Republic of Macedonia

Commission for Protection of Competition

GUIDELINES

on the application of Article 7(3) of the Law on Protection of Competition

1. INTRODUCTION

1. Article 7 (3) of the Law on Protection of Competition (Official Gazette of the Republic of Macedonia No. 04/05, 70/06 and 22/07) sets out an exception rule from the one defined in Article 7 (1), which provides a defence to undertakings against a finding of an infringement of Article 7 (1) of the Law. Agreements, decisions of associations of undertakings and concerted practices[1]caught by Article 7(1) which satisfy the conditions of Article 7 (3) are valid and enforceable, no prior decision of the Commission for Protection of Competition to that effect being required.

2. Article 7 (3) can be applied in individual cases or to categories of agreements and concerted practices by way block exemption regulations. [2]

3. The guidelines establish an analytical framework for the application of Article 7(3). The purpose is to develop a methodology for the application of this Law provision.

4. The standards set forth in the present guidelines must be applied in light of the circumstances specific to each case. This excludes a mechanical application. Each case must be assessed on its own facts and the guidelines must be applied reasonably and flexibly.

2. THE GENERAL FRAMEWORK OF ARTICLE 7 OF THE LAW ON PROTECTION OF COMPETITION

2.1. The Law provisions

5. Article 7 (1) prohibits all agreements between undertakings, decisions by associations of undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition[3].

6. As an exception to this rule, Article 7(3) provides that the prohibition contained in Article 7 (1) may be declared inapplicable in case of agreements which contribute to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefits, and which do not impose restrictions which are not indispensable to the attainment of these objectives, and do not afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products concerned.

7. Agreements which are caught by Article 7 (1) and which do not satisfy the conditions of Article 7 (3) are prohibited, no prior decision of the Commission to that effect being required[4]. Agreements which are caught by Article 7 (1) but which satisfy the conditions of Article 7 (3) are not prohibited, no prior decision to that effect being required. Such agreements are valid and enforceable from the moment that the conditions of Article 7 (3) are satisfied and for as long as that remains the case.

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[1] In the following the term ‘agreement’ includes concerted practices and decisions of associations of undertakings.
[2] Regulations on block exemptions are available on the web site of the Commission for Protection of Competition **www.kzk.gov.mk**
[3] In the following the term ‘restriction’ includes the prevention and distortion of competition.
[4] According to Article 7 (1) such agreements are automatically void.

8. The assessment under Article 7 thus consists of two parts. The first step is to assess whether an agreement between undertakings has an anti-competitive object or actual or potential[5] anti-competitive effects. The second step, which only becomes relevant when an agreement is found to be restrictive of competition, is to determine the pro-competitive benefits produced by that agreement and to assess whether these pro-competitive effects outweigh the anti-competitive effects. The balancing of anti-competitive and pro-competitive effects is conducted exclusively within the framework laid down by Article 7 (3).

9. The assessment of any countervailing benefits under Article 7 (3) necessarily requires prior determination of the restrictive nature and impact of the agreement. To place Article 7 (3) in its proper context it is appropriate to briefly outline the objective and principal content of the prohibition rule of Article 7 (1). The regulations contain substantial guidance on the application of Article 7 (1) to various types of agreements.

2.2. The prohibition rule of Article 7 (1)

2.2.1. *General remarks*

10. The objective of Article 7 is to protect competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources.

11. The prohibition rule of Article 7 (1) applies to restrictive agreements and concerted practices between undertakings and decisions by associations of undertakings in so far as they are capable of affecting competition on the market. A general principle underlying Article 7 (1) is that each economic operator must determine independently the policy, which he intends to adopt on the market. In view of this the Law on Protection of Competition has defined "agreements", "decisions" and "concerted practices" as legal concepts which allow a distinction to be made between the unilateral conduct of an undertaking and co-ordination of behaviour or collusion between undertakings. Unilateral conduct is subject only to Article 14 of the Law.

