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## Art or Science? Assessing efficiencies under the Commission's Article 81(3) Notice

As part of its "modernisation" programme, the EC Commission has published a Notice on the principles that govern whether an agreement should be granted an exemption under Article 81(3).[1] Under the reforms, exemptions can now for the first time be granted by national competition authorities, and parties to such agreements are now required to undertake their own legal assessment since it no longer remains open to them to notify their agreements to the Commission.

The Notice describes a framework for the economic analysis of how an agreement that is held to restrict competition may nevertheless be lawful because it meets the four efficiency defence criteria of Article 81(3). The framework seeks to follow the approach taken on efficiencies in horizontal mergers: first, establish whether there is a likelihood of increased prices; then, if so, evaluate the existence of offsetting efficiencies. As we explain in this Brief, however, there are several difficulties in extending this framework from mergers to the assessment of agreements.

## 81(1) and 81(3) – what goes where?

Although the Notice covers the analysis required to secure an Article 81(3) exemption, it is impossible to assess an agreement without first taking a view on whether it falls within the scope of Article 81(1). Historically, Article 81(1) has been interpreted widely – almost any agreement that restricted commercial freedoms was deemed to distort competition. This meant that substantive analysis was largely confined to the Article 81(3) question, which in turn led to an excessive burden on the Commission.

However, both the Commission and the European courts recognise that this formalistic approach has no place in a modern effects-based competition regime, and a number of recent decisions of national competition authorities and courts have underlined the need for a detailed substantive analysis of the impact of an agreement under Article 81(1).

For example, in 2002 the NMa held that Heineken's 5-year exclusive supply agreements with pub outlets fell outside the domestic equivalent of Article 81(1), despite the fact that they contained real and substantial restrictions on retailers' commercial freedom.[2] This decision recognised the clear pro-competitive rationale for the restrictions, since they formed part of a deal whereby Heineken provided investment funds to retailers that could be justified only if they accepted restrictions on their freedom to switch to rival keg beer suppliers. The NMa also satisfied itself that the effect of the tie imposed by Heineken was not such as to foreclose competitive opportunities to other suppliers in the Dutch market.

A similar approach was also taken in the recent English High Court case involving Pihsiang v Days Medical Aids (DMA).[3] Pihsiang, a Taiwanese manufacturer supplying a major brand of mobility aids, decided to consolidate its distribution in Europe through a single top tier distributor, DMA, on the grounds that vigorous price competition between its distributors had meant that none of them was prepared to make the investments in brochures and visits to trade fairs that were needed to compete effectively with rival brands and to develop sales in new territories. The loss of "intra-brand" price competition arising from this move was tangible, but the judge ruled that the agreement fell outside Article 81(1) because its restrictions were integral to the pro-competitive motivation for, and effect of, the agreement.[4]

1 Notice on the application of Article 81(3) of the Treaty, OJ (2004) C 101/97, 27 April 2004.

2 For further discussion of this case see Simon Bishop, "Pro-Competitive Exclusive Supply Arrangements: How Refreshing!", European Competition Law Review, Volume 24, Issue 5, May 2003.

3 See Days Medical Aids Limited and Pihsiang Machinery Manufacturing Co Ltd, Case No: 2002 Folio 178 [2004] EWHC 44 (Comm) In The High Court Of Justice Queens Bench Division Commercial Court Royal Courts of Justice Strand, London, 29th January 2004. RBB acted as economic experts to DMA in connection with this case.

4 Significantly, one of the main rival brands competed in Europe through a system in which the functions of manufacture and top tier distribution were vertically integrated.

These and other similar cases underline the important fact that assessing whether an agreement restricts competition is no longer a simple box-ticking exercise dependent on the form of the restrictions. Instead, assessing whether an agreement breaches Article 81(1) now requires a substantive analysis of market definition and the economic impact of the restrictions. The potential pay-off from such effort is high, however, if it avoids the need to grapple with the demanding requirements for an Article 81(3) exemption.

## The Notice and the "one size fits all" fallacy

Agreements can broadly be classified according to whether their restrictions are horizontal or vertical, and the two categories raise fundamentally different competition issues. The difference arises essentially from the very different incentive properties of agreements between suppliers of competing (or substitute) and complementary products.[5] However, the Notice adopts a "one size fits all" approach that fails to recognise this distinction.

