Communication from the Commission on the application of the Community competition rules to vertical restraints (Follow-up to the Green Paper on Vertical Restraints)

(98/C 365/03)

(Text with EEA relevance)

SECTION I — INTRODUCTION

1. Shortcomings of current policy

Community competition policy concerning vertical restraints has a history of nearly forty years. Although this policy has been successful a review is necessary. The reasons for this review were amply described in the Green Paper on Vertical Restraints [1]. The Green Paper has identified a number of shortcomings in current policy, which can be summarised as follows.

First, the current Block-Exemption Regulations (BEs) comprise rather strict form-based requirements and as a result are considered too legalistic and work as a strait-jacket. This is especially awkward in the light of the major changes in methods of distribution that have taken place and still are taking place. For the vertical agreements that, sometimes with difficulty, do fall within the current BEs a compliance burden is created through unnecessary legal uncertainty. Companies without significant market power suffer unnecessary regulation and may even be prevented from using vertical restraints to improve their competitive position in the market.

Secondly, for those agreements that fall within the BEs there is the real risk that the Commission is exempting agreements that distort competition. As the BEs are form-based instead of effect-based and do not contain any market share limit, companies with significant market power can benefit from them. The sanction of withdrawal is in this respect not seen as a real deterrent because it works only with effect for the future. Thus, the present BEs exempt for instance, non-compete obligations up to 100 % market share although these may cause serious foreclosure effects and allow the charging of exorbitant prices on the market to the detriment of consumers.

Thirdly, as the BEs only cover vertical agreements concerning the resale of final goods and not intermediate goods or services [2] a significant part of all vertical agreements are not covered by the current BEs, even when the parties involved have no market power. This means that an unnecessarily large number of vertical restraints could in principle be scrutinised, resulting in legal uncertainty and unnecessary enforcement costs.

2. Need for a more economics based approach

To remedy these three shortcomings and better protect competition, the primary objective of Community competition policy, a more economics based approach is required. Such an approach should be based on the effects on the market; vertical agreements should be analysed in their market context. It is only when inter-brand competition is weak and market power exists that it becomes important to control vertical agreements. This should facilitate a relaxation of the form-based requirements, ensure that fewer agreements are covered by Article 85(1) and afford a better scrutiny of agreements of companies having substantial market power. This can be depicted as follows.

Market Power	**Individual Scrutiny** significant market power
	Block-Exempted/*de minimis*
	All types of Vertical Restraints

Most markets are fairly competitive, the companies not having market power. Therefore, the number of cases

(1) Green Paper on Vertical Restraints in Community Competition Policy, COM(96) 721 final, adopted by the Commission on 22.1.1997.

(2) Only under the Franchise Block Exemption Regulation (No 4087/88 of 30 November 1988) are services covered.

that may need scrutiny, as depicted below, will be relatively low. This is confirmed by an analysis of recent merger cases ([1]).

Number of Vertical Restraints	
	Individual Scrutiny
	Block-Exempted/*de minimis*
	All types of Vertical Restraints

In reforming Community competition policy in the field of vertical restraints, the Commission pursues the following objectives:

— the protection of competition, which is the primary objective of Community competition policy, as it enhances consumer welfare and creates an efficient allocation of resources;

— market integration, in the light of enlargement, which remains a second important objective when assessing competition issues.

In addition, the effects on the overall level of legal certainty for business, the enforcement costs to business and competition authorities, and the possibilities for improving decentralisation have to be taken into account.

The policy proposal set out in this Communication is based on a more economic approach. This is required, as was explained above, to remedy the shortcomings of current policy. For situations without significant market power a safe harbour needs to be created, thus providing a presumption of legality for those vertical restraints that are likely to have no net negative effects. Vertical restraints falling outside the safe harbour will not be presumed to be illegal but may need individual examination. In the context of individual examination, the Commission will have the burden of proof that the agreement in question infringes Article 85(1) and will have to examine whether the agreement does or does not fulfil the conditions of Article 85(3).

The proposed safe harbour consists of one broad umbrella Block-Exemption regulation covering all vertical restraints for the distribution of goods and services ([2]). This regulation uses market-share thresholds to distinguish between agreements that are or are not block-exempted. By being based primarily on a black-clause approach, i.e. defining what is not block exempted instead of defining what is exempted, it avoids the strait-jacket effect and facilitates the simplification of the applicable rules. The policy will ensure that the vast majority of vertical agreements where no significant net negative effect can be expected no longer require individual scrutiny. It will thereby allow the Commission and national competition authorities to concentrate on the important cases. It treats different forms of vertical agreements having similar effects in a similar way, preventing unjustified differentiation in policy between forms or sectors and avoiding a policy bias in the choice companies make concerning their formats of distribution. In order to maintain a sufficient level of legal certainty the Block-Exemption regulation will be supplemented by guidelines detailing the Commission's policy concerning individual examination above the market share thresholds and possible withdrawal of the Block-Exemption below the thresholds.

3. **Structure of the present communication**

This Communication has the following structure:

— Section II summarises the comments the Commission received on the Green Paper;

— Section III provides an economic assessment of vertical restraints and their effects;

— Section IV discusses the issues of market-share thresholds and legal certainty;

([1]) In more than 80 % of the merger cases dealt with under the Merger Regulation in 1997, the market shares of the individual parties were below 25 %. As these merger cases only concern large companies and often the most narrow market definition is looked at in the first phase of investigation in order to clear the merger, it can be expected that in the economy as a whole, market shares will be even lower.

([2]) Motor vehicle distribution is the only sector not covered by this exercise, see Green Paper on Vertical Restraints in Community Competition Policy, p. 2, footnote No 2.

— Section V describes the proposed new policy;

— Section VI describes the procedural steps which will be followed to adopt the proposed policy.

SECTION II — SUMMARY OF REACTIONS TO THE GREEN PAPER

1. Written submissions on the Green Paper

The consultation exercise launched by the Green Paper produced 227 written submissions. A large majority (64 %) of the submissions came from either companies or associations representing companies. Only 6 submissions were received from consumer organisations. Of the companies and associations of companies who made submissions, a large percentage (31 %) came from either the beer or petrol sector. The primary concern of most submissions was legal certainty (37 % of all submissions). Only 41 submissions (18 %), mainly from academics and national authorities, placed their primary emphasis on the protection of competition.

Most submissions believe the current system to be too legalistic and favour a more economic approach. It is felt that an economic, effects-based approach rather than a clause-based approach would be more suitable for dealing with a dynamic sector such as distribution. The current system tends to produce negative effects on the evolution of distribution, preventing undertakings from introducing new and innovative distribution formats which could lead to substantial gains in terms of efficiency. Of those who commented on this issue 95 % favour a more economic approach, while 97 % believe that the current system has too much of a strait-jacket effect. Of those who commented on the competition effects of vertical restraints, 42 % view vertical restraints as having primarily a positive effect on competition, while 50 % are of the view that vertical restraints may have both positive and negative effects on competition. As possible negative effects, foreclosure and dampening of competition were mentioned, with the former being seen as the main problem.

While there is general consensus on the need for a more economic based approach, there is no agreement on how to implement such an approach. Nearly half (41 %) of those that commented on market-share tests believe market shares to be a good indicator of market power. Most commentators however pointed out the difficulties of defining markets and assessing market shares. These difficulties were said to give rise to a high degree of legal uncertainty and the majority of those who commented did not favour a market-share cap. In the course of the consultation exercise, the support for the use of a market-share test increased, but companies asked the Commission to adopt sufficient flanking measures so as to make the market-share test operable.

In the Green Paper, five options were described, namely:

1. Option I: maintain the current system;

2. Option II: wider block exemptions without a market-share cap;

3. Option III: more focused block exemptions with a market-share cap of [40 %];

4. Option IV-I: negative clearance presumption up to [20 %] and above wider block-exemptions without a market-share cap; and

5. Option IV-II: negative clearance presumption up to [20 %] and above wider block-exemptions with a market-share cap of [40 %].