12. The type of co-ordination of behaviour or collusion between undertakings falling within the scope of Article 7 (1) is that where at least one undertaking vis-à-vis another undertaking undertakes to adopt a certain conduct on the market or that as a result of contacts between them uncertainty as to their conduct on the market is eliminated or at least substantially reduced. It follows that co-ordination can take the form of obligations that regulate the market conduct of at least one of the parties as well as of arrangements that influence the market conduct of at least one of the parties by causing a change in its incentives. It is not required that co-ordination is in the interest of all the undertakings concerned. Co-ordination must also not necessarily be express. It can also be tacit. For an agreement to be capable of being regarded as having been concluded by tacit acceptance there must be an invitation from an undertaking to another undertaking, whether express or implied, to fulfil a goal jointly.

13. Agreements between undertakings are caught by the prohibition rule of Article 7(1) when they are likely to have an appreciable adverse impact on the parameters of competition on the market, such as price, output, product quality, product variety and innovation. Agreements can have

[5] Article 7 (1) prohibits both actual and potential anti-competitive effects

this effect by appreciably reducing rivalry between the parties to the agreement or between them and third parties.

2.2.2. *The basic principles for assessing agreements under Article 7(1)*

14. The assessment of whether an agreement is restrictive of competition must be made within the actual context in which competition would occur in the absence of the agreement with its alleged restrictions. In making this assessment it is necessary to take account of the likely impact of the agreement on inter-brand competition (i.e. competition between suppliers of competing brands) and on intra-brand competition (i.e. competition between distributors of the same brand). Article 7(1) prohibits restrictions of both inter-brand competition and intra-brand competition.

15. For the purpose of assessing whether an agreement or its individual parts may restrict inter-brand competition and/or intra-brand competition it needs to be considered how and to what extent the agreement affects or is likely to affect competition on the market. The following two questions provide a useful framework for making this assessment. The first question relates to the impact of the agreement on inter-brand competition while the second question relates to the impact of the agreement on intra-brand competition. As restraints may be capable of affecting both inter-brand competition and intra-brand competition at the same time, it may be necessary to analyse a restraint in light of both questions before it can be concluded whether or not competition is restricted within the meaning of Article 7(1):

(1) Does the agreement restrict actual or potential competition that would have existed without the agreement? If so, the agreement may be caught by Article 7(1). In making this assessment it is necessary to take into account competition between the parties and competition from third parties. For instance, where a supplier imposes obligations on his distributors not to sell competing products and these obligations foreclose third party access to the market, actual or potential competition that would have existed in the absence of the agreement is restricted. In assessing whether the parties to an agreement are actual or potential competitors the economic and legal context must be taken into account. For instance, if due to the financial risks involved and the technical capabilities of the parties it is unlikely on the basis of objective factors that each party would be able to carry out on its own the activities covered by the agreement the parties are deemed to be non-competitors in respect of that activity. It is for the parties to bring forward evidence to that effect.

(2) Does the agreement restrict actual or potential competition that would have existed in the absence of the contractual restraint(s)? If so, the agreement may be caught by Article 7(1). For instance, where a supplier restricts its distributors from competing with each other, (potential) competition that could have existed between the distributors absent the restraints is restricted. Such restrictions include resale price maintenance and territorial or customer sales restrictions between distributors. However, certain restraints may in certain cases not be caught by Article 7(1) when the restraint is objectively necessary for the existence of an agreement of that type or that nature. Such exclusion of the application of Article 7(1) can

only be made on the basis of objective factors external to the parties themselves and not the subjective views and characteristics of the parties. The question is not whether the parties in their particular situation would not have accepted to conclude a less restrictive agreement, but whether given the nature of the agreement and the characteristics of the market a less restrictive agreement would not have been concluded by undertakings in a similar setting. For instance, territorial restraints in an agreement between a supplier and a distributor may for a certain period of time fall outside Article 7(1), if the restraints are objectively necessary in order for the distributor to penetrate a new market. Similarly, a prohibition imposed on all distributors not to sell to certain categories of end users may not be restrictive of competition if such restraint is objectively necessary for reasons of safety or health related to the dangerous nature of the product in question. Claims that in the absence of a restraint the supplier would have resorted to vertical integration are not sufficient. Decisions on whether or not to vertically integrate depend on a broad range of complex economic factors, a number of which are internal to the undertaking concerned.

