The Economics of EC Competition Law: Concepts, Application and Measurement

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across industries depending on the cost structure of the industry. Specifically, industries with high fixed costs and low marginal costs will tend to have high price cost margins even under competition.[67]

Impact of a cartel

5–032 Economic analysis is often used to assess the impact of the cartel. The mere fact that a cartel has been in operation does not imply that it was successful in increasing prices above the level that would have been observed under conditions of effective competition. This has been accepted by the courts.[68] For example, although the participants of a cartel might announce publicly the agreed price increase, this does not necessarily mean that those price increases are actually implemented in the sense that customers obtain products or services at those announced prices. This is particularly the case where the prices paid by customers are subject to non-uniform discounts off the announced list price.

Although participation in an ineffective cartel does not provide a defence against an adverse finding against the cartel's participants, an analysis of the actual impact may have a bearing on the size of fine issued by the Commission. Moreover, such analysis often provides a precursor to more detailed work that is undertaken in response to the third-party damages claims that are pursued following the Commission's decision.

Chapter 17 deals in detail with the issue of estimating the impact of a cartel and of the resulting damages. For this reason, we do not consider this issue further here.[69]

[67] See the extended discussion on this issue in Chapters 2 and 3.

[68] See *Cascades v Commission* (T-308/94) [1998] E.C.R. II-925.

[69] There is a considerable amount of economic literature that argues that many cartels are able to raise prices successfully and hence that they do cause consumer harm. Porter and Zona (2001) studied the school milk auctions in southwestern Ohio between 1980 and 1990. Although they found that the average overcharge due to the cartel behaviour was only 6.5%, they also found that for some school districts the overcharge was as high as 49%. Froeb, Koyak and Werden (1993) found an average overcharge of 27% in the US Department of Defence procurement auctions for frozen perch. Kwoka (1997) looked at collusion among bidders in real estate auctions in Washington DC. This was a buyer cartel and so the cartel led to lower prices, not higher prices. He found evidence of an undercharge of about 30%. Howard and Kaserman (1989) estimated overcharges of about 40% in city sewer construction contracts.

These studies all looked at specific cartels. There have also been a number of meta-studies carried out looking at average overcharges across a range of cartels. Connor and Bolotova (2006) looked at 395 cartel episodes. They estimated that the mean overcharge was 29%, with a median overcharge of 19%. In an earlier paper, Connor (2007) distinguished between the level of cartel overcharges in domestic (i.e. US) cartels as opposed to international ones and found that the median overcharge was 18% for domestic cartels and 32% for international ones. He also found that the overcharge was above 20% in about 60% of cases. Levenstein and Suslow (2006) looked at 35 international cartels and estimated that the mean overcharge was 25% and that it ranged between 10% and 100%.

Conclusions

Whether an industry becomes cartelised or not depends on how great the incentives are for the firms in the industry to form a cartel and how sustainable the cartel is. The incentives to create a cartel depend on the potential difference between the profitability of the firms in the presence of a cartel and in the absence of a cartel. A key determinant of the sustainability of the cartel depends on whether the incentives the firms have to cheat on the cartel agreements are outweighed by the likelihood of cheating being detected and punished. This section has discussed the factors that determine the outcome of these various trade-offs. 5–033

However, the supply-side responses by non-cartel members can undermine the cartel. Where entry into a market is easy, or it is easy for non-cartel members to expand their output in response to the cartel members raising their prices, a cartel will not be sustainable. In this sense, these supply-side responses "trump" the other factors discussed above. Furthermore, many industries are not structurally suited to cartelisation. We have discussed the relevant factors that imply that cartel behaviour is more likely to be effective. We have also discussed the role of competition authorities in deterring cartels and the scope for economic analysis to play a role in cartel investigations.

VERTICAL RESTRAINTS

Introduction

Vertical agreements are agreements between firms at different levels in the production and supply chain and include agreements between manufacturers and retailers, manufacturers and distributors, distributors and retailers and so on. Vertical agreements in general contain restrictions imposed by one party on another. On occasion, these restrictions can fall foul of Article 81. Figure 5.2 illustrates the difference between vertical and horizontal relationships. 5–034

Figure 5.2 The difference between vertical and horizontal relationships

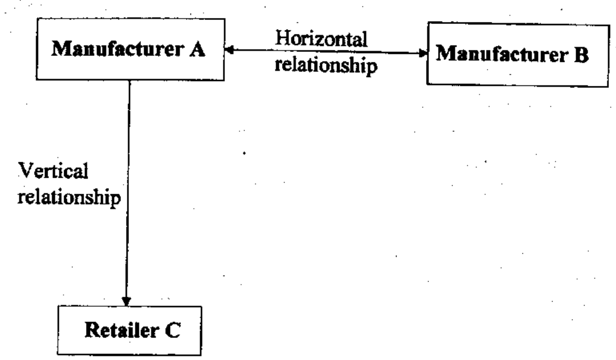


Figure 5.2 shows that manufacturer A and manufacturer B are active at the same stage of the production process (namely, manufacturing) and are competitors in the supply of their products.[70] The relationship between them is deemed to be a horizontal relationship so that any agreement between them would be a horizontal agreement. In contrast, the relationship between manufacturer A and retailer C is a vertical one since they are active at different stages of the production process: manufacturing and retailing, respectively. Manufacturer A supplies product to retailer C that retailer C then sells on to its customers after either using the product as an input in its production process or providing retailing services. Rather than being competitors to one another, the products or services supplied by manufacturer A and retailer C are complementary to each other. Manufacturer A requires the services of retailer C to sell its products, whilst retailer C needs manufacturer A to supply it. Manufacturer A is normally termed the upstream firm and retailer C is termed the downstream firm (the production process of the upstream firm precedes that of the downstream firm).

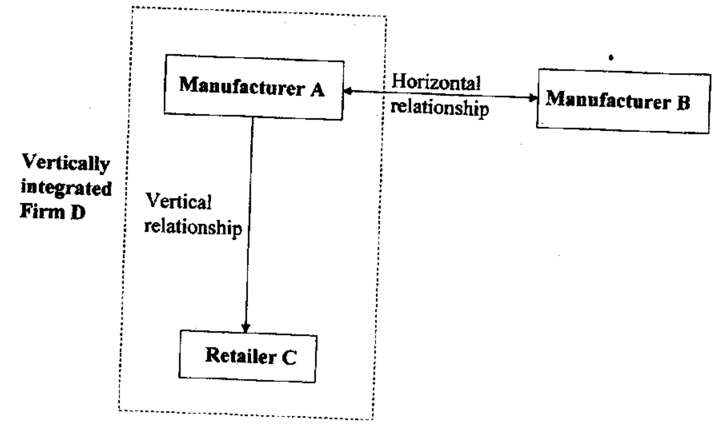
There are a wide variety of vertical restraints employed by firms that may or may not give rise to competition concerns. Some manufacturers distribute their products to selected outlets only ("selective distribution"). This is typically the case with branded products where the manufacturer is concerned with the environment in which its product is sold. Some retailers sell the products of only one manufacturer ("exclusive dealership"). Some retailers are given a guarantee by the manufacturer that no other retailers within their geographic area will be supplied by that manufacturer ("exclusive territories"). On occasion, manufacturers insist that their

[70] This assumes that the products produced by firm A and firm B form part of the same relevant market.

product is sold for a certain minimum amount ("resale price maintenance").[71] Other manufacturers may insist that the retailer sells a certain minimum amount of their product ("quantity forcing").

