

Herbert Smith

University of Oxford Centre for Competition Law and Policy Vertical Restraints Workshop

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Overview

- Brief recap of:
 - background to EU competition rules on vertical agreements
 - role of Verticals Block Exemption
 - reform of the Verticals Block Exemption and Guidelines
 - operation of Block Exemption and key issues arising in relation to vertical agreements
- Interactive case study
- Focus on EU law; but note:
 - UK - Chapter I prohibition and parallel exemptions
 - examples from other Member States

EU approach to vertical agreements

Examples of vertical agreements

- Agreements between parties at **different levels** of the production/distribution chain
- E.g. distribution (exclusive, selective), agency, franchising, supply, purchasing

Assessment of vertical agreements

- Vertical agreements generally viewed with less suspicion - may have positive effects on competition
- But vertical agreements may restrict competition – e.g. foreclosure of competitors or reduction in intra-brand competition
- Number of investigations with both vertical and horizontal element (e.g. *Toys, Football Kits, Tobacco* (UK))

Market integration considerations

- Creation of a **single market** is a fundamental goal of the EU
- Closer scrutiny of vertical agreements in Europe than other jurisdictions

Consequences of infringement

- Invalidity (e.g. *CalorGas* (Scotland))
- Fines (e.g. *Nintendo* (EU))
- Damages (e.g. *Salentine Automobile/GM, Auto 24/Jaguar Land Rover* (France))

Role of Verticals Block Exemption Regulation

- Originally Block Exemption Regulations were aimed at minimising the Commission's workload in dealing with notifications
- New EU competition law enforcement regime implemented in 2004 – individual notification process abolished
- Do we still need Block Exemption Regulations in new self-assessment regime?
- Still provide welcome clarity and common framework
- Where the Verticals Block Exemption applies, no need to undertake any further detailed economic analysis of the effects of the agreement under Article 101(1)/(3) TFEU
- Where outside Block Exemption - Guidelines assist analysis

New Verticals Block Exemption and Guidelines

- Entered into force on **1 June 2010** following consultation
- 12 month transitional period for agreements in force on 31 May 2010 which met conditions for exemption under old regime
- European Commission wanted to take into account number of recent market developments:
 - Increase in the number of large distributors and retailers with market power
 - Significant increase in online sales
- **Market share threshold**
 - Relevant market share threshold is still set at **30%**
 - But now applies to both the supplier and the buyer's market shares
- **Additional guidance regarding online sales restrictions**
 - More detailed consideration of active/passive sales distinction in context of online sales
 - Guidance on restriction of online sales, including within selective distribution network
 - Interplay between competition law considerations and e-commerce policy objectives (and see free movement cases)
- **Additional guidance on Article 101(3) "efficiency defence"**
 - For example in relation to RPM

"Safe harbour" of the Verticals Block Exemption

- Applies to vertical agreements:
 - purchase/sale/resale of goods/services
 - undertakings at different level of the market
 - no provisions on competitors
- **3 conditions** must be met for Block Exemption to apply:
 - 1) absence of market power → below **30%** market share cap
 - 2) no "**hardcore**" restrictions (e.g. RPM)
 - 3) any "**impermissible**" restrictions must be severable from the rest of the agreement (e.g. non-compete)

"Hardcore" restrictions

- 5 types of **hardcore** restrictions:
 - Resale price maintenance (RPM)
 - Absolute territorial restraints or restraints on resale to customers
 - Restraints on resale in a selective distribution system
 - Restraints on cross supplies in a selective distribution system
 - Restraints on supply of spare parts
- If you include any hardcore restraint in a vertical agreement → whole agreement will be excluded from the Block Exemption; self-assessment needed
- Also gives rise to a (rebuttable) presumption that the agreement is unlikely to fulfil the individual exemption conditions under Article 101(3) TFEU

Resale price maintenance (RPM)