16. In the application of the analytical framework set out in the previous paragraph it must be taken into account that Article 7(1) distinguishes between those agreements that have a restriction of competition as their object and those agreements that have a restriction of competition as their effect. An agreement or contractual restraint is only prohibited by Article 7(1) if its object or effect is to restrict inter-brand competition and/or intra-brand competition.

17. The distinction between restrictions by object and restrictions by effect is important. Once it has been established that an agreement has as its object the restriction of competition, there is no need to take account of its concrete effects. In other words, for the purpose of applying Article 7(1) no actual anti-competitive effects need to be demonstrated where the agreement has a restriction of competition as its object. Article 7(3), on the other hand, does not distinguish between agreements that restrict competition by object and agreements that restrict competition by effect. Article 7(3) applies to all agreements that fulfil the four conditions contained therein.

18. Restrictions of competition by object are those that by their very nature have the potential of restricting competition. These are restrictions which in light of the objectives pursued by the competition rules have such a high potential of negative effects on competition that it is unnecessary for the purposes of applying Article 7(1) to demonstrate any actual effects on the market. This presumption is based on the serious nature of the restriction and on experience showing that restrictions of competition by object are likely to produce negative effects on the market and to jeopardise the objectives pursued by the competition rules. Restrictions by object such as price fixing and market sharing reduce output and raise prices, leading to a misallocation of resources, because goods and services demanded by customers are not produced. They also lead to a reduction in consumer welfare, because consumers have to pay higher prices for the goods and services in question.

19. The assessment of whether or not an agreement has as its object the restriction of competition is based on a number of factors. These factors include, in particular, the content of the agreement and the objective aims pursued by it. It may also be necessary to consider the context in which it is (to be) applied and the actual conduct and behaviour of the parties on the market. In other words, an examination of the facts underlying the agreement and the specific circumstances in which it operates may be required before it can be concluded whether a particular restriction constitutes a restriction of competition by object. The way in which an agreement is actually implemented may reveal a

restriction by object even where the formal agreement does not contain an express provision to that effect. Evidence of subjective intent on the part of the parties to restrict competition is a relevant factor but not a necessary condition.

20. Non-exhaustive guidance on what constitutes restrictions by object can be found in regulations on block exemptions. Restrictions that are “black-listed” in by-the regulations for block exemptions or identified as hard core restrictions are generally considered by the Commission for Protection of Competition to constitute restrictions by object. In the case of horizontal agreements restrictions of competition by object include price fixing, output limitation and sharing of markets and customers. As regards vertical agreements, the category of restrictions by object includes, in particular, fixed and minimum resale price maintenance and restrictions providing absolute territorial protection, including restrictions on passive sales.

21. If an agreement is not restrictive of competition by object it must be examined whether it has restrictive effects on competition. Account must be taken of both actual and potential effects. In other words the agreement must have likely anti-competitive effects. In the case of restrictions of competition by effect there is no presumption of anti-competitive effects. For an agreement to be restrictive by effect, it must affect actual or potential competition to such an extent that on the relevant market negative effects on prices, output, innovation or the variety or quality of goods and services can be expected with a reasonable degree of probability[6]. Such negative effects must be appreciable. The prohibition rule of Article 7(1) does not apply when the identified anti-competitive effects are insignificant[7]. This test reflects the economic approach which the Commission is applying. The prohibition of Article 7(1) only applies where on the basis of proper market analysis it can be concluded that the agreement has likely anti-competitive effects on the market. It is insufficient for such a finding that the market shares of the parties exceed the thresholds set out in the regulation on Agreements of Minor Importance *(de minimis)*. Agreements falling within safe harbours of the regulations for block exemption may be caught by Article 7(1) but this is not necessarily so. Moreover, the fact that due to the market shares of the parties, an agreement falls outside the safe harbour of the regulations for block exemption is in itself an insufficient basis for finding that the agreement is caught by Article 7(1) or that it does not fulfil the conditions of Article 7(3). Individual assessment of the likely effects produced by the agreement is required.

