

## *The Vertical Restraints in the European Union Competition Policy*

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### **Abstrak**

Tulisan ini menggambarkan *Vertical Restraints* sebagai bagian dari Kebijakan Kompetisi Uni Eropa (UE) yang mengatur tidak hanya *Vertical Restraints* tetapi juga aspek-aspek lainnya seperti; hak kekayaan intelektual, kartel dan oligopoli, *joint ventures*, merger, dan bantuan negara. Keberadaan Kebijakan Kompetisi UE merupakan suatu keharusan untuk mencegah situasi persaingan yang tidak seimbang antar negara-negara anggota UE. Tulisan ini menjawab 1), definisi kompetisi dan teori untuk menjelaskan kompetisi, 2). Isi Kebijakan Kompetisi UE, 3). Pengertian *Vertical Restraints* dan hubungannya dengan Kebijakan Kompetisi UE termasuk pandangan Komisi UE dan dampaknya beserta dampaknya dalam mempromosikan kompetisi. Lebih lanjut, terdapat dua tujuan dari Kebijakan Kompetisi UE yakni menjaga pasar yang kompetitif dan tujuan pasar tunggal. *Vertical restraints* atau *vertical agreements* bisa mencegah kompetisi antara penyedia dan produsen dalam bersaing terhadap barang dan jasa. Berdasarkan traktat, perjanjian tersebut akan bertentangan dengan Artikel 101 dan 102 TFEU. Walaupun demikian, selain memiliki dampak-dampak negatif, *vertical restraints* dapat memberikan dampak positif dengan syarat-syarat tertentu.

**Keywords:** *Vertical Restraints, Vertical Agreements, the EU Competition Policy,*

### **Introduction**

Competition in trading and business activities nowadays is indispensable for the economic actors, such as government and especially companies, which bind not only nationally but also regionally and internationally.

Since every country and company has different capabilities to compete, therefore, regulating an atmosphere where fair competition can take place is really important and compulsory. Otherwise, there may not be a fair to all elements of business in doing their activities.

Many institutions, nationally such as government and its national chamber of commerce or internationally such as WTO (World Trade Organization), are taking a concern to the issue, including the EU. Although the EU is a regional institution but it has a significant role to prevent what it calls as anti competitive behaviors. Furthermore, the EU has put free competition as a key element for its open market economy. Besides as a

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key element, the free competition accelerates European economic performance and provides a wide choice of better-quality products and services for customers and also at more competitive prices.

Doing so, the EU has issued a policy regulating competitions among its member states, this policy called EU Competition Policy. The competition policy of EU ensures that competition is not distorted in the internal market by ensuring that similar rules apply to all the companies operating within in it.<sup>1</sup> The policy regulates aspects such as; intellectual property rights, cartel and oligopoly, joint ventures, mergers, state aid and Vertical Restraints. But, to be more focused, this paper will only take a Vertical Restraints as its concern.

The research questions that I want to answer from this paper are:

- a. What is definition of competition and which theory could be used to explain the competition?
- b. What is EU competition policy about?
- c. What is the Vertical Restraints and its connection in the EU Competition Policy, including the Commission of the EU perspective and its impact in promoting competition.

Thus, to dig deeper about the theme, this paper will use library research where the data are taken from primary sources, which are directly from the EU treaties, websites, and paper regarding to the EU Competition Policy, and secondary sources focusing on competition, competition theory and competition policy in general.

To be well arranged, this writing is divided into several sections. First section is Introduction which gives a background, aim of the paper, research method and division of paper. Second section is about the definition of competition and the theory of competition by using the explanation of Michael Porter about Five Forces of Competition Position. Third section is an overview about EU Competition Policy. Fourth section is about Vertical Restraints in the EU. And fifth section tries to give evaluation and the last section concludes the paper.

