Office of Fair Trading

Vertical agreements

Understanding competition law

Competition law 2004

Since 1 May 2004 not only the European Commission, but also the Office of Fair Trading (OFT) has the power to apply and enforce Articles 81 and 82 of the EC Treaty in the United Kingdom. The OFT also has the power to apply and enforce the Competition Act 1998. In relation to the regulated sectors the same provisions are applied and enforced, concurrently with the OFT, by the regulators for communications matters, gas, electricity, water and sewerage, railway and air traffic services (under section 54 and schedule 10 of the Competition Act 1998) (the Regulators). Throughout the guidelines, references to the OFT should be taken to include the Regulators in relation to their respective industries, unless otherwise specified.

The following are the Regulators:

- the Office of Communications (OFCOM)
- the Gas and Electricity Markets Authority (OFGEM)
- the Northern Ireland Authority for Energy Regulation (OFREG NI)
- the Director General of Water Services (OFWAT)
- the Office of Rail Regulation (ORR), and
- the Civil Aviation Authority (CAA).

Section 52 of the Competition Act 1998 obliges the OFT to prepare and publish general advice and information about the application and enforcement by the OFT of Articles 81 and 82 of the EC Treaty and the Chapter I and Chapter II prohibitions contained in the Competition Act 1998. This guideline is intended to explain these provisions to those who are likely to be affected by them and to indicate how the OFT expects them to operate. Further information on how the OFT has applied and enforced competition law in particular cases may be found in the OFT's decisions, as available on its website from time to time.

This guideline is not a substitute for the EC Treaty nor for regulations made under it. Neither is it a substitute for European Commission notices and guidelines. Furthermore, this guideline is not a substitute for the Competition Act 1998 or the Enterprise Act 2002 and the regulations and orders made under those Acts. It should be read in conjunction with these legal instruments, Community case law and United Kingdom case law. Anyone in doubt about how they may be affected by the EC Treaty, the Competition Act 1998 or the Enterprise Act 2002 should seek legal advice.

In addition to its obligations under Community law, when dealing with questions in relation to competition within the United Kingdom arising under Part I of the Competition Act 1998, the OFT will act in accordance with section 60 of that Act.

Contents

1 Introduction

1.1 The prohibitions contained in Article 81 of the EC Treaty[1] (Article 81) and section 2 of the Competition Act 1998 (the Act) (the Chapter I prohibition) prohibit agreements[2] between undertakings which have as their object or effect the prevention, restriction or distortion of competition. Article 82 of the EC Treaty (Article 82) and section 18 of the Act (the Chapter II prohibition) prohibit conduct by one or more undertakings which amounts to an abuse of a dominant position. Such activities within the common market which may affect trade between Member States will fall within either Article 81 or Article 82; activities which may affect trade in the United Kingdom will fall within the Chapter I prohibition or the Chapter II prohibition.

1.2 EC Regulation 1/2003[3] (the Modernisation Regulation) requires the designated national competition authorities of the Member States (NCAs) and the courts of the Member States to apply and enforce Articles 81 and 82 of the EC Treaty as well as national competition law when national competition law is applied to agreements which may affect trade between Member States or to abuse prohibited by Article 82.

1.3 This guideline explains how the OFT applies Article 81 and the Chapter I prohibition to vertical agreements. In particular, it describes the application of the EC Block Exemption for Vertical Agreements[4] (the Block Exemption) to vertical agreements and explains how the OFT assesses vertical agreements. It also deals with other issues in relation to vertical agreements.

1.4 Vertical agreements do not generally give rise to competition concerns unless one or more of the parties to the agreement possesses market power on the relevant market or the agreement forms part of a network of similar agreements. The Block Exemption avoids placing on business the unnecessary burden of scrutinising a large number of essentially benign agreements and helps to ensure that the OFT is able to concentrate resources on matters giving rise to significant competition concern.

1.5 Part 2 of this guideline describes the OFT's application of Article 81 and the Chapter I prohibition to vertical agreements. Part 3 describes the scope and effects of the Block Exemption, as applied by the OFT

[1] The Treaty establishing the European Community.

[2] References in this guideline to 'agreement(s)' should, unless otherwise stated or the context demands it, be taken to include decisions by associations of undertakings and concerted practices. The meaning of the terms 'undertakings', 'agreement', 'decisions by associations of undertakings' and 'concerted practices' in the context of the EC Treaty and the Act are described in the competition law guideline *Agreements and concerted practices* (OFT401).

[3] Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (OJ L1, 4.1.03, p1)

[4] Commission Regulation (EC) No 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L336, 29.12.99, p21)

in the context of Article 81 and the Chapter I prohibition. Categories of agreements likely to benefit from the exemption for vertical agreements in the Block Exemption include exclusive distribution agreements, exclusive purchasing agreements, selective distribution agreements and franchise agreements.

1.6 Part 4 discusses the possible application of Article 81(3) or section 9(1) of the Act to vertical agreements which may not benefit from the Block Exemption. Part 5 briefly explains the current operation of the Competition Act 1998 (Land and Vertical Agreements) Order 2000[5] (the UK Exclusion Order). The UK Exclusion Order largely covers vertical agreements that are also covered by the parallel application of the Block Exemption. The UK Exclusion Order is repealed with effect from 1 May 2005 upon entry into force of the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004[6].