Vertical integration is where the activities at different levels of the vertical chain are undertaken by the same firm. In the above example, the activities of manufacturer A and retailer C are assumed to be undertaken by different firms. However, in principle both activities could be undertaken by the same firm, in which case manufacturer A and retailer C would be said to be vertically integrated. This is illustrated in Figure 5.3. Here firm A and firm C are part of the same firm, firm D, and so are said to be vertically integrated. 5-035

Figure 5.3 Vertical integration



Many of these restrictions (resale price maintenance, quantity forcing, exclusive territories and exclusive dealership) are substitutes, albeit in some cases imperfect ones, for vertical integration. For example, selective distribution is only a partial substitute for vertical integration. Both vertical integration and selective distribution lead to a restriction in the number of retailers being supplied with the product. However, whereas a vertically integrated firm might choose not to retail the products of its rivals, under selective distribution retailers would be free to select products from a number of different manufacturers.

Inherent in the notion of vertical integration is the elimination of contractual or market exchanges and the substitution of internal exchanges within the boundaries of the firm. Vertical integration can be pro-

[71] The Commission has condemned resale price maintenance on various occasions and has been endorsed in this by the European Court of Justice. See, e.g. *Schillgalis* (161/84) [1981] E.C.R. 353; [1986] 1 C.M.L.R. 414. However, as we discuss below, the approach to RPM on both sides of the Atlantic appears to be becoming more receptive towards the possibility that RPM can be pro-competitive on some occasions.

competitive in the sense that it allows a firm to improve the efficiency of its operations either through creating transaction cost efficiencies[72] or through enabling a firm to overcome difficulties in contracting with an external party.[73]

5–036 Before discussing the impact on competition of various vertical restraints, it should be noted that many vertical agreements have a similar impact on competition as vertical integration. For example, exclusive purchasing agreements may have the same pro-competitive effect as vertical integration between manufacturing and retailing stages of production. In general, where a vertical restraint can be shown to achieve the same pro-competitive outcomes as vertical integration, then the vertical restraint can be said to be pro-competitive. For instance, exclusive purchasing agreements can stimulate retailer-specific investment by the manufacturer which the manufacturer would not undertake in the absence of a guarantee of demand from the retailer. Such a benchmark is a sensible one. It would clearly be economic and legal nonsense if efficiency-enhancing vertical integration were to be permitted whereas the equivalent vertical restraint between independent undertakings was not. So a useful thought experiment when considering whether a particular vertical restraint is anti-competitive is to consider whether it achieves the same result as vertical integration and, if so, whether in this particular case vertical integration would be considered anti-competitive or pro-competitive.

Vertical restraints are fundamentally pro-competitive

5–037 The difficulty with vertical restraints for the competition law practitioner arises from the need to determine whether a particular vertical restraint is anti-competitive or pro-competitive. There are numerous Commission decisions that have stated that, unless the object of an agreement has a clear anti-competitive intent, the applicability of Article 81(1) to a vertical restraint cannot be determined simply by taking into account its formal terms.[74]

[72] Transaction cost efficiencies arise when it is cheaper to carry out a transaction within a single firm rather than between firms. For instance, when a transaction takes place between firms, the firm selling the product may need to expend resources checking that the buying party is creditworthy. This is not true when the transaction takes place within the same firm. See Williamson (1979) and Klein, Crawford and Alchian (1978) for a discussion of these issues.

[73] This problem arises from the inability of firms to contract for every eventuality. Contracts are therefore said to be "incomplete" in the sense of not being able to specify what happens in every eventuality. This can lead to problems if some eventualities dramatically alter the relevant bargaining power of the two parties and allow one party to exploit the other (e.g. by charging excessive prices for products that have become essential to the other party). See Holmstrom and Hart (1989) or Hart (1988) for good introductory surveys and Tirole (1999) for a discussion of the state of the research agenda.

[74] See, e.g. *Société Technique Minière v Maschinenbau Ulm GmbH* (56/65) [1966] E.C.R. 235; [1966] C.M.L.R. 357 and *Brasserie de Haecht SA v Wilkin* (23/67) [1967] E.C.R. 407; [1968] C.M.L.R. 26.

Agreements between firms that are competitors (e.g. horizontal agreements such as collusion and mergers) can often be anti-competitive. This is particularly likely to be true when the two firms both have market power. However, this is not necessarily true when the agreement is a vertical agreement between an upstream and a downstream firm. Agreements of this type can have economic efficiency rationales even when both firms have market power. This is because in a vertical relationship the two firms produce complementary products, whereas in a horizontal relationship the two firms produce substitute products.[75] The demand for a product declines as the price of substitute products falls, but rises as the price of complementary products falls and this gives rise to a difference in the relationship between firms. Where products are substitutes, each firm would prefer the other firm to increase the price of its product and thereby soften price competition. But where products are complementary, each firm would prefer the other to lower the price of its product. Referring back to Figure 5.2, for any given price set by firm A, he will sell more product the higher firm B's price is. Thus, firm A wants firm B to raise his price. But for any given price, firm A wants the downstream firm, firm C, to price low as this maximises demand for the product. So the upstream firm wants the downstream firm to price low. Equally, the downstream firm wishes the upstream firm to price low as the price set by the upstream firm is the downstream firm's input price.

It is therefore often the case that in a vertical relationship, both firms want the other firm to reduce prices. This has the effect of lowering prices to consumers and hence of raising consumer welfare. In this situation, a vertical restraint imposed by one firm on the other may well be pro-competitive as it is likely to be designed to elicit a lower price from the other firm in the vertical relationship, which is precisely what consumers want. This difference in the incentives of firms engaged in a vertical relationship from those engaged in a horizontal relationship is acknowledged in the Commission's Guidelines on vertical restraints.[76] The Guidelines state that in:[77]

> "[h]orizontal relationships the exercise of market power by one company (higher price of its product) may benefit its competitors. This may provide an incentive to competitors to induce each other to behave anti-competitively. In vertical relationships the product of the

[75] This assumes that the relevant horizontal agreement is between firms selling products in the same product market. If they are not, then the horizontal agreement is not, in general, troubling from an antitrust perspective.

[76] European Commission, "Commission Notice: Guidelines on Vertical Restraints" [2000] OJ C291/01.

[77] Guidelines on Vertical Restraints at para.100.

> one is the input for the other.[78] 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 therefore usually have an incentive to prevent the exercise of market power by the other."