22. Negative effects on competition within the relevant market are likely to occur when the parties individually or jointly have or obtain some degree of market power and the agreement contributes to the creation, maintenance or strengthening of that market power or allows the parties to exploit such market power. Market power is the ability to maintain prices above competitive levels for a significant period of time or to maintain output in terms of product quantities, product quality and variety or innovation below competitive levels for a significant period of time. In markets with high fixed costs undertakings must price significantly above their marginal costs of production in order to ensure a competitive return on their investment. The fact that undertakings

[6] It is not sufficient in itself that the agreement restricts the freedom of action of one or more of the parties. This is in line with the fact that the object of Article 7 is to protect competition on the market for the benefit of consumers.

[7] The Regulation on agreements of minor importance relates to agreements that insignificantly restrict competition according Article 7(1) from the Law. This Regulation defines the significance in negative context. The agreements that fall outside of the application of this degree do not necessarily have significantly restriction effects. An individual assessment is required

price above their marginal costs of production is therefore not in itself a sign that competition in the market is not functioning well and that undertakings have market power that allows them to price above the competitive level. It is when competitive constraints are insufficient to maintain prices and output at competitive levels that undertakings have market power within the meaning of Article 7(1).

23. The creation, maintenance or strengthening of market power can result from a restriction of competition between the parties to the agreement. It can also result from a restriction of competition between any one of the parties and third parties, e.g. because the agreement leads to foreclosure of competitors or because it raises competitors' costs, limiting their capacity to compete effectively with the contracting parties. Market power is a question of degree. The degree of market power normally required for the finding of an infringement under Article 7(1) in the case of agreements that are restrictive of competition by effect is less than the degree of market power required for a finding of dominance under Article 10.

24. For the purposes of analysing the restrictive effects of an agreement it is normally necessary to define the relevant market[8]. It is normally also necessary to examine and assess, inter alia, the nature of the products, the market position of the parties, the market position of competitors, the market position of buyers, the existence of potential competitors and the level of entry barriers. In some cases, however, it may be possible to show anti-competitive effects directly by analysing the conduct of the parties to the agreement on the market. It may for example be possible to ascertain that an agreement has led to price increases.

2.2.3. *Restraints directly connected and necessary for fulfilment of the contract (ancillary restraints)*

25. Paragraph 15 above sets out a framework for analysing the impact of an agreement and its individual restrictions on inter-brand competition and intra-brand competition. If on the basis of those principles it is concluded that the main transaction covered by the agreement is not restrictive of competition, it becomes relevant to examine whether individual restraints contained in the agreement are also compatible with Article 7(1) because they are ancillary to the main non-restrictive transaction.

26. In competition law the concept of ancillary restraints covers any alleged restriction of competition which is directly related and necessary to the implementation of a main non-restrictive transaction and proportionate to it. If an agreement in its main parts, for instance a distribution agreement or a joint venture does not have as its object or effect the restriction of competition, then restrictions, which are directly related to and necessary for the implementation of that transaction, also fall outside Article 7(1). These related restrictions are called ancillary restraints. A restriction is directly related to the main transaction if it is subordinate to the implementation of that transaction and is inseparably linked to it. The test of necessity implies that the restriction must be objectively necessary for the implementation of the main transaction and be proportionate to it. It follows that the ancillary restraints test is similar to the test set out in paragraph 15(2) above. However, the ancillary restraints test applies in all cases where the main

[8] See Commision's Guidelines on defining relevant market for the purposes of the Law on Protection of Competition.

transaction is not restrictive of competition. It is not limited to determining the impact of the agreement on intra-brand competition.