1.7 Other possible UK scrutiny of vertical agreements is set out in Part 6, including scrutiny under Article 82 and/or the Chapter II prohibition. There is no exemption or exclusion from Article 82 or the Chapter II prohibition for vertical agreements and restraints.

1.8 Part 7 of this guideline describes many of the factors that the OFT considers when assessing whether a vertical restraint in an agreement harms competition and/or whether it leads to any beneficial effects.

[5] SI 2000 No 310

[6] SI 2004 No 1260. The competition law guideline *Land agreements* (OFT420) explains how the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004 operates in relation to land agreements, including vertical land agreements.

2 Article 81 and the Chapter 1 prohibition

2.1 There are two substantive provisions which may be applied by the OFT to anti-competitive agreements: Article 81 and the Chapter I prohibition. The key difference between the two is their geographic scope. The Chapter I prohibition is based on Article 81. Both these provisions apply to agreements between undertakings which have as their object or effect the prevention, restriction or distortion of competition:

- within the common market and which may affect trade between Member States in the case of Article 81, and
- within the United Kingdom and which may affect trade within the United Kingdom in the case of the Chapter I prohibition.

Further guidance on the two provisions is given in the competition law guideline *Agreements and concerted practices* (OFT401).

2.2 An agreement will fall within Article 81 and/or the Chapter I prohibition only if it has as its object or effect an **appreciable** prevention, restriction or distortion of competition within the geographic areas as set out above for each provision. In applying the Chapter I prohibition the OFT's focus will be on the effect on competition, as in practice it is very unlikely that an agreement which appreciably restricts competition within the United Kingdom does not also affect trade within the United Kingdom.

2.3 The European Commission's *Notice on Agreements of Minor Importance*[7] sets out, using market share thresholds, what is not an appreciable restriction of competition under Article 81. In determining whether an agreement has an appreciable effect on competition for the purposes of Article 81 and/or the Chapter I prohibition, the OFT will have regard to the European Commission's approach as set out in the *Notice on Agreements of Minor Importance* (see the competition law guideline *Agreements and concerted practices* (OFT401)).

[7] OJ C368, 22.12.01, p13

Administrative priorities

2.4 It is the OFT's practice to consider, on a case by case basis, whether an agreement falls within its administrative priorities so as to merit investigation.

3 The Block Exemption

3.1 The Block Exemption creates a 'safe harbour' for large numbers of vertical agreements under Article 81(3), so that agreements falling within the terms of the Block Exemption are automatically exempt from the application of Article 81(1). The Block Exemption also has the parallel effect of creating a 'safe harbour' exempting agreements from the application of the Chapter I prohibition, by virtue of section 10 of the Act[8]. Thus agreements falling within the terms of the Block Exemption will be exempt from the application of both Article 81 and the Chapter I prohibition. The Block Exemption does not apply to agreements whose subject matter falls within the scope of any other EC block exemption regulation[9].

3.2 The European Commission's Notice *Guidelines on Vertical Restraints*[10] sets out the principles for the assessment of vertical agreements under Article 81, including the application of the Block Exemption to vertical agreements. The OFT will have regard to this Notice in its assessment of vertical agreements, in relation to both Article 81 and the Chapter I prohibition. This guideline should be read together with the Block Exemption and the Notice.

3.3 The Block Exemption states that:

> 'Article 81(1) shall not apply to agreements or concerted practices entered into between two or more undertakings each of which operates, for the purposes of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services.'

3.4 There are two elements to consider:

- the economic relationship between the parties to the agreement, and
- the provisions of the agreement.

These two elements are considered below. Separate conditions applying to vertical agreements which include certain aspects relating to the assignment or use of intellectual property rights are also considered below.

[8] Section 10(1) provides that an agreement is exempt from the Chapter I prohibition if it is exempt from the Community prohibition 'by virtue of a regulation', and section 10(2) provides that 'an agreement is exempt from the Chapter I prohibition if it does not affect trade between Member States but otherwise falls within a category of agreement which is exempt from the Community prohibition by virtue of a Regulation'.

[9] EC block exemption regulations currently in force include: Commission Regulation (EC) No 2658/2000 on the application of Article 81(3) of the Treaty to categories of specialisation agreements; Commission Regulation (EC) No 2659/2000 on the application of Article 81(3) of the Treaty to categories of research and development agreements; Commission Regulation (EC) No 1400/2002 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector; and Commission Regulation (EC) No 772/2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements.

[10] Commission Notice 2000/C 291/01 (OJ C291, 13.10.2000, p1)

Economic relationship between the parties to the agreement

3.5 For an agreement to fall within the Block Exemption, the economic relationship between the parties must be such that each of the parties to the agreement operates **at a different level of the production or distribution chain** for the purposes of the agreement. Examples of activities at different levels of the production or distribution chain include supplying raw materials, manufacturing, wholesaling and retailing. An agreement between a food manufacturer and a supermarket for the supply of baked beans would be an example of a vertical agreement between undertakings operating at different levels of the production or distribution chain.

