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An economics approach to the new rules for vertical restraints

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by

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Abstract

In this paper we focus on vertical agreements from an economics viewpoint. First, we provide a general overview of the main economic forces behind vertical relations and in particular vertical agreements. Then, we present the

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main economic aspects of the June 2010 revision of the vertical agreements Block Exempt Regulation and the accompanying Guidelines. Finally, we present a critical evaluation of the revision. A key observation is that vertical agreements represent incomplete forms of vertical integration and, in general, should be treated as such and not within a formalistic framework. While the BER revision has been overall in the right direction, we argue that it may not have gone far enough towards a simplification of the applicable framework. A useful viewpoint is that vertical agreements are incomplete forms of vertical integration, and in general they should be treated as such, in an effects-based approach, rather than in a formalistic manner. In particular, since it is extremely unlikely that any vertical agreements that only involve firms with small enough market shares will have an anticompetitive effect, we suggest an extension of the *de minimis* rule for all vertical agreements.

I. Introduction

Vertical relations refer to all types of relations among firms that act relative to one another as buyers and sellers of goods or services. These may be relations between wholesalers and retailers, or relations that involve the sale of inputs or intermediate products or services that are, in turn, transformed into final goods. Such vertical relations can be classified into two main categories, the first being vertical integration, or in other words vertical mergers (including vertical acquisitions), and the second being vertical agreements (or "restraints") between otherwise independent firms. In this article we examine vertical agreements, not vertical mergers.

Although our focus is on agreements between independent firms, one of our main arguments in this article is that thinking of vertical agreements within the more general context of vertical relations is a very fruitful way to position the issue, since most - if not all - types of vertical agreements are *incomplete* forms of vertical integration. We argue, therefore, that the treatment of vertical agreements in the law should recognize this fact, rather than following a more formalistic approach that would tend to view such agreements as dangerous unless proven otherwise. Emphasis is also given to the fact that such vertical agreements often tend to lead to significant efficiency gains, as they occur between trade partners (and not between competitors, like horizontal agreements). We also argue that an economics approach should be followed in the analysis of vertical agreements, emphasizing that any such agreement (or the absence thereof) modifies the "rules of the game". In other words, such agreements are expected to change how firms compete with one another, their equilibrium profit levels and the implications for the final consumer and for social welfare in the market.

Our particular focus is on agreements that fall within Article 101 of the Treaty on the Functioning of the European Union (TFEU), that is, agreements where the 'upstream' and the 'downstream' firms involved do not need to have a dominant position in their markets. We discuss the revision of the relevant Block Exemption Regulation (BER), applicable to vertical agreements, which was adopted by the European Commission on June 1, 2010, and the new Guidelines that accompany the revised BER. We do not present the details of the revision since there are now some high quality presentations of the main changes, including several articles in the present volume.[1]

Our attention is mainly given to a discussion of these changes from the viewpoint of economics analysis. We also place the recent revision within the context of the overall framework for vertical agreements, as it has been developed in the last years. We argue that the revision has moved in the right direction, providing some clearly needed simplifications of the framework and various clarifications that will improve the applicability of the law in the future and help avoid possible complications. However, we also argue that the revision could have been more drastic, and should have recognized that it is extremely unlikely that any type of vertical agreements among small enough firms will be harmful for competition. Taking also into consideration that vertical agreements may often also have significant *pro-competitive* effects, when all the firms involved have a small enough market share one could essentially favor a *de minimis* approach that would include any vertical agreement. Perhaps, such an approach can be adopted in a possible future revision of the BER.

[1] For a detailed exposition of the logic and various changes see e.g. Magdalena Brenning-Louko, Andrei Gurin, Luc Peeperkorn, & KatjaViertio, *Vertical Agreements: New Competition Rules for the Next Decade*, Competition Policy Newsletter, DG Competition 2010-2.

The article is structured as follows. Section II offers an introduction to the basic economic analysis behind vertical relations, explaining some positive and negative implications for competition policy. Section III focuses on the related legislation and the new Block Exemption Regulation (BER) applicable to vertical agreements in the EC and the revised accompanying Guidelines. In Section IV, we discuss in some more detail the new BER, examining both its positive aspects and areas where additional improvement relative to the old Regulation could have been possible and where perhaps further improvement may be possible in the future. Section V concludes.

II. An introduction to the economics of vertical relations

It is useful to start by reviewing briefly some of the basic economic arguments in the area of vertical agreements and in that of vertical relations more generally.[2] Along a "vertical chain" we view the vertically linked firms as the producer and the retailer, or the buyer and the seller, or more abstractly as the 'upstream' and the 'downstream' firm. Vertical chains differ in many ways: whether there are two or more stages before reaching the final consumer, whether firms are vertically separated (independent) or vertically integrated (one firm that operates both upstream and downstream, with the goal of maximizing its joint profit), and whether trade is exclusive (with an exclusive supplier or exclusive buyer or both) or more than one firms are actively trading at each stage.