27. The application of the ancillary restraint concept must be distinguished from the application of the defence under Article 7(3) which relates to certain economic benefits produced by restrictive agreements and which are balanced against the restrictive effects of the agreements. The application of the ancillary restraint concept does not involve any weighing of pro-competitive and anti-competitive effects. Such balancing is reserved for Article 7(3).

28. The assessment of ancillary restraints is limited to determining whether, in the specific context of the main non-restrictive transaction or activity, a particular restriction is necessary for the implementation of that transaction or activity and proportionate to it. If on the basis of objective factors it can be concluded that without the restriction the main non-restrictive transaction would be difficult or impossible to implement, the restriction may be regarded as objectively necessary for its implementation and proportionate to it. If, for example, the main object of a franchise agreement does not restrict competition, then restrictions, which are necessary for the proper functioning of the agreement, such as obligations aimed at protecting the uniformity and reputation of the franchise system, also fall outside Article 7(1). Similarly, if a joint venture is not in itself restrictive of competition, then restrictions that are necessary for the functioning of the agreement are deemed to be ancillary to the main transaction and are therefore not caught by Article 7(1).

2.3. The exception rule of Article 7(3)

29. The assessment of restrictions by object and effect under Article 7(1) is only one side of the analysis. The other side, which is reflected in Article 7(3), is the assessment of the positive economic effects of restrictive agreements.

30. The aim of the competition rules is to protect competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources. Agreements that restrict competition may at the same time have pro-competitive effects by way of efficiency gains. Efficiencies may create additional value by lowering the cost of producing an output, improving the quality of the product or creating a new product. When the pro-competitive effects of an agreement outweigh its anti-competitive effects the agreement is on balance pro-competitive and compatible with the objectives of the competition rules. The net effect of such agreements is to promote the very essence of the competitive process, namely to win customers by offering better products or better prices than those offered by rivals. This analytical framework is reflected in Article 7(1) and Article 7(3). The latter provision expressly acknowledges that restrictive agreements may generate objective economic benefits so as to outweigh the negative effects of the restriction of competition.

31. The application of the exception rule of Article 7(3) is subject to four cumulative conditions, two positive and two negative:

(a) The agreement must contribute to improving the production or distribution of goods or contribute to promoting technical or economic progress.

(b) Consumers must receive a fair share of the resulting benefits.

(c) The restrictions must be indispensable to the attainment of these objectives, and finally

(d) The agreement must not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question.

When these four conditions are fulfilled the agreement enhances competition within the relevant market, because it leads the undertakings concerned to offer cheaper or better products to consumers, compensating the latter for the adverse effects of the restrictions of competition.

32. Article 7(3) can be applied either to individual agreements or to categories of agreements by way of regulations for block exemption. The application of Article 7(3) to categories of agreements by way of regulations for block exemption is based on the presumption that restrictive agreements that fall within their scope fulfil each of the four conditions laid down in Article 7(3).

33. If in an individual case the agreement is caught by Article 7(1) and the conditions of Article 7(3) are not fulfilled the block exemption may be withdrawn.

3. THE APPLICATION OF THE FOUR CONDITIONS OF ARTICLE 7(3)

34. The remainder of these guidelines will consider each of the four conditions of Article 7(3). Given that these four conditions are cumulative it is unnecessary to examine any remaining conditions once it is found that one of the conditions of Article 7(3) is not fulfilled. In individual cases it may therefore be appropriate to consider the four conditions in a different order.

35. For the purposes of these guidelines it is considered appropriate to invert the order of the second and the third condition and thus deal with the issue of indispensability before the issue of pass-on to consumers. The analysis of pass-on requires a balancing of the negative and positive effects of an agreement on consumers. This analysis should not include the effects of any restrictions, which already fail the indispensability test and which for that reason are prohibited by Article 7

3.1. General principles

36. Article 7(3) of the Law on Protection of the Competition only becomes relevant when an agreement between undertakings restricts

competition within the meaning of Article 7(1). In the case of non-restrictive agreements there is no need to examine any benefits generated by the agreement.