- If restrictions amount to imposing a **fixed** or **minimum** price → cannot rely on Block Exemption
- Can recommend a resale price to a reseller, or to require a reseller to respect a **maximum** resale price within scope of Block Exemption
- Need to consider pricing practices very carefully – Commission will look carefully at whether "recommended" price is in reality a fixed or minimum price
- Outside safe harbour of Block Exemption, have to carry out detailed assessment under Article 101(3)
- New Guidelines recognise that in some circumstances RPM restrictions in a vertical agreement may lead to "efficiencies" which outweigh any anti-competitive effects

Absolute territorial restraints

- General rule → Block Exemption will not apply where agreement includes:
 - restraints on the **territory** into which a buyer or distributor may sell the contract goods or services; or
 - restraints on the **customers** to whom a buyer or distributor may sell the contract goods or services
- Under new regime this is without prejudice to a restriction on the buyer's place of establishment (e.g. warehouses)
- Number of important exceptions to the general rule
 - e.g. can restrict "**active**" sales by a distributor into a territory **exclusively** allocated to another distributor, or reserved to the supplier
- "**Active**" sales involve directly approaching or specifically targeting particular customers
- "**Passive**" sales involve responding to unsolicited requests from individual customers
- Are **online** sales active or passive sales?

Restrictions on online sales

- Starting point of new Guidelines → **every** distributor must be allowed to use the internet to sell products
- BUT number of important exceptions – in certain circumstances, can restrict online sales
- Limited circumstances where an outright ban on online sales may be **objectively necessary** and fall outside the scope of Article 101 TFEU
- Supplier can require "**quality standards**" for the use of a website to resell his goods
 - relevant in particular for selective distribution
 - not entirely clear what will constitute acceptable "quality standards"
 - use of third party platforms?
- Supplier can require distributors to have **one or more brick and mortar shops** as a condition for becoming a member of the distribution system, where the nature of the product requires it
- Allowed to impose restrictions on **active** sales by a distributor into an **exclusive** territory or to an exclusive customer group reserved to the supplier, or allocated to another distributor

Restraints on resale in a selective distribution system

- Cannot impose restraints in a selective distribution system which prevent distributors from making active or passive sales to end users
- Can prohibit a member of the system from operating out of an 'unauthorised place of establishment'
- Note that Guidelines state that a website/the internet will not be considered to be a "place of establishment"

Restraints on cross supplies in a selective distribution system

- Cannot impose restrictions on cross-supplies between distributors within a selective distribution system
 - Includes restrictions between distributors operating at different levels of trade
- Distributors in a selective distribution system must always be free to purchase from other appointed distributors in the system

Impermissible (but non-hardcore) restraints must be severable

- "**Impermissible**" (but non-hardcore) restraints listed in Article 5
- Include:
 - any direct or indirect non-compete obligation, the duration of which is indefinite or exceeds **five** years (including tacit renewal)
 - non-compete obligations preventing the buyer from dealing in competing goods or services **after the termination** of the agreement, subject to certain exceptions
- Severability applies → Block Exemption can apply to remaining part of the vertical agreement if it is severable from "impermissible" restraints
- Contrast with position in respect of "hardcore" restrictions (whole agreement is excluded from Block Exemption)

What if the Block Exemption does not apply?

- Does not automatically mean that the agreement infringes EU competition law
- But does mean you have to carry out full detailed self-assessment process under Article 101(1)/(3) TFEU
- Commission Guidelines provide a helpful starting point
- Also if the agreement existed prior to 31 May 2010 and met conditions of the old Block Exemption – benefit from transitional period until 31 May 2011

CASE STUDY

- Super Hi-Fi manufactures high-spec hi-fi systems and speakers, which are sold to consumers throughout the EU by Super Hi-Fi and its retailers.



- Super Hi-Fi's Head of Sales and Marketing, George Jones, has been asked to review its distribution agreements in various EU Member States.



- Super Hi-Fi sets a manufacturer's recommended resale price ("MRRP") for its products, which is communicated to all its retailers.