Trade between vertically linked firms may take a simple form, where a single price per unit of quantity sold is arranged, that is, we have 'linear pricing' or the relationship may be a more complex one, in which case the need arises in competition policy to study more carefully these 'vertical agreements'. These include 'nonlinear' pricing schemes, such as two-part tariffs, quantity discounts, royalty payments and

[2] See, for excellent reviews, M. Motta, Competition Policy, ch. 6: Vertical Restraints and Vertical Mergers, (2004), pp. 302-410; Patrick Rey & Jean Tirole, *A Primer On Foreclosure*, in Handbook of Industrial Organization, Vol. III (Marc Armstrong And Robert Porter Eds., 2008); Patrick Rey & Thibaud Vergé, *The Economics Of Vertical Restraint, In* Handbook of Antitrust Economics 353-390, (Paolo Buccirossi, Ed., 2008); Francine Lafontaine & Margaret Slade, *Exclusive Contracts And Vertical Restraints: Empirical Evidence And Public Policy* In Handbook of Antitrust Economics 391-414, (Paolo Buccirossi, Ed., 2008).

rebates and also other forms of 'vertical restraints', such as Resale Price Maintenance (RPM), dictating the price at which the buyer will sell the good further down the vertical chain and various types of exclusivity.

Under vertical separation and linear pricing, that is when we have a constant price for each additional unit sold, vertical separation leads to higher final product prices than those we would have under vertical integration (VI). This is a key result in the economics literature, known formally since Spengler (1950). [3] To see this point let us consider a simple vertical market structure with one upstream firm (U) and one downstream firm (D). Firm U's product is sold to firm D, which in turn (re)sells to the final consumers (possibly after some further processing). Let us assume that the U firm sets the price when it sells its product to firm D and that the D firm sets its price when it sells to the final consumers.

This fundamental *double marginalization* argument relies on the assumption that each firm is independent from the other, in the sense that it seeks to maximize its own profit and not that of the entire chain. The key result that one obtains when working out the equilibrium pricing decision by all parties in this model, a central result in the vertical relations literature, is that this process of double marginalization leads to prices for the final consumers that are ever *higher* than the prices that would emerge under a vertically integrated monopoly. In this sense, two monopolies, one at each stage, produce a worse outcome than a single, vertically integrated, monopoly. Given that the monopoly profit is by definition the maximum profit attainable in any market arrangement, it also follows that with independent sellers at each stage of the vertical chain, in other words under vertical separation, the aggregate profits (the sum of profits of firm D and firm U) will be strictly *below* the profit in the vertically integrated case. Thus, in this case, vertical separation with linear pricing hurts both the consumers and the firms, while vertical integration will *benefit* all parties involved in this market. The main logic behind this result is that independent firms fail to internalize the vertical externality that exists in their pricing - in particular, the U firm does not internalize the impact that an increase in its own price will have on the final price for the consumers.

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[3] J. Spengler, 1950, "Vertical Integration and Anti-trust Policy", 58, 347-352 *Journal of Political Economy*.

As should be apparent from the above discussion, one possible solution to this "double marginalization problem" would be vertical integration.[4] This would improve the situation, moving the market back to a simple, single stage monopoly that covers both stages of the market. Importantly, however, the double marginalization problem can also be eliminated (or in any event, greatly diminished) if alternative, "nonlinear", pricing schemes are used instead of linear pricing, like two-part tariff arrangements. Under such arrangements, if for example the per-unit price is set at the competitive level (cost) and the fixed fee is set a little lower than the total monopoly profit, the exact monopoly solution can be recovered, without having formally a vertical integration arrangement. Another way to solve the double marginalization problem in this case would be some vertical restriction, in particular RPM that would fix the final market price at the monopoly level.

Also note that the double marginalization situation changes if we allow the D firm to have all the price setting power, or bargaining power, against both the final consumers and the U firm. In such a setting, only one profit margin can be applied and there is no additional distortion (relative to the standard monopoly one). Finally, when the D firm is able to participate in setting the price at which it transacts with the U firm, the formal or informal bargaining procedure that is expected to take place between the U and the D firm would restrict the market power of the U firm and would lead to the internalization, at least partially, of the final market price considerations. As a result, the final price will be *lower* in the equilibrium of the game when the bargaining power in balanced between the U and the D firm, or when the D firm is more powerful rather than the U firm.

