

## **Hardcore restrictions under the Block Exemption Regulation on vertical agreements: An economic view<sup>1</sup>**

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### Introduction

The Block Exemption Regulation 2790/1999 (BER) establishes that article 81(1) does not apply to vertical agreements in which the supplier does not hold more than 30% market share. The issuing of the BER, and of the *Guidelines on Vertical Restraints*<sup>2</sup> (henceforth, Guidelines) which accompanied it, was rightly heralded as the introduction of an effects-based approach into EC competition law on agreements. Indeed, economics suggests that vertical agreements are likely to harm welfare only if the firms using them possess substantial market power. Therefore, competition agencies should not use their scarce resources to monitor vertical agreements entered into by firms with little market power, and such firms should benefit from a safe harbour which guarantees legality of their vertical agreements. Since firms with small market shares are unlikely to enjoy substantial market power, and since - unlike the latter - the former can be measured with relative ease, it makes sense from an economic point of view to exempt from article 81(1) vertical agreements by suppliers with a market share below a certain threshold.

Additionally, though, the BER (at Article 4) states that this exemption should not apply to some vertical agreements that the Commission considered more harmful than the others. Among these ‘black-listed’, or ‘hardcore’ clauses, there are in particular resale price maintenance (to be more precise, resale price fixing and minimum resale price) and vertical clauses which aim at restricting active sales from one territory to the other. The BER establishes that vertical agreements containing such hardcore restrictions will not be exempted from the application of Article 81(1), even if the firms concerned hold an arbitrarily small market share (indeed, the *de minimis* Notice does not apply to such hardcore restrictions). Furthermore, the Guidelines (Paragraph 46) establish that “Individual exemption of vertical agreements containing such hardcore restrictions is also unlikely”, thus imposing *de facto* a regime very close to a *per se* prohibition for such hardcore restrictions.

We believe that the fundamental approach of the BER – namely allowing firms with small market share to use the vertical agreements as they prefer - is the correct one. Nor do we see any reason to advocate for a different market share threshold: despite its arbitrariness, the 30% threshold is satisfactory in that: (i) not only dominant firms but also firms with sizeable market power do not automatically benefit from an exemption (recall also that not being exempted from Article 81(1) does not automatically imply that the agreement is anti-competitive); (ii) it ensures that firms with really little market power enjoy legal certainty that they can enter into vertical agreements as they see more convenient.

However, we believe that it is worth considering the possibility to change the EC policy on the so-called hardcore restrictions. In the remaining of this short note, we concentrate on this issue, by first discussing resale price maintenance, and then territorial restrictions.

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<sup>1</sup> The authors are members of the Economic Advisory Group on Competition Policy at the Directorate General for Competition, European Commission.

<sup>2</sup> Commission Notice 2000/C 291/01.

### Resale price maintenance

The economic literature identifies both possible anti-competitive and pro-competitive effects from the use of resale price maintenance (RPM). Let us *briefly* look at them in turn.

A possible anti-competitive effect from RPM comes from the solution of the so-called *commitment problem* of a monopolist, which would impede even a monopolistic supplier from enjoying monopolistic profits.<sup>3</sup> This is because a monopolist would always have the temptation to reduce the wholesale price set to a retailer (in exchange of a compensation) to allow it to expand its market share to the detriment of rival retailers. Since all retailers anticipate that the monopolist could behave in this opportunistic way, the result will be that they will not be willing to accept to pay a high wholesale price for the good in the first place. RPM solves the ‘commitment problem’ of the monopolist – and allows it to restore its monopolistic profits – because it breaks its opportunistic temptations: if the retail price is fixed (or if there is a retail price floor), a lower wholesale price could not lead to lower retail prices (and to higher market shares), thereby eliminating the incentive for the supplier and one retailer to renegotiate a wholesale price to the detriment of rival retailers. This, however, supposes that the RPM agreement itself is made public and/or apply to all retailers. In addition, price *ceilings* would also solve the manufacturer’s commitment problem.<sup>4</sup> O’Brien and Shaffer point out that, since the commitment problem comes from the incentive to free-ride on downstream rivals’ margins, price ceilings do provide a solution to the commitment problem, by allowing the parties to squeeze retail margin. Furthermore, purely “bilateral, vertical” price ceilings suffice to do the trick, whereas in the case of price floors, as noted above, the agreement must be “horizontal” as well in nature (that is, it must be common knowledge that the rivals are also exposed to a similar price floor); in other words, price ceilings could be argued to constitute a more effective solution than price floors.