3.6 Different levels of the production or distribution chain may be found within each of the broad categories mentioned above. Within manufacturing, for example, one undertaking may manufacture a component part of a final product (such as a light bulb) and make an agreement to sell that part to a second undertaking which uses that part in its manufacture of the final product (such as a car). Although each of these undertakings is a manufacturer (one of light bulbs and one of cars), they would be regarded as operating at different levels of the production or distribution chain when they entered into an agreement for the supply of light bulbs to be incorporated into a car. Such an agreement may, therefore, benefit from the Block Exemption.

3.7 **Each** undertaking must operate at a different level of the production or distribution chain for an agreement to benefit from the Block Exemption. For example, an agreement between one manufacturer and a group of six competing wholesalers (where each of the six wholesalers operates at the same level of the production or distribution chain), while being an agreement between undertakings at different levels of the production or distribution chain (that is, manufacturing and wholesaling), would not benefit from the Block Exemption. The agreement would involve more than one undertaking at one particular level of the production or distribution chain (wholesaling). An agreement between a supplier of raw materials, a manufacturer, a distributor and a retailer could, however, benefit from the Block Exemption because each undertaking operates at a different level of the production or distribution chain.

3.8 Undertakings often operate at more than one level of the production or distribution chain. Whilst the Block Exemption in general does not apply to vertical agreements between competitors, an agreement between undertakings that operate at one or more of the same levels of the production or distribution chain may still benefit from the Block Exemption in certain limited circumstances. The agreement can benefit from the Block Exemption because the parties to the agreement each operate at different levels of the production or distribution chain **for the purposes of the agreement**.

3.9 Article 2(4) of the Block Exemption provides that the Block Exemption shall not apply to vertical agreements entered into between competing undertakings[11], subject to certain limited exceptions. The Block Exemption sets out three exceptions to the general exclusion of vertical agreements between competitors, all of which relate to non-reciprocal agreements. Non-reciprocal means, for instance, that while one manufacturer becomes the distributor of the products of another manufacturer, the latter does not become a distributor of the products of the first manufacturer.

3.10 For example, non-reciprocal vertical agreements between competing undertakings are permitted where the supplier is a manufacturer and distributor of goods, whilst the buyer is a distributor that does not manufacture goods competing with the contract goods.

Provisions of the agreement

Conditions of the agreement

3.11 The agreement must relate to the conditions under which the parties to the agreement may purchase, sell or resell certain goods or services to benefit from the Block Exemption. This covers final and intermediate goods and services. The goods or services may be resold by the buyer or may be used as an input by the buyer in producing its own goods or services. Conditions which relate to

[11] Competing undertakings for the purpose of the Block Exemption means actual or potential suppliers in the same product market; the product market includes goods or services which are regarded by the buyer as interchangeable with or substitutable for the contract goods or services, by reason of the product's characteristics, their prices and their intended use.

matters other than the conditions of purchase, sale and resale are not covered by the Block Exemption.

Intellectual property rights provisions

3.12 A vertical agreement that contains provisions relating to the assignment to, or use by, the buyer of intellectual property rights may benefit from the Block Exemption. Where such provisions are included, however, there are four elements with which provisions relating to intellectual property rights must comply in order for the agreement to benefit from the Block Exemption. They must:

- relate to the assignment to the buyer or use by the buyer of intellectual property rights
- not constitute the primary object of the agreement
- be directly related to the use, sale or resale of the goods or services by the buyer or its customers, and
- in relation to the contract goods or services, not contain restrictions that have the same object or effect as vertical restraints which are not exempted under the Block Exemption.

These elements are considered below.

3.13 In order to benefit from the Block Exemption, any provisions relating to intellectual property rights must relate to the assignment of the rights to the buyer or the use by the buyer of those rights. For example, an agreement under which a licence is given to a distributor to distribute and market the contract goods in a particular territory may benefit from the Block Exemption.

3.14 The assignment or use of the intellectual property rights must not be the primary object of the agreement. A simple patent licence, for example, would not benefit from the Block Exemption since the primary object of the agreement is to license the patent. It may, however, benefit from the EC technology transfer block exemption[12].

3.15 The provisions must relate directly to the activity of the buyer or its customers in relation to the use, sale or resale of goods or services.

[12] Commission Regulation (EC) No 772/2004 of 27 April 2004 on the application of Article 81(3) of the Treaty to categories of technology transfer agreements, OJ L123, 27.04.04, p11

The provisions will normally concern the marketing of goods or services, such as in a franchise agreement where the franchisor sells to the franchisee goods for resale and in addition licences the franchisee to use his trade mark and know-how to market the goods.

3.16 The intellectual property rights provisions must not have the same object or effect as restrictions which are not exempted under the Block Exemption. Vertical agreements containing intellectual property rights provisions having such object or effect fall outside the scope of the Block Exemption. The limits to the scope of the Block Exemption are discussed below, in paragraphs 3.17 to 3.29.

Limits to the scope of the Block Exemption (including Excluded Obligations)

3.17 There are two key limits to the scope of the Block Exemption. The Block Exemption will **not** apply to a vertical agreement where:

- the market share of the supplier (or buyer, in the case of an agreement with an exclusive supply obligation[13]) exceeds 30 per cent of the relevant market (Article 3), or
- the agreement contains one or more of the 'hardcore' restrictions listed in the Block Exemption, including price-fixing (Article 4).

3.18 In addition, the Block Exemption does not apply to certain obligations, in particular non-compete obligations, unless specific conditions are fulfilled (Article 5).