In most real world markets, of course, one encounters much richer vertical structures than the simple vertical one-supplier- one-distributor chain. As a result, in addition to the basic vertical double marginalization effect discussed above, we may also have horizontal externalities, arising in the competition among several wholesalers, or several retailers within a single vertical chain, a phenomenon that we could call 'intra-brand' competition. This emerges when one, or more suppliers trade with more than

[4] Of course, vertical integration may have various other positive or negative effects. See e.g. Jean Tirole, ch. 4 in *The Theory of Industrial Organization*, MIT Press. 1988.

one distributor. In such cases, it is not only the vertical strategic interaction between suppliers and distributors that matters, but also all the horizontal relations.[5]

In cases where only intra-brand competition downstream is important, nonlinear pricing schemes or other vertical restraints could be effective in 'softening' the competition in the final market and maximizing the suppliers' (upstream) profits. In the case of a two-part tariff, the wholesale price level may control the horizontal externality and soften competition between the distributors, while profit may be shorted upstream in the form of a fixed fee. RPM, or other resale restrictions set by the supplier, such as restrictions on the retailers' discretion to set a price, or restrictions imposing that each retailer only deals with a part of the final demand, in a territorial or other sense, could also lead to higher downstream prices and higher profit for the entire chain.

The analysis becomes even more complicated, and the final market outcome harder to predict, when there is both 'intra-brand' and 'inter-brand' competition. In such cases, when there are two or more suppliers trading with two or more distributors, some of the trading agreements can be exclusive, either in one or in both directions of trade, and others not. In such setups, controlling the horizontal externality among its own distributors may not be as important a consideration for a supplier, as competition with the rival supplier. Figure 1 presents a typical such scenario, where we assume that there are two large upstream and two large downstream firms. In the particular situation presented, U_2 sells exclusively to D_1, D_2 buys exclusively from U_1, however U_1 sells to both retailers and D_1 buys from both suppliers.

[5] See e.g. Saggi and Vettas (2002) "On Intrabrand and Interbrand Competition: The Strategic Role of Fees and Royalties" 189-200, *European Economic Review.*

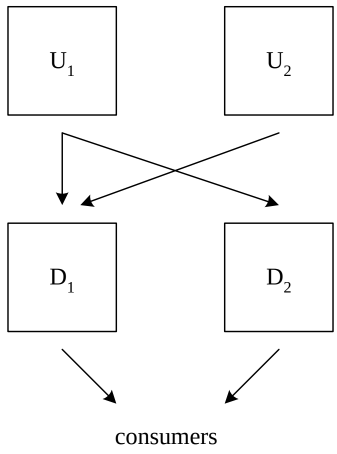

Figure 1.

It is also important to note that final consumers do not only care about the prices at which they buy the products, but also about the ease of access, quality and variety of these products. These other aspects typically depend on actions taken by all parties involved along the vertical chain. Ensuring a particular level of quality or variety typically requires the effective collaboration of all these parties, upstream and downstream. If such collaboration cannot be ensured, product quality will be below the optimal level, not only from the viewpoint of the final consumers but also from that of the vertical chain. Related effects may be particularly important for products, the sale of which depends on a *high quality reputation*. When a manufacturer seeks to establish a strong ‘brand name’, but can only reach the final consumer via a set of retailers, then it is reasonable that both price and non-price aspects of the entire distribution system may have to be appropriately controlled. ‘Spillovers’ or informational externalities play a crucial role here. As the cost associated with assuring high quality is not fully ‘internalized’ by each independent distributor, the market will tend to provide in general sub-optimal quality. Strict rules for controlling the behavior of retailers that collaborate with the seller may have to be set for each product sold, and resale may have to be controlled through a *selective* or otherwise restrictive distribution system.

A closely related issue is that of specific investments by suppliers or by distributors. The effective supply of a product or service to the final consumer often requires investments that are *specific* to the particular transacting pair of supplier and distributor, offering again a rationale for vertical integration or vertical restrictions to neutralize the threat of ‘opportunistic’ behavior or ‘hold-up’ by either party. The key point about specific investments is that their market value tends to be significantly lower than their value for the given pair of trading buyer and seller. Since vertical integration may be an extreme and costly solution, especially due to high administrative or other managerial costs, other appropriate measures will have to be taken to solve the problem, specified in vertical agreements. A comparison between the pros and cons of vertical integration would effectively determine the vertical boundaries of the firm. [6]

Resale price maintenance (RPM) is a common vertical restraint which has received much attention in competition policy. The economics literature has concluded that there are both anti-competitive and pro-competitive effects from the use of RPM. We provide such an analysis in the EAGCP 2010 report *Hardcore restrictions under the Block Exemption Regulation on vertical agreements: An economic view*, by Massimo Motta, Patrick Rey, Frank Verboven and Nikolaos Vettas, *Economic Advisory Group in Competition Policy,* submitted to the EC, DG-Competition. On the one hand a possible anti-competitive effect could be related to the solution of the ‘commitment problem’ of a monopolist, which would impede even a monopolistic supplier from enjoying full monopoly profits, because this supplier would have the temptation to reduce the wholesale price set to one distributor to allow that distributor to expand its market share, even when this hurts rival distributors of the same product. A market-wide RPM if it is credible to all parties could solve this problem because it could prevent this opportunistic behaviour on the part of the supplier. RPM may also possibly soften competition when two or more suppliers sell their products to two or more distributors (‘interlocking relationships’). RPM might also facilitate collusion, either among suppliers or among distributors. In particular, collusion among suppliers may be easier to achieve because RPM can help offer a superior monitoring of deviations from the collusive agreement. On the other hand there may be also significant pro-competitive effects, since RPM may help protect necessary specific investments by preventing opportunistic or free-riding behaviour among distributors. It may also help with signaling the quality of products, or help establish a price reputation and the overall brand image for the supplier’s product.