Let us also note that this line of argument would equally apply to non-price restrictions such as territorial provisions, which can also solve the manufacturer’s commitment problem.

Recent contributions have also analysed the possibility that RPM *softens competition* in more sophisticated models where two (or more) suppliers sell their products to two (or more) retailers, a situation which could be termed of “interlocking relationships”. Whether due to the reduction of the incentives to behave aggressively,<sup>5</sup> or to bargain for lower wholesale prices,<sup>6</sup> RPM might have an anti-competitive effect because it might dampen incentives to compete and result in higher prices.

Finally, RPM might *facilitate collusion*, either among upstream firms (manufacturers) or among downstream firms (retailers). Collusion among manufacturers may be better sustained because RPM would allow better monitoring (and therefore punishment) of deviations, thereby pushing firms to stick to the collusive action. Indeed, if RPM did not exist, a supplier would find it difficult to understand whether a lower retail price of a rival product is due to a decision of the retailer to cut its profit margin, or to a decision of the rival supplier to deviate from the collusive (upstream) price.

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<sup>3</sup> See Oliver Hart and Jean Tirole (1990), “Vertical Integration and Market Foreclosure”, *Brookings Papers on Economic Activity: Microeconomics*, 205-286, and Patrick Rey and Jean Tirole (2007), “A Primer on Foreclosure,” *Handbook of Industrial Organization*, vol. III, Mark Armstrong and Rob Porter eds, North Holland, 2145-2220..

<sup>4</sup> See O’Brien, Daniel, and Greg Shaffer (1992), “Vertical Control with Bilateral Contracts”, *Rand Journal of Economics*, 23:299-308.

<sup>5</sup> Intuitively, retailers act as common agents for the suppliers, and RPM eliminates competition among these common agents. See Patrick Rey and Thibaud Vergé (2002), “Resale Price Maintenance and Horizontal Cartel,” CMPO Working Paper 02/047, University of Bristol, and empirical validations based for the French market by Pierre Biscourp, Xavier Boutin and Thibaud Vergé (2008), “The Effects of Retail Regulations on Prices: Evidence from the Loi Galland”, INSEE-DESE Discussion Paper G2008/02, and Céline Bonnet and Pierre Dubois (2004), “Inference on Vertical Contracts between Manufacturers and Retailers Allowing for Non Linear Pricing and Resale Price Maintenance,” mimeo.

<sup>6</sup> See Paul Dobson and Michael Waterson (2007), “The competition effects of industry-wide vertical price fixing in bilateral oligopoly”, *International Journal of Industrial Organization*, 25(5); 935-962.

Under RPM, instead, the retail price is chosen by the manufacturer, rendering it immediately clear that a price cut coincides with a deviation. Anticipating that the deviation would be immediately spotted and punished with a price war, suppliers would abstain from deviating in the first place.<sup>7</sup>

Collusion among retailers may instead be facilitated by the existence of sham (that is, fictitious) RPM. If retailers are endowed with sufficient bargaining power, they may be able to convince a manufacturer to ‘impose’ RPM and to indicate the retail price, as a way to engage into retail price-fixing.

The analysis of anti-competitive effects of RPM suggests therefore that: (i) for both the commitment effect and for the softening competition effect to be a source of worry, the suppliers engaging into RPM should be endowed with considerable market power.<sup>8</sup> Therefore, it is likely that such effects could be overlooked if suppliers have small market share; (ii) the pro-collusive effects of RPM require industry-wide RPM to exist, and can therefore be taken care of by the BER’s provisions (article 8) that the exemption can be revoked in the case of networks of vertical restraints covering more than 50% of the market.<sup>9</sup> Further, where firms have deliberately coordinated to establish RPM so as to sustain collusion, anti-cartel law would apply anyhow.<sup>10</sup>

To sum up, it does not seem that by allowing firms with small market shares to engage in RPM one would incur significant competitive risks.