PRICE LIST	
PRODUCT	MRRP
SHF120 Hi-Fi	£759.00
SHF120 Speakers	£399.00
SHF130 Hi-Fi	£995.00
SHF130 Speakers	£550.00
SHFLux Hi-Fi	£1399.00
SFLux Speakers	£625.00
iPod Dock add-on	£ 50.00
Speaker stands	£129.00

- Following discussions at a recent internal sales meeting, Super Hi-Fi has concluded that it does not want its products to be sold at more than 20% below the MRRP.

- There are a number of reasons for this:
 - Super Hi-Fi wants to make sure that retailers secure sufficient profit margins to enable them to provide the pre-sale marketing and post-sale customer services that Super Hi-Fi considers necessary to grow sales of the products
 - Super Hi-Fi is concerned that if some of the bigger retailers sell its products at heavily discounted prices then other retailers will decide not to stock Super Hi-Fi products anymore, on the basis that there are more profitable opportunities with other products.
- George Jones is considering how he can ensure Super Hi-Fi products are not sold at more than 20% below the MRRP, bearing in mind these concerns.

Discussion Question 1

Which, if any, of the following options would be most likely to be permissible under EU competition law?

- (a) Imposing a minimum resale price which is set at 20% under the MRRP.
- (b) Requiring the retail outlets owned by Super Hi-Fi to sell all Super Hi-Fi products at the MRRP.
- (c) Delaying deliveries of Super Hi-Fi products to retailers who sell those products at more than 20% below the MRRP.
- (d) Making the grant of volume-related rebates to retailers subject to not selling any Super Hi-Fi products at more than 20% below the MRRP.
- (e) None of the above.

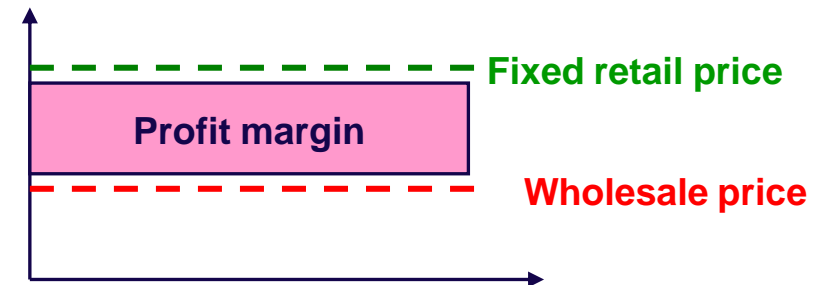
- Super Hi-Fi has recently developed a new type of state of the art wireless and waterproof headphones.
- The company is keen to push this product as quickly as possible as it wants to target this year's summer holiday market, which it sees as one of its key markets.



- In order to ensure that its retailers engage in the necessary promotional activities, George Jones has decided to set the retail price at a fixed £125 per headphone set for all distributors during the launch period.



- According to Jones this should give them a decent margin with plenty of extra to spend on promotional campaigns.