5–038 The pro-competitive nature of vertical restraints can be illustrated with reference to the so-called double marginalisation problem. Suppose that both firms in a vertical relationship have market power in the academic sense (i.e. they can price above marginal cost).[79] The upstream firm will set his wholesale price above the marginal cost of production and the downstream firm will set price above his input price (i.e. the wholesale price). The result is that the retail price is marked up over the marginal cost of production twice, leading to a higher price, and lower output, for the upstream firm's product.[80] Given the wholesale price that he sets, the upstream firm would prefer the downstream firm not to add another mark up as this lowers the demand for the product and hence the upstream firm's profits. In this situation a vertical restraint imposed by the upstream firm on the downstream firm that prevented the downstream firm marking up over marginal cost could increase not only the upstream firm's profits, but also consumer welfare.[81] There are a number of vertical restraints that could be used in this case. For instance, the upstream firm could impose the restraint that the downstream firm was not able to price above his marginal cost (a maximum price cap). Or he could impose the restraint that the downstream firm had to buy a certain given number of units from the upstream firm where the number of units was set equal to the level that would push the retail price down to the downstream firm's marginal cost.

There are two points that should be noted here. First, although this is an example in which a vertical restraint is pro-competitive, it is not the case that the vertical restraint ensures that the retail price is at the competitive price. By assumption, the manufacturer has market power (in the academic sense: see fn.80) and so will set his selling price (the wholesale price) above

78 The recently released draft update to the Guidelines (Draft Commission Notice: "Guidelines on Vertical Restraints" (July 2009)) at this point adds the phrase "in other words the activities of the parties to the agreement are complementary to each other".

79 For the avoidance of doubt, we are not suggesting that market power in the sense relevant to competition law is about the ability to price above marginal cost. As we argued at length in Chapters 2 and 3, many firms can price above marginal cost without having market power in a sense that is relevant to competition law.

80 This provides the answer to the question, "What is worse than a monopolist?" The answer is: "A chain of monopolists".

81 It is assumed here that the manufacturer imposes the vertical restraint on the retailer. The general result (that a vertical restraint can increase consumer welfare) holds equivalently if instead it is assumed that the retailer imposes a vertical restraint on the manufacturer.

his marginal cost.[82] Secondly, the effect of the vertical restraints in this case is to remove the market power of the retailer. If the retail sector were perfectly competitive so that retailers did not have market power, the vertical restraint would not be needed. This implies that when assessing the competitive effect of a vertical restraint, it is important to understand the nature of competition at each vertical level.[83]

BOX 5.2: DOUBLE MARGINALISATION

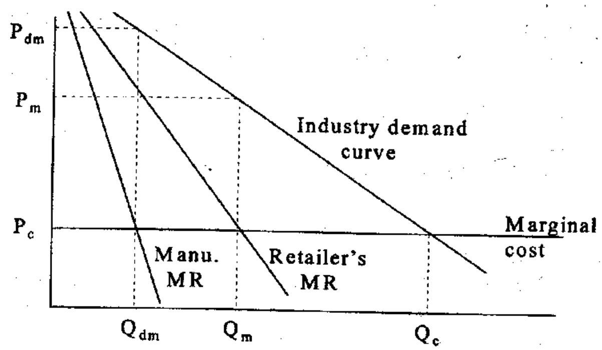
We can present the double marginalisation problem in a more formal setting. Assume we have a monopoly manufacturer supplying a monopoly retailer, so both have market power. Further assume that the retailer's only marginal cost is the wholesale price at which the manufacturer sells to him. We know from Chapter 2 that firms set their price so that their marginal cost is equal to their marginal revenue.[84] So the manufacturer knows that the retailer will price so that its marginal cost is equal to its marginal revenue. This means that the amount of product that the retailer demands from the manufacturer will be determined by where the retailer's marginal cost (i.e. the manufacturer's wholesale price) cuts the retailer's marginal revenue curve. So the manufacturer will treat the retailer's marginal revenue curve as his demand curve and so the manufacturer will set his marginal cost equal to his marginal revenue curve as defined by the retailer's marginal revenue curve (i.e. the manufacturer's demand curve). This is shown in Figure 5.4.

82 Of course, if the retailer imposed the restraint on the manufacturer, it would be the retailer who priced above his marginal cost. The fundamental point is the same: the retail price would be above the competitive price level.

83 Steiner (1996) is particularly scathing of the assumption of perfect competition at the retail level and of the length of time it has taken for the full implications of dropping this assumption to become apparent. He writes that "[t]he death of the unrealistic single-stage [of market power] paradigm has been effectively delayed because those who develop and apply the theory seldom have operated in the field and have not acquired the intuition, borne of experience, that sounds an alarm when the theory has run off the track." (p.409). He goes on to say that "[m]any economists freely admit that they prefer to work with models that assume either monopoly or pure competition because the math becomes so complex and messy with imperfect competition at both stages. Unfortunately, business people operating in an imperfectly competitive climate are not similarly relieved of their responsibility to figure out their firm's profit-maximising policies under these messy conditions" (p.409).

84 As noted earlier, this is not true in the special case of cartels.

Figure 5.4 Double marginalisation



5–039 The price under perfect competition, where the industry demand curve cuts the marginal cost curve, is P_c and the competitive output is Q_c. As a result of double marginalisation, the manufacturer charges the retailer P_m and the retailer charges a price of P_{dm}, with output at Q_{dm}. However, if the manufacturer could force the retailer to sell at the retailer's marginal cost, then the retailer would charge P_m (the manufacturer's wholesale price) and output would be Q_m. That is, output under the vertical restraint would be larger, and price would be lower, than in the absence of the vertical restraint. Vertical restraints that could achieve this include the manufacturer imposing a maximum retail price at which the retailer is allowed to sell (P_m) or imposing a minimum amount of product that the retailer must sell and setting this at Q_m. Note that even with vertical restraints, the market power of the manufacturer means that the retail price is above the competitive level (i.e. at P_m rather than P_c). Note also that although we have assumed monopoly at both vertical levels, this is not necessary: the double marginalisation problem arises whenever there is market power (in the academic sense: see fn.80) at both levels. It is therefore likely to be pervasive and so may be a benefit of many vertical restraints that are agreed. The importance and potential frequency of double marginalisation is recognised in the Commission's Non-Horizontal Merger Guidelines.[85]

There are two important implications of the discussion so far. The first is that vertical restraints can be pro-competitive. The second is that since the vertical aspect of the relationship tends to align the incentives of firms with those of society, this suggests that any potential anti-competitive effects of vertical agreements arise from their effects at a horizontal level. It turns

[85] For a detailed discussion of these, see Chapter 8.

out, and is now generally accepted, that this is indeed the case. Whether a given vertical restraint turns out to be anti-competitive or not turns largely on the question of whether the vertical restraint reduces competition at the horizontal level. Vertical restraints can be used to reduce both inter-brand competition (competition between different brands) and intra-brand competition (competition between the same brand sold in different outlets). When vertical restraints reduce the level of inter-brand or intra-brand competition significantly, they may be anti-competitive. A loss of inter-brand competition is usually more concerning than a loss of intra-brand competition. As the Commission noted in its Green Paper on vertical restraints as far back as 1997[86]:

> "The heated debate among economists concerning vertical restraints has calmed somewhat and a consensus is emerging. Vertical restraints are no longer regarded as *per se* suspicious or *per se* pro-competitive. Economists are less willing to make sweeping statements. Rather, they rely more on the analysis of the facts of the case in question. However, one element stands out: the importance of market structure in determining the impact of vertical restraints. The fiercer is inter-brand competition, the more likely are the pro-competitive and efficiency effects to outweigh any anti-competitive effects of vertical restraints. Anti-competitive effects are only likely where inter-brand competition is weak and there are barriers to entry at either producer or distributor level."