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Complements are defined by the existence of negative cross-price elasticity, such that when the price of A rises the demand for B falls. Virtually all vertical agreements (e.g. between manufacturing and distribution) involve complements, as do many other kinds of agreements between non-competing products (e.g. between suppliers of knives and forks).

Horizontal agreements involve restrictions agreed between suppliers of competing products. Such agreements are capable of creating market power where none previously existed. They have an inherent tendency to remove rivalry between the parties that gives rise to a justifiable suspicion of the parties' motives. This suspicion can of course be countered by good evidence on pro-competitive effects on economic efficiency, the most likely source of which arise from the realisation of scale economies or other ways of improving productive efficiency by pooling the resources of the parties.

Vertical agreements, in contrast, involve agreements between suppliers engaged in complementary activities. Unlike horizontal agreements, such agreements are incapable of creating market power where none previously existed. Since each party benefits if the other acts to reduce its price, the underlying incentive effects behind such agreements are likely to push towards price reductions and improved coordination of the activities in question. Vertical agreements can be anti-competitive, but their underlying tendency is pro-competitive in effect. Their positive effects rarely if ever arise from lower per unit production costs as such, but are more likely to take the form of better coordination of pricing decisions or the realisation of mutually beneficial investments that boost consumer demand.

The failure of the Notice to draw an explicit distinction between horizontal and vertical agreements reduces its ability to identify an appropriate framework for the economic analysis of efficiencies.

## Horizontal agreements - the "net price test" and lessons from horizontal merger efficiencies

Efficiencies from horizontal agreements have been extensively analysed in the context of horizontal mergers,[6] and the framework for identifying and quantifying horizontal agreement efficiencies under Article 81(3) ought to be substantively similar. Although the measurement challenges are substantial, the basic idea is that cost efficiencies can more than offset the adverse effects of the horizontal agreement. Simplistically, one can envisage this in terms of a net price test, or a trade-off between the competition-reducing impact that the restrictive agreement has on price-cost margins (which become wider as rivalry is eliminated), and the price-reducing impact that the efficiencies have on marginal costs. An agreement that allowed price-cost margins to rise by A2 per unit, but which reduced marginal costs by A3 per unit would have a net beneficial effect on prices.

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See, for example, paras 76 to 88 of the Commission Notice on horizontal mergers, 28 January 2004.

Reductions in marginal costs (as opposed to fixed costs) are likely to be required in order to convince the competition authority that savings, once achieved, will be passed on to the benefit of customers. Lower marginal costs provide incentives for firms to seek increased sales volumes, and this makes them likely to "spend" some of their efficiency gains in the form of price reductions that will induce extra sales. In contrast, simple theories of the firm predict that fixed costs savings will not affect competitive behaviour and hence that their benefit accrues to the firm rather than its customers.[7]

7 However, such an approach often ignores important dynamic efficiencies whereby changes in fixed costs can feed through to affect investment decisions and other competitive variables that have an impact on customers

## Vertical agreements – comparing "apples and pears"

However, most agreements falling within the scope of Article 81 are vertical in nature, and these require an entirely different type of analysis to that described above. The main categories of efficiency that can be achieved by vertical agreements include solving the double mark-up problem, eliminating free-rider distortions, and avoiding investment hold-up problems. Due to its focus on production cost efficiencies, the Notice provides little guidance on how to analyse such benefits.

Many pro-competitive vertical restraints work by generating beneficial investments that would not otherwise occur, thus enhancing welfare by boosting demand and/or product quality, but in the process also possibly increasing prices. Methodologies exist for quantifying the consumer welfare gains that arise from quality improvements. However, modelling such gains is intrinsically more complex than the assessment of marginal cost reductions, especially where customers place different subjective valuations on product attributes, creating a mix of winners and losers.