Discussion Question 2

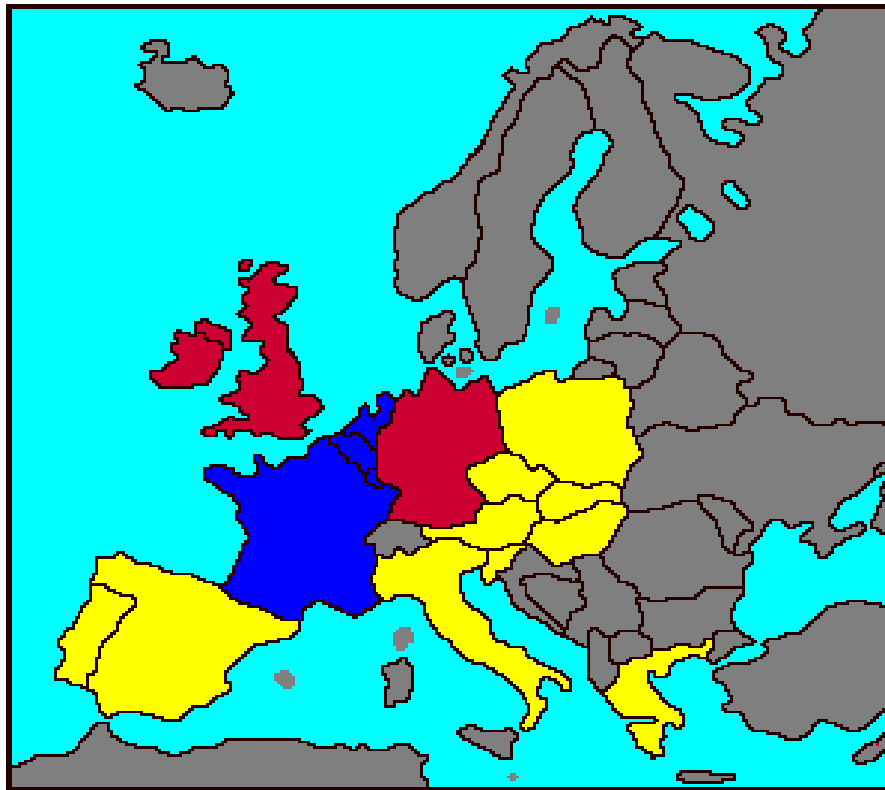
Which of the following statements is correct?

- (a) This is blatant RPM and is always prohibited under the EU competition rules.
- (b) This is RPM and will infringe Article 101(1), but there may be grounds for exemption under Article 101(3) as it will make it easier for the new product to enter the market, which is ultimately in the interest of consumers.
- (c) RPM is always permitted for new products, so this is not an issue at all.

RPM - Summary

- If restrictions amount to imposing a **fixed** or **minimum** price: hardcore restriction, Block Exemption does not apply
- Permitted to **recommend** a resale price to a reseller, but Commission will look carefully at whether "recommended" price is in reality a fixed or minimum price
- Permitted to require a reseller to respect a **maximum** resale price
- New Guidelines recognise that in some circumstances RPM restrictions in a vertical agreement may lead to efficiencies which outweigh any anti-competitive effects (para 225)

- In France, Super Hi-Fi retails its products exclusively in its own stores.
- In Germany and the UK, Super Hi-Fi has appointed exclusive retailers - Musik Markt in Germany and Pure Sounds in the UK.
- In other EU countries where Super Hi-Fi products are sold, Super Hi-Fi products are distributed by a number of non-exclusive retailers.

