

CLEARY GOTTLIB

Challenges to the dichotomy of horizontal/vertical restrictions of competition in hybrid relationships

European Competition Day, Vienna,
Dr. Romina Polley LL.M.

September 24, 2018

clearygottlieb.com



Overview

Introduction

EU legal framework

Current regime for hybrid agreements

Economic theory

Potential competitive effects resulting from hybrid relationships

No current enforcement priority

Does competition law provide the necessary tools?

Conclusion

Introduction

- The classical supply chain is no longer the rule in modern trade.
- Buyers and/or buying groups have taken over supplier functions like production planning, warehousing and logistical functions.
- In many FMCG categories retailers compete with suppliers through private label products.
- Online platform operators offer their own goods in competition with independent merchants on integrated online platforms.
- Increasingly, suppliers open an own distribution channel in parallel to third party distribution, *e.g.* own online shop on top of dealer network.

The dichotomy of horizontal vs. vertical restrictions

- EU legal framework distinguishes between horizontal and vertical arrangements despite joint foundation in Article 101 TFEU.

- Classification of agreement as horizontal or vertical is crucial for further assessment of agreements (Vertical Guidelines, para 27; Horizontal Guidelines, para 12, 226).
- Horizontal Guidelines and Specialization BER cover horizontal and hybrid agreements.
- Vertical Guidelines and Vertical BER cover vertical only agreements.
- R&D and TT-Transfer BER distinguish between agreements between competitors and non-competitors.
- Hardcore restrictions and market share thresholds differ for horizontal and vertical restrictions.

- Distinction between horizontal and vertical restrictions is even more relevant under US law, because of *per se* illegality vs. rule of reason.

Current EU legal framework for hybrid agreements

- Vertical BER and Guidelines generally only cover vertical agreements between companies at different levels of production (Article 1 a), 2 Vertical BER, Vertical Guidelines, para 24 et seq).
- 3 exceptions: dual distribution, small purchasers with revenues of less than EUR 100 million and private label products (Art. 2 (4) Vertical BER).
- Private label manufacturers are not considered competing suppliers, even if they provide product specifications and market product under their brand (Vertical Guidelines, para 27).
- Vertical agreements between competitors are primarily assessed under the Horizontal Guidelines, but in addition vertical angles can be assessed under the Vertical Guidelines (Vertical Guidelines, para 27; Horizontal Guidelines paras 12, 227).
- Treatment of hybrid arrangements as horizontal is acknowledged in practice. FCO treated Amazon's integrated online platform as distribution agreement between competitors (Case Report November 26, 2013).
- Reason for different treatment of private label products and integrated platforms?

Economic Theory

- Horizontal vertical dichotomy does not make sense; arrangements can have both horizontal and vertical effects at the same time.
- Vertical competition between supplier and buyer for profit share in vertical chain comes on top of horizontal competition between different suppliers (Steiner).
- Locus of market power and source of restraints matter. Buyer restrictions are normally more harmful than supplier restrictions.
- Buyer power can lead to higher retail prices. Strong buyers get more favorable conditions which cannot be matched by other buyers (so-called waterbed effect).
- Dual distribution less harmful than horizontal relationship at production level. Helps to avoid collusion between dealers and to monitor their performance. However, supplier may have incentive to limit vertical competition to increase his profits.
- Effect of private label products is ambiguous. Increases consumer choice but also increases buyer power. Will increase search costs for consumers and may lead to higher retail prices if second tier brands are delisted.

Potential pro-competitive effects from hybrid relationships, e.g. private label and online platforms

- Buyer's offering of own products leads to broader consumer choice of products.
- Buyer's competing offering leads to lower prices downstream because of increased competitive pressure.
- Online marketplace promotes optimal distribution of goods and reduces search costs for users.

Potential anticompetitive effects from hybrid relationships

- Conflict of interest inherent in hybrid relationship creates threat to competitive market structure and increases buyer power. Gatekeeper function of retailer/platform can be abused.
- Private label manufacturers and independent merchants get dependent on buyer/platform.
- Favoring of buyer's own offering in downstream competition, *e.g.* product presentation, faster logistics, listing/handling fees, *etc.*
- Delisting second tier brands to place own products.
- Potential for predatory pricing, *e.g.* offering successful products directly (through own manufacture or by bypassing retailer).
- Lower marketing risk profile of private label manufacturer/platform conveys competitive advantage.
- Risk for innovation because of copycatting by retailer/platform.
- Lower profitability downstream also reduces incentive to innovate for branded manufacturers.
- Sensitive competitive information on new products, prices, promotions from vertical relationship can be used for competitive initiatives downstream.
- Risk of collusion between independent merchant and platform on product range offered downstream.
- Collusion risk arising from use of the same pricing algorithm by independent merchant and platform.

