They could be amended so as to apply only where each party has less than, for instance, 40% market

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[77]In the sense of the Commission recommendation of 3 April 1996 concerning the definition of small and medium-sized enterprises, O.J. n° L107 of 30.4.1996

share of the relevant market in the contract territory. There would be no block exemption above that threshold, at least in respect of the following restrictions:

- protection against active sales from outside the territory

- protection for exclusive dealing (prohibition to sell competing products/services).

288. Within the framework of the present option, comments are also welcome about the appropriateness to adopt a block exemption regulation in respect of selective distribution agreements, to the extent that these agreements fall within Article 85(1). In case such a regulation would be adopted, it would apply only where the producer or distributor does not hold more than for instance, 40 % share of the relevant market or a lower figure in an oligopolistic market.

289. The suggestions made in Option II could be applied to agreements below the market share threshold.

290. Parties may have doubts about the correct definition of a market and calculation of their share thereof, which could lead them to notify agreements to the Commission in a search for legal certainty. There would also be notifications of agreements where the parties have market shares in excess of the threshold.

291. The Commission would appreciate estimates of the number and type of cases likely to be notified, and views on whether guidelines explaining the circumstances in which the Commission would grant exemptions under Article 85(3) could solve this problem. Possible grounds for exemption could include the condition that there be no significant price discrimination to the detriment of customers.

292. In line with the general rule above, no protection would be given to exclusive beer-supply agreements in favour of a brewer with a share above eg 40% on a given national on-trade market. However, a sector specific alternative could be to limit the extent of the exclusivity either to a given percentage of the total beer throughput of a particular pub (eg. 3/4 tied, 1/4 free) or to certain containers (eg. draught tied, bottles and cans free). A further alternative could be to limit the scope of the exclusivity to beer only. In the context of filling stations, it should be considered whether, in cases where the supplier has a market share in excess of a certain percentage, eg 40%, the maximum contract term permitted by the exemption should be reduced.

OPTION IV - <u>Block exemptions with measure to specify the economic circumstances in which Article 85(1) applies</u>

293. The idea underlying this option is that economic analysis of vertical restraints should be implemented by legal instruments which give undertakings a considerable degree of legal certainty. The economic criteria designed to determine the market conditions in which Article 85(1) would apply could be developed, in the first place, within the framework of a new Commission notice and subsequently, in the light of the experience acquired, within the framework of a negative clearance regulation.

294. This option would provide for more flexible treatment of vertical arrangements for agreements between parties with no significant market power. The alleged limiting effect of block exemptions and emphasis on the legal classification of different forms of distribution would be reduced.

295. For parties with less than, for instance, 20 % market share in the contract territory, there would be a rebuttable presumption of compatibility with Article 85(1) *("the negative clearance presumption")*. In other words, vertical restraints in such circumstances would not normally be caught by Article 85(1). This presumption would cover all vertical restraints except those relating to minimum resale prices, impediments to parallel trade or passive sales, or those contained in distribution agreements between competitors.

296. This negative clearance presumption could be rebutted by the Commission on the basis of a market analysis which would take account of factors such as:
- market structure (e.g. oligopoly)
- barriers to entry
- the degree of integration of the single market, evaluated on the basis of indicators such as the price differential existing between Member States and the level of market penetration in each Member State of products imported from other Member States, or
- the cumulative impact of parallel networks.

297. Agreements which, as a result of this market analysis, were shown to fall within Article 85(1) could benefit from a block exemption if they fulfilled the necessary conditions (see below variants I and II). The negative clearance presumption could be implemented by a Commission Notice and subsequently in the light of the experience acquired, within the framework of a negative clearance regulation which would require a new Council enabling Regulation under Article 87 of the Treaty.

298. For cases with market share above for instance 20 %, and for those below 20 % which fall with Article 85(1), there could be two possibilities, as follows:

Variant I

299. All cases over 20 % could be covered by the block exemption described in Option II. (wider block exemption)

Variant II

300. All cases over 20% would be covered by the block exemption described in Option III (ie inapplicability of block exemption to certain restrictions above 40% market share).