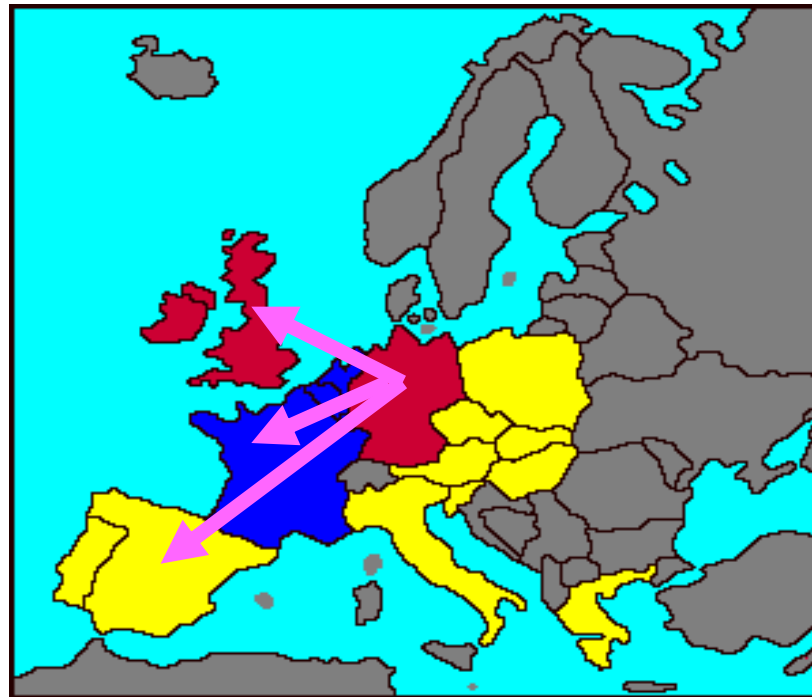


-  Exclusive retailer
-  Exclusively reserved to Super Hi-Fi
-  Non-exclusive retailers

- George Jones has received a complaint from UK retailer Pure Sounds that German retailer Musik Markt is supplying "its" UK customers with cut-price Super Hi-Fi products which can be ordered via Musik Markt's website and delivered to the UK.
- Pure Sounds' CEO is very angry about this and has demanded that Super Hi-Fi take immediate steps to prevent Musik Markt from selling Super Hi-Fi products to customers based in the UK.



- When investigating the complaint, George Jones visits the Musik Markt website and notes that it is also possible to order Super Hi-Fi products for delivery in France and Spain.



→ Sales by Musik Markt

- Super Hi-Fi's CEO has asked George to come up with a way of resolving Pure Sounds' complaint.
- He also wants George to prevent Musik Markt from selling to any customers located in any other EU countries apart from Germany.



Discussion Question 3

Which, if any, of the following restrictions could be imposed on Musik Markt in its exclusive agreement with Super Hi-Fi under the Block Exemption?

- (a) Requiring Musik Markt to re-route customers located in the UK who try to order from Musik Markt's website to Pure Sounds' website and re-route customers located in France to Super Hi-Fi's website.
- (b) Requiring Musik Markt to terminate any attempted online transaction if the customer's credit card details reveal an address which is not within Germany.
- (c) Prohibiting Musik Markt from engaging in newspaper and/or TV advertising specifically targeted at customers located in the UK.
- (d) Prohibiting Musik Markt from sending unsolicited mailshots or e-mails to customers located in Spain.
- (e) Prohibiting Musik Markt from offering non-German language options on its website, which allow consumers to view the website in English, French, Spanish or other EU languages.
- (f) None of the above.

Discussion Question 4

Can Super Hi-Fi prohibit Musik-Markt from listing prices in both GBP and EUR on its website?

(a) Yes

(b) No

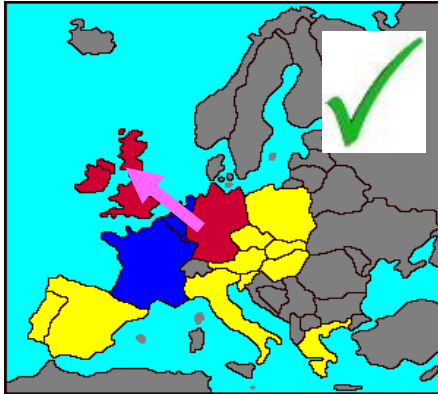
Discussion Question 5

Would the position be any different if Super Hi-Fi did not operate an exclusive distribution system for its retailers in Germany and the UK, but instead operated a selective distribution system?

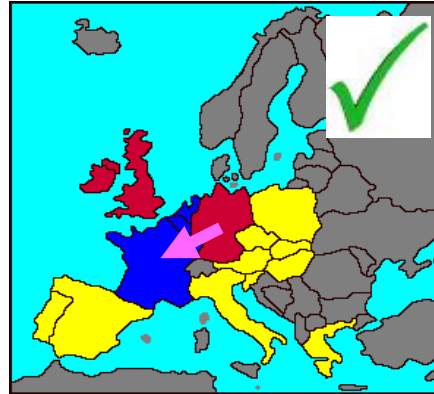
- (a) No – the position would be the same.
- (b) Yes – Super Hi-Fi would be able to impose all of the above restrictions if it operated a selective distribution system.
- (c) Yes – Super Hi-Fi would not be able to impose any of the above restrictions if it operated a selective distribution system.