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<sup>1</sup> [http://europa.eu/legislation\\_summaries/competition/index\\_en.htm](http://europa.eu/legislation_summaries/competition/index_en.htm), on 29.03.2014

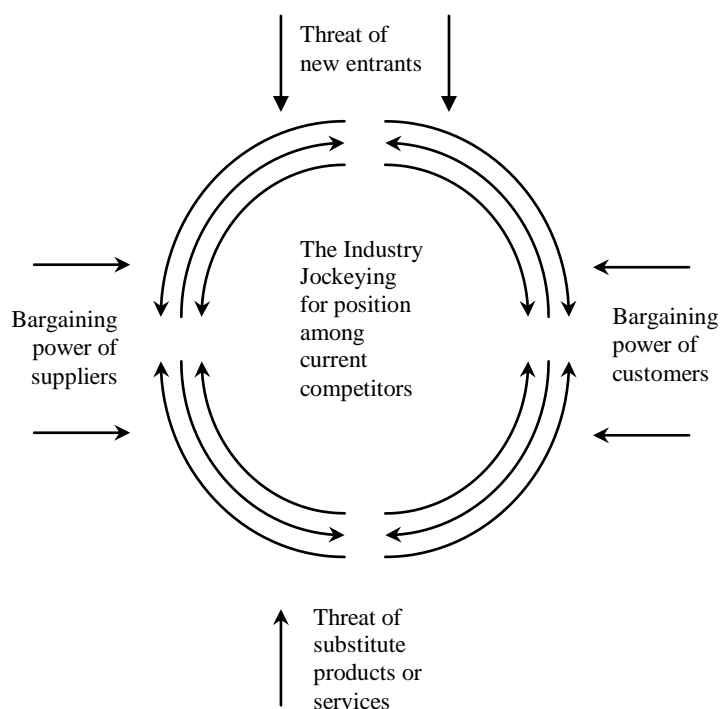
## Understanding Competition Policy

### a. Competition and Theory

Competition is defined as the “*struggle or contention for superiority, in the commercial world ... means a striving for the custom and business of people in the market place*”.<sup>2</sup> Competition occurs when there is a fight among firms for customers by offering them a better of price, quality, range, reliability and associated services.<sup>3</sup>

Moreover, according to Michael Porter there are 5 basic forces in which the state of competition is depending, as can be seen in diagram below<sup>4</sup>:

Figure: *Forces Governing Competition in Industry*



A short explanation of the figure:

#### *Contending Forces*

There are forces or force that determine the profitability and different forces have prominence in shaping competition.

#### *Threat of Entry*

<sup>2</sup> R. Whish, *Competition Law*, 2<sup>nd</sup> edn. (London: Butterworths, 1989) p. 3. in Michelle Cini and Lee Mc Gowan, *Competition Policy in the European Union*. (Hampshire: Palgrave MacMillan, 1998). p. 2.

<sup>3</sup> Bruce Lyons, *Cases in European Competition Policy: The Economic Analysis*. (Cambridge: Cambridge University Press, 2009). p. 1.

<sup>4</sup> Michael E. Porter. *On Competition*. (USA: The Harvard Business Review Book Series, 1998). p. 22

The seriousness of the threat of entry depends on the reaction from existing competitor and on the barriers, which are; economic scale, product differentiation, capital requirements, cost disadvantages independent of size, access to distribution channels, and government policy.

*Powerful Suppliers and Buyers*

The power of each important supplier or buyer group depends on the number of characteristics of its market situation and on the relative importance of its sales and purchases to the industry compared to overall business.

*Substitute Products*

Substitutes often come rapidly into play if some developments increase competition in the industries and cause price reduction or performance improvement.

*Jockeying for position*

Rivalry among existing competitors takes the familiar form of jockeying for position—using tactics like price competition, product introduction, and advertising slugfests.<sup>5</sup>

Based on the theory of Michael E. Porter above, thus, we can find out that in competition there are many aspects affecting the competition. Unfortunately, every company and even every state has a different in capability, some of them are really strong in many aspects and on the other hand some of them are really weak.

In order to prevent the unfair competition because of these differentiations many countries and international organization regulate policy called competition policy.

