UPFRONT ACCESS PAYMENTS, CATEGORY MANAGEMENT AND THE NEW REGULATION OF VERTICAL RESTRAINTS IN EU COMPETITION LAW: IMPORTING THE RETAIL SIDE OF THE STORY [1]

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Abstract: *By integrating more fully the retailer power story, the new vertical restraints guidelines and block exemption regulation provide for a more equilibrated regime for vertical restraints in Europe. The objective of the Commission was not only to address the important concern of retailer power and its possible anticompetitive effects in a retail sector that is characterized by increasing concentration, although not necessarily increasing profitability, but also to respond to the concerns (and political pressure) over big distribution and the power of multi-brand retailers that have been expressed at the national level, with the adoption of a hard or a soft law type of approach in order to regulate the relation between suppliers and retailers. By bringing these concerns within the realm of EU competition law, the Commission offers an alternative relief valve that takes more into account the effect of these practices on consumers than the regulations adopted at the national level.*

Summary: I. Vertical restraints – integrating the retailer power story. II. Retailer market power as a filter to the application of the block exemption regulation. III. Upfront access payments. IV. Category management. V. Conclusion.

1 The article has already been published by the author with the following title: Ioannis Lianos, "New Kids on the Block: Retailer-driven Vertical Practices and the New Regulation of Vertical Restraints in EU Competition Law", (2010) The CPI Antitrust Journal June 2010 (2).

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I. VERTICAL RESTRAINTS – INTEGRATING THE RETAILER POWER STORY

The antagonistic nature of the relationship between suppliers and retailers constitutes the main justification for adopting vertical restraints. It has been a constant feature of the dominant story on the competitive effects of vertical restraints that competition between vertical structures (inter-brand competition) will mitigate any anticompetitive exercise of market power by the manufacture imposing vertical restraints on her distributors and that it will eventually preserve consumers' interest.[3] This conclusion is based on the assumption that the interest of the manufacturer is to reduce the distribution margin of the retailer at the level that will be optimal for the consumer and which will guarantee the reward of the promotional efforts of retailers up to what is necessary to ensure quality distribution services.[4] This also constituted the conceptual foundation of the shift towards a more lenient antitrust regime for vertical restraints in Europe, following the enactment of regulation 2790/99 and the publication of the vertical restraints guidelines in 2000.[5] The underlying assumption of the dominant story was that vertical restraints are generally imposed by the suppliers/producers to the dealers and that the downstream retail market is close to perfectly competitive.[6]

3 E.g. Leegin Creative Leathers Products, Inc. v. PSKS, Inc, at 2715 ('The promotion of interbrand competition is important because 'the primary purpose of the antitrust laws is to protect [this type of] competition.')

4 Posner, 1977; Easterbrook, 1984: 156-157.

5 For a comparative analysis of this shift in Europe and in the United States, *see* Lianos, 2007; As the Commission explained during the preparatory steps for the adoption of regulation 2790/99, "(i)t is [...] generally recognized that vertical restraints are on average less harmful than horizontal competition restraints. The main reason for treating a vertical restraint more leniently than a horizontal restraint lies in the fact that the latter may concern an agreement between competitors producing substitute goods/services while the former concerns an agreement between a supplier and a buyer of a particular product/service. In horizontal situations the exercise of market power by one company (higher prices of its products) will benefit its competitors. This may provide an incentive to competitors to induce each other to behave anti-competitively. In vertical situations the product of the one is the input for the other. This means that the exercise of market power by either the upstream or downstream company would normally hurt the demand for the product of the other. The companies involved in the agreement may therefore have an incentive to prevent the exercise of market power by the other (the so called selfpolicing character of vertical restraints)": Communication from the Commission on the application of the Community competition rules to vertical restraints - Follow-up to the Green Paper on vertical restraints, COM(98) 544 final [1998] C365/3. The self-policing character of vertical restraints is, however, limited when competition between the different vertical structures remains weak. In this case, the reduction of intra-brand competition from vertical restraints will not be fully compensated by the positive impact of inter-brand competition between vertical structures.

6 Comanor & Rey, 2000; OFT, 1996: 23-25.

The reality of the marketplace is somehow different, as large multi-brand retailers may also take the initiative of suggesting or imposing vertical restraints to their suppliers, in particular as the balance of power between the different segments of the vertical chain has in recent years evolved in their favor.[7] As the Commission noted in its Green paper on vertical restraints,

> manufacturers are more and more dependent on distributors and grocery retail for getting their products to the consumers. Since the shelf space for new products is limited, conflicts arise between the increasing number of new product launches and the retailers' objective of profit optimization. The conflict has resulted in retailers asking for listing fees (key money) or for discount schemes which sometimes go beyond possible cost savings of the manufacturers.[8]