Territorial Restrictions - Summary

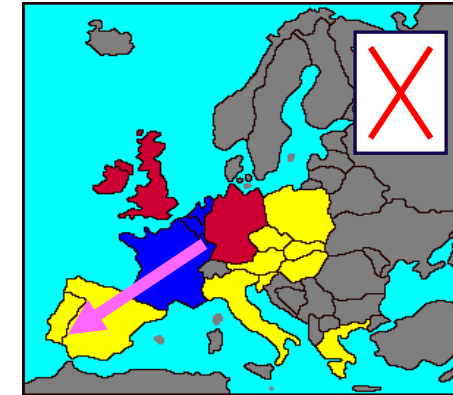
EXCLUSIVE DISTRIBUTION



Active sales into territory already exclusively allocated to another distributor **CAN** be restricted



Active sales into territory exclusively reserved to supplier **CAN** be restricted

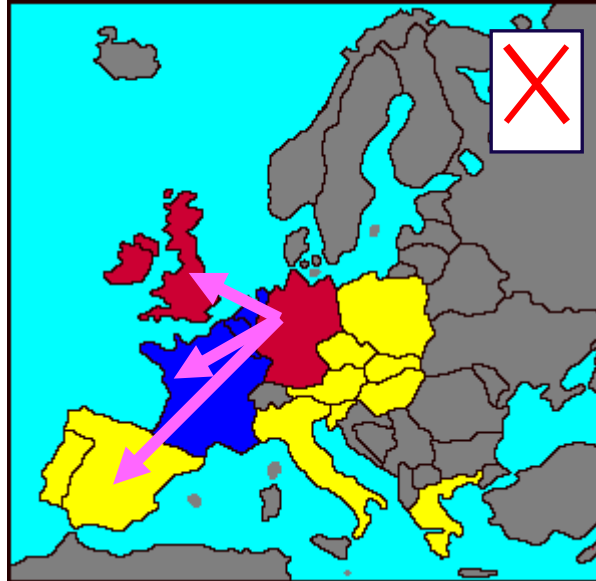


Active sales into territory not exclusively allocated to another distributor or reserved to supplier **CANNOT** be restricted

Passive sales CANNOT be restricted in any case

Territorial Restrictions - Summary

SELECTIVE DISTRIBUTION AT THE RETAIL LEVEL OF TRADE



CANNOT restrict either active or passive sales to end consumers

- Pure Sounds has informed Super Hi-Fi that it is considering closing many, or even all, of its retail shops in the UK, with a view to focussing instead on online sales.



- Super Hi-Fi is concerned about these plans as it wants to ensure that Super Hi-Fi products are on display and available for purchase in bricks and mortar retail stores in the UK, so that customers can view the products prior to purchase and obtain specialist advice and recommendations.



- Super Hi-Fi is therefore reviewing whether to continue with Pure Sounds as its exclusive retailer in the UK.
- As part of this review, Super Hi-Fi is considering imposing some additional restrictions on Pure Sounds if it is to remain the exclusive retailer for Super Hi-Fi products in the UK.
- George has heard, however, that the EU is opposed to restrictions on online sales.

Discussion Question 6

Which, if any, of the following would be permissible under EU competition law?

- (a) Requiring Pure Sounds to have at least 5 retail shops in certain specified locations as a condition for engaging in online sales of Super Hi-Fi products.
- (b) Requiring Pure Sounds to limit its online sales of Super-Hi products to £2m worth of products per year.
- (c) Super Hi-Fi agreeing to pay Pure Sounds a rebate of 1% of the purchase price for each product sold off-line.
- (d) None of the above.

Discussion Question 7

Can Super Hi-Fi require Pure Sounds to sell at least £40m worth of Super-Hi products off-line each year as a condition for being permitted to engage in online sales?