It was stated clearly in the Green Paper that the list of options proposed was not exhaustive. It is therefore not surprising that three other options have been proposed by several interested parties ([1]), namely:

6. An umbrella block-exemption: one wide block-exemption based on a blacklist approach and without market shares;

7. Guidelines: no block-exemption but only guidelines indicating how the Commission would apply Article 85 in individual cases;

8. A control-of-abuse system: all vertical restraints would be presumed *a priori* lawful, with the Commission having the power to suspend the positive presumption only with effect for the future.

([1]) A number of other individual options were proposed, such as a foreclosure test based on market shares.

Set out below is a statistical breakdown of support for the various options referred to above:

Options	In favour	Not in favour	No comment
1. Option I (maintain current system):	16,6 %	51,6 %	31,8 %
2. Option II (wider block-exemptions without a market-share cap)	46,2 %	23,3 %	30,5 %
3. Option III (more focused block-exemptions with a market-share cap of [40 %])	6,7 %	59,6 %	33,7 %
4. Option IV-I (negative clearance presumption up to [20 %] and above wider block-exemptions without a market-share cap)	20,2 %	59,5 %	20,3 %
5. Option IV-II (negative clearance presumption up to [20 %] and above wider block-exemptions with market-share cap of [40 %])	8,1 %	82,4 %	9,5 %
6. Umbrella Block-exemption without market shares	17 %	4,9 %	78,1 %
7. Guidelines only	1,8 %	10,8 %	87,4 %
8. Control-of-abuse system	10,8 %	6,3 %	82,9 %

2. **Public hearing**

On 6 and 7 October 1997, the Commission organised a public hearing for industry and other interested parties on the Green Paper. Companies, associations, law firms, consumer organisations etc. who had made a written submission were invited to come to the hearing. Most Member States also sent observers, as did the EFTA Surveillance Authority, Norway, Iceland, and a considerable number of the Central and Eastern European countries.

There was a large element of consensus that market power and a reduction in inter-brand competition are the circumstances under which vertical restraints may have negative effects. There was similar consensus that the Commission sould adopt a more economic approach to get away from the current legalistic strait-jacket. Most also considered that there is a link between market power and market share but stressed that they are not synonymous.

In the light of the increased legal uncertainty that a market share test would bring to those who currently benefit from existing BE Regulations, a large majority were against introduction of such a test to limit the applicability of block-exemptions. A limited number of commentators stressed that a market-share test would be feasible and is the best possible indicator of market power available. No alternatives were provided.

On the question of which vertical restraints should remain *per se* prohibited there was consensus that resale price maintenance and absolute territorial protection should not be covered by any block-exemption and should in most cases also not qualify for individual exemption. However, it was argued that individual exemption should not be completely excluded. At the hearing support was expressed to allow true maximum resale price maintenance, it being recognised that it is difficult to identify what a true maximum price is.

On the argument that vertical restraints can help to solve free rider problems, i.e. to ensure that the one who makes an effort is able to appropriate all the benefits the effort engenders, opinions were divided. At the hearing some argued that free rider problems occur quite often, especially through the actions of retailers outside the official dealer network. This was argued by representatives from amongst others the car, perfumes, petrol, consumer electronics and toy industries. They favoured action to stop 'leakage' from the system, including the power to ban parallel imports. However, it was not explained whether real free-rider problems were at the heart of the problem — that is that the outside retailers truly profit from the investments made by the network — or whether the issue was really one of trying to shut out certain retailers in order to reduce competition and increase prices. The latter argument was mentioned by several participants, including distributors and large retailers. These commentators stressed the vital importance of parallel imports to enable them to make use of price differences between Member States.

It was recognised that in order to achieve a more economic approach, a compromise has to be found between such an approach and legal certainty. A number of participants were of the opinion that most vertical agreements are innocuous from a competition point of view or are even pro-competitive. They therefore favoured either option II (wider block-exemptions), Option IV-I (the same in addition to a negative clearance presumption) or one very wide block-exemption, preferably with only black clauses. A few were in favour of a future policy using market share thresholds as in Option IV-II (block-exemptions with a market-share cap) or a foreclosure test based on market shares.

It was stressed that, in the event market-share tests were introduced, the Commission should provide as many flanking measures as possible to protect legal certainty. In particular, it was mentioned that the Commission should 1. provide guidelines on the application of the rules above the market-share thresholds, 2. solve the problem of automatic nullity under Article 85(2) where a company has failed to notify because it incorrectly assessed its market share, 3. possibly introduce a non-opposition procedure, and 4. reduce the burden of notification.

3. Opinions of the Community Institutions and of the Member States

The European Parliament

In its Resolution of 18 July 1997 the European Parliament notes that, apart from the *de minimis* notice, business is opposed to the use of a market-share approach and that this approach is not always the most efficient indicator of market power. It therefore calls on the Commission to examine the possibility of using other parameters. It stresses the need to secure legal certainty for SMEs so that voluntary retail chains are put on the same footing as large integrated groups, particularly in terms of a common pricing strategy. It also calls on the Commission to examine whether it is necessary to draw up a block-exemption regulation for selective distribution and asks for attention to be paid to the special commercial or financial advantages in beer supply and service-station agreements.

The Parliament expresses a preference for a system in which the vertical agreements of companies having less than 10 % market share fall outside Article 85(1). Above this threshold, block-exemptions should leave more room for flexibility without disturbing the balance between the contracting parties. Above a certain market share threshold the benefit of a block-exemption should be easy to withdraw. Only if such an easy withdrawal procedure is not possible should the Commission consider creating block-exemptions that do not apply above a certain market-share threshold, and then only for companies with a significant turnover.

The Economic and Social Committee

In its Opinion of 4 June 1997 the Economic and Social Committee recognises that the current block-exemption regulations are too rigid and often difficult to interpret. Emphasis should be placed on the importance of market structure in assessing the effects of vertical restraints, together with the need to focus on the market impact, rather than the formal content of agreements. The Committee is in favour of expanding the block-exemptions to apply to upstream linkages in the supply chain between producers and suppliers of necessary inputs. The wider the coverage of the block-exemptions, the less the need for individual notifications of vertical agreements. It would also welcome the addition of a non-opposition procedure.

While not opposed to Option II (wider block-exemptions without a market-share cap) the Committee strongly recommends Option IV, Variant I (Option II with a negative clearance presumption up to [20 %]). It has reservations about Option IV, Variant II (Option IV-I with a market-share cap of [40 %]). However, if the Commission were able to introduce Option IV, Variant I, combined with extremely wide block-exemptions, then the Committee could see a case for a procedural mechanism for monitoring vertical distribution agreements with high market shares.

Committee of the Regions

In its Opinion of 12 June 1997 the Committee of the Regions considers that the multi-faceted nature of the question of vertical restraints makes it difficult to select a single option which is not highly debatable for one sector or another. Whichever option is selected, agreements — such as those for beer — must be safeguard. Views other than those of manufacturers and distributors should be brought into the process of assessing consumer benefit.

In relation to Options III and IV, the introduction of market-share thresholds only makes sense if these are expressed in terms of the entire Community market. The Committee believes that ultimately the option which should be selected is Option I.

