Vertical Agreements Notice & Declaration.

Further Authority guidelines would cut compliance costs and risks.

The Competition Authority's Notice and Declaration on vertical restraints, published on 5 December 2003, apply to vertical agreements and concerted practices, i.e., agreements between firms at different levels in the production and supply chain, such as exclusive distribution and exclusive purchasing agreements. They pretty much follow the provisions of the corresponding EU block exemption.

In recent years the EU Commission, in drafting various block exemptions, has emphasised the importance of adopting an economics-based approach in deciding what types of arrangements should be permitted and what should not. In this regard several aspects of the Authority's decisions are worth noting.

- In contrast to the previous Category Licence granted under the 1991 Act, they only apply to agreements where parties have a market share of up to 30%.
- They do not apply in the case of agreements or concerted practices involving resale price maintenance (RPM), although maximum RPM is permitted.
- The Notice and Declaration exclude agreements in respect of motor fuels and LPG.

Economics of Vertical Restraints.

While there is some divergence of views among economists regarding the merits or otherwise of vertical agreements, the majority consensus is that, whether or not, such arrangements have a negative impact on welfare will depend on the specific market circumstances in each case. This reflects a view that, in many cases, vertical restraints are efficiency enhancing. The argument is that other things being equal, competition between retailers is in manufacturers' interests as this keeps retailer margins, and thus retail prices, down to a minimum and maximises sales. Consequently, manufacturers will only adopt vertical restraints, which, by definition, limit competition at the retail level, if they increase efficiency.

The counter argument is that vertical restraints may, in certain circumstances, reduce competition at the upstream manufacturing level and that this may be an alternative reason why manufacturers enter into such arrangements.

The general economic consensus is that vertical restraints are unlikely to be welfare reducing in the absence of market power at either the upstream or downstream level. It is only where firms have some degree of market power that the anti-competitive effects of vertical restraints might outweigh any potential efficiency gains.

In analysing vertical restraints, economists distinguish between intra and inter brand competition. Intra brand competition refers to competition between retailers selling the same brand, while inter brand competition involves competition between retailers selling rival brands. By definition vertical restraints reduce intra brand competition but it is generally believed that they result in a greater increase in inter brand competition.

Where there is evidence of market power, therefore, the question of whether the increase in inter brand competition is sufficient to compensate for the loss of intra brand competition becomes very important. In other words, where there is evidence of market power, one can no longer assume that increased inter brand competition will automatically compensate for a reduction of intra brand competition. Where the evidence suggests that inter brand competition is weak, the net effect of vertical restrains is likely to be harmful. Similarly, evidence of economies of scope at the retail level would tend to suggest that vertical restraints are anti-competitive.

Implications of the Authority Decisions.

In economics terms the Authority Notice and Declaration may be interpreted as indicating that:

1. In the Authority's opinion, vertical restraints have no anti-competitive effects, where the supplier's market share is below 15%.
2. Where the supplier has a market share of between 15% and 30%, the Authority believes that any restriction on competition will be more than offset by increases in efficiency.

This is the theory, at least. In practice it seems that the Authority has simply chosen to follow the thresholds set in the EU block exemption. In fact, the decisions contain virtually no economic reasoning, which is in contrast to the previous Category Licence.

In economic terms, the Notice and Declaration use market share thresholds to identify instances where market power is unlikely to pose a problem and so they effectively provide legal protection to vertical restraints in those cases. This is fine as far as it goes but the question is does it go far enough?

The Notice and Declaration identify market share thresholds below which vertical restraints are considered not to be harmful. This does not mean that vertical restraints should automatically be considered illegal just because suppliers' market shares exceed these thresholds. The decisions effectively, however, create considerable uncertainty for firms in such circumstances. In addition, while the Declaration provides for a transitional period during which firms may still benefit from the old Licence, it is nevertheless the case that a number of firms whose agreements previously enjoyed the legal protection afforded by the Category Licence will lose it in the near future. Under the 2002 Act firms no longer have the option of notifying their agreements and requesting an individual exemption and, indeed, the Authority Chairman in an address to a conference recently indicated that it would not respond to any requests for advice on individual agreements.