- (a) Yes**
- (b) No**

Discussion Question 8

Can Super Hi-Fi require Pure Sounds to have a 24 hour call centre to deal with after-sales queries for on-line sales and requiring Pure Sound's website to contain video clips of Super Hi-Fi products approved by Super Hi-Fi?

- (a) Yes**
- (b) No**

Online sales restrictions - Summary

- Restrictions on online sales generally considered undesirable by Commission (including measures falling short of a ban on online sales, e.g. dual pricing)
- Starting point of new Guidelines (para 52):
 - every distributor must be allowed to use the internet to sell products
 - having a website considered a form of passive selling
- BUT number of important exceptions – in certain circumstances online sales can be restricted

Online sales restrictions - Summary

Permissible

- Limited circumstances where an outright ban on online sales may be **objectively necessary** and fall outside the scope of Article 101 (para 60)
- Supplier can require "**quality standards**" for the use of a website to resell his goods and selective distribution criteria relating to online sales (para 54, para 56)
- Supplier can require distributors to have **one or more brick and mortar shops** as a condition for becoming a member of the distribution system, where the nature of the product requires it (para 54, para 56, para 176)
- Restricting a distributor from sending out **unsolicited sales e-mails** to individual customers located in a territory exclusively allocated to another distributor (or reserved to the supplier) (para 51)
- Restricting a distributor from making online **advertisements specifically addressed** to certain customers exclusively allocated to another distributor (para 53), e.g.
 - territory based banners on third party websites
 - paying a search engine or online advertisement provider to have an advertisement displayed specifically to users in a particular territory

Online sales restrictions - Summary

Not permissible

- Agreeing that the distributor shall prevent customers located in another territory from viewing its website or shall put on its website automatic re-routing of customers to the manufacturer's or other distributors' websites (para 52)
- Agreeing that the distributor shall terminate consumers' transactions over the internet once their credit card data reveal an address that is not within the distributor's (exclusive) territory (para 52)
- Agreeing that the distributor shall limit its proportion of overall sales made over the internet, **BUT** can require buyer to sell certain absolute amount or products off-line (para 52)
- Agreeing that the distributor shall pay a higher price for products intended to be resold by the distributor online than for products intended to be resold off-line, **BUT** can provide buyer with a fixed fee not linked to turnover/volume to support off-line sales efforts (para 52)
- Imposing selective distribution criteria for online not **overall equivalent** to criteria for bricks and mortar shops (para 56)

- Super Hi-Fi has previously been advised that its existing distribution agreements with each of the retailers in its exclusive distribution network fall within the "safe harbour" of the EU Vertical Agreements Block Exemption.
- It was queried at a recent internal meeting whether the recent changes to the EU competition law rules relating to vertical agreements would mean that Super Hi-Fi could no longer rely on that safe harbour.



- Super Hi-Fi's in-house lawyer, Sarah Taylor, has been asked to give some initial consideration to this question, with a view to determining whether to seek more detailed specific advice from outside counsel.
- Sarah reviews the new Block Exemption and Guidelines, and concludes that none of Super Hi-Fi's existing distribution agreements contain any "hardcore" or "excluded" restrictions.
- However, she is concerned that the changes made to the market share threshold may impact Super Hi-Fi.

