

The banning of vertical agreements in Europe: an anti-competitive policy

The European Commission has set out since its earliest days to make an offence of different firms co-operating in ways it considers "restrictive". Agreements between companies working on various consecutive stages of a good's production, such as its manufacture and its distribution, have drawn special attention from the Commission. However, these vertical agreements may be the means that best meet certain needs shown by consumers. Far from being anti-competitive, as European authorities claim, these practices have their place in a competition process that leaves consumers free to support industries organised in different ways.

Examination of the Grundig-Consten case* is of particular interest because it is the major precedent in terms of vertical agreements. This case, involving an agreement between these two companies that was declared illegal in 1964, reveals the flawed notion of competition that the Commission has adopted.



Competition policy against exclusive agreements: the Grundig precedent

The Grundig company initially made itself known in Germany through its broad range of receivers, recorders, dictation machines and, of course, television sets. In the late 1950s, the German firm decided to move on to a new stage in its development. Seeking to duplicate its success across Europe, particularly in France, it had to establish a strategy to make itself better known, building and preserving a reputation among consumers in the face of established competitors. With this in mind, Grundig chose the distinctive business model of "territorial protection".

* Neri, Massimiliano, "Suffering at the Hands of the EU Antitrust Police," Daly Article, Ludwig von Mises Institute, disponible à <http://www.mises.org/story/2440>

In each country (with the exception of Germany, its country of origin), Grundig joined forces with a local company to ensure the distribution of its products, bound by exclusive distribution agreements. Consten, Grundig's representative for France, accepted an agreement of this sort effective 1 April 1957. As a Grundig representative, Consten was committed in particular to assuming the costs of local advertising. Consten also agreed to ensure after-sales service and not to sell products from Grundig competitors. In return, Grundig agreed to sell its products in France only through this sole distributor. Each of its distributors in Europe was generally bound under contract not to sell Grundig products in other countries, which is why this was called "territorial protection" for each of them.

Despite the existence of these contracts, several distributors set out to deliver Grundig products outside the distribution zones in which they were supposed to operate. In April 1961, the UNEF company, based in France, started buying Grundig products in Germany from one of these resellers. UNEF thus became

a "parallel importer", in other words a company that obtained products outside the official circuit laid out by the exclusive agreements between the manufacturer and its distributors.

Consten took legal proceedings in France against the parallel importer. But UNEF brought the case to the Commission of the European Economic Community, asserting that exclusive rights should be regarded as void under the terms of Article 85 of the EEC Treaty (currently Article 81) against cartels. This vertical agreement would have represented a characteristic attack on competition. By limiting competition between distributors of the same brand, it would have harmed consumers.

With the Commission and the European Court of Justice having backed this thesis through their rulings, the Grundig case would be used as a precedent in many other cases. Going after cartels and "restrictive" agreements could sometimes be quite far-ranging since, in some cases, company executives merely had to meet for their companies to be subject to legal action and sanctions. This was what happened, for example, to the Pioneer company, accused of having organised a meeting with its local distributors in Europe to establish measures against parallel trade.

An unjustified attack against exclusive distribution agreements

"The observation that parties to the agreements wanted Consten to be isolated from the competition of other importers for the importation and wholesale distribution of Grundig products in France, is enough to conclude that competition is restrained within the meaning of Article 85 paragraph 1",¹ the Commission's decision stated.² With the Grundig-Consten ruling³ and the decisions that followed, Community authorities claimed to act on behalf of consumers by defending the free play of "competition". However, it is inaccurate to consider exclusive agreements a

priori as harmful to consumers.

Exclusive agreements are first and foremost a means for companies to make themselves known and build their reputations. Accordingly, the benefit of the required investment in advertising conducted by the distributors must not be diverted to the advantage of competing distributors that are not taking part in this promotional effort. Without exclusive agreements, investments would not take place and consumers would miss out on the information provided to them by advertising. To the extent that they would choose these products based on the promotional effort, the banning of exclusive agreements harms them.

To understand this suggestion, it should first be understood that consumers are not automatically well informed about products available to them. This is why advertising is generally a necessary step in producing an item such as a television set, just as its manufacturing is. Industrial firms must compete imaginatively, not only to discover how to attract the attention of potential buyers of a product but also to ensure that their success pays off in terms of sales.