Except in the case of exclusive supply agreements, the Authority Notice and Declaration only apply market share thresholds in the case of suppliers. This seems to ignore the possibility that downstream firms may have market power. For example, a buyer with market power may be able to impose exclusive distribution arrangements on suppliers as a means of limiting competition in the downstream market. This possibility has been ignored.

The Notice and Guidelines also indicate that, it may, in future withdraw the benefit of the Notice and Declaration in markets where the cumulative market share of products that are subject to vertical restraints is too high. Unfortunately, it fails to define what level of cumulative market share would be considered too high.

Further Guidelines Would Cut Costs.

Economic analysis would suggest that vertical restraints may well satisfy the provisions of Section 4(5) of the 2002 Act in many cases where firms have more than 30% of the market. In these circumstances there is arguably an onus on the Authority to provide guidance for business and for the courts on analysing the competitive and efficiency effects of vertical restraints in such circumstances.

Placing the onus on business to self assess such arrangements, imposes potentially substantial compliance costs on firms. Such compliance costs account for the major share of the cost of regulation. Compliance costs are not borne by the regulator, in this case the Authority, but by the regulated firm and/or its customers. Compliance costs may not even be measured by the regulator which is one of the main reasons why regulators generally favour excessive regulation.

A related problem arising from the absence of guidelines is that firms anxious to avoid falling foul of the law, may terminate vertical agreements, even though such arrangements may be efficient. In other words, the lack of guidance may cause firms to adopt less efficient arrangements. The aim of competition is to enhance efficiency and obviously there is something wrong if the Authority's interventions end up having the opposite effect.

A firm with a market share of more than 30% may indeed enjoy market power, but equally it may not. Similarly, as previously outlined, in order to establish whether or not vertical restraints are harmful one needs to consider the degree of interbrand competition and whether there are economies of scope at the downstream level. Finally, given that the economic justification for vertical restraints is that they increase efficiency, in the absence of any evidence of efficiency gains, vertical restraints must be presumed to be harmful.

Resale Price Maintenance.

Many economists argue that RPM has the same effect as other non-price vertical restraints such as exclusive distribution. Consequently, they argue that it makes no sense to treat the two practices differently. Others take a different view, noting that maximum RPM is all that is needed to address problems in supplier-distributor relationships, and suppliers do not, therefore, need to set minimum or fix resale prices. Consequently, they argue there must be some other reason for suppliers to adopt RPM. It is recognised that RPM may be used to help sustain collusion in either the upstream or downstream market.

LPG – Its Make Your Mind Up Time.

The Notice and Declaration do not apply to distribution agreements for LPG. In 2002, the Authority instituted a consultation on whether it should exempt such agreements. On the face of it, the circumstances in the LPG market, would suggest that vertical restraints would be likely to restrict competition and not provide offsetting benefits.[1] In particular the market is highly concentrated and there is evidence of:

- Market power;
- Weak interbrand competition;
- Economies of scope at retail level; and
- Little evidence of efficiency gains.

The Authority in its Notice and Declaration has taken the rather unusual step of announcing that it is terminating the previous consultation, which it began more than a year ago, and will institute a new consultation sometime next year. If the Authority accepts the arguments that vertical restraints in this market are harmful, then it should take action against them to protect consumers. If it does not accept these arguments, then it should authorise such arrangements. It is time it got down off the fence on this issue.

Conclusion.

Vertical restraints may not be harmful even where suppliers have a market share of more than 30%. Further guidance is required on the Authority's views regarding vertical restraints above these thresholds. This is necessary to reduce compliance costs and to prevent risk averse firms from adopting less efficient arrangements.

[1] In a previous *Competition* article, the present author cited evidence from price data which indicated that there was not a single market for energy products and that LPG was not in the same market as natural gas, electricity, or heating oil.