37. Where in an individual case a restriction of competition within the meaning of Article 7(1) has been proven, Article 7(3) can be invoked as a defence of the parties. The burden of proof under Article 7(3) rests on the undertaking(s) invoking the benefit of the exception rule. Where the conditions of Article 7(3) are not satisfied the agreement is null and void (Article 7(2). However, such automatic nullity only applies to those parts of the agreement that are incompatible with Article 7, provided that such parts are severable from the agreement as a whole.

38. According to law the four conditions of Article 7(3) are cumulative, i.e. they must all be fulfilled for the exception rule to be applicable. If they are not, the application of the exception rule of Article 7(3) must be refused. The four conditions of Article 7(3) are also exhaustive. When they are met the exception is applicable and may not be made dependant on any other condition.

39. The assessment under Article 7(3) of benefits flowing from restrictive agreements is in principle made within the confines of each relevant market to which the agreement relates. The competition rules have as their objective the protection of competition on the market and cannot be detached from this objective. Moreover, the condition that consumers must receive a fair share of the benefits implies in general that efficiencies generated by the restrictive agreement within a relevant market must be sufficient to outweigh the anti-competitive effects produced by the agreement within that same relevant market. Negative effects on consumers in one geographic market or product market cannot normally be balanced against and compensated by positive effects for consumers in another unrelated geographic market or product market. However, where two markets are related, efficiencies achieved on separate markets can be taken into account provided that the group of consumers affected by the restriction and benefiting from the efficiency gains are substantially the same. Indeed, in some cases only consumers in a downstream market are affected by the agreement in which case the impact of the agreement on such consumers must be assessed. This is for instance so in the case of purchasing agreements.

40. The assessment of restrictive agreements under Article 7(3) is made within the actual context in which they occur and on the basis of the facts existing at any given point in time. The assessment is sensitive to material changes in the facts. The exception rule of Article 7(3) applies as long as the four conditions are fulfilled and ceases to apply when that is no longer the case. When applying Article 7(3) in accordance with these principles it is necessary to take into account the initial sunk investments made by any of the parties and the time needed and the restraints required to commit and recoup an efficiency enhancing investment. Article 7 cannot be applied without taking due account of such ex ante investment. The risk facing the parties and the sunk investment that must be committed to implement the agreement can thus lead to the agreement falling outside Article 7(1) or fulfilling the conditions of Article 7(3), as the case may be, for the period of time required to recoup the investment.

41. In some cases the restrictive agreement is an irreversible event. Once the restrictive agreement has been implemented the ex ante situation cannot be re-established. In such cases the assessment must be made exclusively on the basis of the facts pertaining at the time of implementation. For instance, in the case of a research and development agreement whereby each party agrees to abandon its respective

research project and pool its capabilities with those of another party, it may from an objective point of view be technically and economically impossible to revive a project once it has been abandoned. The assessment of the anti-competitive and pro-competitive effects of the agreement to abandon the individual research projects must therefore be made as of the time of the completion of its implementation. If at that point in time the agreement is compatible with Article 7, for instance because a sufficient number of third parties have competing research and development projects, the parties' agreement to abandon their individual projects remains compatible with Article 7, even if at a later point in time the third party projects fail. However, the prohibition of Article 7 may apply to other parts of the agreement in respect of which the issue of irreversibility does not arise. If for example in addition to joint research and development, the agreement provides for joint exploitation, Article 7 may apply to this part of the agreement if due to subsequent market developments the agreement becomes restrictive of competition and does not (any longer) satisfy the conditions of Article 7(3) taking due account of ex ante sunk investments.