When a brand of television sets aims to build a reputation and to challenge the success of other brands, it has all the more reason to make itself known. There are various ways of achieving this. For example, a manufacturer can simply handle distribution of a product on its own. This is a model of pure vertical integration, comparable to the model adopted

¹ "The following shall be prohibited as incompatible with the common 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 common market..."

http://eur-lex.europa.eu/en/treaties/dat/12002E/htm/C_2002325EN.003301.html

² 64/566/CEE: Décision de la Commission, du 23 septembre 1964, relative à une procédure au titre de l'article 85 du traité (IV-A/00004-03344 "Grundig-Consten")

<http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:31964D0566:FR:NOT>

³ Judgment of the Court of 13 July 1966. *Établissements Consten S.à.R.L. and Grundig-Verkaufs-GmbH v Commission of the European Economic Community*. Joined cases 56 and 58-64. http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61964J0056&lg=en

by Dell for its computers. Alternatively, to ensure more effective investment in advertising and in high-quality customer service needed to build the brand's reputation, the manufacturer may also have an interest in handing this task to local distributors. Local firms generally know their markets better and know how to communicate most effectively with consumers. Thanks to exclusivity, a local distributor has an interest in providing the required amounts of advertising and promotion of the manufacturer's brand because the result of its efforts will not be diverted. With leakage blocked, the distributor and the manufacturer come out ahead. But consumers also gain to the extent that they choose products they would not have known about without the advertising and also to the degree that a firm's reputation and customer service bring added value to them.

It is conceivable, however, that this effort may amount to nothing if consumers do not care about the products brought to their attention. Exclusive agreements - like other ways of organising business - must pass the test of the market. Indeed, if exclusive agreements fail to bring value to consumers, there is little to prevent them from going over to competitors and shifting their purchases of television sets to other brands.

An anti-competitive competition policy

Vertical agreements are part of the free play of competition. This involves competition between different brands, and there is no reason to regard such agreements as any more suspect than other vertical integration practices which do not suffer from this scorn.

Vertically integrated firms, with various stages of production such as the manufacture of the product and its distribution taking place inside the firm, generally do not bring on the same level of opprobrium. When their internal operations are inefficient, with high costs and little additional service to consumers, other companies already in the

market or ready to enter it can benefit by offering better solutions to consumers. Dell is not criticised for sapping competition by handling distribution of its products on its own because that in no way prevents Hewlett Packard, IBM or others from offering their own products. Similarly, the Grundig business model did not prevent Sony, Philips or other brands from offering their own television sets in France.

The relationship between two divisions of the same firm performing two consecutive stages of the production of an item is typically exclusive. Dell's distribution division sells and delivers only Dell products. In the end, it is as if there were exclusive agreements binding the various divisions of the same firm. Rather than have as many firms as there are stages in production, there is just a single company. Its internal organisation amounts to an actual vertical agreement, more complete than exclusive relations between independent firms.⁴ Thus, if firms that handle several stages of production are not a danger to the maintenance of competition, then it should be clear that exclusive agreements between different firms are not a danger either.

It may be true that companies collude without this bringing any advantage to consumers, as might have applied in the Grundig case. However, even in this situation, there was no need for Community authorities to intervene. Consumers could simply turn to competing brands, requiring Grundig and Consten to reconsider their mode of organisation or to disappear.

What, then, is the impact on competition and on consumer service of a policy stigmatising vertical agreements? Given that vertical agreements cannot be considered a

⁴ The European Commission never claimed that the rules of "competition" were complied with only if the economy were made up of self-employed workers. Other forms of company always involved exclusive internal agreements, and this thesis follows logically from the ruling against cartels. On this subject, see Xavier Méra, *Destroying competition in the name of competition*, The EU Reporter, 22-29 November 2004.

priori as harmful, it is competition that enables consumers to decide on the form of company organisation that serves them best. By prohibiting vertical agreements, the Commission prevents consumers from leading the free play of competition between various business models and ends up harming them. In actual fact, interventionist policy is what proves to be anti-competitive.



Conclusion

Competition is not distorted by exclusive distribution contracts. Vertical agreements are an attempt to maximize the benefits to those who engage in them. Like all other strategic choices of a company, however, they are always subject to the judgement of the market. Their success or failure depends ultimately on their ability to satisfy the preferences of consumers who are free to deal with a competing brand as long as no legal obstacles get in the way.

“Maintaining competition for the benefit of consumers requires other choices: unreservedly respecting contractual freedom and the contracts between producers, distributors and consumers.”

To let competition work and to show it respect it involves, on the contrary, having regulatory authorities abstain from penalising these agreements. Otherwise, consumers - the best regulators there are if their interests are allowed to prevail - cannot decide on this. As such, the Grundig case reveals the essentially anti-competitive turn that European competition policy took right from the start. Maintaining competition for the benefit of consumers requires other choices: unreservedly respecting contractual freedom and the contracts between producers, distributors and consumers.

Cécile Philippe, Valentin Petkantchin, Xavier Méra
IEM thanks Massimiliano Neri for his collaboration to this note.

Institut Economique Molinari

rue Luxembourg, 23 bte 1
1000 Bruxelles
Belgique
Tél. +32 2 506 40 06
Fax +32 2 506 40 09
e-mail:
cecile@institutmolinari.org
www.institutmolinari.org

The Molinari Economic Institute is an independent, non-profit research and educational institute. It endeavors an economic approach to the study of public policy issues.

Reproduction is authorized on condition that the source is mentioned.

© Institut Economique
Molinari

Printed in Belgium

Design by LEONard