Beer and petrol

301. The presumption of non-applicability of Article 85(1) as described above would apply to the exclusive beer-and petrol -supply agreements only insofar as the cumulative impact of parallel networks has no significant foreclosure effect.

III. SUGGESTIONS FOR TOPICS TO COVER IN COMMENTS

302. Whilst those wishing to submit comments are free to raise any issues in relation to vertical restraints and are not necessarily bound by the options listed above, it would nevertheless be *helpful* for the Commission if comments could be made in relation to both questions of substance and questions of procedure and legal instruments. The following may be useful as a guide to structure comments in these two areas :

303. **Questions of substance**

Efficiency - The efficiency of policy in distinguishing competitive from anti-competitive restraints should be considered, along with the associated "cost" of such a policy, eg cost may be high if a strict policy identified effectively all anti-competitive restraints but only at the price of being unduly severe.

Market integration - Policy should promote market integration.

Innovation and entrepreneurial freedom - Policy should be sufficiently flexible to accommodate the introduction by producers and distributors of new or appropriate forms of distribution (sometimes driven by need to introduce new technologies). It should not impose any unjustified regulatory cost for distribution.

Consumers and SMEs - Policy should allow consumers to gain a fair share of the benefit and be compatible with other policy goals, in particular the promotion of SMEs, who should be encouraged to develop their activities when faced with some more powerful participants in the production-distribution process.

Market power - Policy may need to make a distinction between firms depending on their market power. Market power is used in this context to mean a degree of influence over price and output where this influence is below that enjoyed by a dominant firm (Article 86) but enough to bring agreements between such firms within the scope of Article 85(1) because of their appreciable impact on competition. One of the proxies for market power that avoids individual analysis (impractical in a large number of cases) is a threshold expressed in terms of market share. Comments would be welcome on the effect of introducing market share thresholds either as

- a condition for an exemption in a block exemption (ie above a certain market share block exemption does not apply)
- a condition for non-opposition procedure in a block exemption (ie above a certain market share, parties must apply for exemption by non-opposition procedure),
- a guideline in a block exemption indicating a level below which the Commission is unlikely to withdraw the benefit of the block exemption, or
- an indication of the level below which vertical agreements are generally presumed to be compatible with Article 85(1) and beyond which they are subject to the provisions of a block exemption.

The comments on use of market share thresholds should particularly address the procedural issues listed below especially their impact on legal certainty and ability to deal with a mass problem of a large number of cases. Where specific market share figures are given in an option comments should also be made on the appropriateness or otherwise of the figure.

304. **Questions of procedure and legal instruments**

Legal certainty - Policy should provide legal certainty.

Mass problem - Policy should lead to speedy and efficient enforcement without giving rise to a huge number of individual notifications, the so-called mass problem.

Subsidiarity - Policy should strike a balance between one-stop-shopping and/or decentralisation to national authorities and courts.

Procedures - The Commission would welcome comments on whether a policy can be implemented under current procedures or whether changes would be needed, in particular to :
- comfort letters
- non-opposition procedures, or
- withdrawal of exemption granted under block exemptions[78]

The Commission welcomes comments on the extent to which an option necessitates changes to current rules and Regulations, in particular whether an option can be implemented by relatively easily accomplished changes to current practice eg de minimis notice, or changes to administrative practice explained in a regularly updated Commission Administrative Guidance Notice outlining policy, in particular the economic circumstances in which Article 85(1) applies, and still provide adequate legal certainty. On the other hand, certain options necessitate changes to the three relevant block exemption Regulations (1983/83, 1984/83 and 4087/88).

305. The Commission realises that no policy towards vertical restraints can achieve simultaneously to the desired extent all the substantive objectives and be consistent with all the procedural considerations. Policy must therefore achieve the best possible overall balance taking account of the objectives of competition policy within its overall context in the Treaty.

[78] NB. Withdrawal of exemption under current block exemptions must follow procedures laid down in Regulation 17/62, which is not feasible to carry out in a large number of cases.

306. **Please send comments by 31.07.1997**

By mail to :

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