42. Article 7(3) does not exclude a priori certain types of agreements from its scope. As a matter of principle all restrictive agreements that fulfil the four conditions of Article 7(3) are covered by the exception rule. However, severe restrictions of competition are unlikely to fulfil the conditions of Article 7(3). Such restrictions are usually black-listed in the regulations for block exemption. Agreements of this nature generally fail (at least) the two first conditions of Article 7(3). They neither create objective economic benefits nor do they benefit consumers. For example, a horizontal agreement to fix prices limits output leading to misallocation of resources. It also transfers value from consumers to producers, since it leads to higher prices without producing any countervailing value to consumers within the relevant market. Moreover, these types of agreements generally also fail the indispensability test under the third condition.

43. Any claim that restrictive agreements are justified because they aim at ensuring fair conditions of competition on the market is by nature unfounded and must be discarded. The purpose of Article 7 is to protect effective competition by ensuring that markets remain open and competitive. The protection of fair conditions of competition is a task for the legislator in compliance with Law on Protection of Competition and not for undertakings to regulate themselves.

3.2. First condition of Article 7(3): Efficiency gains

3.2.1. *General remarks*

44. According to the first condition of Article 7(3) the restrictive agreement must contribute to improving the production or distribution of goods or services or to promoting technical or economic progress.

45. In principal, only objective benefits can be taken into account. This means that efficiencies are not assessed from the subjective point of view of the parties. Cost savings that arise from the mere exercise of market power by the parties cannot be taken into account. For instance, when companies agree to fix prices or share markets they reduce output and thereby production costs. Reduced competition may also lead to lower sales and marketing expenditures. Such cost reductions are a direct consequence of a reduction in output and value. The cost

reductions in question do not produce any pro-competitive effects on the market. In particular, they do not lead to the creation of value through an integration of assets and activities. They merely allow the undertakings concerned to increase their profits and are therefore irrelevant from the point of view of Article 7(3).

46. The purpose of the first condition of Article 7(3) is to define the types of efficiency gains that can be taken into account and be subject to the further tests of the second and third conditions of Article 7(3). The aim of the analysis is to ascertain what are the objective benefits created by the agreement and what is the economic importance of such efficiencies. Given that for Article 7(3) to apply the pro-competitive effects flowing from the agreement must outweigh its anti-competitive effects, it is necessary to verify what is the link between the agreement and the claimed efficiencies and what the value of these efficiencies is.

47. All efficiency claims must therefore be substantiated so that the following can be verified:
   (a) The nature of the claimed efficiencies;
   (b) The link between the agreement and the efficiencies;
   (c) The likelihood and magnitude of each claimed efficiency; and
   (d) How and when each claimed efficiency would be achieved.

48. Letter (a) allows the decision-maker to verify whether the claimed efficiencies are objective in nature, cf. paragraph 45 above.

49. Letter (b) allows the decision-maker to verify whether there is a sufficient causal link between the restrictive agreement and the claimed efficiencies. This condition normally requires that the efficiencies result from the economic activity that forms the object of the agreement. Such activities may, for example, take the form of distribution, licensing of technology, joint production or joint research and development. To the extent, however, that an agreement has wider efficiency enhancing effects within the relevant market, for example because it leads to a reduction in industry wide costs, these additional benefits are also taken into account.

50. The causal link between the agreement and the claimed efficiencies must normally also be direct. Claims based on indirect effects are as a general rule too uncertain and too remote to be taken into account. A direct causal link exists for instance where a technology transfer agreement allows the licensees to produce new or improved products or a distribution agreement allows products to be distributed at lower cost or valuable services to be produced. An example of indirect effect would be a case where it is claimed that a restrictive agreement allows the undertakings concerned to increase their profits, enabling them to invest more in research and development to the ultimate benefit of consumers. While there may be a link between profitability and research and development, this link is generally not sufficiently direct to be taken into account in the context of Article 7(3).

51. Letters (c) and (d) allow the decision-maker to verify the value of the claimed efficiencies, which in the context of the third condition of Article 7(3) must be balanced against the anti-competitive effects of the agreement, see paragraph 96 below. Given that Article 7(1) only applies in cases where the agreement has likely negative effects on competition and consumers (in the case of hard core restrictions such effects are presumed) efficiency claims must be substantiated so that they can be verified. Unsubstantiated claims are rejected.