## **b. Competition Policy**

### *b. 1. Definition of Competition Policy*

So, what is competition policy actually? A precise definition for competition policy is not really clear, but however, a possible definition is “*the set of policies and laws which ensure that competition in the marketplace is not restricted in a way that is detrimental to society*”.<sup>6</sup> Another definition also says that “*competition policy is a cornerstone of economic policy in a market economy, founded on well-defined property*

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<sup>5</sup> *Ibid* p. 23-33

<sup>6</sup> Massimo Motta. *Competition Policy: Theory and Practice*. (Cambridge: Cambridge University Press, 2004). P. 31

*rights and freedom of contract, supported by policy aiming at stable money, a high level of employment and social security”.*<sup>7</sup>

#### *b. 2. Objectives of Competition Policy*

After knowing the definitions above, we should know then the objectives of competition policy, which are:

- establishing a competitive order as an end in itself to safeguard economic freedom,
- maintaining a competitive order to foster economic efficiency and technological and economic progress,
- providing for a level playing field of fair competition, which implies prohibition of deceptive and fraudulent practices, threat, extortion and blackmail as well as unfair advantages through government subsidies,
- maintaining a decentralized structure of supply because small and medium-sized enterprises are considered as the backbone of a democratic society.<sup>8</sup>

### **An Overview of EU Competition Policy**

#### **a. Competition Policy in the EU Perspective**

##### *a. 1. Objectives of the EU Competition Policy*

Talking about objectives of the EU competition policy, we should take a look at a report made by EU Commission, which stated that:

*“The first objective of competition policy is the maintenance of competitive markets. Competition policy serves as an instrument to encourage industrial efficiency, the optimal allocation of resources, technical progress and the flexibility to adjust to a changing environment. In order for the community to be competitive on worldwide markets, it needs a competitive home market. ... The second is the single market objective. An internal market is an essential condition for the development of an efficient and competitive industry.”*<sup>9</sup>

The competition policy is facing some items as its targets to against, which:

“Thus, the Community’s competition policy has always taken a very strong line against price-fixing, market sharing cartels, abuses of dominant position, and anti competitive mergers. It has also prohibited unjustified state-granted monopoly rights and state aid measures which do not ensure the long-term

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<sup>7</sup> Manfred Neumann. *Competition Policy: History, Theory and Practice*. (Cheltenham: Edward Elgar Publishing Limited, 2001). P. 1

<sup>8</sup> *ibid*

<sup>9</sup> European Commission. *XXIX Report on Competition Policy, 1999*. Brussels: Commission of the European Communities, 2000.

viability of firms but distort competition by keeping them artificially in business.”<sup>10</sup>

Therefore, competition policy is used by Commission of the EU as an active tool to prevent (erecting private barriers to trade), prohibiting, and fining heavily the parties to, two main types of agreement: distribution and licensing agreement that prevent parallel trade between Member States, and agreements between competitors to keep out of one another’s ‘territories’.<sup>11</sup>

#### *a. 2. Treaty Provisions*

The prohibition of the items mentioned above can be found back in *Treaty of Paris* (also known as *Treaty of ECSC (European Coal and Steel Community)* because it created ECSC in 1951). Article 65 of the Treaty banned agreement and concerted practices between firms and associations of firms which tend directly or indirectly to prevent, restrict or distort normal competition within the Common Market. Article 66 (7) dealt with the abuse of a dominant position by firm which use such a position to pursue objectives that are contrary to the Treaty. Article 66 also dealt with mergers and concentrations between firm in the coal and steel industry.<sup>12</sup>

The competition policy is then reset in the Treaty of EEC/EC in Article 81 and 82. These articles are also adopted in the new TFEU with different article numbers that are Article 101 and 102.

#### *Article 101 (ex Article 81 TEC)*

1. The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:

- (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
- (b) limiting or control production, markets, technical development, or investment;
- (c) sharing markets or sources of supply;
- (d) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

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<sup>10</sup> Massimo Motta, *op.cit*, p. 15

<sup>11</sup> *ibid*

<sup>12</sup> *Ibid*, p. 13

(e) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:

- any agreement or category of agreements between undertakings
- any decision or category of decisions by associations of undertakings,
- any concerted practice or category of concerted practices,

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.