This view is also reflected in the approach set out in the Guidelines[87]:

> "In the assessment of individual cases, the Commission will adopt an economic approach in the application of Article 81 to vertical restraints. This will limit the scope of application of Article 81 to undertakings holding a certain degree of market power where inter-brand competition may be insufficient. In those cases, the protection of inter-brand and intra-brand competition is important to ensure efficiencies and benefits for consumers."

The draft of the updated Guidelines makes the same point when it is stated that:

> "[I]f inter-brand competition is fierce, it is unlikely that a reduction in intra-brand competition will have a negative effect for consumers."[88]

[86] European Commission, "Green Paper on Vertical Restraints in EC Competition Policy" (1997), p.iii.
[87] Guidelines, para.102.
[88] Draft Commission Notice: "Guidelines on Vertical Restraints" (July 2009), para.98.

and

> "the loss of intra-brand competition can only be problematic if inter-brand competition is limited"[89]

5–040 However, even when a particular vertical restraint can be shown to affect competition negatively by harming inter-brand competition, it is not necessarily the case that it should be prohibited since vertical restraints can have efficiency benefits that might outweigh the anti-competitive effects. As already discussed, vertical restraints might remove the problem of each firm in the vertical relationship pricing higher than is optimal for the other firm in the relationship (i.e. the double marginalisation problem). There are a number of other economic inefficiencies that may arise in a vertical relationship that vertical restraints can be used to alleviate or solve.

In many instances, the imposition by a manufacturer of a vertical restraint on downstream customers is motivated by the need to align the interests of that downstream customer to that of the manufacturer himself. There are a variety of circumstances in which the behaviour of the retailer, whilst optimal from the retailer's perspective, is disadvantageous to the manufacturer. This can result in a situation which is sub-optimal not only for the manufacturer, but also for society in general. Many of these instances are the result of the retailer not being able to appropriate all of the benefits of investment that he undertakes in his store. This leads the retailer to under-invest relative to the level that he would invest if he could appropriate all of the benefits of the investment. This under-investment might be harmful to the manufacturer, and to society, particularly if it leads to a lower demand for the products.

A classic example of this type of inefficiency arises when consumers value pre-sales service in a shop. Pre-sales service can increase the demand for some products, particularly if they are rather complex goods whose quality is not immediately apparent (e.g. expensive consumer electronics). Manufacturers want retailers to offer pre-sales service, such as knowledgeable sales staff, as it increases the demand for their products. However, if most retailers offer pre-sales service, it is profitable for some retailers to offer no pre-sales service and to free-ride on the service offered by other retailers. Consumers can get pre-sales service at one retailer and then buy the product at another retailer that is able to offer a lower price because it does not offer any pre-sales service and so does not incur the cost of offering pre-sales service. The problem for the manufacturer is that this type of behaviour reduces the incentive of any retailers to offer pre-sales service. The result is that too little pre-sales service, from the manufacturer's and society's perspective, is offered. In this case a vertical restraint may be able to remove this problem. If the manufacturer only supplies retailers who

[89] Guidelines on Vertical Restraints, para.149.

offer pre-sales service, the problem disappears. The manufacturer can solve the problem by selectively distributing his product only through outlets that offer pre-sales service.[90]

A similar problem can arise in retailer advertising. If advertising by a retailer of a particular brand of, say, DVD player raises the demand for that brand from all retailers in the area, each retailer is likely to try and free-ride on the advertising of other retailers. But if each retailer attempts to do this, little or no promotional activity will be undertaken. Certainly, there will be less promotional activity than if there was no incentive to free-ride. The result is that the particular brand of DVD player will be under-promoted and sales will be lower than in the presence of advertising. The manufacturer could solve this problem by making advertising a condition of the selective distribution agreement. A vertical restraint of this type can therefore facilitate the entry of a new product that would otherwise struggle to compete due to a lack of advertising and hence a lack of consumer awareness of the new product.[91] 5–041

Note that selective distribution might be anti-competitive. If a manufacturer uses selective distribution to reduce significantly the number of outlets that sell his products, this may reduce intra-brand competition significantly. If there is also relatively weak inter-brand competition, this may allow prices to rise above the competitive level. Selective distribution is likely to enhance economic efficiency when the relevant products genuinely require pre-sales service or there is a need to protect the brand from inappropriate distribution and when either intra-brand competition is not significantly reduced or inter-brand competition remains strong.

Economic inefficiencies can also arise when the manufacturer cannot appropriate all of the benefit of an investment that he makes. Suppose a manufacturer invests in training the retail staff that sell his product. It may be that this training allows these staff not just to sell the manufacturer's product better, but may also allow them to sell the products of other manufacturers better. Since the manufacturer will not take account of this in his calculations, or may even factor it in as a negative effect of the

[90] Although this may lead to another inefficiency. There may be consumers who do not want pre-sales service (e.g. because they are already well-informed about the product) but who have to pay more for the product as a result of the manufacturer insisting that all his retailers offer pre-sales service. Selective distribution in this case is imposed by the manufacturer in order to avoid the free-riding problem and hence raise sales. It is therefore aimed at encouraging marginal consumers to buy the product. It may hurt some consumers who would buy the product even in the absence of selective distribution (infra-marginal consumers).

[91] An alternative vertical restraint in this case might be exclusive territories. If the exclusive territories are large enough, they can reduce the extent to which retailers can free-ride on the pre-sales service or advertising of other retailers. However, the Commission has traditionally taken a very dim view of territorial restrictions. This is because they are not only potentially anti-competitive (i.e. they reduce intra-brand competition) but they are also anathema to the Commission's single market programme. See, e.g. *Newitt/Dunlop Slazenger* (IV/32.290) [1993] 5 C.M.L.R. 352; [1992] OJ L131/32 and *GlaxoSmithKline v Commission* [2006] E.C.R. II 2969; [2006] 5 C.M.L.R. 29.

training, he will tend to under-invest in training. This inefficiency can be cured by the manufacturer selling his products in outlets that stock only his products (i.e. exclusive dealership). Again, note that exclusive dealership may be anti-competitive. It reduces inter-brand competition within each outlet. If inter-brand competition is already relatively weak, this may allow prices to rise.

5–042 Vertical restraints may also be used to allow the manufacturer to capture economies of scale. A manufacturer may want to avoid supplying many outlets with a small amount of stock and would instead prefer to supply only a few outlets but with more stock each. A vertical restraint such as a quantity forcing requirement can solve this problem. Note that although this seems to be a legitimate use of a vertical restraint, it may be anti-competitive if the result is that so few retailers are supplied that intra-brand competition is significantly reduced in a market where inter-brand competition is weak.[92]

Vertical restraints can also be used to avoid opportunistic behaviour by one or other party to a vertical relationship. Where the vertical relationship requires relationship-specific investment, parties may be unwilling to make that investment unless they can be reassured that the other party will not try to expropriate the value of the investment ex post. An example of opportunistic behaviour might be the electricity generation plant built next to a steel plant that decides to raise prices to the steel plant because, once the steel plant's location decision has been made, the steel plant has no alternative suppliers. Knowing this danger, the steel company will not build its plant unless it is sure that it will not suffer from opportunistic behaviour. A long-term supply agreement could be used to avoid this problem.