Member States

All but one of the fifteen Member States made written submissions on the Green Paper. Many of these submissions were made on a preliminary basis. There was no clear consensus on the format of future policy in this area. With regard to the options set out in the Green Paper, none of the Member States expressed a preference for Option I or III, four gave a preference for Option II, three gave a preference for Option IV, Variant I, and two gave a preference for Option IV, Variant II. The remaining five Member States put forward other substantive options of their own. These may be summarised as follows:

1. a negative-clearance regulation providing that almost all vertical restraints would be deemed *a priori* lawful, irrespective of market share, with the Commission, national authorities and national judges having the power to declare the regulation inapplicable with retroactive effect if there is no effective competition or if there are high barriers to entry in the market;

2. a single block-exemption for all vertical agreements, with a market-share threshold of [25 %]. Above this market share, agreements would be covered by the individual exemption system. Below this threshold, the Commission would have the power of withdrawal for problematic cases;

3. a negative clearance regulation with two market-share thresholds. The first (25-40 %) to indicate the market share level above which a company is likely to exercise substantial market power. The second (60-80 %) to indicate the possible restrictions caused by companies with at least a 10-15 % market share in case of a cumulative effect of parallel network agreements;

4. a single black-clause block-exemption. The exemption would apply irrespective of market share. The Commission would be able to ask for individual notifications. The block-exemption would confer provisional validity upon vertical agreements, which could be withdrawn only with effect for the future;

5. broader and more flexible block-exemptions, the application of which would be controlled, *a posteriori* by the national competition authorities.

The first element of general consensus amongst the Member States relates to the need to change the Commission's current policy on vertical restraints. It is recognised that the adoption of a more economic based approach would of necessity result in a system with less legal certainty for companies with market power who currently benefit from existing BE Regulations. The second element of consensus relates to the most recent economic literature, according to which vertical restraints should only be considered as capable of harming competition when they are linked to some degree of market power. The third element of consensus relates to the need for maintaining the importance given to the market integration objective in the assessment of vertical restraints, particularly in the light of future enlargement.

As a follow up to this consensus there appear to be two trends of thought. The first tends to simply promote the introduction of a level of flexibility within the existing system by reducing the regulatory approach of the current block-exemption regulations. A second approach is based on the need to adopt a real change in policy. This second approach has two major hypotheses. The first is based on maintaining the current prohibition system of Article 85. This system could be adjusted by the introduction of market-share thresholds. The aim of these thresholds would be to determine, on the basis of the market-power level, both the absence of grounds for the application of Article 85(1) and the field of application of a single, wide block-exemption covering all vertical restraints. The second hypothesis is based on a switch from a prohibition to a control of abuse system. This system would in effect grant almost all vertical restraints an *a priori* presumption of compatibility with Article 85(1), with the possibility for the Commission to withdraw this positive presumption with effect only for the future.

In the course of the consultation exercise, the positions expressed by the Member States on the Green Paper have evolved and led to a greater consensus on the policy proposal set out in this communication, i.e. one broad Block-Exemption regulation limited by one/two market-share threshold(s).

SECTION III — ECONOMICS OF VERTICALS

1. **Vertical restraints and market power**

As indicated in the introduction, economics tells us that in the field of vertical restraints competition concerns can only arise if there is insufficient inter-brand competition, i.e. if there exists a certain degree of market power. On the one hand, the fiercer the inter-brand competition is, the more likely it is that vertical restraints have no negative effect or at least a net positive effect. On the other hand, the weaker the inter-brand competition, the more likely it is that vertical restraints have a net negative effect. This means that the same vertical restraint can have different effects depending on the market structure and on the market power of the company applying the vertical restraint.

In economics, market power is usually defined as the power to raise price above the competitive level (in the short run marginal cost, in the long run average total cost). In other words, a company has market power if it has a perceptible influence on the price against which it can sell and if by charging a price above the competitive level it is able, at least in the short term, to obtain supra-normal profits. Most economists would agree that there exists market power below the level of dominance as defined by the Court of Justice. This view was also expressed in the Green Paper (1), to indicate that vertical restraints can harm competition below the level of dominance and therefore that Article 86 and merger control will not suffice. Article 85 needs to be applied to vertical restraints, in particular in oligopolistic markets where none of the individual companies hold a dominant position.

It is also generally recognised that vertical restraints are on average less harmful than horizontal competition restraints. The main reason for treating a vertical restraint more leniently than a horizontal restraint lies in the fact that the latter may concern an agreement between competitors producing substitute goods/services while the former concerns an agreement between a supplier and a buyer of a particular product/service. In horizontal situations the exercise of market power by one company (higher price of its product) will benefit its competitors. This may provide an incentive to competitors to induce each other to behave anti-competitively. In vertical situations the product of the one is the input for the other. This means that the exercise of market power by either the upstream or downstream company would normally hurt the demand for the product of the other. The companies involved in the agreement may therefore have an incentive to prevent the exercise of market power by the other (so called self-policing character of vertical restraints).

However, this self-restraining character should not be over-estimated. When a company has no market power it can only try to increase its profits by optimising its manufacturing and distribution processes, with or without the help of vertical restraints. However, when it does have market power it can also try to increase its profits at the expense of its direct competitors by raising their costs and at the expense of its buyers/consumers by trying to appropriate some of their surplus. This can happen when the upstream and downstream company share the extra profits or when one of the two imposes the vertical restraint and thereby appropriates all the extra profits.

2. **The negative effects**

2.1. ***Individual vertical restraints***

The negative effects on the market that may result from anti-competitive vertical agreements and that Community competition law aims at preventing are the following:

- foreclosure, either of other suppliers or of other buyers;
- the deterioration of price and non-price conditions available to consumers, either for one particular brand (reduction of intra-brand competition) or between different brands (reduction of inter-brand competition);
- collusion amongst suppliers or buyers facilitated by vertical restraints;
- the creation of obstacles to market integration, including, most of all, limitations on the freedom of the European consumers to purchase a good or service in any Member State they may choose.

Such negative effects may result from various vertical restraints. Special care is needed due to the fact that agreements which are different in form may have the same substantive impact on competition. To analyse these possible negative effects it is appropriate to divide vertical restraints into four groups: an exclusive-distribution group, a single-branding group, a resale-price maintenance group and a market-partitioning group. The vertical restraints within each group seem to have similar negative effects on competition.

Before describing the four groups a number of general points need to be made. First, the analysis applies to both goods and services, although certain restraints are mainly

(1) Green Paper on Vertical Restraints in Community Competition Policy, point 303.

used in the distribution of goods. This is why throughout this text the term good(s) means both good(s) and service(s) unless otherwise stated. Secondly, vertical agreements can be concluded for intermediate and final goods and services. Unless otherwise stated the analysis and arguments in the text apply to all levels of trade and the neutral terms supplier and buyer are used. When only a specific level is implicated this is indicated. Thirdly, the classification is based upon what could be described as the basic components of vertical restraints. In practice many vertical agreements make use of more than one of these components. To give an example, exclusive distribution usually limits the number of buyers the supplier can sell to and often at the same time limits the area where the buyers can be active. The first component may lead to foreclosure of other buyers while the second component may lead to market partitioning.

Exclusive-distribution group

Under the heading of exclusive distribution come those agreements/components that have as their main element that the manufacturer is selling only to one or a limited number of buyers. This may be to restrict the number of buyers for a particular territory or group of customers, or to restrict the kind of buyers. This group comprises amongst others exclusive distribution and exclusive customer allocation as the supplier limits its sales to only one buyer for a certain territory or class of customers. It also comprises exclusive supply and quantity forcing on the supplier, where an obligation or incentive scheme agreed between the supplier and the buyer makes the former to sell on a particular market only or mainly to one buyer. This group also comprises selective distribution, where the conditions imposed on or agreed with the selected dealers may limit their number.

There are two main effects on competition: 1. certain buyers within that market can no longer buy from this particular supplier, i.e. it leads, in particular in the case of exclusive supply, to foreclosure, and 2. as far as the distribution of final goods is concerned, since less distributors will offer this good it will also lead to reduced intra-brand competition. In the case of wide exclusive territories or in case of exclusive customer allocation the result may be total elimination of intra-brand competition. In addition, when a selective distribution agreement is used rather strictly, i.e. not many stores can carry the product, it also leads to less in-store competition and reduced inter-brand competition. Furthermore, selective distribution contains a limitation on resale since approved dealers may only sell to end consumers and other approved dealers.