Furthermore, it is not always true that the interests of consumers and producers correspond, as it is likely that vertical restraints may lead to non-optimal distribution services for certain classes of consumers (in particular infra-marginal consumers), who will pay higher prices for services they feel they do not need.[9] In the absence of sufficient inter-brand competition, vertical restraints will therefore harm infra-marginal consumers. The need to ensure coordination between the different levels of the vertical chain will not always justify the adoption of vertical restraints.[10]

Recent economic and management literature has also presented a different perspective on the economics of vertical relations. Robert Steiner has challenged the dominant view that relationships between the different

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7 *See* OFT, 1997: 46-47: "over the last decade or so, retailers have tended to become a more important element in the overall value chain, partly at the expense of manufacturers. This change has occurred for various reasons, including: increased retailer size and retail concentration; increased importance of retailer image, which means that own-brand products have become more competitive with branded products; increased retailer information on consumers' preferences (partly as a result of scanner technology); and increased retailer command of technology."

8 Commission Green Paper, COM(96) 721 at 66 final (January, 1997).

9 *See* Comanor, 1985; Comanor, 1992.

10 Scherer, 1989 criticized the quality certification argument for resale price maintenance: "...what is the wider economic significance of a high-status image that comes from the high prices at which the product is sold, and not from the product intrinsic superiority? If an individual consumer derives utility from exclusiveness, and if the utility declines when a product enters mass distribution, there must be external diseconomies in consumption, violating one of the fundamental assumptions on the basis of which the efficiency of market processes is judged. The argument that product quality certification through resale price maintenance is efficiency-enhancing becomes even more dubious."

levels of the vertical structure are complementary.[11] Steiner considers that the retail level is not characterized by perfect competition and therefore it will not be reasonable to assume that the retailers will pass on to consumers the eventual additional margins that will follow from vertical contractual restraints that were adopted to increase inter-brand competition. If antitrust enforcement ignores intra-brand competition between retailers, that might lead to higher prices for consumers. The existence of inter-brand competition will not be sufficient to preserve consumers' interest. Retailers will not pass on the benefit of increased inter-brand competition to the consumers but will instead increase their own margin. Retailers are not passive price takers but they are actively involved in the strategy of increasing their vertical market share. According to Steiner, there are two forms of competition that co-exist in vertical structures: First, the horizontal competition between the different vertical structures or between the retailers of the same vertical structure and, second, the vertical competition between the different levels of the vertical structure, such as suppliers versus retailers over the sharing of the profits of the vertical chain.[12]

Steiner perceives competition as a struggle between firms aiming to capture a perceptible share of markets from each other (which is the traditional view of horizontal competition) but also an important share of sales or margins. He argues that vertical competition between retailers is as important for consumers as horizontal competition between different vertical structures. Concentration and market power in one stage of the vertical structure may lead to higher margins at this stage and lower margins at the other stage. Empirical research has confirmed some of Steiner's intuitions.[13] But it has also been critical on the linkage made between the increased concentration of the retail sector and the reduction of competition. It has been noted that despite the high concentration ratios in the retail sector in many Member States,[14] the sector remains generally competitive, as is reflected by the relatively low

11 Steiner, 1993; Steiner, 1991; Steiner, 2007.

12 Steiner, 1991.

13 Lynch, 2004.

14 In the United Kingdom, the top 4 retailers in the food supply chain account for 65 percent of the market and the German top 5 for 90 percent. *See*, Commission Staff Working Document – Competition in the food supply chain, SEC(2009) 1449, at 2.3.

net operating margins of retailers (on average around 4 percent) and the increasingly intense competition between different retail formats.[15]

Individual or collective retailer power has nevertheless been at the center of the attention of public authorities in Europe,[16] with certain investigations being recently carried out at the national level.[17] Retailer power manifests itself increasingly with the use of private labels, which compete directly with leading manufacturers' brands and other national brands and illustrate this shift in balance of power between retailers and suppliers.[18] However, empirical evidence of the negative welfare effects of private labels is lacking and is, at best, ambiguous, thus not giving clear directions to competition authorities for action.[19] The emergence of commercial practices, such as slotting allowances and category management agreements, are also illustrations of the increasing importance of retailer bargaining power that started to characterize the evolution of the distribution sector in the 1980s.

II. RETAILER MARKET POWER AS A FILTER TO THE APPLICATION OF THE BLOCK EXEMPTION REGULATION

The previous vertical restraints guidelines, adopted by the Commission in 2000, recognized that "for most vertical restraints, competition concerns can only arise if […] there is some degree of market power at the level of the supplier or the buyer or at both levels."[20] The market position of the buyer was also one of the parameters considered in the analysis of vertical restraints under Article 101(1), the Commission noting that "the effect of buying power on the likelihood of anti-competitive effects is not the same for the different vertical restraints" and it has particularly negative effects in case of restraints from the limited distribution and market partitioning groups such as exclusive supply, exclusive distribution, and quantitative selective

15 *Id.*

16 *See* the study commissioned by the OFT, 1998; OECD, 1999; European Commission, 1999; UK Competition Commission, 2000, Cm. 4842.