#### *Article 102 (ex Article 82 TEC)*

Any abuse by one or more undertakings of a dominant position within the internal market or in a substantial part of it shall be prohibited as incompatible with the internal market in so far as it may affect trade between Member States.

Such abuse may, in particular, consist in:

- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
- (b) limiting production, markets or technical development to the prejudice of consumers;
- (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.<sup>13</sup>

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<sup>13</sup> Treaty on Functioning of the European Union

## **b. Sectors for the Competition Policy in the EU**

The European Union is gradually opening up the national transport, energy, telecommunications and postal markets to competition. The liberalization of these basic services makes it possible to increase their competitiveness, improve their quality and make them more affordable for all consumers. Although the agricultural sector is subject to competition rules, it must comply with the provisions of the Community policy on agriculture and rural development and with its international obligations stemming from the World Trade Organization (WTO) agreement on agriculture. The Union ensures that the Member States carry out and implement in practice all the provisions for the liberalization of these specific sectors.<sup>14</sup>

## **The Vertical Restraints in the EU**

### **a. Definition of the Vertical Restraints**

Vertical restraints are “agreements or concerted practices entered into between two or more companies 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.”<sup>15</sup>

Due to there are agreements or provision in vertical structure, that is why we can understand that vertical restraints are called also as *vertical agreements* in many books. Within this paper, the term *vertical restraints* or *vertical agreements* will be often used.

Vertical restraints might happen because in markets products are not traded straight by producers to end user or customer, but rather through distributors which could be representative, wholesalers or other type of intermediaries.<sup>16</sup> Therefore, the producers must decide what kind of distribution method would be chosen.

According to Alison Jones and Brenda Sufrin, there are some methods can be decided, which are<sup>17</sup>:

#### **a) Vertical Integration**

It is a method where the supplier with enough resources, who wants to retain maximum control over distribution, sets up a distribution arm (internal growth) or acquire an undertaking that is already in the distribution business (external growth).

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<sup>14</sup> [http://europa.eu/legislation\\_summaries/competition/specific\\_sectors/index\\_en.htm](http://europa.eu/legislation_summaries/competition/specific_sectors/index_en.htm)., accessed on 30.03.2014

<sup>15</sup> [http://europa.eu/legislation\\_summaries/other/l26061\\_en.htm](http://europa.eu/legislation_summaries/other/l26061_en.htm), on 29.05.2011

<sup>16</sup> *ibid*

<sup>17</sup> Alison Jones and Brenda Sufrin. *EU Competition Law: Text, Cases and Materials*, fourth edition. (Oxford: Oxford University Press, 2008). p. 630-633



b) Agency

An agency (commercial and independent distributor) option will be taken by supplier, when the supplier needs a distributor which has restricted and limited functions to negotiating sales or purchasing. Usually the agency will receive either a commission based on sales they make or a fixed salary.

c) Distribution through Independent Distributors

Independent distributor is an undertaking that will itself sell, or use the goods or supply the services. This distributor, in some cases, will not just resell the supplied product but may use raw material or component to produce another product.