Single-branding group

Under the heading of single branding come those agreements/components that have as their main element that the buyer is induced to concentrate his orders for a particular type of good with one supplier. The group comprises amongst others non-compete and quantity forcing on the buyer, where an obligation or incentive scheme agreed between the supplier and the buyer makes the latter purchase its requirements for a particular good or service and its substitutes only or mainly from one supplier.

There are two main effects on competition: 1. other suppliers in that market cannot sell to the particular buyers, i.e. foreclosure of competing suppliers, and 2. as far as the distribution of final goods is concerned, the particular retailers will only sell one brand, therefore there will be no in-store competition in their shops. Both effects may lead to a reduction in inter-brand competition.

The reduction in inter-brand competition may be mitigated by stronger ex-ante competition between suppliers to obtain the single branding contracts, but the longer the duration the more likely it will be that this effect will not be strong enough to fully compensate for the lack of inter-brand competition.

Resale-price maintenance group

Under the heading of resale price maintenance (RPM) come those agreements/components that have as their main element that the buyer is obliged or induced to resell not below a certain price, at a certain price or not above a certain price. This group comprises minimum, fixed, maximum and recommended resale prices. Maximum and recommended resale prices, while unlikely to have negative effects, may work as fixed RPM. As RPM relates to the resale price it is mainly relevant for the distribution of final goods.

There are two main effects of minimum and fixed RPM on competition: 1. the distributors can no longer compete on price for that brand, leading to a total elimination of intra-brand price-competition, and 2. there is increased transparency on price and responsibility for price changes, making horizontal collusion between manufacturers or distributors easier, at least in concentrated markets. The reduction in intra-brand competition may, as it leads to less downward pressure on the price for the particular good, have as an indirect effect a reduced level of inter-brand competition.

Market-partitioning group

Under the heading of market partitioning come agreements/components that have as their main element that the buyer is restricted as to where it either sources or resells a particular good or that the supplier is restricted to whom it may sell its good. This group includes exclusive purchasing, where an obligation or incentive scheme agreed between the supplier and the buyer makes the latter purchase its requirements for a particular good or service exclusively from the supplier, but leaving the buyer free to buy and sell competing goods or services. It also includes territorial sales restrictions, customer sales restrictions, after-market sales restrictions, prohibitions of resale and tying.

The main effect on competition is a reduction of intra-brand competition that may help the supplier or the buyer (in case of after-market sales restrictions) to partition the market and thus hinder market integration. This may facilitate price discrimination. Tying is slightly the odd one out. Its main effect is that the buyers may pay a higher price for the tied good than they would otherwise do but it may also lead to foreclosure of other suppliers and reduced inter-brand competition in the market of the tied good.

2.2. ***Combinations of vertical restraints***

The next question to be considered is whether a combination of different vertical restraints increases the negative effects. In the Green Paper a rather prominent place is given to the argument that certain combinations of vertical restraints are better for competition than their use in isolation from each other [1]. Although this may occasionally be the case, it does not appear to be the general rule. In general the opposite seems true, a combination usually aggravates the possible negative effects.

For example, a combination of single branding with exclusive distribution combines a reduction of inter-brand competition with a reduction of intra-brand competition. In the case of final goods a market is created with local brand monopolists without in-store competition. Also, to foreclosure at manufacturer level is added foreclosure at the retail level. This means that not only may it be difficult for a manufacturer to sell a new brand as stores are tied to one brand, but also that new entrants to the retail market may have difficulty obtaining some of the leading brands. This results in a situation where it may be both difficult to find outlets and unprofitable to set up new outlets.

Another example is the combination of one of the restraints of the exclusive distribution group like selective distribution with RPM. To the reduction of intra-brand competition of the first is added the elimination of intra-brand price competition of the second. This quickly leads to a total elimination of intra-brand competition. This elimination of intra-brand competition may also help to sustain collusive tendencies between manufacturers facilitated by RPM. In general, this combination does also not make sense from an efficiency point of view as both protect the margin of the retailer. One of these restraints would normally suffice to overcome, for example, a free rider problem between retailers.

A combination of one of the restraints of the single branding group with RPM may combine a reduction of inter-brand competition resulting from a lack of in-store competition with a facilitation of collusive behaviour between the manufacturers induced by RPM. Collusive behaviour may become easier as the lack of in-store competition takes away some of the competitive pressure. In addition, the reduction of inter-brand competition is combined with a loss of intra-brand price competition resulting from RPM.

Finally, all combinations of vertical restraints which make arbitrage either by final customers or by distributors more difficult, if not impossible, are negative from a market integration perspective. Examples include the combination of: 1. territorial sales restriction combined with selective distribution at the same level of distribution, 2. exclusive distribution combined with exclusive purchasing, and 3. selective distribution combined with exclusive purchasing.

(1) Green Paper, point 67.

Certain combinations may however be viewed more positively, because it can be argued that one of the vertical restraints limits the possible negative effects of the other. In the combination of exclusive distribution with maximum RPM the latter restraint may help the supplier to limit possible price increases the buyer may want to implement under the protection of the territorial exclusivity obtained. The same reasoning can be applied to the combination of selective distribution and maximum RPM. Also the combination of exclusive distribution with quantity forcing on the buyer may work in the same way as the latter may prevent the distributor from raising his prices.

3. **The positive effects**

It is said that in a number of situations the usual arm's length dealings between manufacturer and retailer, determining only price and quantity of a certain transaction, lead to a sub-optimal level of investments and sales. The following generalisations can be made about this:

1. The first and main reason why this — i.e. a sub-optimal level of investments and sales — is supposed to happen is the existence of some form of free-rider problem. The person who makes an effort may not be able to appropriate all the benefits his or her effort engenders and may therefore be inclined to invest sub-optimally. This may be the result of free riding by one retailer on the promotion efforts of another retailer. Exclusive distribution or similar restrictions or RPM may be helpful in avoiding such free riding. Free-riding can also occur between manufacturers where one invests in promotion in the shops for its brand, thereby also attracting customers for its competitors. Non-compete type restraints can help to overcome this latter type of free-riding.

   For there to be a problem there needs to be a real free-rider issue, something that is not always so obvious. Free-riding between retailers can only occur on pre-sales services and not on after-sales services. The good needs to be relatively new or technically complex as the customer otherwise may very well know what he wants from past purchases. And the good must be of a reasonably high value as it is otherwise not attractive for a customer to go to one shop for information and to another to buy. On top of this, when all these conditions are fulfilled it must not be practical for the manufacturer to agree with the retailers effective service requirements concerning the pre-sales services [1].

   Free-riding between manufacturers is also limited by rather strict conditions. Where a product is promoted by the manufacturer through national advertising there seems to be little scope for a free-rider issue to arise that could be addressed through non-compete obligations imposed on the distributors. Only in case the promotion takes place in certain retail outlets could a non-compete type agreement help capture the full benefits. In addition, it can only occur on pre-sales service, it must not be possible to make the promotion brand specific and is only likely for relatively new and complex products as customers may otherwise already very well know what they want.

2. A second general point that needs to be made concerns the possible divergence between what is privately efficient and what is efficient from a total welfare/consumer point of view. What is privately efficient is not always good for total welfare. To go back to the free-riding between retailers or between manufacturers. Let us suppose a real free-rider problem exists and sales can be expanded by inducing more pre-sales services although this would also lead to higher prices. When these extra services are valued equally by the majority of consumers this may very well lead to higher total welfare. But when the inframarginal consumers (that is those who are already buying at the current price/service level) know what they want and do not appreciate the extra service, they only suffer from the higher price, especially if there is insufficient inter-brand competition. It may be privately efficient to increase the service level to attract more marginal consumers and thereby increase sales, but total welfare may nonetheless suffer.