Market share

3.19 Generally, the market share of the supplier on the market in which it sells the contract goods or services will determine whether the market share threshold is exceeded. The market share of the buyer on the relevant market in which it purchases the contract goods or services will only be relevant where the agreement includes an exclusive supply obligation.

3.20 In order to calculate market share, it is necessary to determine the relevant market. This means defining the relevant product and

[13] Article 1(c) of the Block Exemption defines exclusive supply obligation as 'any direct or indirect obligation causing the supplier to sell the goods or services specified in the agreement only to one buyer inside the Community for the purposes of a specific use or for resale'.

geographic markets. The analysis the OFT undertakes to determine the relevant market is described in the competition law guideline *Market definition* (OFT403). The OFT's approach to assessment of market shares is described in the competition law guideline *Assessment of market power* (OFT415).

3.21 Vertical agreements in which the market share threshold is exceeded will be subject to scrutiny under Article 81 and/or the Chapter I prohibition. However, it is possible for an agreement that falls within Article 81(1) but which satisfies the conditions set out in Article 81(3) not to be prohibited even where it does not fall under the Block Exemption. This is explained further in Part 4 below.

Hardcore restrictions

3.22 There are five 'hardcore' restrictions which, if included in a vertical agreement, have the effect of taking the entire agreement outside the scope of the Block Exemption. The most significant restriction is price-fixing. This is explained in paragraphs 3.23 to 3.25 below. The other four restrictions relate to specific types of sales restrictions and are described briefly in paragraphs 3.26 to 3.27 below.

3.23 The benefit of the Block Exemption does not apply to vertical agreements that fix prices. The Block Exemption provides that the exemption for vertical agreements does not apply to any vertical agreement which directly or indirectly (whether on its own or in combination with other factors under the control of the parties) has the object of restricting a buyer's ability to determine its sale price.

3.24 An agreement where the supplier imposes a maximum or recommended sale price may benefit from the Block Exemption unless such a maximum or recommended sale price results, in practice, in a fixed or minimum sale price because of pressure from, or any incentives offered by, any of the parties to the agreement. Where pressure and/or incentives in relation to recommended or maximum prices have such an effect the agreement will not benefit from the Block Exemption. Examples of the types of practices that may result in fixed or minimum sale prices include:

- an agreement fixing the maximum level of discount a distributor can grant from a prescribed price level, or
- intimidation, delay or suspension of deliveries and contract terminations in relation to the observance of a certain price level.

3.25 Price-fixing agreements that do not benefit from the Block Exemption are subject to scrutiny under Article 81 and/or the Chapter I prohibition and are capable of having an appreciable effect on competition even if the parties' combined share of the relevant market is less than the thresholds specified in the Commission's Notice on *Agreements of Minor Importance*. Details of how price-fixing agreements that fall within Article 81 and/or the Chapter I prohibition will be treated by the OFT can be found in the competition law guideline *Agreements and concerted practices* (OFT401).

3.26 In addition to price-fixing, there are a further four 'hardcore' restrictions in the Block Exemption. Where an agreement directly or indirectly (whether on its own or in combination with other factors under the control of the parties) has as its object one of these restrictions, it will not benefit from the Block Exemption and will be subject to scrutiny under Article 81 and/or the Chapter I prohibition. These are:

- **Restrictions concerning the territory into which, or the customers to whom, the buyer may sell** – as a general principle a buyer must remain free to decide where and to whom he sells the contract goods or services and this cannot be restricted by the agreement. This general principle is subject to certain exceptions[14].
- **Restrictions on sales to end-users by authorised retail distributors in a selective distribution system** – a producer applying a selective distribution system cannot restrict active or passive selling by the authorised distributors (operating at the retail level of trade) to end-users, except that the supplier can require the distributor to sell only from a given location.
- **Restrictions on authorised distributors in a selective distribution system selling or purchasing from other members of the network** – the appointed distributors in a selective distribution system cannot be restricted from buying or selling the

[14] The supplier can restrict a buyer from making 'active sales' into a territory allocated exclusively to another buyer or which the supplier has reserved exclusively to itself; the supplier can restrict sales by a wholesaler to end-users; the supplier can restrict distributors in a selective distribution system from selling to unauthorised distributors in markets where such a system is operated; and the supplier can restrict a buyer of components supplied for incorporation from re-selling them to competitors of the supplier (Article 4(b) of the Block Exemption).

contract goods to or from other appointed distributors within the network operating either at the same or at a different level of trade.

- **Restrictions on the sale of components as spare parts by the manufacturer of the component to end-users, independent repairers and service providers** – an agreement between a supplier of component parts and a buyer which incorporates these parts into its own products (the original equipment manufacturer) may not prevent or restrict sales by the supplier of these component parts as spare parts to end-users, independent repairers or service providers.

3.27 These restrictions are discussed in further detail in the European Commission's Notice *Guidelines on Vertical Restraints*.

Excluded obligations

3.28 Article 5 of the Block Exemption imposes specific conditions for certain types of obligations. If such obligations are contained in a vertical agreement and they do not comply with the conditions in Article 5, the Block Exemption will not apply to those obligations. This does not prevent the remainder of the agreement from benefiting from the Block Exemption, if the obligations are severable from the remainder of the agreement.