17 UK Competition Commission, 2008; OFT, 2006: 42-49; Svetlicinii, 2009; Nehl, 2007.

18 Ezrachi, 2010; Foer, 2005; Vogel, 1998.

19 For a more detailed analysis of the literature on the welfare effects of private labels *see* Lianos, 2008 and Ezrachi, 2010.

20 Commission notice - Guidelines on Vertical Restraints [2000] OJ C291/1, at 6.

distribution.[21] However, retailer power was not the focus of the analysis under the block exemption regulation: A vertical agreement between a powerful retailer and a weaker supplier could pass through the 30 percent market share threshold that conditioned the application of the block exemption regulation, in the absence of hardcore restraints on competition.

It is important here to make a distinction between the two dimensions of retailer market power, that is their ability to affect one of the parameters of competition (price, quality, innovation, consumer choice) profitably. Retailers may dispose of buying power but also of selling power. Buying power is exercised upstream to suppliers. It is characterized as "countervailing buying power" in case the supplier disposes of market power. If there is only one buyer it takes the form of a monopsony.[22] Selling power is exercised downstream to the retailers' customers, the final consumers. In most cases buying and selling power are interlinked: a supermarket chain with selling power has also an important buying power, as it becomes the principal gateway for the suppliers' products. Of course, this is not always the case, as some retailers may have a local selling power, because they are the only retail outlet within a specific geographical community, but do not dispose buying power, because the supplier operates at the national level.

The new block exemption regulation on vertical agreements, Regulation 330/2010 takes into account retailer market power. It adds in its Article 3 a second market share threshold for falling within the scope of the block exemption regulation, based not only on the market share held by the supplier, but also on that held by the buyer. In its first draft of the block exemption regulation, the Commission chose a general formulation of this rule and provided the exemption from the application of Article 101(1), "on condition that the market share held by each of the undertakings party to the agreement does not exceed 30% *on any* of the relevant markets affected by the agreement."[23] The block exemption regulation provides a safe harbor for agreements only if neither party (supplier, retailer) has a market share above 30 percent. However, as some of the contributions to the consultation process noted, such a broad definition could encompass both dimensions of retailer market power and could indeed cover also circumstances of retailer selling

21 *Id.*, at 125.

22 For an analysis *see* Blair & Harrison, 2010.

23 Article 3, Reg. 330/2010.

power. Van Bael & Bellis comments on the draft vertical agreements block exemption also noted the:

> practical difficulty for a supplier to estimate the market share of each and every buyer forming part of its distribution system across the EU, [as] it is not unusual…for a supplier to appoint hundreds, if not thousands, of distributors in the E.U. [and] it may often not be possible for the supplier just to assume, as a methodological short-cut, that the buyer operates on a relevant market with the same product and geographic scope as the supplier, given that downstream distribution markets may frequently be broader in product terms but much narrower in geographic terms.[24]

Other contributors noted that the increasing power of retailers was more adequately taken into account by the 1999 Guidelines on vertical restraints adopted by the Commission, which, in paragraph 73, referred to a possible withdrawal of the benefit of the block exemption regulation in "situations where the buyer, for example in the context of exclusive supply or exclusive distribution, has significant market power in the relevant downstream market where he resells the goods or provides the services."The final text of the block exemption regulation and the guidelines takes into account some of these concerns. According to Article 2 of Reg. 330/2010, the exemption applies on condition that the market share held by the buyer does not exceed 30 percent "of the relevant market on which he *purchases* the contract goods or services." The regulation thus emphasizes the buying dimension of retailer power, not its selling side, which would have led to practical difficulties for business in terms of compliance to the regulation.

The focus of the regulation on retailer power is also manifested by the inclusion of two retailer-driven commercial practices in the text of the guidelines: upfront access payments and category management. I will examine each of them separately.

III. UPFRONT ACCESS PAYMENTS

According to the vertical restraints guidelines, upfront access payments are "fixed fees that suppliers pay to distributors in the framework of a vertical relationship at the beginning of a relevant period, in order to get access to their distribution network and remunerate services provided to the suppliers

24 Van Bael & Bellis, 2009: 1-2.

by the retailers."[25] The category includes practices such as slotting allowances, pay-to-stay fees, and payments to have access to distributors' campaigns.

There are conflicting stories on the rationale of upfront access payments.