Potential anti-competitive effects of vertical restraints

5–043 The discussion so far has focused on examples of vertical restraints being used to remove economic inefficiencies that may arise as a result of the vertical relationship, although it has been noted that even efficiency enhancing vertical restraints may also have anti-competitive effects. However, it is also the case that vertical restraints can be used for anti-competitive purposes. Vertical restraints can harm competition in three ways. First, they can be used to foreclose the market to competitors. Secondly, they can be used to soften price competition between competitors. Thirdly, they may be used to facilitate (usually tacit) collusion.

There are two main reasons for a firm wanting to foreclose a market through using vertical restraints. One reason is simply that a firm may wish to avoid any increase in inter-brand competition due to new entry. For example, an incumbent manufacturer might attempt to foreclose the

[92] In effect, quantity forcing in this situation may be akin to exclusive territories.

market to new manufacturers, particularly if they are potentially more efficient than the incumbent, by signing exclusive dealership agreements with all the retailers. If there are barriers to entry into retailing, then the manufacturer might be able to ensure that any new manufacturer would not be able to distribute its product.[93] Equally, a retailer might try to foreclose the market to new retail entry by signing exclusive distribution contracts with all the manufacturers.[94] The key point is that a manufacturer (or retailer) may be able to use a vertical restraint to prevent a rival from being able to trade with other parties, such as retailers or manufacturers, that the rival needs to trade with if it is to enter successfully. The result is that vertical restraints can on occasion be used to deter entry.

The second reason for using vertical restraints to foreclose the market is that an upstream monopolist may wish to reduce intra-brand competition downstream, even when the downstream market is competitive.[95] The standard Chicago argument is that the upstream monopolist can set the wholesale price so as to capture the entire monopoly profit. The monopolist offers this wholesale price to all retailers and thus mimics the vertically integrated solution. However, contrary to the standard Chicago argument, the monopolist may not be able to take the entire monopoly profit. The Chicago argument does not work if there is scope for the monopolist to offer different prices to different retailers at different times (i.e. if contracts are secret and are not signed simultaneously). Once the monopolist has offered one price to one retailer, the monopolist's profit-maximising behaviour is to offer a lower price to the next retailer.[96] However, the first retailer knows this and so would not accept the earlier higher price. Unless the monopolist can commit to a common price for all retailers, the monopoly price will not be credible. This implies that the monopolist will be unable to extract the monopoly profit that is in theory available.[97] A solution to this is for the monopolist effectively to "tie his

[93] A slightly attenuated form of this foreclosure would be for the manufacturer to sign up the "best" retailers (e.g. those retailers whose premises are in the best locations). This would not foreclose the market entirely to new entry, but it would make entry harder. In effect, it would raise the cost of entry because the entrant would have to invest more in order to counteract the disadvantage of having weaker retailers (e.g. more brand advertising, refurbish retailers and so on).

[94] Or, at least, with all the best ones.

[95] Hart and Tirole (1990) consider this issue in the setting of Cournot competition, whilst O'Brien and Shaffer (1992) assume price competition in a differentiated products setting.

[96] The logic underlying this is the same as in the case of the durable good monopolist discussed in Chapter 2.

[97] The logic of this argument implies that competition law interventions that impose non-discrimination terms on monopolists may raise consumer prices. We discuss the welfare implications of price discrimination in more detail in Chapter 6.

hands" by signing an exclusive distribution agreement with just one retailer or by giving retailers exclusive territories.

BOX 5.3: THE COMMITMENT PROBLEM[98]

5–044 Suppose that the upstream monopolist faces just two retailers. Assume that the vertically integrated profit maximising output and price are Q_M and P_M. Further, assume that the retailers' costs, apart from the wholesale price, are zero. The inverse demand curve is $P = P(Q)$. The monopolist's constant marginal cost is c. There are no fixed costs. Then the standard Chicago argument holds that the monopolist will offer the product to the retailers at P_M and each retailer (assuming symmetry) will sell $Q_M/2$. Now assume that there is scope for secret contracts, so the retailers are not guaranteed the same price as each other and they do not know the price offered to the other retailer. Denote the two retailers as R_i where $i = 1$ or 2. Suppose that R_1 expects that R_2 will purchase q_2 units from the manufacturer. R_1 will then be prepared to pay a price of $P(q + q_2)$ for any amount of product q. The monopolist's profit-maximisation problem with respect to R_1 is then to maximise $[P(q + q_2) - c]q$. The situation is symmetric with the other retailer, so we have the standard Cournot maximisation problem. This implies that the monopolist is unable to make more than the Cournot profits, which by definition are below the vertically integrated monopoly profits. The intuition here is that a retailer will only buy q units at price p subject to the requirement that this is profit maximising for the monopolist only if all other retailers get the same terms, since only then is it credible that the monopolist will not offer lower prices to other retailers. But this is the definition of the Nash equilibrium under Cournot competition (see Chapter 2 and particularly Figure 2.5).

The Commission has shown itself to be wary of vertical restraints that may lead to foreclosure. An example of Commission action in this regard was the decision regarding the Irish impulse ice-cream market.[99] The Commission found Unilever guilty of abusing its dominant position on the grounds that it had foreclosed the market to new entry by supplying freezers to retailers on the condition that they were used to stock only Unilever products. The Commission argued that many retailers either cannot or do not wish to install two or more freezers in their outlet. This implied that in many retail outlets, freezer exclusivity was akin to exclusive

[98] This treatment follows that of Rey and Tirole (1996).

[99] *Masterfoods Ltd v HB Ice Cream Ltd* [2001] All E.R. (EC) 130; [2001] 4 C.M.L.R. 449. The following discussion is not intended to condemn or condone the Commission's analysis in this decision.

dealing. That is, once Unilever had installed an exclusive freezer in the outlet, no other manufacturers could supply the outlet, so the outlet became a de facto exclusive dealership.

Some commentators have argued that vertical restraints should only be subject to competition law intervention where they can be shown to lead to foreclosure. For instance, London Economics[100] argued that:

> "Overall, the contribution of the economic literature on vertical restraints has been to establish that there should be no competition policy intervention, except where they are used strategically by the incumbent to foreclose the market to a new entrant, essentially by reducing rival manufacturers' access to downstream distributors."