3.29 The Block Exemption does **not** apply to the following obligations:

- **Non-compete obligations[15] during the term of the contract which exceed five years** – any direct or indirect non-compete obligation which is indefinite (including those which are tacitly renewable beyond five years) or exceeds five years. The five year time limit does not apply if the contract goods or services are sold by the buyer from premises and land owned or leased by the supplier. In such cases, the time limit must not exceed the buyer's occupancy.

- **Non-compete obligations after the termination of the contract** – any direct or indirect non-compete obligation on the buyer not to manufacture, purchase, sell or resell goods or services

[15] Non-compete obligations for the purposes of the Block Exemption are obligations that directly or indirectly cause the buyer not to manufacture, purchase, sell or resell competing goods or services, or to purchase from the supplier, or another designated undertaking, more than 80 per cent of the buyer's total purchases of the contract goods or services and their substitutes on the relevant market, thereby preventing the buyer from purchasing competing goods and services or limiting such purchases to 20 per cent (Article 1(b) of the Block Exemption).

after termination of the contract. However, such an obligation can be covered by the Block Exemption provided that the obligation is limited to a period of **one** year after termination of the agreement, relates to goods or services which compete with the contract goods or services, is limited to the premises and land from which the buyer has operated during the contract, and is indispensable to protect know-how[16] transferred from the supplier to the buyer.

- **Obligations not to sell particular competing brands in a selective distribution system** – any direct or indirect obligation causing the members of a selective distribution system not to sell the brands of particular competing suppliers.

Withdrawal of the Block Exemption

3.30 As mentioned above, the Block Exemption exempts vertical agreements because they do not generally give rise to competition concerns. The OFT may, under Article 29(2) of the Modernisation Regulation, withdraw the benefit of the Block Exemption from any agreement if the following conditions are met:

- the agreement in question has effects that are incompatible with Article 81(3) in the territory of the United Kingdom, or a part of the United Kingdom, and
- the relevant territory has all the characteristics of a distinct geographical market.[17]

In the case of withdrawal of the Block Exemption by the OFT, it will be for the OFT to demonstrate that the agreement infringes Article 81(1) and that it does not satisfy the conditions of Article 81(3) of the United Kingdom (or part of the United Kingdom) that is a distinct geographic market. In practice the OFT is likely to exercise this power only rarely. The United Kingdom courts have no power to withdraw the benefit of the Block Exemption.

3.31 Where the OFT proposes to exercise its powers to withdraw the benefit of the Block Exemption from an agreement it must, following the procedures specified in the *OFT's Rules*[18], give written notice to the parties to that agreement and give them the opportunity to make representations. It may also consult the public. If the OFT has

[16] According to the definition in article 1(f) of the Block Exemption, the know-how needs to be 'substantial', meaning that the know-how includes information which is indispensable to the buyer for the use, sale or resale of the contract goods or services.

[17] Article 29(2) of the Modernisation Regulation.

[18] The Competition Act 1998 (Office of Fair Trading's Rules) Order 2004 (SI 2004/2751), rule 13

decided to withdraw the benefit of the Block Exemption it will notify the parties to that agreement of its decision and will publish the decision on a public register on the OFT's website.

Consequences of withdrawal

3.32 Where the OFT decides to withdraw the benefit of the Block Exemption from a particular agreement it at the same time establishes that the agreement infringes Article 81. Such an infringement finding can have effect only from the date of the withdrawal. The agreement will be void only from the date of withdrawal and any financial penalties imposed in respect of that agreement can relate only to the period after the withdrawal of the Block Exemption.

3.33 Withdrawal of the Block Exemption in a particular case will result in any parallel exemption also ceasing to have effect, by virtue of section 10(4)(b) of the Act.

4 Article 81(3) and section 9(1) of the Act

4.1 A vertical agreement that does not benefit from the Block Exemption or from any other block exemption may still not be prohibited if it falls under the **legal exception regime**, introduced by the Modernisation Regulation. The phrase **legal exception regime** means that an agreement that falls within Article 81(1) but which satisfies the conditions set out in Article 81(3) shall not be prohibited, no prior decision to that effect being required. Such an agreement is valid and enforceable from the moment that the conditions in Article 81(3) are satisfied and for as long as that remains the case.

4.2 The Act has been amended similarly to mirror this approach so that an agreement that falls within the Chapter I prohibition but which satisfies the conditions set out in section 9(1) of the Act shall not be prohibited, no prior decision to that effect being required. Such an agreement is valid and enforceable from the moment that the conditions in section 9(1) are fulfilled and for as long as that remains the case.

4.3 Article 81(3) sets out four conditions which must all be met. It provides that the prohibition in Article 81(1) is inapplicable in respect of any agreement:

> 'which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
>
> (a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives
>
> (b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.'

4.4 The wording of section 9(1) is similar to that of Article 81(3) except that in the first condition in section 9(1) the phrase 'of goods' is not included. The omission of these words is intended to make clear (consistent with the practice of the European Commission in relation to Article 81(3)) that improvements in production or distribution in relation to services may also satisfy the first condition in section 9(1).