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[6] Interest in this issue has been great in economics since the classic paper of Ronald R. Coase (1937) “The Theory of the Firm”, 386-405 *Economica*.

Resale restrictions may be used to limit, geographically or otherwise, the markets in which a certain distributor can operate. These are often essential for a supplier to implement a *price discrimination strategy* across markets or groups of consumers, so that the supplier can charge different prices at markets where there are different elasticities of demand (in other words, markets across which consumers' willingness to pay differs significantly). This is because, more generally, in order to price discriminate across consumers, firms need to prevent *arbitrage,* in other words to prevent buying in parts of the market where prices are low and reselling where the prices are high. Thus, to study the effects of territorial or other resale restrictions, one has to study the implied price discrimination. The literature has shown that price discrimination has *ambiguous* effects on welfare, and that the final net effect depends on various parameters, such as the relative importance of the different types of consumers and the product characteristics. Also, allowing rival oligopolistic firms to price discriminate typically leads to more intense competition among them. As a result, territorial or other resale restrictions have mixed welfare results, from an economics point of view.

In general, we should emphasize that vertical relations in markets refer to completely different economic phenomena than horizontal relations, that is, relations between firms operating in the same market. Along a vertical chain all trading firms have to cooperate with each other, in order for the goods or services to reach the final consumer. In other words, horizontal relations are between firms that sell substitute products, whereas vertical relations are between firms that sell complementary products. Horizontal agreements take place among competitors; thus, it is reasonable to start the analysis from the *presumption* that competition will be likely harmed, and often significantly so, at least on impact. Vertical agreements, in contrast, do not take place among competitors in the same market and, therefore, there cannot be a presumption that competition will be harmed, except under specific sets of circumstances. One such condition for vertical agreements to be harmful is that at least some of the firms involved already possess some significant market power. The adverse effects for competition emerge indirectly, either through foreclosure of rivals, or because the change in the form or terms of the vertical relation adversely affects the horizontal behavior of firms in a market.

III. The treatment of vertical agreements in EC competition policy

The early treatment of vertical restrictions in the law, starting in the U.S. and then in Europe, was focused on *form* and assumed the rather simplistic view that restraints of all types reduce independence in the market, foreclosing seller access to customers or seller access to key inputs. This formalistic approach, dominating the debate at least until the late 1960s, could be simply described as taking the view that as long as a restriction was imposed on market transactions, it reduced the freedom of the market participants. Such a restriction on competition, according to the same logic, could not be desirable. The conclusion of this logic was that these restraints should not be allowed. Very little attention was given to the fact that these vertical agreements are, by their nature, agreements among firms collaborating in the markets and acting in a complementary manner, and not among competitors. For example, the imposition of minimum price RPM by an upstream firm was viewed as almost the same as horizontal price fixing, a view that had not been formally overturned in the U.S. case law until recently.

Since the 1960s the 'Chicago School' approach significantly changed the overall competition policy debate, again starting from the US. As a result the formalistic approach started to become weaker, albeit only gradually. By applying neoclassical economic theory, the 'Chicago School' approach has brought some economic 'discipline' to the overall competition policy analysis. This was particularly true for the treatment of vertical agreements. Competition takes place within markets and not across markets, and as a result it is only horizontal agreements and not vertical ones that can reduce it. The implication for vertical restraints like RPM is that the focus of competition policy should be on protecting and promoting inter-brand competition rather than being preoccupied with intra-brand competition. In addition, when vertical restrictions reduce the choices of a wholesaler or retailer, the benefits from achieved efficiencies must exceed the costs from reduced competition, for that firm to be willing to accept these restrictions in the first place.

The more modern approach to competition policy has been developed in parallel to the emergence of game theory as the language for industrial organization analysis in the 1980s. Contrary to the Chicago view, it has been shown that vertical integration or contractual restrictions could indeed have anticompetitive outcomes, by ‘changing the game’, in other words by changing the strategies available to the firms and in particular their commitment power. Foreclosure, that is when access to some buyers or suppliers becomes impossible as a result of a merger, an agreement or other action that changes the game, became a central issue in the discussion about vertical relations. Thus, starting from an early stage when vertical restraints were viewed as harmful (the formalistic approach), and then another stage when they were viewed as not harmful (the Chicago school approach), the current status of the academic and policy debate generally recognizes that vertical restraints may be harmful, but only under a particular set of circumstances that should be explicitly described. It is also important to note that whereas a particular vertical agreement may influence adversely a competitor, the impact on competition and on the final consumers may be positive.