However, this is too strong a statement. Although the ability of firms to use vertical restraints to foreclose markets represents a major anti-competitive concern, vertical restraints can also be used as a way of softening price competition between manufacturers and/or facilitating collusion. It is frequently alleged by consumer bodies that this is the intended effect of selective distribution. The argument is that selective distribution can be used by the manufacturer to increase his prices by reducing intra-brand competition. Increased prices may then encourage rival manufacturers to increase their prices (i.e. a reduction in inter-brand competition). On this view, selective distribution by a group of rival manufacturers is akin to tacit collusion. Exclusive distribution may have a similar effect as it also reduces intra-brand competition. Exclusive dealership has a more direct effect on inter-brand competition by removing other brands from the outlet. Again, if all manufacturers used exclusive dealerships, this might be considered akin to collusion. Resale price maintenance (RPM) is another vertical restraint that can be akin to collusion if a number of major manufacturers use it. RPM directly reduces both intra-brand and inter-brand competition. 5–045

RPM does not fall within the scope of the Block Exemption Regulation. Traditionally the Commission has been very hostile towards RPM and it was very unlikely that an individual exemption under Article 81(3) would

[100] London Economics (1997).

be granted for it.[101] However, this is an area where policy may be changing, as we discuss in Box 5.4 below.[102]

BOX 5.4: EMERGING POLICY TOWARDS RPM—A TRIUMPH FOR ECONOMICS

Resale price maintenance provides a good example of the effect of economic analysis on antitrust rules. RPM has been designated by the European Commission as a "hardcore" vertical restraint, which means that it is effectively per se illegal. The United States has also had a per se rule against RPM for many years. However, the US position has softened after the recent *Leegin* case. Leegin is a manufacturer of leather goods and fashion accessories. It competes in a market with many other competitors and so inter-brand competition is strong. Since 1997 Leegin has had an explicit policy of refusing to supply retailers who discount its product below the price recommended by Leegin. One of its customers, Kay's Kloset, took Leegin to court after Leegin had stopped supplying Kay's Kloset because it was selling below the prices recommended by Leegin. A lower court found in favour of Kay's Kloset on the grounds that RPM was per se illegal. The case ended up at the Supreme Court, which overturned the per se ban on RPM and substituted a rule of reason approach instead.[103]

The Supreme Court accepted the argument that RPM could on occasions be pro-competitive. It noted that RPM could be justified on similar grounds to other vertical restraints: "absent vertical price restraints, the retail services that enhance inter-brand competition might be underprovided." This is not to say that RPM cannot also be anti-competitive. The Court was clear that RPM could be anti-

[101] There are occasions when RPM can be efficiency-enhancing, although they may be relatively rare. Publishers have traditionally argued that books are an example where RPM is beneficial to society. The argument appears to be that RPM allows publishers to cross-subsidise books that are "worthy", but would not be published if they had to make a profit on their own behalf. However, the Commission has not been impressed by this argument. The Commission ruled against the book-pricing cartels within Belgium and the Netherlands and within the United Kingdom and Ireland. After issuing a Statement of Objections, it accepted undertakings that ensure that the German book cartel (the "Sammelrevers") does not affect trade between Member States.

[102] An example of where it was argued that RPM was efficient is the UK OFT's decision against John Bruce (UK) Ltd (CA/12/2002 *Price Fixing Agreements involving John Bruce (UK) Ltd, Fleet Parts Ltd and Truck and Trailer Components*). The Director General of Fair Trading concluded that Bruce (UK) Ltd, Fleet Parts Ltd and Truck and Trailer Components (a subsidiary of the Unipart Group of Companies) infringed the Competition Act 1998 by entering into price-fixing agreements. All of the above-named undertakings were engaged in the supply of the MEI brand of automatic slack adjuster. However, it was argued that RPM was necessary in order to provide retailers with a sufficient margin for them to promote the John Bruce brand of product, which was a new entrant to the market.

[103] This position was supported by an amicus curiae brief submitted by 25 antitrust economists.

competitive, such as when it is used to facilitate a cartel. Importantly, the Court argued that the following three factors would be important in any inquiry into RPM.

1. How many other firms were using the same practice?
2. What was the driving force behind the restraint? The Court argued that RPM is more likely to be anti-competitive if it is driven by retailers rather than by manufacturers.
3. Does the manufacturer or retailer have market power?

5–046 The economic logic behind these factors is clear. If only a few firms were using RPM and they did not have market power, then the practice is unlikely to be anti-competitive. This is because it is unlikely to have a significant adverse effect on inter-brand competition. If RPM was driven by the retailers, then this is consistent with retailers wanting to soften downstream competition. However, manufacturers typically want to encourage efficient downstream distribution of their product as their incentives are aligned with that of consumers.

The *Leegin* decision has caused considerable debate, and it should be noted that the Supreme Court itself split 5/4 on the issue. It is noticeable that the Commission's draft new Guidelines on vertical restraints already indicate a softening of its stance against RPM. The Commission proposes to keep RPM as a "hardcore" restraint, but it now offers the possibility that it could nonetheless be exempted under Article 81(3). Thus the new draft Guidelines now state that[104]:

> "[T]his is a rebuttable presumption which leaves open the possibility for undertakings to plead an efficiency defence under Article 81(3) EC in an individual case. In case the undertakings substantiate that likely efficiencies result from including the hardcore restriction in the agreement and that in general all the conditions of Article 81(3) are fulfilled, this will require the Commission to effectively assess—and not just presume—the likely negative effects on competition before making the ultimate assessment of whether the conditions of Article 81(3) are fulfilled."

Furthermore, the draft Guidelines accept that "RPM may not only restrict competition but may also sometimes lead to efficiencies" and list a number of such examples, such as facilitating the entry of a new brand. As with the Supreme Court's decision in *Leegin*, there is no suggestion that RPM will generally be pro-competitive. It remains the

[104] Para.47 (and repeated at para.219).

case that the Commission will treat RPM with great suspicion. However, it appears that the Commission is moving to a "rule of reason" approach based on economic analysis of the particular facts of the case, consistent with both the US *Leegin* decision and with its general attitude since 2000 towards vertical restraints.

The Commission's policy on vertical restraints

5–047 The Commission implemented the Block Exemption Regulation governing vertical agreements in June 2000 and at the same time issued a Notice providing Guidelines in which the principles for assessing vertical agreements under Article 81 are set out.[105] The Block Exemption Regulation creates a presumption of legality for those vertical agreements implemented by firms with a market share below 30 per cent.[106] Where a firm has a market share above 30 per cent the Commission will carry out an effects-based analysis to examine whether the relevant vertical restraint has anti-competitive effects in practice. The Commission reserves the right to remove the block exemption from vertical agreements where market shares are below 30 per cent on rare occasions and in particular to do so when 50 per cent of a market is covered by a network of similar restraints imposed by firms which individually have less than 30 per cent of the market. Finally, as noted above, some restraints, such as resale price maintenance, are termed as "hardcore" restraints and so fall outside the scope of the Block Exemption Regulation.

The Block Exemption Regulation addressed three major shortcomings associated with the previous policy approach towards vertical agreements. These were as follows.

1. The then current block exemption Regulations were seen as comprising rather strict form-based requirements and as a result were considered to be too legalistic and to work as a straightjacket.
2. There was a real risk that the then current block exemptions were exempting agreements that actually did distort competition.