On the pro-competitive side, RPM might help protect investments by avoiding free-riding behaviour among retailers, signalling the quality of products, or help establish a price reputation (and the overall image) for the manufacturer’s product. In many markets, consumer welfare may depend on the quality of the product (including information about new products) and other sales services and not only on prices.

It is difficult to say a priori whether one should expect pro-competitive effects to outweigh anti-competitive effects. Furthermore, in the economic literature the empirical evidence on the effects of RPM is scarce, and it gives rather mixed conclusions.<sup>11</sup> For instance, one case study on spirits indicates that output is lower in U.S. states where RPM was allowed.<sup>12</sup> Another study on the French retail sector suggests that prices increased and no longer showed a positive relationship with concentration after a change in legislation that gave firms the possibility to set industry-wide price

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<sup>7</sup> See Bruno Jullien and Patrick Rey (2007), “Resale Price Maintenance and Collusion”, *Rand Journal of Economics*, 38(4):983-1001.

<sup>8</sup> Research on interlocking relationships is still at its early stages, and it is difficult to formulate policy implications from it. On the one hand, it seems the very nature of interlocking relationships – the fact that competition is removed among common agents – that relaxes competition, so softening of competition may take place also when the industry is relatively fragmented; on the other hand, RPM would probably soften competition to the extent that it is an industry-wide practice. Therefore, the fact that the exemption from article 81(1) does not apply to a network of vertical agreements might suffice to avoid problems associated with this effect.

<sup>9</sup> It is admittedly not clear to us how the procedure to revoke the exemption works. To the extent that this procedure does not allow to intervene in a timely way, the Regulation or the Guidelines should clarify that RPM which go beyond the 50% market share would not enjoy exemption. Since firms can observe RPM made by rivals, they should be able to see whether their RPM would exceed the 50% share or not.

<sup>10</sup> If fictitious RPM agreements are made to sustain cartels, they will be considered a violation of article 81.

<sup>11</sup> For an overview on the limited empirical evidence on vertical restraints, including RPM, see Francine Lafontaine and Margaret Slade, 2005, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in: Paolo Buccirossi (ed.), *Handbook of Antitrust Economics*. Cambridge: MIT Press. From their survey they conclude that voluntary vertical restraints do not hurt consumers, whereas those imposed from outside do.

<sup>12</sup> See Stanley Ornstein and Dominique Hanssens (1987), *Resale Price Maintenance: output increasing or restricting? The case of distilled spirits in the United States*, *Journal of Industrial Economics*, 36, 1-17.

floors.<sup>13</sup> In contrast, a case study on US glassware reports evidence against anti-competitive theories, and consistent with a principal-agent explanation where RPM helps to increase sales.<sup>14</sup> Finally, a study on the stock price effects of RPM antitrust challenges concludes that RPM has no single explanation but is instead consistent with a variety of theories.<sup>15</sup>

It is therefore difficult to conclude on theoretical or empirical grounds whether the anti-competitive or the pro-competitive effects of RPM are more important. However, one should notice: first, that firms with little market share are unlikely to give rise to significant anti-competitive effects; second, that the smaller the market power possessed by a firm the smaller the efficiency gain required for RPM to have a positive effect. This suggests a rule that exempts RPM entered into by firms with low market share.<sup>16</sup> (Furthermore, these are likely to be small firms which otherwise would not want to bear the cost of an investigation because of the high legal costs, and associated uncertainty. In other words, they may have excellent reasons to want RPM, but absent the legal certainty of an exemption they would find it too costly to run the risk associated with a complaint and an infringement procedure.) Third, RPM is less likely to harm if it is an isolated practice, and it may also matter whether relationships are interlocked or not. For instance, if a new entrant relies on RPM to convince established distributors to help it enter the market – and incumbent rivals do not use RPM – it is unlikely that RPM may be harmful. At the other extreme, competition may even be completely eliminated in a situation where RPM is pervasive and there are interlocking relationships.