An extreme way in which two vertically linked firms can agree to ‘cooperate’ is a merger between them. The matter of vertical mergers, like other mergers (or acquisitions; more generally ‘concentrations’) is dealt with by the EC Merger Regulation (Regulation 139/2004). It is important to note that the formal ‘Non-Horizontal Merger’ Guidelines were only issued in November 2007, following a substantial debate as to whether it was really advisable or even possible to issue such guidelines, due to the complexity and variety of non-horizontal mergers. These Guidelines clearly state that horizontal and vertical mergers are to be approached very differently.

Vertical agreements represent a looser form of vertical cooperation relative to a merger (note that every type of behaviour that is supported by an agreement could also be replicated within a merger). Since such agreements represent a less drastic change in the market structure, they cannot be equally harmful as a corresponding merger. Vertical agreements may involve firms that have a dominant position in the market, upstream or downstream. Then, Article 102 of the Treaty on the Functioning of the European Union (TFEU), ex Article 82 EC Treaty, becomes applicable. Vertical agreements, however, may be subject to legal restrictions, even when they do not involve a firm with dominant position in its markets. Then Article 101 TFEU, ex Article 81 Treaty EC, becomes applicable.

The ‘Modernization of Article 81’, has responded to a number of growing concerns, which could be summarized as the view that the Commission should move away from treating vertical restrictions as restrictions to economic freedom, and towards focusing on the efficiency effects of the practices under consideration. The publication of the Commission Regulation No 2790/1999, on the application of Article 81(3) of the Treaty to certain categories of vertical agreements and concerted practices (Official Journal L 336, 29.12.1999, p. 21-25), was an important development in the area of vertical relations. This ‘Block Exemption Regulation’ (BER) was intended to provide a ‘safe harbour’ to firms with less than a 30% market share and was accompanied by the relevant Guidelines on Vertical Restraints (Official Journal C 291, 13.10.2000, p. 1-44). The BER has been viewed as the first of a new generation of block exemption regulations and guidelines, inspired by an effects-based approach, and it has been followed by similar reforms in other areas of competition policy. The core of this approach is that, in order to reach an assessment about a given vertical agreement, the precise potential effects of the agreement on the market should be analysed, thus moving away from the old formalistic approach.

The 1999 BER established that article 81(1) does not apply to vertical agreements in which the supplier does not hold more than 30% market share. Since vertical agreements are likely to harm welfare only if the firms using them possess substantial market power, Competition Authorities should not use their scarce resources to monitor vertical agreements entered into by firms with small market power. Such firms should benefit from a safe harbour which guarantees legality of their vertical agreements. The BER (in its Article 4) also stated that the exemption should not apply to some vertical agreements that the Commission considered harmful. These 'black-listed' - or 'hardcore' - clauses include in particular RPM (more precisely resale price fixing and minimum resale price) and vertical clauses which aim at restricting ‘active’ sales from one territory to the other. Vertical agreements containing such hardcore restrictions were not exempted from the application of Article 81(1), even if the firms concerned had an arbitrarily small market share, since the *de minimis* Notice (2001/C 368/07) does not apply to such hardcore restrictions. Moreover, according to the 1999

Guidelines, paragraph 46, "Individual exemption of vertical agreements containing such hardcore restrictions is also unlikely", thus implying a regime which is in practice very close to *per se* prohibition for these black-listed restrictions.[7]

With the BER bound to expire in May 2010, the Commission proceeded to a review and revision process.[8] Along with the new Guidelines on Vertical Restraints (2010/C 130/01), the new BER came into force on June 1, 2010 and will be valid until 2022, with a one-year transitional phase. As it was judged that the old BER had worked reasonably well overall, there were no drastic changes in the new BER. The revisions could be described as proceeding to a 'modernisation' of the Regulation where that was appropriate, as well as offering some needed clarifications.

The most significant change in the new BER is that it is not longer enough (for a vertical agreement to fall under the block exemption) that the seller's relevant market share does not exceed 30%, but also that the market share of the associated buyer does not exceed 30% in the same market. This change reflects the increased recognition that vertical contracts are not determined by the sellers alone. In a market where there

[7] We should also note here the Block Exemption Regulation for the motor vehicle sector. Following a consultation process, the Commission adopted new rules for this sector to replace Regulation 1400/2002 which expired in 2010. The Commission Regulation No 461/2010 of May 27, 2010 on the application of Article 101(3) of the Treaty, along with the Supplementary Guidelines on vertical restraints in agreements for the sale and repair of motor vehicles and for the distribution of spare parts for motor vehicles (2010/C 138/05), have been introduced.