3. A special form of free-riding is the certification free-rider issue. The hypothesis is that certain retailers perform a valuable service by identifying 'good' products. The fact that these retailers sell a certain

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(1) The standard argument against contractability of service requirements is that the costs of monitoring and the contract costs may be prohibitive for the manufacturer in case of a large number of small retailers.

product signifies to the consumer that it is a good buy. This hypothesis may sometimes be useful for explaining the introduction of new products. New and complex products are first stocked by high-quality, high-margin stores where they are bought by avant-garde consumers. Gradually its reputation becomes established and demand grows enough for it to be sold through low-price chains. If the manufacturer cannot initially limit its sales to the premium stores, it runs the risk of being delisted and the product introduction may fail. If this is true, a problem analogous to invention patent protection exists. It may be necessary to provide temporary protection against price discounters to help the introduction of the product. However, a period of protection which is too long may only delay the product moving into the mature, price-competitive stages of its life cycle, to the disadvantage of consumers. This means, at best, that there may be a reason to allow for a limited duration a restriction of the exclusive distribution or RPM kind; enough to guarantee introduction, but not so long as to hinder large-scale dissemination.

4. Yet another special form of free riding is the so-called 'hold-up' problem. Sometimes there are specific investments to be made by either the supplier or the buyer, such as in special equipment or training. In such a case, after the investments have been made the investor becomes to a certain extent prisoner to the other side. The balance of power will shift. In fear of this the necessary investments may not be made, unless *ex-ante* supply arrangements can be fixed. The investor fears that the other side will free ride on its investment. However, as in the free riding example between retailers, there are a number of conditions which have to be met before such a risk is real. First, the investment must be sunk and specific to deal with that other party only. Secondly, it must be a long-term investment which is not recouped in the short run. And thirdly, the investment must be asymmetric; i.e. one invests more than the other. Only when these conditions are met can there be a real reason to have a vertical restraint for a limited duration, of the non-compete type when the investment is made by the supplier and of the exclusive distribution or exclusive supply type when the investment is made by the buyer.

5. The last reason for sub-optimal sales that should be mentioned, is the problem of 'double marginalisation'. In case both the manufacturer and the retailer have market power each will set its price above marginal cost. They both add their margin that exceeds the one that would exist under competition. This may result in a final price that even exceeds the monopoly price an integrated company would charge, to the detriment of their collective profits and consumers. In this case quantity forcing on the buyer or maximum RPM could help the manufacturer bring the price down to monopoly level.

6. In the economic literature it is explained that there is a large measure of substitutability between the different vertical restraints. This means that the same inefficiency problem can be solved by different vertical restraints. For example, as explained above, the problem of free-riding between retailers or the certification free-rider problem can be solved by means of exclusive distribution or fixed or minimum RPM. This is of importance as the negative effects on competition may differ between the various vertical restraints. This plays a role when indispensability is discussed under Article 85(3). As RPM is generally considered to be less acceptable from a competition point of view this is a reason only to allow exclusive distribution or other less serious restraints and not RPM.

4. General rules for the evaluation of vertical restraints

In evaluating vertical restraints from a competition policy perspective, some general rules can be formulated.

As a first general rule it can be said that vertical restraints which reduce inter-brand competition are generally more harmful than vertical restraints that only reduce intra-brand competition. For example, non-compete obligations are likely to have more net negative effects than exclusive distribution. The former, by foreclosing other brands, may prevent these brands from reaching the market. The latter, while foreclosing certain buyers, does not, in general, prevent the good from reaching the final consumer.

A second general rule is that exclusive agreements are generally worse for competition than non-exclusive agreements. Exclusive agreements make, by the express language of the contracts or their practical effects, one party fulfil all or practically all its requirements from another party. For example, a non compete obligation makes that the buyer purchases only one brand, while quantity forcing leaves the buyer scope to purchase competing goods. The degree of foreclosure is therefore different, while often the efficiencies are remarkably similar.

A third general rule that can be formulated is that the possible negative effects of vertical restraints are reinforced when not just one supplier with its buyers practies a certain vertical restraint but when also other suppliers and their buyers organise their trade in a similar way. These so called cumulative effects may be a problem in a number of sectors. To make a valid assessment of the effects of a cumulation of vertical agreements requires a sector wide investigation and overview. The issue of withdrawal of the proposed BE Regulation is reviewed in section V-3 and will be further developed in the guidelines.

In addition to these three general rules some further points can be made:

— Restraints agreed for intermediate goods are in general less harmful than restraints affecting the distribution of final goods. As intermediate goods are not sold to final consumers but are used as an input, brand and image are less important. This makes a possible loss of intra-brand competition less important. This distinction between intermediate and final goods and services will be taken up in guidelines.

— Within the RPM group, fixed and minimum price maintenance are serious restraints. Maximum and recommended prices, when really maximum or recommended, are not considered to be restrictive of competition.

— Within the market-partitioning group restriction of resale and after-market sales restrictions seem the worst as they allow market partitioning without clear possible efficiencies. 'Tying' is in general considered a somewhat less serious restriction. It concerns the possible extension of market power from one market into another. Possible efficiency arguments ('need to assure the buyer uses the right sort of input for the fragile machine we sold him as breakdowns may hurt our products image' or 'joint delivery is cost saving') may be limited. Exclusive purchasing, i.e. the obligation to source directly from one supplier without a restriction on selling competing brands, is the last serious restriction within this group.

— RPM is usually considered to be more restrictive than the other vertical restraints. In case of efficiencies it can often be replaced by less competition distorting restraints with similar positive effects. This is reflected by the current policy in most countries which tends to be very strict on RPM while allowing exclusive distribution in certain market conditions.

— Community competition policy, with its emphasis on the necessity to protect arbitrage and the general prohibition on resale restrictions, reflects the concern to further market integration.

SECTION IV — MARKET-SHARE THRESHOLDS AND LEGAL CERTAINTY

1. **Existing block-exemptions**

The present block-exemption regulations (exclusive distribution, exclusive purchasing and franchising) follow a legalistic clause-based approach where the focus is on the freedom of action of dealers and on intra-brand competition between dealers belonging to the same distribution system. Apart from the withdrawal system and the possible application of Article 86, the exemptions are granted for all companies irrespective of market power.

This system exempts from Article 85(1), without distinction, companies with 1 % and 100 % market share even for non-compete obligations and certain combinations of vertical restraints such as exclusive and selective distribution (see franchising regulation). It leads to the result that small operators (the vast majority of companies) suffer unnecessarily strict regulation while companies with significant market power can protect themselves simply by drafting the contract clauses so as to fit within the existing block-exemption regulations.

The Commission can withdraw the benefit of these exemption regulations only with effect for the future. Companies with market power can apply the most serious restrictions until the Commission adopts a prohibition decision. There is no pressure on companies to change their agreements or conduct because they effectively enjoy provisional validity for their contracts. Therefore, the preventive effect of the prohibition system of Article 85(1) is lost. Irreparable damage to competition can be caused without any remedy for the past (e.g. market foreclosure through exclusive dealings). At the same time, smaller operators are prevented from using vertical restraints in an innovative way to improve their competitive position on the market. This hinders the development of new dynamic forms of distribution. Therefore the existing block-exemption regulations cannot be carried forward.

2. **Economic approach and market-share thresholds**

Two policy conclusions can be drawn from the economic learning described in the previous section: firstly, in the absence of market power, a presumption of legality for vertical restraints can be made except for certain hardcore restrictions; secondly, when market power exists, no general presumption of legality can be made. Therefore, it makes economic sense to use market-share thresholds to limit the application of a block-exemption regulation.

It is clear that market share is not a substitute for market power. In an individual case the establishment of an infringement in respect of a particular vertical restraint can normally only be assessed by looking at all aspects of market structure and market behaviour. However, such a market analysis imposes significant enforcement costs on the competition authority and cannot be applied to every single case.