Some authors have advanced anticompetitive theories. Slotting fees might be a mechanism for manufacturers to raise rivals' costs: Dominant suppliers aim to secure a sufficient amount of shelf space in order to increase the costs and impose barriers to entry to potential upstream competitors.[26] Upfront payments provide dominant manufacturers an instrument to leverage their power against potential competitors by raising their cost of entry. Economies of scale or scope must of course be present at the supplier level and the shelf space should be foreclosed for a significant amount of time for the raising rivals' costs strategy to succeed.[27]

Small manufacturers are also disadvantaged in comparison to large manufacturers because they lack adequate access to capital markets and thus may not be able to pay the large upfront fees that are demanded by the retailers. It has been argued that "the dominant firm prefers to pay for scarce shelf space with slotting allowances rather than with wholesale price concessions because the former go directly to the retailers' bottom line, whereas the latter are mitigated by retail price competition;" "by paying retailers with lump-sum money, the dominant firm can compensate retailers for their scarce shelf space without having to lower its wholesale price, which would reduce the overall available profit to be split."[28]

Slotting allowances make exclusion by dominant firms of their competitive fringe profitable: "if the dominant firm had to pay for exclusion by offering retailers lower wholesale prices, exclusion would not be profitable."[29] These theories of harm focus on the abuse of retailers' buying power by dominant manufacturers that aim to exclude their smaller rivals in the upstream market. A possible generalization would be that upfront payments are welfare-

25 Vertical Restraints Guidelines, at 203.

26 For an overview *see* Bloom, Gundlach & Cannon, 2000: 96-97.

27 Klein & Wright, 2007, note however that "most slotting arrangements involve relatively short-term retailer shelf space commitments," usually a period of six months to a year. They also note that some large retailers, such as Wal-Mart prefer receiving the single best wholesale price that suppliers can offer instead of slotting fees.

28 Shaffer, 2005: 3.

29 Shaffer, 2005: 23.

reducing if they are initiated by dominant manufacturers and are unlikely to lead to exclusion when they are initiated by powerful buyers.

However, other theories emphasize the role of downstream market power in excluding competitors and limiting the distribution of small manufacturers' products. Marx & Shaffer have recently argued that upfront payments may allow a retailer with bargaining power to earn positive profits while it prevents small manufacturers from obtaining distribution from another retailer: "the manufacturer will not want to trade with the rival retailer because of fears that if it did, the dominant retailer would cut back on some or all of its planned purchases."[30] The welfare implications are that retail prices will be higher, because there is less competition at the retail level, and with fewer retailers buying from the small manufacturer, the choice in the marketplace will be reduced. Policy makers should also be concerned when slotting allowances are initiated by powerful retailers and should, in this case, not just prohibit slotting allowances, but also other means to achieve exclusion, such as explicit exclusive-dealing provisions.

Other authors advance the view that retailers employ three-part tariffs that combine slotting allowances (negative upfront payments made by the manufacturer even if the retailer does not buy anything afterwards) with two-part tariffs (the supplier charges wholesale prices and the retailers pay conditional fixed fees on actual trade) in order to achieve a monopolistic outcome and reduce retail competition.[31] This is not possible with a two-part tariff structure if the retailer has bargaining power, as in this case each retailer has an incentive to free-ride on its rival's revenue by reducing its own prices. The story goes as follows:

> (w)holesale prices above costs maintain retail prices at the monopoly level, while large conditional payments (corresponding to the retailers' anticipated variable profits) protect retailers against opportunistic moves by their rivals: any price-cutting by one retailer would lead the others to 'opt out'; upfront payments by the manufacturer (slotting allowances) can then be used to give ex ante each retailer its full contribution to the industry profits.[32]

30 Marx & Shaffer, 2007: 838.

31 Rey, Thal & Vergé, 2006.

32 Rey, Thal & Vergé, 2006: 4-5.

Slotting allowances do not lead to the exclusion of efficient retailers but they allow firms to maintain monopoly prices in a situation in which competing manufacturers offer contracts to a common retailer.

Other authors have argued that slotting fees constitute a facilitating practice to increase profit levels at the expense of suppliers and final consumers.[33] As Shaffer explains,

> (i) in providing a means for retailers to commit contractually to high prices, a manufacturer indirectly raises retailer profits by eliminating their incentive for aggressive downstream pricing. Although manufacturers would prefer lower retail prices and hence greater sales, the competition among themselves for the scarce shelf space provides the incentive for such contracts.[34]

Some authors noted, however, that empirical evidence does not support this theory as retailer profits and prices did not increase following the introduction of slotting allowances, and manufacturer profits did not fall, as they would have if retailers have been using slotting allowances to price discriminate.[35]

To these anticompetitive stories for slotting allowances one could oppose an efficiency rationale. Slotting allowances enable retailers to manage efficiently a scarce resource – shelf space – and allocate it to its best possible use. They might serve as a signaling device for new products and "a basis for achieving efficient cost sharing and risk shifting among manufacturers and retailers."[36]

Slotting allowances moderate the risks of new product introductions and compensate retailers for the increasing costs of introducing and managing new products: they help equate an oversupply of new products with a less-than commensurate consumer demand for them.[37]