4.5 Part 7 of this guideline describes some of the ways in which vertical agreements might contribute to improving production or distribution, or promoting technical or economic progress.[19]

4.6 The European Commission has issued a Notice entitled *Guidelines on the application of Article 81(3) of the Treaty*[20] to assist companies and their advisers in determining whether an agreement satisfies the conditions in Article 81(3). The OFT will have regard to this Notice in considering the application of Article 81(3) and section 9(1) of the Act. More detailed information on the legal exception regime can be found in the competition law guideline *Agreements and concerted practices* (OFT401).

[19] This part of the guideline should be read together with the European Commission's Notice *Guidelines on Vertical Restraints*, in which the Commission has set out the principles and factors relevant for the assessment of individual agreements under Article 81(1) and Article 81(3). As mentioned in paragraph 3.2 above, the OFT will have regard to this Notice in its assessment of vertical agreements, in relation to both Article 18 and Chapter I prohibition.

[20] OJ C101, 27.04.04, pp 97–118.

5 The UK Exclusion Order

5.1 The UK Exclusion Order, made under section 50 of the Act, excludes vertical agreements (as defined in the UK Exclusion Order) from the application of the Chapter I prohibition. It is repealed with effect from 1 May 2005 upon entry into force of the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004[21] (Land Agreements Exclusion Order). During the transitional period the operation of the UK Exclusion Order remains unchanged. Following the repeal of the UK Exclusion Order vertical agreements that do not benefit from the Land Agreements Exclusion Order will need to be assessed for compatibility within the Chapter I prohibition. Such agreements may benefit from the parallel application of the Block Exemption, which is discussed in Part 3 above, or under the legal exception regime which is discussed in Part 4 above.

[21] SI 2004 No 1260. The competition law guideline *Land agreements* (OFT420) explains how the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004 operates in relation to land agreements, including vertical land agreements.

5.2 The UK Exclusion Order and, when it comes into force, the Land Agreements Exclusion Order, only offer protection from the Chapter I prohibition and do not preclude the application of Article 81 where there is an effect on trade between Member States.

5.3 The UK Exclusion Order largely applies to the same types of agreements as the Block Exemption, as it was intended to follow closely the treatment of vertical agreements in the European Community. The main differences between the operation of the UK Exclusion Order and the Block Exemption are:

- The UK Exclusion Order does not preclude the application of Article 81 where there is an effect on trade between Member States, whereas the Block Exemption has a parallel effect and thereby precludes the application of both Article 81 and the Chapter I prohibition
- The UK Exclusion Order is not subject to a market share threshold test (although, like the Block Exemption, the OFT may withdraw the benefit of the exclusion in certain cases, and where one party is dominant it does not preclude the application of Article 82 and/or the Chapter II prohibition)
- The UK Exclusion Order has only one 'hardcore' restriction, which relates to price-fixing. An agreement which includes a price-fixing restriction cannot benefit from the exclusion.

5.4 The UK Exclusion Order provides that the Chapter I prohibition does not apply to an agreement **to the extent that** it is a vertical agreement. The exclusion may therefore apply only to certain parts of an agreement rather than an agreement in its entirety. It is therefore possible for some provisions in an agreement to benefit from the exclusion while others do not.

5.5 Where an agreement is only partly covered by the exclusion, and the OFT has competition concerns about the object or effect of the agreement, it is able to have regard to the whole agreement (including those parts of the agreement that benefit from the exclusion for vertical agreements) to assess whether the Chapter I prohibition has been infringed. The OFT is not, however, able to take any action against the parts which benefit from the exclusion without first withdrawing the UK Exclusion Order. The process for, and consequences of, withdrawal of the UK Exclusion Order are discussed in the competition law guideline *Land agreements* (OFT420).

6 Other possible United Kingdom competition scrutiny of vertical agreements

Article 82 and the Chapter II prohibition

6.1 A vertical agreement entered into by an undertaking which holds a dominant position in a market may be subject to Article 82 and/or the Chapter II prohibition. There is no exemption or exclusion for vertical agreements from Article 82 or the Chapter II prohibition. The OFT's application of these prohibitions is described in the competition law guideline *Abuse of a dominant position* (OFT402).

6.2 The economic analysis of vertical restraints is often similar whether a vertical restraint is assessed under Article 81 and/or the Chapter I prohibition or Article 82 and/or the Chapter II prohibition. The factors described in Part 7 of this guideline (below) therefore also apply to the analysis of a vertical restraint when it is assessed in the context of Article 82 or the Chapter II prohibition.

The Enterprise Act 2002

6.3 The market investigation provisions in the Enterprise Act 2002 (see the Enterprise Act guidance *Market investigation references* (OFT511)) may, in certain circumstances, be relevant for dealing with possible competition problems in relation to vertical agreements. A market investigation may, for example, be appropriate where vertical agreements are prevalent in a market and have the effect of preventing the entry of new competitors into the market, but there is no evidence of collusion between the firms involved which might have caused this situation to arise.

7 Assessment of vertical agreements

7.1 This Part describes many of the factors that the OFT considers when assessing whether a vertical agreement restricts competition and/or whether it leads to any beneficial effects. These factors relate to the economic analysis of vertical agreements in the context of Article 81 and the Chapter I prohibition. Vertical agreements may also be assessed in the context of Article 82 and the Chapter II prohibition, where the economic analysis will often be similar. This Part does not describe the application of the Block Exemption: see Part 3 above for a discussion of its application.