Hybrid relationships currently no enforcement priority

- Recent enforcement focus in Europe/US has been on price effects of restrictions:

- Consumer welfare approach neglects market structure, entry barriers, fairness of competitive process, incentive for innovation (*Khan, Yale L.J 126 (2017), 710 et seq.*).
- FCO highlighted efficiencies of horizontal online sales platform and only criticized most favored treatment clause in Amazon case (2013).
- FCO Retailer Sector Inquiry (2014) found that private label products tend to increase buyer power, but did not identify need to take action.
- EC studies on impact of private label products on choice and innovation (2014) and on impact of private labels on competitiveness of European food supply chain (2011) did not advocate intervention by competition authorities.

- However, this will apparently change in the future:

- Commissioner Vestager announced preliminary investigation into Amazon's use of merchants' data on September 19, 2018.
- President Mundt announced FCO investigation into potential abusive practices by Amazon on its hybrid online sales platform, in particular hindrance of competing retailers in August 2018.
- Expert study on modernization of German dominance provisions (August 2018), p. 113-115.

Does competition law provide the necessary tools – Merger control ?

- Data as competitive advantage
 - Vertical integration can give the merged entity access sensitive competitive information about upstream and downstream activities of competitors (Vertical Merger Guidelines, para 78).
 - Access to sensitive information about main competitor through the transaction was found to be competitive concern by EC (J&J/Pfizer Consumer Healthcare, 2006, para 126).
 - 9th Amendment of German Act against Restrictions of Competition added “access to competitively relevant data” as a criterion to assess dominance (Section 18 3 a) no. 4 ARC).
 - FCO’s „CTS Eventim/Four Artists“ merger case addresses use of customer information from prior vertical integration through own online shop as competitive advantage (Decision of November 23, 2017, para 190 et seq.), independent concert organizers were withheld access to customer data, but only got aggregated information.
- Own brands as competitive advantage
 - Own brands can increase retailer’s profitability because unlike for branded products no direct price comparison possible (Rewe/Meinl, 1999, para 51).
- Private label products increase buyer power and therefore contribute to dominance
 - Manufacturer gets dependent on retailer for lack of own market access, weaker brands to be replaced by private label products (Rewe/Meinl, 1999, para 112).

Does competition law provide the necessary tools to assess hybrid relationships - cartels/exchange of information ?

- Integrated platforms are sales cooperation between competitors to be assessed under Horizontal Guidelines, para 230 et seq.
- Market share threshold of 15%.
- Price fixing always by object restriction. Joint sales cooperation normally entails exchange of sensitive business information.
- Efficiency analysis under Article 101 (3) TFEU required. Online platforms enlarge product offering and reduce search cost.
- Price fixing only allowed if necessary for the integration of other marketing functions.
- Use of sensitive business information by platform operator/retailer for own competitive initiatives not indispensable within the meaning of Article 101 (3) TFEU.
- Use of platform operator's pricing algorithm by independent merchant can give rise to collusion and access to sensitive information.
- Treatment of agreements between branded goods manufacturers and retailers as only vertical under Vertical BER is inconsistent with merger decision „Rewe/Meinl“ para 112 and passage on category captain role in Horizontal Guidelines, para 210.

Does competition law provide the necessary tools to assess hybrid relationships - Abuse of dominance ?

- Dominance/quasi dominance
 - Retailer/Platform will only rarely meet absolute dominance threshold.
 - Collective dominance and relative dominance (Germany, Austria) thresholds could be met.
 - New German expert proposal contemplates introduction of platform dependence as new form of quasi dominance.

- Abusive conduct
 - Discrimination (favoring of own products)
 - Hindrance
 - Predation
 - Excessive pricing, *e.g.* listing/handling fees
 - Predatory use of data on neighboring markets

How should horizontal/vertical arrangements be assessed?

- Review of both horizontal and vertical effects of agreements.
- Gatekeeper function of buyer, conflict of interest, effects on innovation, barriers to entry to be taken into account.
- Source of the restriction matters.
- Invalidity does not have to affect vertical agreement. Cease and desist orders/commitment decisions are a possibility.
- Additional guidance on hybrid relationships in Horizontal/Vertical Guidelines would be welcome.
- Firewall arrangements to protect sensitive information should become standard.
- Unfair competition/consumer protection/data protection regulation applies in parallel.
- Relative dominance to be introduced in further jurisdictions or expanded in Germany by new criterion of platform dependence?