33 Shaffer, 1991.

34 Shaffer, 1991: 121.

35 Sullivan, 1997: 490

36 Marx & Shaffer: 2007: 93.

37 Sullivan, 1997. *Supra* note 42.

Finally, some authors have advanced "the promotional services theory of slotting contracts."[38] Retail shelf space is thought of as a means to create incremental or promotional sales that would not occur otherwise and for which infra-marginal consumers would not be willing to pay, as they would purchase the product without promotional shelf space. The manufacturers want greater retailer promotional shelf space supplied for their products but retailers have sub-optimal incentives to provide it, as they would not take into account the manufacturer's profit margin on the incremental sales produced by the promotional shelf space, which is particularly problematic if the manufacturer is supplying a differentiated product. Upfront fees can thus be thought as a way to incentivize retailers to supply the optimal promotional shelf space and also as targeted discounts to marginal consumers, thereby increasing the marginal elasticity of demand. Manufacturers with the greatest profitability from incremental sales will be able to pay the most for shelf space and thus win the competition between suppliers for obtaining superior promotional shelf space.

But why choose upfront payments, instead of a wholesale price reduction, that could arguably achieve a similar result and provide more information on the value of the shelf space provided by the retailer? Klein & Wright explain that, in the presence of inter-retailer price competition, retailers will be obliged to decrease their price more than they will increase incremental sales for the manufacturer, as they are selling to both marginal and infra-marginal consumers, the latter being ready to switch retailers if they find the product cheaper elsewhere, and thus any shelf payment through a lower wholesale price will be eroded.[39] The manufacturer will thus have to reduce even more considerably its wholesale price in order to create the equilibrium shelf space rental return. However, if the retailer competition is intense, Klein & Wright argue that there will be a point where a lower wholesale price would be an inappropriate way for a manufacturer to compensate retailers for the supply of promotional shelf space and the manufacturers will thus employ upfront payments.

The new guidelines on vertical restraints take into account these different anticompetitive and pro-competitive stories for slotting allowances. The guidelines indicate the anticompetitive effects that upfront access payments

38 Klein & Wright, 2007; Wright, 2007.

39 *Ibid.*

may have for other distributors, when such payments induce the supplier to channel its products through only one distributor. In this case upfront access payments may have the same downstream foreclosure effect as an exclusive supply obligation and, according to the Guidelines, should be assessed by analogy to the assessment of exclusive supply obligations.[40] The Guidelines add that "exceptionally" upfront payments may also foreclose other suppliers, because of the increased barrier to entry. In this case, the assessment of that possible negative effect would be made in analogy to the assessment of single branding obligations.[41] It seems thus that the Commission considers that upfront access payments are more problematic, from the point of view of competition, if they are initiated by powerful retailers aiming to dampen competition at the distribution market.

Upfront access payments may also soften competition and facilitate collusion between retailers. The Commission follows Shaffer's 1991 study by indicating that slotting allowances are likely to increase the price charged by the supplier for the contract products, and higher supply prices may reduce the incentive of the retailers to compete on price on the downstream market and increase the profits of the distributors. However, the final version of the guidelines added some limitations to this scenario by explicitly indicating that there should be a cumulative use of upfront access payments and that the distribution market should be highly concentrated.[42]

The Guidelines also list possible positive effects of slotting allowances. They note both their contribution to the efficient allocation of shelf space for new products and as a means to prevent free riding by suppliers on distributors' promotional efforts, by shifting the risk of product failure back to the suppliers. However, no mention is made of the "promotional services theory of slotting contracts." A possible reason is that such a theory would also lead to more positively viewing other mechanisms of shelf space compensation to prevent inter-retailer price competition, such as resale price maintenance clauses or rebates on a well-known product as a way to gain shelf space for another less well-known product, which was a "no go" for the Commission.[43]

40 Vertical Restraints Guidelines, at 204.

41 *Id.*, at 205.

42 *Id.*, at 206.

43 Resale price maintenance is considered a hardcore restraint in EU competition law and excluded from the benefit of the block exemption regulation under Article 4(a) of Commission Regulation (EU) 330/2010

The introduction of a section on upfront access payments in the text of the vertical restraints regulation constitutes an important novelty, but it should be understood as responding to an increasing concern, justified or not, over retailer power in the different Member States. Some Member States have instituted prohibitions on slotting allowances in their fair competition statutes.[44]