[105] European Commission, "Commission Notice: Guidelines on Vertical Restraints" [2000] OJ C291/01. These guidelines divide vertical restraints up into four categories and discuss the potential efficiencies and anti-competitive aspects of each. As a reference source, the guidelines are very useful and are included as an Annex to this book. The new draft Guidelines were issued shortly before this book went to press, but they are only draft and are subject to revision after the deadline for comments of late September 2009.

[106] Usually the upstream firm, but the downstream firm where appropriate, such as with exclusive supply agreements.

3. The block exemptions covered only vertical agreements concerning the resale of final goods, not intermediate goods or services.

In assessing vertical agreements that do not benefit from the exemption, the Guidelines state that "the Commission will adopt an economic approach that is based on the effects on the market"[107] and that:

> "[T]he Commission will adopt an economic approach in the application of Article 81 to vertical restraints. This will limit the scope of application of Article 81 to undertakings holding a degree of market power where inter-brand competition may be insufficient".[108]

This sentiment is echoed in the new draft Guidelines, which state that[109]:

> "For most vertical restraints, competition concerns can only arise if there is insufficient competition at one or more levels of trade, i.e. if there is some degree of market power at the level of the supplier or the buyer or at both levels."

The use of a 30 per cent market share threshold is consistent with the focus 5–048
only on vertical restraints imposed by firms (or groups of firms) with some degree of horizontal market power. The Commission has proposed extending this market share threshold to both parties to the agreement, i.e. both the upstream and downstream party. Previously the assumption was that the market share threshold referred only to the firm imposing the vertical restraint (usually the upstream firm). The Commission has specifically flagged this change as one that they want to receive comments on as part of the consultation process over the new Block Exemption. Our view is that the market share threshold should refer only to the party imposing the vertical restraint and that it is generally very clear which party this is.

The change in Commission policy towards a more economically focused and coherent policy is to be applauded. It has been argued that the new approach provides less legal certainty than the previous more form-based approach. However, even if this were the case, companies are freed from the straightjacket on commercial practices which the old interpretation of Article 81 often implied. The new policy therefore represented in our view an unambiguous improvement in the Commission's competition policy. The Commission has recognised that vertical restrictions can only harm competition in the presence of horizontal market power and the

[107] Guidelines, para.7.

[108] Guidelines, para.102.

[109] Para.6 of the draft Guidelines.

Commission's more economically coherent policy makes it much more likely that it will focus on vertical restraints that raise market power concerns than under the old system. There is a widespread acceptance that the policy has been a success. This is reflected in the fact that the Commission's current consultation on the revision of the Block Exemption and the Guidelines, which is required to be completed by May 2010, envisages little change to the policy.

There are, however, a number of issues arising from the Commission's approach that should be highlighted. First, the Commission continues to make use of the concept of "hard-core" vertical restraints. These are vertical restraints that are considered always to fall outside the scope of the proposed block exemption and have been presumed to be illegal. We have discussed RPM at some length above, but there are also four other "hardcore restraints". These relate to:

- restrictions concerning the territory into which, or customers to whom, the buyer may sell;
- restrictions on active or passive selling to end-users by authorised retail distributors in a selective distribution system;
- restrictions on authorised distributors in a selective distribution system selling or purchasing from other members of the network; and
- restrictons on the sale of components as spare parts by the manufacturer of the component to end-users, independent repairers and service providers.

5–049 What is interesting about these restrictions is that they relate to restrictions on intra-brand competition and they do not seem to be motivated by a concern about inter-brand competition. Instead, they are motivated by a concern that these restraints can lead to segmented markets and an opportunity for price discrimination. The Commission's concern is therefore less a competition concern than a market integration concern. The Guidelines are explicit that this is one of the aims of the Commission's policy. At para.7 the Guidelines state that:

> "Market integration is an additional goal of EC competition policy. Market integration enhances competition in the Community. Companies should not be allowed to recreate private barriers between Member States where State barriers have been successfully abolished."

The concept of hardcore vertical restrictions has no corollary in economics: the competitive effects of vertical restraints need to be assessed on the facts

of the particular case. While the prohibition of some of the hardcore restraints may be justified by the market integration goal of EC competition law, it should be understood that a policy of blanket prohibition will also include some efficiency-enhancing agreements.

Secondly, the Guidelines divide vertical restraints into four groups on the basis of their possible negative effects. These are:

- the "single branding group", i.e. non-compete agreements, quantity forcing, tying and so on. The common element is that these restraints directly affect inter-brand competition;
- the "limited distribution group", i.e. selective distribution, exclusive distribution and so on. These restraints directly affect intra-brand competition, although they may also in some circumstances indirectly affect inter-brand competition;
- the "resale price maintenance" group, i.e. minimum prices, maximum prices, recommended resale prices and so on. The concern here is that these may in practice become de facto RPM; and
- the "market partitioning group", i.e. territorial resale restrictions, exclusive purchasing and so on. The concern here relates to the market integration objective.

The Guidelines hold that RPM and market partitioning are more likely to 5–050
be anti-competitive and to have fewer efficiency benefits than the other two groups. This is consistent with the Commission's approach to "hardcore" restrictions, but the inclusion of the market partitioning group as being of more concern than the "single branding" or "limited distribution" groups is not well grounded in competition economics. The pursuit of market integration will sometimes clash with the pursuit of economic efficiency and consumer welfare.

Thirdly, in the Guidelines the Commission for the most part takes the view that combinations of vertical restraints are worse than individual vertical restraints. Thus at para.119(6) it is stated that:

> "In general, a combination of vertical restraints aggravates their negative effects. However, certain combinations of vertical restraints are better for competition than their use in isolation from each other."

It may well be true that in general combinations of vertical restraints are worse than single vertical restraints, but it is important to note that the Commission is right that this is not always the case. There is no per se rule to follow here and each combination of vertical restraints should be analysed in the particular market context in which it arises.

Fourthly, the 2000 Guidelines adopt a hostile stance towards vertical agreements employed by dominant firms.[110] According to the Guidelines, dominant firms are unable to obtain an exemption under Article 81(3)[111]:

> "Where an undertaking is dominant or becoming dominant as a consequence of the vertical agreement, a vertical restraint that has appreciable anti-competitive effects can in principle not be exempted."

The Guidelines' reasoning on this point appears to be motivated by a belief in a consistent trade-off between inter- and intra-brand competition, i.e. an absence of inter-brand competition can be remedied through intra-brand competition and vice versa. However, if there is an absence of inter-brand competition, that failure is not generally solved by increasing intra-brand competition—making downstream firms compete more fiercely does not generally resolve a lack of competition between upstream firms. Similarly, there are no general presumptions that restrictions on intra-brand competition will weaken inter-brand competition. As noted above, where there is vigorous inter-brand competition, there is no reason to be concerned about the lack of intra-brand competition that vertical restraints might imply. But it is incorrect to extend this to argue that where inter-brand competition is ineffective (i.e. where there is a dominant firm) vertical restraints cannot be permitted. This fails to acknowledge that dominant firms have many of the same pro-competitive rationales for implementing vertical restraints as non-dominant firms.