To conclude, we would favour a change in the BER as follows. The presumption that RPM is welfare detrimental and that it is unlikely that an exemption would be granted even to firms enjoying less than 30% market share should be replaced by a statement that ‘the larger market power the stronger should be the demonstrated efficiency gains’ with a concrete rule that states: (1) the *de minimis* rule applies also for RPM (i.e., a firm with less than 15% market share can engage in RPM); (2) for a firm with a share above 15%, the burden of proving that RPM will have beneficial effects on competition is resting upon it; (3) it is unlikely that a firm with a share in excess of 30% will be able to show that RPM will have a net beneficial effect.

### Territorial restrictions

To understand the effects of clauses which aim at enforcing territorial restrictions, we have to understand the effects of price discrimination. Indeed, in order to discriminate prices across consumers, firms need to prevent *arbitrage*, that is, to prevent consumers (or intermediaries) to buy where price is low and resell where the price is high.<sup>17</sup> Hence, to study the effects of clauses which restrict arbitrage is tantamount to studying the effects of price discrimination.

Price discrimination is a very widespread phenomenon in all industries. By this practice, firms try to make consumers with a higher valuation for their goods pay a higher price than those with a lower

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<sup>13</sup> See Pierre Biscourp, Xavier Boutin and Thibaud Vergé (2008), *The Effects of Retail Regulations on Prices: Evidence from the Loi Galland*, working paper.

<sup>14</sup> Pauline Ippolito and Thomas Overstreet (1996), *Resale Price Maintenance: an Economic Assessment of the Federal Trade Commission’s Case against the Corning Glass Works*, *Journal of Law and Economics*, 39, 285-328.

<sup>15</sup> Thomas Gilligan (1986), *The Competitive Effects of Resale Price Maintenance*, *Rand Journal of Economics*, 17, 544-556.

<sup>16</sup> Similar considerations are well accepted in merger analysis. A merger among two competitors would have the anti-competitive effect of increasing market power, and *may* entail an efficiency gain. The higher the market power held by the merging firms the larger the efficiency gain required for the merger to have an expected net effect. For this reason, only mergers among firms which possess a sizeable market share are scrutinised.

<sup>17</sup> When arbitrage takes place among different countries it coincides with the legal concept of *parallel trade*.

valuation, thereby increasing profits by extracting more surplus from consumers that have higher willingness to pay, while at the same time proposing more adequate conditions to consumers with a lower willingness to pay.

The economic literature on price discrimination is well established and it suggests that price discrimination has *ambiguous* effects on welfare.<sup>18</sup> Suppose for instance that consumers' valuation for a certain product is positively correlated with their incomes, so that richer consumers are willing to pay more. Compared to a situation where prices are the same across consumers, price discrimination has the effect of increasing the firm's profits, reducing the surplus of richer consumers (they will have to pay more for the good) and improving the surplus of poorer consumers (they will have to pay less for the good). The final net effect of price discrimination depends therefore on several variables, including the relative importance of the different types of consumers. In particular, absent distributional concerns and keeping constant the behaviour of the other firms, a *necessary* condition for price discrimination to improve welfare is that total sales of the product increase. In addition, allowing firms to offer differentiated terms tends to result in more intense competition, which also tilts the balance against a ban on discrimination.<sup>19</sup>

To understand the effect of clauses which restrict parallel trade, one should also consider the impact of exclusive territorial clauses, i.e. vertical agreements which assign the right to sell a certain product in a given area to a particular retailer or distributor. The literature on exclusive territories shows that such agreements may have anti-competitive effects (the more likely the larger the share of the market held by the firm), for instance when they are used to solve the commitment problem of a monopolist (see above); or to relax competition between vertical (manufacturer-distributor) chains, leading to higher final prices of the products.<sup>20</sup> But it also shows that exclusive territories are often an indispensable tool to protect investments by retailers (or manufacturers) by solving free-rider problems: absent such clauses, a retailer would invest less because it would not be able to appropriate (wholly or in part) the fruits of its investments into sales services which benefit also competing retailers.