Other Member States, such as the United Kingdom and Ireland have recently adopted soft law instruments that also banned this practice. In the United Kingdom, the Groceries Supply Code of Practice ("GSCOP"), published by the Competition Commission in August 2009, provides that retailers may not require suppliers to pay for shelf space, although payments may be allowable for promotions of new product listings where the payments are proportional to the risk incurred by the retailer in stocking the new line.[45] The GSCOP is the result of the Competition Commission's investigation of the groceries market between May 2006 and April 2008. The Commission suggested the adoption of the GSCOP, an improved version of the existing Supply Code of Practice, together with an Ombudsman to ensure effective enforcement of the new provisions for suppliers and retailers. The new U.K. government is committed to introducing an Ombudsman in the Office of Fair Trading in order to pro-actively enforce the GSCOP. Further developments on the final institutional arrangements for the enforcement of the GSCOP are expected in late July 2010. Similar provisions have been added to the Irish draft code of Practice for Grocery Goods Undertakings, published in August 2009.[46]

There is a considerable benefit in adopting provisions that integrate a competition test and that take into account both the benefits and the costs of slotting allowances for consumers. Bringing these issues within the realm of competition law and the scope of action of competition agencies accomplishes this objective and potentially reduces the pressure to institute *per se* prohibitions or formalistic bans on such practices at the Member States'

[2010] OJ L 102/1. The ability to provide rebates on sales of a well-known product as a way to gain shelf space for a less well-known product was limited in the Coca-Cola undertaking, case COMP 39.116, B-2/ Coca-Cola*, available at* http://ec.europa.eu/competition/antitrust/cases/decisions/39116/tccc_final_undertaking_041019.pdf, at p. 6.

44 *See* Article L-442-6 of the French Code de Commerce.

45 GSCOP, Part 5, 12. *See* also, UK Competition Commission, 2000.

46 *See* Mullan, 2010.

level. The inclusion of this new section in the new vertical guidelines is a step towards that direction.

IV. CATEGORY MANAGEMENT

Category management is a vertical partnership in which previously confidential information is shared between manufacturers and retailers in order to cut costs in distribution and increase the margin of both parties. The major impetus for this type of arrangement came from the supermarket industry as a response to the intense competition from warehouses and discount stores. The category captain presents a plan-o-gram to the retailer suggesting a layout and a promotional plan for the entire category.

There are different forms of category management arrangements, going from strong ones, when the category captain has joint responsibility with the retailer for category development and is entrusted with all category decisions, to loose forms of category management, where the retailer also received second opinions and recommendations from other category captains or the role of the category captain is an advisory one.[47]

Category management is efficiency-enhancing: it reduces retailers' risk of being out of stock or having excess inventories, speeds up delivering times, and enables the retailers to plan their production schedules. Suppliers and retailers have complementary information on consumers' needs and category management is a way to pool this information together for the benefit of consumers.[48]

Alongside these various justifications, Klein & Wright have also advanced that category management is a way to ensure that the distributor provides a sufficient level of promotion desired by the supplier.[49] The story is similar to the promotional services theory advanced for slotting contracts. The distributors do not supply the sufficient level of promotion desired by the supplier because they do not take into account the supplier's marginal profit

47 Desrochers, Gundlach & Foer, 2003: 204.

48 *See* FTC 2001, "the manufacturers may know things like the times of year when a product will best sell, the kind of promotion that are most effective in moving the product or the kinds of complementary goods that might be advantageously displayed in adjacent markets." Retailers have point of sale data and knowledge of their promotional efforts. However, because retail outlets carry thousands of categories of products, the retailer cannot be expected to understand detailed aspects pertinent to the marketing of each category.

49 Klein & Wright, 2006. *See* also Wright, 2009.

when deciding what level of promotion to supply. Shelf space is a particular type of promotional service. Klein & Wright argue that category management is a substitute contractual device to a limited exclusivity provision in the distribution contract. The fundamental limitation on the degree of exclusivity is that the category captain is obliged to place rival brands on its plan-o-grams and that the final decision regarding listing and the allocation of shelf space belongs to the retailer and not the category captain. The retailer has the incentive to hold up the manufacturer by providing insufficient shelf space and promotional effort. The suppliers provide payment to ensure sufficient shelf space, either by reducing their wholesale prices, or by paying upfront access fees (slotting allowances) or through the premium earned by the retailers because of an RPM clause. Category management allows the supplier to prevent retailer hold up, for example, by selling the same shelf space twice, and ensures some return to the supplier in the form of a limited exclusive distribution for their products. There is, indeed, an implicit understanding that category captaincy is intended to privilege the brands of the category captain. This conceptualization of category management as a limited form of exclusive distribution has gained acceptance in the recent *JT International South Africa (Pty) Ltd and BAT South Africa* case of the South African Competition Tribunal.[50]

The European Commission's guidelines on vertical restraints do not embrace this conceptualization when they examine the possible positive effects of category management. It is certainly noted in the guidelines that category management is generally positive and can produce anticompetitive effects only in specific circumstances.[51] The Commission made a similar positive assessment of the effects of such agreements on consumers in its *Procter & Gamble* case in the context of EU merger control.[52] The Commission

50 Case No: 05/CR/Feb05, The Competition Commission, JT International South Africa (Pty) Ltd and British American Tobacco South Africa (Pty) Ltd, available at http://www.saflii.org/za/cases/ZACT/2009/46.html, at 77.