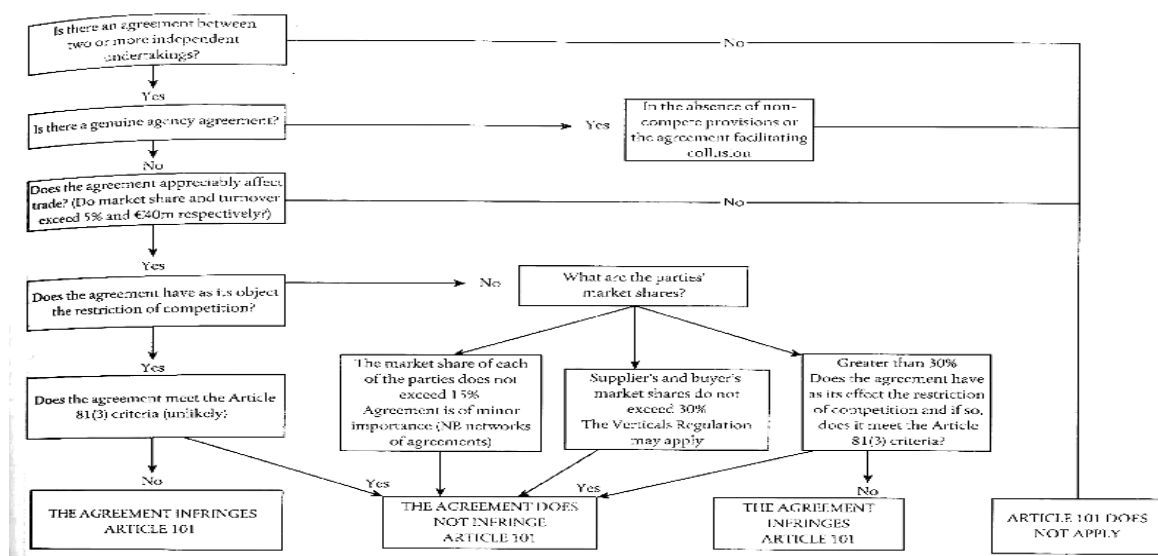
By having the kind of those vertical agreements it may restraint the competition between the suppliers and producers of competing goods and services. Therefore, it may prevent dealers from manufacturing, buying, marketing or selling products or services which compete with contracted goods or services.<sup>18</sup> And based on the treaty this agreement will infringe Article 101 and Article 102 of TFEU.

**b. Treatment of Vertical Restraints**

Regulation reserved by Commission for the vertical agreements is generally except for motor vehicle distribution, which is the Verticals Regulation-Regulation 339/2010 came into force after replacing Regulation 2790/1999.

Based on the regulation the treatment of vertical restraints in EU can be seen in Figure below<sup>19</sup>

Figure: Analysis of Vertical Agreement under Article 101



<sup>18</sup> *ibid* p. 633

<sup>19</sup> *Ibid* p. 653

The treatment of vertical restraints itself has triggered large controversy. Since vertical agreements are not made between competitors (horizontally), but between providers of complementary goods and services (vertically). Thus, they are less obviously anti-competitive than horizontal agreements.<sup>20</sup>

Although the regulation based on economic approach by saying that vertical agreements which do not include hardcore restraints and undertaking with not more 30 % of market share is compatible with Article 101, but however in the article itself there is no explanation about percentage of market share threshold.<sup>21</sup>

### **c. BER (Block Exemption Regulations)**

However, the BER, issued by the EU Commission in the Regulation (EU) No 330/2010, offers a “protection” for most vertical agreements. With the BER the prohibition of Article 101(1) TFEU is not fitting to vertical agreements which fulfill specific conditions.

The BER contains certain requirements that must be fulfilled before a particular vertical agreement is exempt from the prohibition of Article 101(1) TFEU. The first requirement is that the agreement does not contain any of the **hardcore restrictions** set out in the BER. The second requirement concerns a **market share cap** of 30 % for both suppliers and buyers. Thirdly, the BER contains conditions relating to three **specific restrictions**.<sup>22</sup>

#### **c.1. Hardcore restrictions<sup>23</sup>**

This BER has five hardcore restrictions guiding to the refusal of the whole agreement from the benefit of the BER, although the market shares are below 30 % of the buyer and supplier. Hardcore restrictions are considered to be dangerous for competition because of they may spoil the consumers. In most cases they will be prohibited and it is considered unlikely that vertical agreements containing such hardcore restrictions fulfil the conditions of Article 101(3) TFEU.

The **first hardcore restriction** focuses on resale price maintenance: the (minimum) price at which distributors can resell their products may not be fixed by suppliers.