It is possible to make two policy assumptions that assist in this market analysis. First, in the majority of cases a market share of 20 % is normally insufficient to bring about net negative effects on competition that would result from vertical restraints practised by a single firm. Secondly, for certain vertical restraints in the light of significant efficiencies a block-exemption up to 40 % market share, which is the level at which a risk of dominance starts, can be envisaged. Above that level there is a risk that the last condition of Article 85(3) is no longer fulfilled. Accordingly, the use of market-share thresholds in a block-exemption regulation does not establish an infringement but serves to exclude certain categories of vertical restraints from the application of Article 85(1) by applying Article 85(3).

By working with these two policy assumptions based on market share only, the Commission is aware that it may exempt certain agreements that do not justify exemption. The higher the market shares used the higher that risk will be. The Commission considers that the market-share thresholds of 20 % and 40 % linked to the nature of the vertical restraint and the importance of efficiencies involved are appropriate levels for a future block-exemption regulation. However, the exact level of the market-share thresholds and the question of whether one should only work with one threshold instead of two will be reconsidered by the Commission in the course of the consultation on the BE and the guidelines (see explanation following hereafter). The Commission intends to maintain the withdrawal mechanism for the rare cases where a serious competition problem may arise below these levels of market shares. The withdrawal mechanism will in particular be applied in cumulative effect cases (see Section V for further details).

Nobody has been able to suggest a better single indicator than market share for use in a block-exemption regulation. The only alternative would be to only work with guidelines that would make it possible to use the full set of market factors for the assessment of vertical restraints. The Commission considers that this would, at the present stage, represent too radical a change and afford industry a lower level of legal certainty than the use of a block-exemption with market-share thresholds.

Competition rules are economic rules that by their very nature involve a certain degree of legal uncertainty. Companies holding market power are exposed to the risk of violating the competition rules. The Commission pursues the objective to create a reasonable level of legal certainty for industry that is compatible with the efficient protection of competition. The use of market-share thresholds makes it possible to create the link between a more economic approach and legal certainty.

Market shares are not an unknown phenomenon in the Community competition rules. Industry has been living for many years with market-share thresholds which dispense with notification (see the 15 % market share in Article 4(2) of Council Regulation No 17), create a presumption of negative clearance (see the 10 % market share in the Notice on agreements of minor importance or the 25 % market share threshold in the Merger Regulation) or grant a block-exemption (see the 10 % and 20 % market-share thresholds in Regulations (EEC) No 417 85 [1] and (EEC) No 418/85 [2]. This has not created an intolerable level of legal uncertainty for industry.

3. **Market-share cap a condition for a wider block-exemption**

Under the present system the majority of vertical agreements are not covered by any block-exemption regulation. Only goods for resale are covered as far as exclusive distribution, exclusive purchasing and franchising are concerned. Except for cars, selective distribution is not covered by any block-exemption. There is no block-exemption for services (except for franchising), for intermediate goods or for goods undergoing processing. To the extent that a block-exemption applies, it sets out which clauses are exempted (white-list approach) with the consequence that everything else is not exempted. This approach limits the scope of application of the existing block-exemptions and results in excessive regulation for industry. At the moment, the majority of companies are not covered by any block-exemption and thus either take the risk of not notifying or of notifying and accepting in most cases a comfort letter from the Commission.

The Commission wants to correct this situation by considerably widening the existing block-exemptions to include services, intermediate goods, goods for resale combined with transformation and selective distribution. It also wants to largely replace the present white-list approach by a black-list approach. The Commission considers that this will ultimately give legal certainty to more companies than the present narrow clause-based block-exemption approach. With a much wider block-exemption, it is, however, impossible to continue exempting irrespective of market power. The Commission therefore intends to work in its future Block-Exemption Regulation with two parameters: the nature of the vertical restraint and the level of market power involved.

4. **No presumption of illegality above the market-share cap**

The Commission recognises that the use of a market-share cap will create a certain degree of uncertainty for companies as to the application of the BE regulation. This is due to the difficulty of defining markets and assessing a company's position on the relevant product and geographic market. It also results from the volatility of market shares that change over time.

However, this legal uncertainty is mitigated by the following two elements:

— The use of market-share thresholds does not create a presumption of illegality above the market-share cap. The market-share threshold will only operate as a safe harbour, to distinguish the agreements that are presumed to be legal from those which may require individual examination. In respect of the latter, the Commission will continue to bear the burden of proof that the agreement in question does violate Article 85(1) and will have to examine whether the agreement does fulfil the conditions of Article 85(3). This is the normal situation of an agreement not covered by a block-exemption regulation. Above the threshold, three situations can thus arise: negative clearance, individual exemption or a prohibition *ex tunc* if the conditions of Article 85(3) are not fulfilled.

— Companies will need to know what policy the Commission is going to apply above the thresholds. The Commission therefore intends to issue a set of guidelines which should basically cover three issues: the scope of Article 85(1) above the market-share cap, the Commission's policy under Article 85(3) and its policy of withdrawal of the benefit of the block-exemption, particularly in cumulative-effect cases. These guidelines should set out clear and simple rules so as to allow companies to make in most cases their own assessment under Article 85(1) and (3). The objective must be to reduce the enforcement cost for

(1) Commission Regulation (EEC) No 417/85 of 19 December 1984 on the application of Article 85(3) of the Treaty to categories of specialisation agreements (OJ L 53, 22.2.1985, p. 1).

(2) Commission Regulation (EEC) No 418/85 of 19 December 1984 on the application of Article 85(3) of the Treaty to categories of research and development agreements (OJ L 53, 22.2.1985, p. 5).

industry and to eliminate as far as possible notifications of agreements that do not raise any serious competition problem.

Since the BE regulation uses market-share thresholds combined with a more economic approach to vertical restraints, less agreements will be covered by Article 85(1). A consistent application of the guidelines and the publication of leading decisions will further increase the level of legal certainty for industry.

5. **Revision of Article 4(2) of Regulation No 17**

If a company makes a mistake in assessing its market share, it should not be punished for the fact that it has not notified its agreement. At present the Commission can only exempt back to the date of notification. Therefore, if a contract infringed Article 85(1) and has not been notified, a national judge may declare the contract null and void for the sole reason that it has not been notified, even if all the conditions of Article 85(3) are fulfilled.

To change that situation it will be necessary to modify Article 4(2) of Council Regulation No 17 so that all vertical distribution agreements can be exempted retroactively when notification takes place at a later date. Such a change will have several beneficial effects:

— where a company has made a mistake in the assessment of its market share and is not covered by the block-exemption, the Commission will be able to exempt retroactively provided all the conditions of Article 85(3) were fulfilled from the beginning;

— it will eliminate artificial litigation before national courts, where the competition rules are often invoked to escape from contractual obligations even though there is no real competition problem; this will strengthen the civil enforceability of contracts by putting the emphasis on protection of competition instead of protection of private interests often unrelated to competition;

— it will reduce the number of notifications presently occurring with a view to obtaining legal certainty; companies will not have to notify in advance to obtain the benefit of an individual exemption, but can make their own assessment under Article 85(1) and (3) and avoid the cost of notification unless they have a real doubt about the applicability of Article 85(3); this reduction in notifications is very likely to occur, as is evident from those agreements already covered by Article 4(2) of Regulation No 17 which are not normally notified. This will allow the Commission to reduce the advance control system based on notifications and to concentrate, together with the competition authorities of Member States on the more important cases, thereby increasing the efficiency of the Community competition rules. The objective is to reduce the enforcement costs to industry and to eliminate as far as possible notifications which do not raise any serious competition problems.