51 Vertical Restraints Guidelines, at 210 ("in most cases category management agreements will not be problematic").

52 Case No COMP/M.3732 – Procter & Gamble/ Gillette, (2005) *available at* http://ec.europa.eu/competition/mergers/cases/decisions/m3732_20050715_20212_en.pdf, at 151 "category management policy appears to provide an advantage to leading brands in general, and not only to the parties. This may be seen as largely pro-competitive, as it makes it easier for retailers to stock the most-demanded brands and easier for consumers to find them in sufficient quantities on the shelves. Hence, there is no elimination of competition."

also notes in the vertical restraints guidelines that category management arrangements might also bring a number of efficiency gains: They may allow distributors to achieve economies of scale as they ensure that the optimal quantity of products is presented timely and directly on the shelves.[53] They may also enable suppliers to achieve economies of scale by allowing them to better anticipate demand and to tailor their promotions accordingly.[54]

However, no effort is made to develop a more holistic view of this practice, such as the "the promotional services theory" advanced by Klein & Wright. The reason might be that accepting this theory could provide room for a more lenient approach towards RPM, another mechanism of retailer promotional services compensation,[55] which is something the Commission did not want to pursue in this revision of the Block exemption regulation on vertical agreements.

Category management may "sometimes distort competition between suppliers, and finally result in anticompetitive foreclosure of other suppliers, where the category captain is able, due to its influence over the marketing decisions of the distributor, to limit or disadvantage the distribution of products of competing suppliers."[56] This view comes essentially from the conflict of interest between the supplier and the retailers, although the Commission notes, "in most cases the distributor may not have an interest in limiting its choice of products."[57] Category management might, however, produce exclusionary effects on other suppliers, in particular when the category captain is able, due to its influence over the marketing decisions of the distributor, to limit or disadvantage the distribution of products of competing suppliers.

The U.S. litigation in *Conwood v. US Tobacco Co.* provides an illustration of this risk for anticompetitive effects, although one should note that the factual circumstances of this case are exceptional.[58] This conflict of interest

53 Vertical Restraints Guidelines, at 209.

54 *See* also, Case No COMP/M.3732 – Procter & Gamble/ Gillette, (2005), above, at 150.

55 *See*, most recently, Klein, 2009.

56 Vertical Restraints Guidelines, at 210.

57 *Id.*

58 Conwood Company, L.P. v. United States Tobacco Co., 290 F.3d 768 (6thCir. 2002) (finding maintenance of monopoly power through exclusionary conduct, including the destruction of competitors' promotional stands, payments for exclusive product display space).

is particularly acute when the distributor also sells private labels, in which case he has incentives to exclude certain suppliers, in particular intermediate national brands, as is also noted in the Commission's vertical restraints guidelines.[59] The Commission will assess this upstream foreclosure effect by analogy to the assessment of single branding obligations, and will integrate factors such as the market coverage of these agreements, the market position of competing suppliers, and the possible cumulative use of such agreements.[60]

The Commission also examines the possible collusive effects of category management agreements at the upstream and downstream level. This was an important concern in the recent U.K. Competition Commission ("CoCo") market investigation of the supply of groceries in the United Kingdom.[61] The CoCo acknowledged that category management might provide increased opportunities to exchange information between suppliers, whether directly or indirectly via retailers. The report reviewed category management in two product categories – fresh fruit and yogurt – and found varying degrees of supplier interaction as a result of category management relationships.[62] The Commission concluded, "the degree of interaction among suppliers arising from category management is a cause for concern."[63]

The European Commission also recognizes in the vertical restraints guidelines that "category management may also facilitate collusion between suppliers through increased opportunities to exchange via retailers sensitive market information, such as for instance information related to future

59 Vertical Restraints Guidelines, at 210. *See*, however, the more positive for category management analysis of the Commission in Case No COMP/M.3732 – Procter & Gamble/ Gillette, (2005), above, at 143-145, where the Commission notes that there is little likelihood that category managers would provide biased recommendations to retailers, as "the market investigation has shown that there is no significant information asymmetry between retailers and suppliers which could be abused" and that "most of the parties, competitors and some of the retailers, through their private labels, provide a full range of oral care products, sometimes similar or even broader than the parties' range, which prevents the parties from forcing retailers to buy a full line of their own branded products".

60 *Id.*, referring to 132-141 (single branding obligations).

61 UK Competition Commission, 2008.

62 Appendix 8.1. of the Report.

63 Competition Commission, The Supply of groceries in the UK market investigation (April 30, 2008), at 151 noting that "there were also some examples where suppliers offered information to grocery retailers regarding the future plans of competitors" and at p. 155, observing that "(o)ur review of the conditions necessary for tacit coordination to arise and be sustainable suggested that these conditions may be present in UK grocery retailing."

pricing, promotional plans or advertising campaigns."[64] The risk might be more significant if the retailers sell private labels and are thus competitors to the supplier/category captain.