[8] The comparison of the developments of the EC policy approach to that in the U.S. system is useful. In particular, minimum or fixed price RPM belongs to the 'black-listed' practices in the BER (both the old one and its revision), and even for firms with a very small market share the burden of proof is reversed: the accused party has to provide evidence regarding the implied pro-competitive effects, otherwise the agreement could be viewed as illegal. In the U.S., the Supreme Court overturned, in its 2007 decision in *Leegin* (Leegin Creative Leather Prods., Inc v. PSKS, Inc., 551 U.S. 877), the almost century-old rule, since its 1911 Dr. Miles decision (Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373) that viewed minimum RPM as *per se* illegal.

is a strong buyer, this buyer may possess market power which could be used to impose certain types of vertical agreements that could have an anticompetitive effect.[9]

Additional revisions, that in general can be viewed as positive, include the following. The rule that an agreement would be exempt, under the BER, when the turnover of a competitor who acted as a distributor was below EUR 100 million has been changed. Also, the requirement of 'dual distribution' (i.e. the requirement that the buyer is active only in the distribution market) for an agreement to be exempt under the BER has now been extended to services markets, whereas previously this requirement was only applicable to product markets. Also for *agency* agreements to be considered genuine and therefore to fall outside Article 101(1), the 'principal' in the trading relation must bear the costs and the risk not only of the specific agreement, but also the ones related to other activities that it requires the 'agent' to undertake in the same market.

Like in its old version, the new BER contains a list of restrictions that are 'black-listed'. The black list includes RPM and other (that is, non price) resale restrictions. These are viewed as hard-core violations that represent serious restrictions of competition and the view is taken that there should be a presumption in the EC law that they should be prohibited. Specifically, according to Paragraph 47 of the Guidelines, if an agreement contains a 'black listed' restriction, then there are two consequences: the agreement presumptively falls within the scope of prohibited agreements under Article 101(1) as having actual or likely negative effects; and it presumptively does not satisfy the justification standards of Article 101(3). This means that once a hardcore restriction is established, the agreement is presumptively both anticompetitive and unjustifiable. Still, it is recognized that this double presumption is rebuttable and the parties can bring forward evidence that the positive effects of the agreement under examination outweigh the presumed negative effects.

Regarding minimum price and fixed price RPM, in particular, the new Guidelines offer a detailed exposition about evidence that could be put forward in RPM cases. Specifically, Paragraph 224 of the Guidelines describes various possible ways in

[9] This may be true even when this buyer does not have the market share and other characteristics that would make it possible to determine that he has a dominant position and apply Article 102.

which RPM may restrict competition, whereas Paragraph 225 states that justifications will be considered and that the possible efficiencies will be assessed under Article 101(3). Similar to RPM, regarding Resale Restrictions, the BER generally does not cover agreements that restrict the buyer's ability to sell in some territories or to some consumers the goods or services that the agreement refers to. However, there are a number of important exceptions, where such restrictions are not considered hard-core, like in the old BER. The two most important ones are systems of 'exclusive distribution' and 'selective distribution'. Regarding exclusive distribution, a supplier is allowed to protect an exclusive distributor from active sales by other distributors in the specified as exclusive territory or consumer group. The new Guidelines also clarify that the exclusive distribution is covered by the BER, even when the supplier itself is also selling directly to the customers in the territory or consumer group otherwise treated as exclusive for some distributor. However, a restriction on passive sales, that is responding to unsolicited requests from customers outside the specified territory or consumer group, would be considered a hard-core restriction. Regarding selective distribution, the BER allows suppliers to have a selective distribution system, where distributors are selected according to some specified criteria.[10]

IV. Discussion of the 2010 revision of the Block Exemption Regulation and Guidelines

As discussed above, the overall logic of the BER is correct. For vertical agreements, in contrast to horizontal ones, there cannot be in general a presumption that they harm competition. This is because vertical agreements do not occur among competitors but among firms that in any event have to collaborate in the market, for the products or services to reach the final consumers. The 2010 revision has rightly maintained the general structure of the previous BER, offering a modernization and some useful clarifications and simplifications. The fundamental logic of the BER, to allow firms

[10] The new BER pays particular attention to the matter of online (Internet) sales, since the Resale Restrictions rules apply to both online and (traditional) store sales. Once distributors have been authorised, they must be free to sell on their websites as they do in their traditional shops and physical points of sale. For selective distribution, this means that manufacturers cannot limit the quantities sold over the Internet or charge higher prices for products to be sold online.

with a market share that is not too high to use vertical agreements as they wish, has appeared to be working well enough and is not expected to create problems in the future. Keeping the relevant market share threshold at 30% also appears satisfactory, since not only firms with a market share high enough to be considered dominant, but also firms with sizeable market power do not automatically benefit from an exemption. At the same time, it ensures that firms with low market power enjoy legal certainty which is important for the overall planning of their business strategies.