Legal certainty will be further enhanced by the following additional elements:

— cumulative effects resulting from networks of vertical restraints will only be subject to the withdrawal system, with effect for the future;

— in the event of a dual-threshold system the agreements of SMEs will be subject to the higher market-share cap. However, they will remain subject to withdrawal and hardcore restrictions;

— for the calculation of the market-share thresholds, the following rules will apply:

(i) coverage by the future block-exemption will be based on the relevant antitrust market as explained in the Commission Notice on market definition [1];

(ii) the market share will be based on data for the preceding financial year;

(iii) the market share can be calculated on the basis of sales volume where there is insufficient data on sales value;

(iv) agreements remain covered by the block-exemption regulation for a period of two years as long as the threshold is not exceeded by more than 5 % market share;

(v) if the threshold is exceeded, including the 5 % increase referred to in point (iv), a grace period of one year will apply during which period

[1] Commission Notice on the definition of relevant market for the purposes of Community competition law (OJ C 372, 9.12.1997, p. 5).

the block-exemption regulation will continue to apply; the grace period would start in the year following the financial year in which the threshold was exceeded;

— in general, it will only be necessary to estimate the market share of the supplier, as it is this market share that decides whether an agreement is block exempted or not. However, in cases of exclusive supply the market share of the buyer may have to be used as the relevant indicator. In addition, the guidelines will address the issue of how the Commission will take account of the buyer's market position in the analysis of individual cases.

It is recognised that these measures will not create absolute legal certainty. However, a more economic approach is incompatible with absolute legal certainty. The aim of the present revision exercise is to bring about a new balance between a more economic approach and a reasonable level of legal certainty. This new approach is ultimately to the benefit of smaller operators without market power which are the vast majority of companies. It will also be to the benefit of bigger companies operating in competitive markets. However, companies with significant market power which would practice anti-competitive vertical restraints will be subjected to stricter control to the benefit of competition, other competitors and finally consumers.

6. Increased decentralisation

Under the existing BE regulation, there is very little scope for decentralised application of the Community competition rules. If a company drafts its agreement in accordance with the BE regulations there is no scope for the application of Article 85(2) by the national competition authorities or the national courts, because all companies are covered up to 100 % market share and only the Commission has the power to withdraw the benefit of those BE regulations. Therefore, while the existing block-exemptions apply third parties have no other course of action than to bring a complaint to the Commission.

Under the new proposed BE regulation, decentralised application of the Community competition rules is opened up for national competition authorities and courts above the market-share threshold(s) of the BE regulation. In addition it is proposed to give national competition authorities the power to withdraw the benefit of the BE regulation in their territory if the conditions of Article 85(3) are no longer fulfilled.

The Commission will closely cooperate with national competition authorities and courts to assist them in the increased application of Article 85. This cooperation is already operational since the adoption of the notices on cooperation with national competition authorities [1] and national courts [2].

SECTION V — POLICY PROPOSAL

1. Different options

During the Green Paper exercise the policy options described in Section II (see in particular the Table in II.1) were reviewed. Most of these are not acceptable as they would not solve the three major shortcomings of current policy: form-based strait-jacket regulation, neglect of market power and block-exemptions which are too narrow.

Option I of the Green Paper retains all these short-comings. Options II and IV-I reduce the strait-jacket effect but increase the neglect of market power. The umbrella block-exemption without market shares takes the neglect of market power to the extreme. Option III and Option IV-II do take account of market power but do stay too much with narrow block-exemptions with a strait-jacket effect.

Two other options, fundamentally different from the one that is proposed below, would not solve the main drawbacks of the current policy. The first, which relies on a single black clause block-exemption without market-share thresholds, would confer provisional validity upon vertical agreements, subject only to with-drawal with effect for the future. This solution would lead to the elimination of the preventive effect which is inherent in the prohibition system provided for by Article 85 and based on the *ex tunc* nullity of anti-com-

[1] Notice on cooperation between national competition authorities and the Commission in applying Articles 85 and 86 of the EC Treaty (OJ C 313, 15.10.1997, p. 3).

[2] Notice on cooperation between national courts and the Commission in applying Articles 85 and 86 of the EC Treaty (OJ C 39, 13.2.1993, p. 6).

petitive practices. It should be recalled that such a preventive effect plays a fundamental role in ensuring effective compliance by the companies and, ultimately, sound competition conditions.

The second option that is not acceptable is to start from the presumption that vertical restraints (subject to hardcore) are in general not anti-competitive and thus can be covered by a wide negative-clearance regulation, the benefit of which can be taken away with retroactive effect in cases where competition is distorted without any offsetting gains in efficiency. This general positive presumption is supported neither by economic thinking nor enforcement experience. Furthermore, it would result in increased legal uncertainty for industry. In fact, as there would be no market-share limits that would create a safe harbour the national courts, the national competition authorities and the Commission could all retroactively declare the negative clearance inapplicable at any level of market power.

2. **The proposed new policy**

As was explained in the introduction, future policy should avoid the three major shortcomings of current policy. The new policy should first and foremost protect competition and market integration. It should also provide a reasonable level of legal certainty for business, result in acceptable enforcement costs for industry and the competition authorities and increase decentralisation.

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

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

— It is based mainly on a black-clause approach, i.e. defining what is not block-exempted instead of defining what is exempted. This removes the strait-jacket effect.

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

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

— It will create a safe harbour to distinguish the agreements that are presumed to be legal from those which may require individual examination. Vertical restraints falling outside the safe harbour will not be presumed to be illegal but may need individual examination. In respect of agreements that fall outside the BE the Commission will continue to bear the burden of proof that the agreement in question does infringe Article 85(1) and will have to examine whether the agreement does fulfil the conditions of Article 85(3).

[1] In the course of consultation on this document a majority of the Member States expressed a preference for a single-threshold system.

This is the normal situation for an agreement not covered by a block-exemption regulation. Above the threshold, three situations may arise: negative clearance, individual exemption or prohibition if the conditions of Article 85(3) are not fulfilled. The proposed policy will provide for guidelines detailing the Commission's policy concerning individual negative clearance, exemption or prohibition above the market-share thresholds and possible withdrawal of the Block-Exemption below the thresholds.

— There will be a number of flanking measures as outlined in the previous section. The most important one is the extension of Article 4(2) of Regulation 17 to all vertical distribution agreements [1]. Taken together as a package with the other elements of the proposal, i.e. the fact that this very wide Block-Exemption will cover many agreements that are not presently covered by a block-exemption, the possible gradation in exemption, and guidelines, the overall level of legal certainty for industry will be improved.

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

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

(1) A draft of the required Council Regulation is jointly submitted with this Communication.

3. **Specific points**

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

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

1. fixed resale prices or minimum resale prices;

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

3. the prevention or restriction of active or passive resales, imports or exports to final or non-final buyers, other than (a) the restriction on active sales in the territory of an exclusive distributor, (b) the restriction on active sales to exclusively allocated customers, (c) the restriction on members of a selective distribution system from selling to unauthorised distributors, and (d) the restriction on the buyer of intermediate goods and/or services from selling these to other direct or indirect buyers of the supplier;

4. the prevention or restriction of cross-supplies between distributors at the same or different levels of distribution in an exclusive or selective distribution system or between distributors of these different systems of distribution: i.e. exclusive or selective distribution combined with exclusive purchasing;

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

6. the combination, at the same level of distribution, of selective distribution and exclusive customer allocation;

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

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

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

— Again assuming a dual-threshold system, the second threshold of 40 % would cover vertical restraints that, on the basis of the economic thinking or past policy experience, lead to less serious restrictions of competition. Firstly, one finds here the non-exclusive type of agreements such as quantity forcing on buyer or supplier. As they leave room for dealing with others they are less serious than their exclusive counterparts. Two exclusive types of agreement are also subject to this threshold: 1. exclusive distribution, as it does not directly harm inter-brand competition and often has efficiencies, and 2. exclusive purchasing, as it does not lead to foreclosure or a direct reduction of inter-brand competition. Lastly, this threshold would also apply to agreements between SMEs.