Direct information exchange between competitors is not covered by the Block Exemption Regulation on vertical agreements, as these constitute horizontal agreements that fall outside the scope of Regulation 330/2010, according to Article 2(4) of Reg. 330/2010.[65] The Commission's guidelines on maritime transports that include a section on information exchange agreements,[66] as well as the new information exchange agreements between competitors section of the draft guidelines on horizontal cooperation agreements,[67] provide more detailed information on the Commission's assessment of information exchange in a horizontal context.[68] Any information exchange between the supplier/category captain and the retailer that carries its own private label should be carefully monitored, for example by the constitution of Chinese walls or firewalls and the separation of the category management and product sales functions.[69] It is also possible that trading negotiations between retailers and suppliers (vertical relations) might be qualified to horizontal collusion with anticompetitive information exchange.[70] Competition authorities in various Member States of the EU have increasingly employed the hub and spoke theory to bring within the realm of competition law indirect information exchanges between retailers via their suppliers in the context of vertical relations but facilitating collusion at the supply level.[71]

64 Vertical Restraints Guidelines, at 212.

65 According to Art. 2(4) of Reg. 330/2010, "The exemption provided for in paragraph 1 shall not apply to vertical agreements entered into between competing undertakings". *See also*, Vertical Restraints Guidelines, at 27-28.

66 Guidelines on the application of Article 81 of the EC Treaty to maritime transport services, OJ C245/2, at 38-59 (2008).

67 Draft Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements, SEC(2010) 528/2, at 54-104.

68 On information exchange agreements in EU competition law *see* the materials of the conference organized by UCL Faculty of Laws in May 2010: http://www.ucl.ac.uk/laws/cyprus/.

69 *See* the recommendations at FTC, 2001.

70 On the horizontal/vertical characterization for category management agreements *see* Glazer, Henry & Jacobson, 2004. *See* also Lianos, 2008b; Whelan, 2009.

71 *See* the replica football kits and the toys sagas in the UK: CA 98/06/2003, Price Fixing of Replica Football Kit, [2004] UKCLR 6; CA/98/8/2003 Agreements between Hasbro UK Ltd, Argos Ltd & Littlewoods

Furthermore, the Commission acknowledges in the vertical restraints guidelines that category management agreements may facilitate collusion between distributors when the same supplier serves as a category captain for all or most of the competing distributors on a market and provides these distributors with a common point of reference for their marketing decisions.[72] One could question the possibility of this anticompetitive effect happening, unless there is a widespread adoption of the same category captain by all retailers. The category captain may also only provide advice about stocking and presentation of the category and is not involved in setting the retail selling price. As the U.K. Competition Commission noted in its report in the groceries market investigation, this concern might be overstated as there was no evidence from the case studies that category management activities were being used to facilitate, or had the effect of facilitating, collusion between grocery retailers.[73]

V. CONCLUSION

By integrating more fully the retailer power story, the new vertical restraints guidelines and block exemption regulation provide for a more equilibrated regime for vertical restraints in Europe. The objective of the Commission was not only to address the important concern of retailer power and its possible anticompetitive effects in a retail sector that is characterized by increasing concentration, although not necessarily increasing profitability, but also to respond to the concerns (and political pressure) over big distribution and the power of multi-brand retailers that have been expressed at the national level, with the adoption of a hard or a soft law type of approach in order to regulate the relation between suppliers and retailers. By bringing these concerns within the realm of EU competition law, the Commission offers an alternative relief valve that takes more into account the effect of these practices on consumers than the regulations adopted at the national level.

Ltd fixing the price of Hasbro toys and games, [2004] 4 UKCLR 717; JJB Sports Plc [2004] CAT 17; Argos Ltd, Littlewoods Ltd v. OFT [2004] CAT 24; Argos Ltd, Littlewoods & OFT, JJB Sports & OFT [2006] EWCA Civ 1318; the recent Dairy investigation (http://www.oft.gov.uk/news-and-updates/press/2010/45-10) and Tobacco decision (Case CE/2596-03: Tobacco, April 10, 2010, *available at* http://www.oft.gov.uk/shared_oft/ca98_public_register/decisions/tobacco.pdf) at the OFT (although the hub and spoke elements of the claim were dropped). Desrochers, Gundlach & Foer, 2003: 206 note that "(a)s a result of the hub and spoke nature of Category Captain arrangements, rivals may learn about one another's pricing, merchandising, and promotion plans". The same authors, however, acknowledge that "no evidence of category captain facilitated collusion has been made public."

72 Vertical Restraints Guidelines, at 211.

73 Competition Commission, April 30, 2008: Appendix 8.1, 25. *See also* 8.19 of the main report.

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