Discussion Question 9

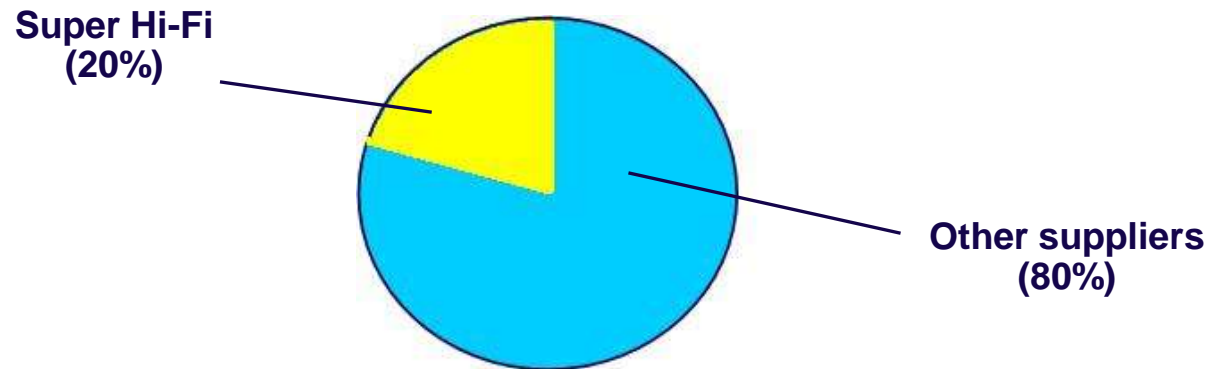
Sarah has identified 4 potentially relevant markets:

- 1) the market(s) on which Super Hi-Fi sells the products to its distributors
- 2) the market(s) on which Super Hi-Fi purchases the components it uses to manufacture the products
- 3) the market(s) on which the retailer sells the Super Hi-Fi products
- 4) the market(s) on which the retailer purchases the Super Hi-Fi products

Which of these markets would be relevant when considering whether Super Hi-Fi's distribution agreements fall within the safe harbour of the Block Exemption?

- a) 1 only
- b) 1 and 3
- c) 2 only
- d) 1 and 4

- Sarah estimates that Super Hi-Fi's relevant market share is around 20% in all relevant geographic markets.



- Based on the limited information which is publicly available, Sarah also estimates that the relevant market shares of some of Super Hi-Fi's exclusive retailers are as follows:
 - Pure Sounds (UK) – 16%
 - Musik Markt (Germany) – 37%
 - Ultima Musica (Spain) – 29%
 - TMC (Netherlands) – 5%

Discussion Question 10

On the basis of these market share estimates (and assuming that Sarah is correct that none of the agreements contain any hardcore or excluded restrictions), will Super Hi-Fi still be able to rely on the safe harbour of the new Block Exemption?

- (a) Yes, because Super Hi-Fi's relevant market share is less than 30%.
- (b) Only in respect of the agreement for distribution in the Netherlands, where the combined market share of Super Hi-Fi and TMC is less than 30%.
- (c) No, because Musik Markt has a market share of more than 30%, which means that all of the distribution agreements which form part of the exclusive distribution network fall outside the safe harbour.
- (d) Only in those territories where the retailer has a relevant market share of less than 30% i.e. in the UK, Spain and the Netherlands on the basis of the above estimates.

- Sarah subsequently receives some updated sales figures, which show that Ultima Musica has had an excellent Christmas period, and now has a market share of 31%.

**ULTIMA MUSICA
PRESS RELEASE**

- Sales up over key Christmas period
- Market share increases to 31%
- Strong sales expected to continue in New Year



- Sarah is concerned that this means that Super Hi-Fi can no longer rely on the safe harbour of the Block Exemption in respect of its distribution agreement with Ultima Musica.

Discussion Question 11

Is Sarah correct that Super Hi-Fi can no longer rely on the safe harbour of the Block Exemption in respect of its distribution agreement with Ultima Musica?

- (a) Yes
- (b) No

Market share threshold - Summary

- **30%** market share threshold now applies to both the supplier and the buyer – consider each individually, not cumulatively (para 87)
- Relevant markets are:
 - the market on which the supplier sells the products
 - the market on which the buyer purchases the products (para 87)
- Block Exemption will only apply for as long as the market share threshold continues to be met
- Important to ensure ongoing careful monitoring of relevant market shares
- Some exceptions which cover temporary increases above 30% threshold – Article 7(d) and 7(e) – but only available in limited circumstances

Questions?

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