— It is proposed to impose a duration limit on non-compete agreements in view of the possible serious foreclosure effects connected with non-compete obligations. The Commission is also considering imposing a duration limit for exclusive purchasing combined with quantity forcing on the buyer. The Commission is further considering dispensing with the duration limits in the particular cases where the supplier owns the premises from which the buyer operates or in equivalent situations. The guidelines will take account of the particular relationship between long term investments and duration limits.

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

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

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

According to the Commission's experience, the possible negative outcome resulting from the cumulative effect of the same type of vertical restraints are especially at issue in the field of selective distribution. To address this problem, it is proposed that the Block-Exemption may be declared inapplicable to companies operating a selective distribution system on a market where more than two-thirds of the total sales is channelled through parallel networks of selective distribution. As the companies concerned may not be in possession of such a sector-wide information, it is proposed that this condition would not operate automatically. The future Block-Exemption Regulation would provide that the

Commission would, at its own initiative, establish that the aforesaid condition is fulfilled in respect of a specific market and fix a transition period at the expiry of which the Block-Exemption would no longer be applicable to selective distribution agreements relating to that market. Such a transitional period should not be shorter than six months. The Commission will publish a decision to this effect in the *Official Journal of the European Communities*.

— The choice has been made to propose one wide block-exemption regulation instead of different regulations for specific forms of vertical restraints or sectors. It thus treats different forms of vertical restraints having similar effects in a similar way, preventing unjustified differentiation between forms or sectors. In this way it is avoided, to the greatest extent possible, to have a policy bias in the choice companies make concerning their formats of distribution. The company's choice should be based on commercial merit and not on unjustified differences in exemptability. This has a number of consequences that are spelled out in the next points.

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

— Vertical agreements relating to the manufacture of goods, in particular when they involve the use of know-how or patents, are not covered. Licence agreements covered by Regulation (EEC) No 240/96 [1] on the transfer of technology will be outside the scope of the future BE regulation. The subject matter of the 1979 Notice on subcontracting [2] also remains outside the scope of the BE regulation. However, vertical agreements relating to the supply of goods, produced on the basis of specifications given by the buyer to the supplier, but not involving the use of know-how or patent rights of the buyer for the manufacture of these goods, will be covered.

— As regards vertical agreements relating to the distribution or supply of goods or services, it is proposed that the BE regulation cover intellectual property rigths to the extent that these do not relate to the manufacture of goods and are 1. indispensable for and complementary to those agreements which are exempted, and 2. contain obligations which are not more restrictive of competition than those vertical restraints which are exempted under the draft BE Regulation. This relates to restrictions on the use and application of intellectual property rights in the context of vertical agreements covered by the future block-exemption regulation.

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

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

— Certain distribution forms — in particular franchising — involve the licensing of Intellectual Property Rights (IPR). In franchising, the transfer of IPR is an essential element of this distribution format and is used to assimilate the commercial practises of the franchisee as closely as possible to those of the fran-

[1] Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85(3) to certain categories of technology transfer agreements (OJ L 31, 9.2.1996, p. 2).

[2] Notice on subcontracting agreements (OJ C 1, 3.1.1979, p. 2).

chisor. This licensing may include restrictions which are necessary or complementary to the vertical restraints placed on the sale of the goods or services. While vertical restraints on the goods or services are important from a competition perspective and may result in a franchise agreement falling within the scope of Article 85(1), these necessary or complementary restraints must be examined in the light of the need to protect the know-how provided or the maintenance of the network's identity and reputation [1].

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

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

— For reasons of coherence and unity of policy it is proposed not to retain sector specific rules for beer and petrol [2]. There are insufficient economic or legal reasons to continue to have a special regime for these sectors. In as far as sector specific treatment is justified this will be taken into account in the guidelines.

— It is proposed not to apply the rule of severability but to make the exemption of agreements dependent on all the provisions in the BE being complied with.

(1) See *Pronuptia* v. *Schillgalis,* Case 161/84, [1986] ECR 353, paras 23-24.

(2) The Block-Exemption regulation on car distribution, which expires in 2002, is not covered by the current proposal.

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

4. **Conclusions**

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

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

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

— guidelines detailing the policy above the thresholds and possible withdrawal of the BE;

— the adjustment of Article 4(2) of Regulation 17 to reduce the number of notifications, to stop artificial litigation before national courts and strengthen the civil enforceability of contracts;

— an increase in the role of national competition authorities and national courts in the application of Article 85(1) above the market-share thresholds and the withdrawal of the BE below the thresholds.

SECTION VI — PROCEDURE

1. **Legislative changes**

Implementation of the policy proposal outlined in Section V will require three new legislative texts, namely two Council amending regulations extending the Commission's powers under Regulation No 19/65/EEC [1] and amending Article 4(2) of Regulation No 17, and a Commission block-exemption regulation covering all vertical restraints in almost all sectors of distribution.

(1) OJ 36, 6.3.1965, p. 533/65.

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

The second Council amending regulation relates to the amendment of Article 4(2) of Regulation No 17, the First Regulation implementing Articles 85 and 86 of the Treaty. This is necessary because under the current system the date upon which an exemption can enter into effect cannot precede the date of notification. The Commission wants to change that system so as not to punish those companies which under the new more economic based system working with market-share thresholds may make mistakes in the assessment of their market position. Section IV.5 of this policy paper outlines a number of measures which are necessary to create a reasonable level of legal certainty for economic operators. The proposed amendment to Article 4(2) of Regulation No 17 is the most important of the measures identified. This is because under Regulation No 17, as currently worded, the earliest date upon which an individual exemption can have effect, subjet to certain limited exceptions, is the date of notification and not the date of the agreement. This has the effect that many vertical agreements falling under Article 85(1), despite fulfilling the requirements for exemption under Article 85(3), are automatically void under Article 85(2) until they have been notified to the Commission. The fact that such agreements are automatically void, pending notification, has two negative effects. First, it results in an unnecessarily high number of notifications and secondly, it results in the competition rules being used as a strategic tool to avoid the enforcement of contracts, rather than as a means to address competition problems. The objective of the draft amending text is to enable the Commission to exempt retroactively when the notification takes place at a later date. The practical effect of such a legislative amendment is that companies would no longer have to notify vertical agreements which they do not believe to cause competition concerns, simply to ensure legal certainty. Instead, companies will place greater weight on their own analysis of the economic effects of the vertical restraints at issue, knowing that in the event of subsequent litigation it would not be too late to apply for an exemption under Article 85(3).

The current Commission block-exemption regulations in the field of distribution, adopted pursuant to Regulation No 19/65/EEC, are limited to exclusive distribution (1), exclusive purchasing (2), franchising (3), and motor-vehicle distribution (4). These regulations, with the exception of the block-exemption on motor-vehicle distribution which has been excluded from the scope of the current review, cannot be satisfactorily amended to provide for the change in policy proposed in this Communication. Therefore, subject to the adoption of the two Council Regulations outlined above, a new Commission Regulation will be proposed. The Regulation will extend to all vertical restraints in all sectors of distribution other than motor vehicles, covering, *inter alia*, selective distribution, services, intermediate goods and agreements between more than two parties each operating at different levels in the distribution chain. In the light of the new regulation the *de minimis* notice may need to be reviewed.

2. **Procedural steps and timing**

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

(1) Commission Regulation (EEC) No 1983/83 of 22 June, 1983 on the application of Article 85(3) of the Treaty to categories of exclusive-distribution agreements (OJ L 173, 30.6.1983, p. 1).

(2) Commission Regulation (EEC) No 1984/83 of 22 June 1983 on the application of Article 85(3) of the Treaty to categories of exclusive-purchasing agreements (OJ L 173, 30.6.1983, p. 5).

(3) Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements (OJ L 359, 28.12.1988, p. 46).

(4) Commission Regulation (EC) No 1475/95 of 28 June 1995 on the application of Article 85(3) of the Treaty to certain categories of motor vehicle distribution and servicing agreements (OJ L 145, 29.6.1995, p. 25).