If the treatment of clauses which try to enforce territorial protection was based on pure *economic efficiency* grounds only, therefore, it would be difficult to argue for their *per se* prohibition (or of clauses which try to enforce it). But in EC competition law, there is not only the objective of economic efficiency but also that of promotion of *market integration*. According to this fundamental objective of the Treaty, goods should be free to circulate in the Common Market: clauses which aim at restricting the free movements of goods among Member States should therefore be prohibited.

However, the BER – following the case-law of the Community Courts – makes a distinction between active and passive sales, and it states that a manufacturer might legitimately use clauses that restrict active sales, but may not restrict passive sales. In other words, a firm which tries to make, say, German consumers pay more than Portuguese consumers for its products, may forbid its Portuguese retailers from actively seeking to sell in Germany, but may not prevent German consumers (or parallel traders) from going to Portugal and buy the product there, to consume it (or resell it) in Germany.

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<sup>18</sup> See M. Motta (2004: chapter 7) for a textbook presentation of the arguments made in these paragraphs.

<sup>19</sup> See e.g. J.-F. Thisse and X. Vives, "On The Strategic Choice of Spatial Price Policy", *American Economic Review*, Vol. 78, No. 1 (Mar., 1988), pp. 122-137.

<sup>20</sup> See P. Rey and J. Stiglitz, "The Role of Exclusive Territories in Producers' Competition", *RAND Journal of Economics*, Vol. 26, No. 3 (Autumn, 1995), pp. 431-451.

There are at least two questions that the current treatment of territorial restrictions raises: (i) Is it reasonable to prevent firms with little market power from using territorial restrictions clauses? (ii) Is it reasonable to treat in such a different way active and passive sales?

- (i) It is well established that even firms with little market power will have an incentive to try and discriminate prices across consumer groups (or countries), for the very principle indicated above. However, it is clear that the lower their market power the smaller the effect their price discrimination will have on the market. Since it is also unclear whether this effect is positive or negative, it would be hard to justify on economic grounds a prohibition of territorial restrictions for such firms.
- (ii) From an *economic* perspective, it is not clear to us why active and passive sales should be treated in different ways, as both have the same effect, which is to lead to price uniformity. The distinction between active and passive sales is also increasingly fuzzier given that online sales become more important, and given the Guidelines' interpretation that general advertising and promotion on the Internet amount to passive sales.<sup>21</sup> Furthermore, it is not clear why the parallel trade activities of large wholesalers should be treated as if they were purchases of individual consumers.<sup>22</sup> It is questionable, therefore, whether such a distinction should be given such an important role in competition policy. Rather than resorting to a formal and to a large extent arbitrary approach aiming to classify active v. passive sales, it may be worth using a more "effect-based" approach according to which the treatment of firms which use territorial restrictions would depend of the market share they hold and the possible efficiency justifications associated with such restrictions.

Given these considerations, we would advocate for territorial clauses a similar approach as for RPM. (1) A *de minimis* rule should apply for territorial restrictions of the parallel trade activities of firms (be they wholesalers or retailers active in other territories); (2) firms holding a market share between 15% and 30% will have the burden of proving the efficiency gains associated with territorial restriction clauses; (3) it is unlikely that firms which hold a market share in excess of 30% will be able to show that clauses limiting parallel trade have a net beneficial impact on competition.

This policy – which uses market share criteria to interpret the effects of territorial restrictions - would be in line with economic efficiency objectives.

To guarantee the rights of citizens not to be discriminated against on the basis of their location or nationality, it may be established that individual purchases could never be restricted. This would amount to redefine the prohibition of restricting passive sales as the prohibition to restrict sales to *individual* consumers only.

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<sup>21</sup> Guidelines, paras 50-51.

<sup>22</sup> In other words, it might be worth reconsidering the principle according to which restricting the activities of firms which act as wholesalers (or parallel traders) amounts to restricting passive sales. If this reconsideration was adopted, a manufacturer could not restrict the rights of individual citizens to buy where it suits them most, while – subject to considerations related only to economic criteria, including that of market shares – it could restrict activities by firms, be they wholesalers or retailers-distributors operating in other countries.