5-051 We note that the new draft Guidelines do not include the wording quoted above. This may be indicative that the Commission has softened its stance on dominant firms and vertical restraints. However, the Commission states at para.123 that:

> "A restrictive agreement which maintains, creates or strengthens a market position approaching that of a monopoly can normally not be justified on the grounds that it also creates efficiency gains".

Although much obviously hangs on the meaning of "normally" in this sentence, it seems that the Commission's policy stance has not softened much, if at all, and so the concern remains that vertical restraints used by a dominant firm may not be allowed even when their net effect is to increase consumer welfare.

One response to the Guidelines' hostility towards dominant firms is to argue that the restraints fall outside the scope of Article 81(1).[112] This is

[110] This discussion draws heavily on Bishop and Ridyard (2002) and Bishop (2003).
[111] Guidelines, para.135.
[112] See Peeperkorn (2002), who also discusses the reasoning behind the Commission's policy in this area.

precisely the approach adopted by the Dutch Competition authority, the NMa, in its decision assessing the competitive impact of exclusive supply agreements employed by Heineken, the large Dutch brewer, when supplying draught pilsner beer to those pubs and other licensed outlets ("on-premises") to which it provided financial and commercial support.[113]

In assessing whether Heineken's agreements fell outside the scope of Article 81(1), the NMa stresses the importance of examining the overall impact of those agreements on competition and notes that such an assessment cannot be inferred from a firm's market position: 5-052

> "The position of Heineken on the relevant market is of importance because the stronger that position is, the larger is the risk of anti-competitive effects . . . The question whether Heineken has a dominant position (and whether exclusivity in that case is objectively justifiable) is only relevant, if it can be established that the agreements can have appreciable anti-competitive effects."[114]

In other words, the fact that a firm might be held to be dominant does not necessarily imply that the vertical agreements which it employs give rise to appreciable anti-competitive effects. In this particular instance, the NMa found that whilst Heineken's market position justified individual scrutiny, its new supply agreements did not have anti-competitive effects and fell outside the scope of Article 81(1).[115]

Empirical evidence on vertical restraints

There is a remarkable dearth of empirical analysis of the effects of vertical restraints, particularly when compared to the large theoretical literature. Lafontaine and Slade (2008) have surveyed the existing empirical literature. This literature covers a number of industries, such as beer and spirits distribution, car distribution, gasoline, contact lenses, railroads, cable TV, film distribution and crude oil refining. Although the authors are quick to point out that this is a narrow group of industries and so may not be representative of the economy as a whole, they also argue that this literature consistently points to two quite clear conclusions. First, vertical restraints entered into voluntarily by firms tend to be pro-competitive. This is consistent with the fundamental insight that products in a vertical chain are complements, not substitutes, and so we should expect vertical restraints to often have pro-competitive rationales. Secondly, when vertical restraints are imposed on manufacturers as a result of government action, 5-053

[113] NMa decision of May 28, 2002, *Heineken – Horecaovereenkomsten* (2036).
[114] See para.85 of the decision, unofficial translation from Dutch.
[115] This interpretation accords with the narrower, more economic interpretation of Article 81(1) discussed in the introduction to this section.

they are usually anti-competitive and tend to raise prices and lower service levels. Lafontaine and Slade argue that:

> "It appears that when dealers or consumer groups convince the government to 'redress' the unfair treatment that they allege to be suffering, the consequences are higher prices, higher costs, shorter hours of operation and lower consumption as well as lower upstream profits."[116]

Conclusions

5–054 Two key conclusions are apparent from the above discussion of vertical restraints. The first is that whether a given vertical restraint is anti-competitive in a given situation depends, in particular, on the degree of inter-brand competition. Where inter-brand competition is vigorous, it is unlikely that a vertical restraint will have a significant anti-competitive effect even if it reduces or removes intra-brand competition. Where both inter-brand and intra-brand competition are vigorous, there is even less danger of a vertical restraint having an anti-competitive effect. However, where inter-brand competition is weak, vertical restraints can potentially lead to foreclosure or to a softening of price competition.

Table 5.2 provides a non-exhaustive list of vertical restraints and indicates which directly affect which type of competition. This table looks at the direct effects of each vertical restraint. Thus, selective distribution directly reduces intra-brand competition, but not inter-brand competition. This is not to deny that selective distribution may be used to lower inter-brand competition if it is used as an instrument of tacit collusion by a number of manufacturers acting in concert.

Table 5.2 Effect of selected vertical restraints on competition at the retail level

	Reduces intra-brand competition	Reduces inter-brand competition
Selective distribution		X
Exclusive dealership		X
Exclusive distribution	X	
Price ceiling		
Exclusive territories	X	
Resale price maintenance (RPM)	X	X
Full-line forcing		X
Non-compete		X

[116] Lafontaine and Slade (2008), p.408.

There are three points to make about this table. First, those restraints listed in Table 5.2 above that reduce inter-brand competition are generally treated more harshly by the Commission than those that reduce only intra-brand competition. Thus RPM is a "hardcore" restraint whilst exclusive dealership, full-line forcing and non-compete clauses all come under the Commission's "single branding" umbrella. Secondly, price ceilings do not directly reduce either intra-brand or inter-brand competition. Our discussion of the complementary nature of vertical relationships suggests that in general price ceilings should be a pro-competitive way of avoiding double marginalisation problems. Given this, it is surprising that they have sometimes been found to be anti-competitive. The argument has been that maximum resale prices can be used as "focal points" for manufacturers to collude around.[117] Although the argument is not entirely without merit from a theoretical point of view, our experience is that in practice it has usually been a weak argument.[118] Hence we think that Table 5.2 conveys the generally right message with respect to price ceilings. Thirdly, this table is only indicative. The exact effect of each vertical restraint is likely to be context specific.

The second key conclusion from this section is that the complementary nature of vertical relationships means that vertical restraints will usually increase economic efficiency. Thus even vertical restraints that have some anti-competitive effect can still have a net social benefit if there are significant efficiencies associated with them. Of course, good policy is to ensure that where there are anti-competitive effects as well as efficiencies, the vertical restraints chosen should be those with the least anti-competitive effects amongst those vertical restraints that would safeguard the efficiencies. 5–055

HORIZONTAL AGREEMENTS

Horizontal agreements include agreements such as joint ventures, licensing agreements between firms and co-operative standards setting. Joint ventures can cover a number of different activities, such as R&D, production or marketing. Unlike vertical agreements, horizontal agreements are 5–056

[117] Para.226 of the Vertical Guidelines state that "[t]he possible competition risk of maximum and recommended prices is firstly that the maximum or recommended price will work as a focal point for the resellers and might be followed by most or all of them. A second competition risk is that maximum or recommended prices may facilitate collusion between suppliers."

[118] For instance, the European Commission dismissed the argument in *Repsol CPP* (see paras 18–20 of the Market Test Notice (OJ C258 (2004)). On the other hand, the UK Monopoly and Mergers Commission invoked it against recommended retail prices in consumer electronics (UK MMC inquiry into "Domestic electrical goods" (Cm. 3675)). The idea of tacit collusion being sustainable when there is as much product differentiation as there is in consumer electronics can best be described as a very "challenging" argument to make.