From an economics viewpoint, the main aspects of the 2010 revision of the BER can be classified in two categories. First, the new BER offers a clarification and a modified approach to particular issues of competition policy implementation that had emerged. Second, it has moved more decidedly ahead, better acknowledging the efficiency gains that could arise from all types of vertical restraints.

First, the most important of the implementation-type changes is that the benefit of the block exemption no longer depends only on the supplier's market share, but also on the buyer's market share: neither of these two market shares can now exceed 30% for the exemption to apply. This approach seems to be in the right direction, given that in practice the buyers can often be as powerful as sellers, or even more powerful. Vertical restraints need not generally be imposed by the suppliers: strong buyers can also use their market power to impose anticompetitive vertical restraints. From a practical viewpoint, of course, we can expect some problems when it comes to implementation. Accurately calculating the market share of a buyer may not always be easy or even feasible for a seller, and of course the accuracy of market definition becomes even more crucial then before.

Another change is about restrictions on the use of the Internet for trade. This change also seems in the right direction and both the BER and the Guidelines now describe in more detail how one can distinguish between 'active' and 'passive' sales in the case of Internet sales. Thus, *assuming that one does wish to distinguish between active and passive sales,* the revision appears useful since online sales have become increasingly more important, since the old BER was initially enacted. One could argue however that, from the viewpoint of an economist, it is not really clear why active and passive sales should be treated differently in the law, since both have the same effect: more uniform prices across markets. Furthermore, whether in a particular market price uniformity or price discrimination implies higher consumer welfare, depends crucially on the market conditions, including the actions and reactions of other firms. As a result, it may be more appropriate in the future to move away from the active versus passive sales distinction, which may be too formalistic and to some extent arbitrary. Instead, it may be preferable to use a more 'effects-based' approach, according to which the treatment of firms that use territorial restrictions would depend of the market share they hold and the possible efficiency justifications associated with such restrictions.

Second, the new BER better acknowledges the efficiency gains that possibly result from all types of vertical restraints, including these in the hard-core list. The language in the Guidelines generally appears now more supportive of the view that firms should be free to select their own distribution strategies, including the use of various kinds of vertical agreements, and that consumers can benefit from these, especially when firms do not have high market power. This is also a step in the right direction.

One could, however, make some remarks regarding aspects of the revision that have not been as drastic and clear as perhaps they should have been. These refer both to the specific treatment of the 'black listed' or 'hard-core' restraints, but also to its more general logic. Let us start the discussion from the specifics of Article 4. Regarding RPM, and relatively to the old one, the new BER makes a step towards more fully acknowledging the potential efficiency gains that can follow from this practice, somewhat similar to the recent trend in the U.S.[11] However, the BER continues to place in the 'black list' a number of vertical restraints that are considered 'hard core', including minimum and fixed price RPM and other resale restrictions. It would have been a good idea to consider a change in this policy that would allow *small enough*

[11] The Guidelines present (in Paragraph 224) details about the various anticompetitive uses of RPM. These include a consideration of the source of the restraint, the market power of the firm or firms imposing it, and the degree to which RPM is used widely in an industry. It also describes additional ways in which RPM can be anticompetitive, such as dampening competition and diminishing pressure on manufacturers' margins, turning in this point its attention to intra-brand competition. Paragraph 107 of the Guidelines, in contrast, details a range of positive effects that can flow from vertical restraints, generally. Thus, on the one hand, the fact that the potential efficiencies of RPM can be considered under Article 101(3) appears as a more tolerant attitude towards RPM, but, on the other hand, the order of bringing forward evidence is reversed and it is the parties that have to provide evidence for the pro-competitive effects of agreements that involve RPM.

firms when trading with other *small* firms to use any type of vertical agreement. Regarding RPM, economic analysis has shown that it could have both anti-competitive and pro-competitive effects. For the anti-competitive effects to be possible, the suppliers should be endowed with considerable market power. Therefore, it is likely that such effects could be overlooked if suppliers and their buyers have small enough market shares.[12] Such a *de minimis* treatment of all vertical agreements appears appropriate.

More generally, it also appears appropriate that EC competition policy and law now moves still further and more decisively away from the old formalistic approach that would view various types of vertical restraints as suspicious. The idea here is that, contrary to the old view, according to which any restriction would be considered harmful for competition, since by definition it would be restricting the actions of some market participants (sellers or buyers), a more modern approach should be effects-based and not form-based. Careful analysis should indicate what would be the precise type of harm caused by any type of vertical restrictions used. Restrictions modify the 'game' played among oligopolistic firms and the strategies available to them – as a result, the *equilibrium* properties of such a game could be significantly modified if some restriction could or could not be used. Of course that would have significant implications for profits levels, prices and consumer welfare.