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<sup>20</sup> *Ibid.* p. 204

<sup>21</sup> *ibid*

<sup>22</sup> [http://europa.eu/legislation\\_summaries/competition/firms/cc0006\\_en.htm](http://europa.eu/legislation_summaries/competition/firms/cc0006_en.htm), on 30.03.2014

<sup>23</sup> *Ibid*

The **second hardcore restriction** focuses on restrictions relating to the area into which or the customer to whom the buyer may sell. To the market partitioning by territory or by customer is this hardcore restriction related. Distributors must be open to choose where and to which customer they sell. There are exceptions to this rule in the BER, that is, when the companies are being able to run an exclusive distribution system or a selective distribution system.

The **third and fourth hardcore restrictions** focus on selective distribution. Firstly, selected distributors cannot be constrained in the end-users to whom they may sell, when they are banned to trade to unauthorised distributors. Secondly, the appointed distributors must be open to trade or to buy the contract goods to or from other appointed distributors within the connection.

The **fifth hardcore restriction** focuses on the stock of spare parts. A settlement between a producer of spare parts and a customer that integrates these parts as their commodities may not prevent or restrict sales to end customers, free members or service providers.

#### c.2. The 30% market share cap<sup>24</sup>

The BER covers a vertical agreement when the supplier and the buyer of the goods or services have no market share over 30 %. For the supplier, it is its market share on the relevant supply market, i.e. the market on which it sells the goods or services that is decisive for the application of the block exemption. For the buyer, it is its market share on the relevant purchase market, i.e. the market on which it purchases the goods or services, which is decisive for the application of the BER.

#### c.3. The excluded restrictions<sup>25</sup>

The rule may be implemented to all vertical agreements besides those above hardcore restraints. However, it can be enforced to specific circumstances on three vertical restraints:

- non-compete obligations during the contract;
- non-compete obligations after termination of the contract;
- the exclusion of specific brands in a selective distribution system.

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<sup>24</sup> *Ibid*

<sup>25</sup> *Ibid*

These vertical restraints are not included from the exemption by the BER, when the circumstances are not fulfilled. However, when the part is severable (i.e. can operate independently) from the non-exempted vertical restraints, the BER remains to be applied to the left part of the vertical agreement

### **Evaluation of the Implications of the Vertical Restraints**

The vertical restraints, in my opinion, have a positive implication and negative implication to the competition itself.

Positive implications are:

- a. Vertical agreement will give benefit for the competition as long as before the agreement between suppliers and distributor has been made there is a fair bid to tender. So, with a bid to tender, every distributor has a fair chance to take a place in the business process.
- b. By having a strong agreement with its distributor, a producer could have a secure feeling doing business. This secure feeling, off course, can affect to the company's performance. It makes the company can concentrate to the competition with other producers.
- c. When the producer is having less or no more problems with distribution, then the production of goods can be increased including its quality. This means also the increasing of customer satisfaction.
- d. If the producer has a secure distribution channel in another and new country as it makes business expansion, then it will increase a competition atmosphere within the country.
- e. The distributor itself will work hard to get a best result so it can keep "hiring" by the producers.

Negative impacts:

- a. Vertical agreements in other side will give a bad impact for the new producer which just begins to enlarge its market, because most of the capabilities distributors are taken by "big companies".
- b. Not only because the competence distributors are "taken" by big or old producers but also the market, it is getting more saturated, filled with only them.
- c. There will be a big issue that the vertical agreement could be a cartel and monopoly the market when it is getting stronger.

## **Conclusion**

Vertical restraints are not so bad if they can be managed well. Thus the fair rules are really needed in order to have more the positive effect of them rather than negative impacts.

From this perspective I am able to understand why the EU not really closes the door for the vertical agreement, instead, it is giving a minimum standardization by putting a 30 % of threshold and not incorporating hardcore restraints to prevent negative impacts.

I think it is quite a dilemma for the EU to really erase the vertical agreement. In one hand many EU's companies in doing their business they need a secure feeling from their distributor and this secure feeling they can get by having such an agreement. But in another hand, this agreement will reduce the competition among companies, especially for the new ones.

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