7.2 In this Part, reference is usually made to agreements between a manufacturer and a retailer for convenience, but the same principles apply to agreements between any two parties which, for the purposes of the agreement, operate at different stages in the supply chain and in the supply of goods or services.

7.3 There are many contracts between manufacturers and retailers which place some restriction on the commercial freedom of one or both parties, but most will not raise competition concerns because they relate to undertakings which do not have market power, either individually or collectively.

7.4 Generally, for a vertical agreement to raise competition concerns, one or more parties to the agreement must have market power, or obtain market power as a result of the agreement.[22] Even where none of the undertakings party to a vertical agreement possesses market power individually, there may be a series of similar agreements which cover a group of undertakings that collectively possess market power. Such networks of agreements may raise competition concerns.

[22] See the competition law guideline *Assessment of market power* (OFT415).

7.5 Vertical agreements may also produce benefits, even where they do not fall under the Block Exemption or the UK Exclusion Order. Therefore vertical agreements generally need to be assessed on a case by case basis.

Types of vertical restraint

7.6 The term **restraint** in this Part is used to describe a restriction occurring within a vertical agreement. However, a vertical restraint may also occur as a result of the unilateral conduct of an undertaking and a similar analysis would apply to those situations in the context of Article 82 and the Chapter II prohibition.

7.7 There is a wide range of restraints which might appear in vertical agreements and which might potentially restrict competition. The following list is not exhaustive but covers the main types.

- **resale price maintenance (RPM)**: where the supplier specifies the resale price of the product. Where fixed or minimum resale prices are specified these are hardcore restrictions which will almost invariably infringe Article 81 and/or the Chapter I prohibition.[23] Price-fixing agreements, by their very nature, restrict competition to an appreciable extent. Maximum prices and recommended resale prices will not usually infringe competition law, unless their effect is to fix prices and dampen price competition
- **selective distribution**: where a manufacturer supplies only a limited number of dealers that are then restricted in their ability to re-sell products
- **exclusive distribution**: a particular form of distribution where the manufacturer supplies only one retailer in a particular territory or allows only one retailer to supply a particular class of customer (e.g. businesses or consumers)
- **non-compete or exclusive dealing**: where the retailer agrees to purchase, or deal in, goods from only one manufacturer
- **tie-in sales and bundling**: where the manufacturer makes the purchase of one product (the tying product) conditional on the purchase of a second product (the tied product). A set of tied products is sometimes referred to as a bundle of products

[23] See Part 3, above.

- **full-line forcing**: an extreme form of tie-in sale where, in order to obtain one product in the retailer's range, the retailer must stock all the products in that range and
- **quantity forcing**: where the retailer is required to purchase a minimum quantity of a certain product.

7.8 The following paragraphs explain briefly possible anti-competitive effects of vertical restraints and some countervailing benefits they might produce.

Competition effects

7.9 The important issue is generally not the form of the vertical restraint but its effect on competition. Usually, the first step in the analysis of a vertical restraint is to assess whether one or more parties to the agreement has market power[24]. Where this is the case, the restraint may have anti-competitive effects if its (likely) effect is to foreclose (a substantial part of) a market to competition or to dampen competition and/or in the context of Articles 81 and 82, to create obstacles to market integration. The following paragraphs provide some examples.

[24] See the competition law guideline *Market definition* (OFT403) for a discussion of the analysis the OFT undertakes to determine the relevant market, and the competition law guideline *Assessment of market power* (OFT415) for a discussion of the OFT's approach to assessment of market shares.

Example of foreclosure

7.10 A market is foreclosed either completely or partially when undertakings face barriers to entering that market, or barriers to expansion once in that market.

7.11 Selective distribution may foreclose a market to retail competition, where it is practised by a sufficient proportion of manufacturers. For example, if manufacturers of the most popular brands of a product have similar distribution agreements with their retailers (with the effect that relatively few retailers are authorised to stock the full range of popular brands), this may prevent unauthorised retailers from providing effective competition and thereby provide the authorised retailers with market power.

7.12 Selective distribution may be less likely to lead to foreclosure if, rather than imposing an absolute restriction on the number of retailers in the distribution network, any retailer may join the network provided it meets certain objective standards (where these standards are not clearly designed to favour existing retailers over new entrants).

Examples of competition dampening

7.13 Vertical restraints can also affect competition by reducing its intensity, or 'dampening' competition.

7.14 Competition dampening might occur in various ways. For instance, RPM will generally have direct negative effects on competition. Where prices are fixed absolutely, or minimum prices are specified, there will be no price competition between the retailers affected for the product concerned (i.e. no 'intra-brand' competition). RPM can also facilitate collusion, for example, by becoming a focal point for colluding undertakings, or by allowing undertakings to detect deviations from the collusive price more easily. Competition dampening of this sort could occur with other vertical restraints, for example exclusive distribution.

7.15 Another way is that vertical restraints can dampen not only intra-brand competition but also inter-brand competition ('inter-brand' competition refers to competition among manufacturers). For example, suppose manufacturers distribute exclusively to different retailers. Each retailer would then sell only one manufacturer's brand and so there would be no in-store inter-brand competition (i.e. competition among competing brands in the same retail outlet). Where the retailers in question are differentiated by location, this might make it harder for customers to compare each manufacturer's product. This could lead to demand for each manufacturer's brand becoming less price sensitive, thereby dampening competition at the manufacturing level.