It would be useful also recognize that vertical agreements are incomplete forms of vertical integration. Every type of behaviour that is supported by an agreement could essentially also be replicated within a merger between the two parties involved. It

[12] In the 2010 EAGCP report mentioned above we had made the following specific recommendation: "…. we would favour a change in the BER as follows. The presumption that RPM is welfare detrimental and that it is unlikely that an exemption would be granted even to firms enjoying less than 30% market share should be replaced by a statement that 'the larger the market power the stronger should be the demonstrated efficiency gains' with a concrete rule that states: (1) the de minimis rule applies also for RPM (i.e., a firm with less than *15%* market share can engage in RPM); (2) for a firm with a share above *15%,* the burden of proving that RPM will have beneficial effects on competition is resting upon it; (3) it is unlikely that a firm with a share in excess of 30%) will be able to show that RPM will have a net beneficial effect." This recommendation could easily be modified by also specifying similar thresholds for a buyer involved in such an agreement, to be consistent with the revision of the BER regarding market shares. A similar argument and recommendation can be made regarding 'territorial restrictions' that are also generally black-listed under the BER.

remains a question, if two parties can be allowed to have a vertical merger why they cannot have any type of vertical agreement between them. Take an example where a supplier and retailer each have such a small market share and small enough overall market power that it would not even be conceivable to block a vertical merger between them. If a merger has taken place, and given that the merged entity is not in a dominant position, then the vertically integrated firm could sell anywhere and at any price it chooses, with no restrictions in its behaviour whatsoever. If the two firms have remained independent entities, why would it be a good idea to view any agreement between them as presumably anti-competitive?[13]

Let us consider RPM as a leading example for the discussion just above. As discussed earlier, the economics literature has shown that the use of RPM could have either positive or negative competitive effects, depending on the overall market conditions. Despite the progress made in the revision, in both the old and the new version of the BER, RPM is viewed by the Commission as detrimental for competition, enough so that it should be treated as a hard-core restriction and that the usual order in bringing forward evidence should be reversed. The Commission here appears to be following a form-based approach, stating that since fixed or lower price RPM restricts the ability of retailers to sell at a lower price than the one dictated by the RPM, this represents an obvious way in which consumers are harmed, by facing higher prices in the market.

Certainly, RPM can possibly have serious enough anti-competitive effects (even when the parties involved are not dominant). However, such a position, by essentially focusing on protecting intra-brand competition independently from inter-brand competition, does not appear to be fully taking into consideration how changes in the overall strategies of the firms involved, could possibly affect consumer welfare, directly or indirectly. In other words, a much preferable approach would be to study the overall effect of using RPM in a particular market. To make this point clearer, since the prices (upstream and downstream), the quality and the other product

[13] We should note here that an analogous argument could not be made with respect to horizontal relations, since these would take place in the same market, between competitors. One could then rightly use in these cases the argument that a horizontal merger may imply synergies and efficiencies that horizontal agreements do not imply. This is why the law treats horizontal agreements as generally anticompetitive whereas for proposed horizontal mergers among large enough firms one has to compare the pro-competitive and the anti-competitive effects.

characteristics are decided endogenously by the competing firms, it is possible that removing the ability of some firms to use RPM will lead to an *inferior* overall market outcome. For instance, it may be that the use of RPM by small firms is essential for their ability to penetrate markets otherwise dominated by stronger competitors. Also, it may be that the wholesale prices that will prevail in the market when RPM cannot be used are higher than the wholesale prices when RPM is possible and, as a result, the final (retail) prices may be lower under RPM. In addition, of course, even if RPM may lead to higher prices, it may also allow the provision of greater variety and higher quality of products in the markets, for instance through the provision of better services.

V. Conclusion

In this article we have discussed the new (2010) vertical agreements Block Exempt Regulation that exempts from Article 102 TFEU most types of vertical agreements between firms that do not have too high a market share. We take an economics view in our analysis and make a number of specific points. These can be summarized as follows. First, the overall logic of the BER is correct: for vertical agreements, in constrast with horizontal ones, there cannot be in general a presumption that they harm competition, since they do not occur among competitors. The revision is also in the right direction: it has offered clarifications and simplifications in areas where they were needed and it has also taken overall a more positive stand relative to various types of agreements.

However, we also argue that the revision could have gone further in various respects, in particular to recognize that even some types of currently ‘black-listed’ restraints (like RPM and other resale restrictions) cannot be expected to have a negative net impact on competition, unless one or more of the parties involved has a large enough market share. Thus, a *de minimis* approach can be justified, even for such restraints, and such an approach could be considered in future possible revisions. Second, the overall approach of this BER, by its nature, appears to be a legacy of the old formalistic approach to competition policy, where certain types of restraints were viewed as suspicious and presumably anticompetitive. The general logic of the modernization could be pushed further, so that economic analysis is used to establish that harm can be expected, before some type of a vertical restraint can be viewed as suspicious. Vertical agreements are incomplete forms of vertical integration and may have a positive or a negative effect, depending on the market conditions. To reach a conclusion, an analysis would be needed that would take into account how the strategic incentives of the firms and the overall market equilibrium would change as a result of the use of a given agreement.