Consider a case where a vertical agreement has the pro-competitive effect of solving a free rider problem on pre-sales advice, and where improved showroom facilities boost demand for the product by bringing its attributes to the attention of a large number of new customers. It is possible to estimate the welfare gains to those marginal consumers who were previously frozen out of this market due to their lack of information, but it is also possible that some existing consumers (who may have been better informed and thus did not need the showroom facilities to aid their choice) may be worse off after the agreement is implemented, especially if they are obliged to "pay" for the unwanted pre-sales service through a higher distribution margin. The Notice is reluctant to consider this kind of trade-off between winners and losers, but in reality there is no alternative but to do so.

Whilst the efficiencies that arise from pro-competitive vertical restraints are real and substantial, they are therefore less amenable to direct measurement than is the case for the kind of production cost economies that can arise from horizontal agreements. In contrast to the "net price test" approach to horizontal agreement efficiencies, the assessment of vertical efficiencies invariably requires a comparison of "apples and pears."

## The burden of proof under the Notice

One of the major challenges under Article 81(3) is the need for the parties to an agreement to prove that their efficiency gains outweigh the anti-competitive effect that has been identified. The Notice sets out an intimidating standard, warning parties that their efficiencies "must be substantiated so that they can be verified" and that "unsubstantiated claims are rejected".[8] The Commission has seldom if ever met this standard in its own Article 81(3) decisions, but arguably these tougher stipulations are in line with the needs of a more economics-based enforcement regime.

8 See paragraphs 55 and 56.

However, whilst the requirement to establish efficiency gains is potentially applicable to horizontal agreements that achieve unit cost reductions, it is harder to see how this framework will be applied to measure pro-competitive effects from vertical agreements.

The Notice implicitly acknowledges this in its references to "qualitative efficiencies", and in practice there will be more scope to escape the strict burden of proof in this area.[9] The challenge here is to construct practical and workable measures of qualitative gains that come as close as possible to meeting the spirit of the requirement for sound quantification. Nevertheless, there is clearly scope for greater discretion in this area which might favour the chances of securing an exemption for vertical agreements.

9 See paragraphs 69 to 72.

## The "efficiencies offence"

One feature that can apply equally to vertical and horizontal agreements is the danger that a persuasive efficiencies analysis is turned against the parties into an "efficiency offence". The Commission's tendency to respond to competitor complaints is well documented, especially where it perceives a danger that a firm with market power may gain further competitive advantage over rivals. Although the Notice does not admit to the efficiencies offence problem, it contains a clear warning that static efficiency gains will be disregarded if there is any indication that dynamic rivalry will be harmed in the process.[10]

10 See paragraph 106.

The danger of the efficiency offence under the new regime increases with a more robust approach to Article 81(1). If the Article 81(1) filter, combined with the various market share thresholds laid down in the Block Exemption Regulations, performs a better task of eliminating from consideration agreements between firms with little or no market power, 81(3) analyses should focus largely on cases where the firms involved enjoy substantial market power or dominance. For such firms, the risk of falling into the efficiencies offence trap will never be far away, and the framework laid down in the Notice, along with its attitude to the burden of proof, provides a clear invitation to third party complainants to make life hard for parties seeking an individual exemption.

## Policy issues and conclusions

The Notice provides a useful contribution towards an economic framework for the assessment of efficiencies under Article 81. However, in view of the weak track record of the use of economic analysis in this area it is perhaps inevitable that there are many gaps in that framework. Our discussion highlights two areas in particular.

First, the absence of a clear distinction between the analysis of vertical and horizontal restrictions marks a missed opportunity. By drawing out this important distinction, the Notice could have more clearly signalled the end of the old formalistic approach to Article 81 enforcement, and also provided a more workable framework for the assessment of the very distinct efficiency gains that can accrue from these two types of restriction.

Second, whilst the intention of the Notice to require solid empirical support for efficiency gains is a sound one, the Notice adopts an overly simplistic model for the quantification of efficiencies that assumes measurable marginal cost reductions are at the core of the efficiency defence. This may work well for the minority of cases where the assessment of a restrictive agreement can be reduced to a scientific analysis of the net price effect. However, it leaves unexplored the implications for efficiency analysis in that majority of cases where the benefits are more qualitative in nature. The analysis of such effects may be more of an art than a science, but that need not place it outside the reach of systematic economic and empirical analysis.