Other effects

7.16 Vertical restraints might be used in combination, with a mutually reinforcing effect. For example, a selective distribution system when combined with full-line forcing might have the effect that retailers in a manufacturer's distribution system sell only that manufacturer's product.

7.17 Different forms of vertical restraints may, in some cases, have similar effects. For example, a manufacturer might require that its retailers purchase a minimum quantity of its product. If the minimum quantity is set just below each retailer's total input requirement, the effect is de facto exclusive dealing.

7.18 The parties to a vertical agreement might both benefit from a vertical restraint at the expense of consumers. For example, where a vertical restraint provides a retailer with market power, that retailer may generate excessive profits some of which are paid to the manufacturer (known as 'rent sharing').

Benefits of vertical restraints

7.19 While vertical restraints, in the presence of market power, can lead to anti-competitive effects, they may also produce economic benefits. For example, vertical restraints can generate benefits through:

- promoting efficiencies
- promoting non-price competition, and
- promoting investment and innovation.

Efficiencies

7.20 Vertical restraints may generate efficiencies. For example, selective or exclusive distribution might reduce 'transaction costs' between undertakings, such as where, by limiting the number of retailers in a distribution network, a manufacturer significantly reduces its costs of distribution and of monitoring any promotional efforts required of its retailers.

7.21 In the above example, in order to reduce transaction costs the manufacturer may wish to limit the number of retailers in its network to such a degree that each retailer gains market power. If retailers exploited this market power, the manufacturer might suffer lower profits through reduced sales. Therefore, the manufacturer might set a maximum price to ensure that some of the savings in transaction costs are passed on to consumers.

Non-price competition

7.22 In some cases, a manufacturer may use vertical restraints to overcome 'free-rider' problems, for example, by dampening price competition in order to set stronger incentives for its retailers to promote non-price factors (e.g. pre-sales services). Overall, customers might gain, where their valuations of non-price features of the product are sufficiently high.

Example of free-riding among retailers

7.23 In some markets, 'full-service' retailers provide 'promotional effort' such as demonstrating new products, and providing pre-sales advice to potential purchasers. These services might bring benefits to the customer and help manufacturers increase sales of their products. However, strong promotional effort by full-service retailers might benefit other 'discount' retailers who sell but do not promote the product. The discount retailers could undercut the full-service retailers, since they would not incur its promotional cost. Customers might then opt to use the demonstration facilities at the full-service retailer but purchase the products from the lower-cost discount retailer. The discount retailer would then be free-riding on the demonstration services of the high-cost retailer who would lose sales and therefore be likely to cut back on its demonstration services. This might have a material adverse effect on consumers where they place a high value on pre-sales service.[25]

7.24 These problems might be more likely to arise where customers lack prior knowledge of the product and so need pre-sales information as might be the case with new or complex products or expensive, one-off purchases.

7.25 Manufacturers may use vertical restraints to overcome the problems resulting from free-riding by, for example, selective distribution conditions which would require all retailers selling their products to provide the necessary demonstration services. At the extreme, the manufacturer could use a system of exclusive distribution to ensure there was only one outlet in a particular area and therefore no prospect of free-riding. While dampening price competition between

[25] Similar free-riding arguments might arise when retailers advertise on behalf of the manufacturer and thereby generate sales for competing retailers that also stock the manufacturer's product.

retailers, the latter may have a stronger incentive to provide promotional or other pre-sales services and overall customers might gain.

7.26 However, the free-rider problem might be capable of being solved more effectively and in a way less restrictive of competition. For example, rather than using a selective distribution network, another way to encourage promotional effort by retailers is for the manufacturer to contribute to its retailers' promotional costs.

Example of free-riding between manufacturers

7.27 Free-riding between manufacturers normally arises when a manufacturer provides support to a retailer. This might include providing information on potential customers, funding technical support for staff training and providing generic promotional equipment or material.[26] If the retailer sells the products of a number of the manufacturer's competitors, this support may generate sales for the competitors as well as the manufacturer. In this sense, the manufacturer's competitors might free-ride on the investments and support it provides the retailer.

[26] Where the manufacturer has a strong brand image, it might even provide the retailer with a mark of quality assurance, the idea being that the manufacturer would not allow its product to be stocked in a low quality retail outlet.

7.28 The manufacturers might try to remedy this problem by requiring the retailer to commit to an exclusive purchasing obligation, or by using some form of quantity or line-forcing.

Investment and innovation

7.29 Vertical restraints might promote investment and innovation. For example, if a retailer contributed to the cost of a manufacturer developing a new product (e.g. financially or by transferring important know-how) then, once the product was developed, the retailer might be in a weak bargaining position since the manufacturer could sell its new product to rival retailers. Therefore, the retailer might require that prior to contributing finance or know-how, the manufacturer must agree that, once developed, the product will be sold exclusively to the retailer for a reasonable period.

Competition law guidelines

The OFT is issuing a series of competition law guidelines. New guidance may be published and the existing guidance revised from time to time. For an up-to-date list of guidance booklets check the OFT website at www.oft.gov.uk

All guidance booklets can be ordered or downloaded from the OFT website at www.oft.gov.uk Or you can request them by:

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