52. In the case of claimed cost efficiencies the undertakings invoking the benefit of Article 7(3) must as accurately as reasonably possible calculate

or estimate the value of the efficiencies and describe in detail how the amount has been computed. They must also describe the method(s) by which the efficiencies have been or will be achieved. The data submitted must be verifiable so that there can be a sufficient degree of certainty that the efficiencies have materialised or are likely to materialise.

53. In the case of claimed efficiencies in the form of new or improved products and other non-cost based efficiencies, the undertakings claiming the benefit of Article 7(3) must describe and explain in detail what is the nature of the efficiencies and how and why they constitute an objective economic benefit.

54. In cases where the agreement has yet to be fully implemented the parties must substantiate any projections as to the date from which the efficiencies will become operational so as to have a significant positive impact in the market.

3.2.2. *The different categories of efficiencies*

55. The types of efficiencies listed in Article 7(3) are broad categories which are intended to cover all objective economic efficiencies. There is considerable overlap between the various categories mentioned in Article 7(3) and the same agreement may give rise to several kinds of efficiencies. It is therefore not appropriate to draw clear and firm distinctions between the various categories. For the purpose of these guidelines, a distinction is made between cost efficiencies and efficiencies of a qualitative nature whereby value is created in the form of new or improved products, greater product variety etc.

56. In general, efficiencies stem from an integration of economic activities whereby undertakings combine their assets to achieve what they could not achieve as efficiently on their own or whereby they entrust another undertaking with tasks that can be performed more efficiently by that other undertaking.

57. The research and development, production and distribution process may be viewed as a value chain that can be divided into a number of stages. At each stage of this chain an undertaking must make a choice between performing the activity itself, performing it together with (an) other undertaking(s) or outsourcing the activity entirely to (an)other undertaking(s).

58. In each case where the choice made involves cooperation on the market with another undertaking, an agreement within the meaning of Article 7(1) normally needs to be concluded. These agreements can be vertical, as is the case where the parties operate at different levels of the value chain or horizontal, as is the case where the firms operate at the same level of the value chain. Both categories of agreements may create efficiencies by allowing the undertakings in question to perform a particular task at lower cost or with higher added value for consumers. Such agreements may also contain or lead to restrictions of competition in which case the prohibition rule of Article 7(1) and the exception rule of Article 7(3) may become relevant.

59. The types of efficiencies mentioned in the following are only examples and are not intended to be exhaustive.

3.2.2.1. *Efficiency related to the costs (cost efficiencies)*

60. Cost efficiencies flowing from agreements between undertakings can originate from a number of different sources. One very important source of cost savings is the development of new production technologies and methods. In general, it is when technological leaps are made that the greatest potential for cost savings is achieved. For instance, the introduction of the assembly line led to a very substantial reduction in the cost of producing motor vehicles.

61. Another very important source of efficiency is synergies resulting from an integration of existing assets. When the parties to an agreement combine their respective assets they may be able to attain a cost/output configuration that would not otherwise be possible. The combination of two existing technologies that have complementary strengths may reduce production costs or lead to the production of a higher quality product. For instance, it may be that the production assets of firm A generate a high output per hour but require a relatively high input of raw materials per unit of output, whereas the production assets of firm B generate lower output per hour but require a relatively lower input of raw materials per unit of output. Synergies are created if by establishing a production joint venture combining the production assets of A and B the parties can attain a high(er) level of output per hour with a low(er) input of raw materials per unit of output. Similarly, if one undertaking has optimised one part of the value chain and another undertaking has optimised another part of the value chain, the combination of their operations may lead to lower costs. Firm A may for instance have a highly automated production facility resulting in low production costs per unit whereas B has developed an efficient order processing system. The system allows production to be tailored to customer demand, ensuring timely delivery and reducing warehousing and obsolescence costs. By combining their assets A and B may be able to obtain cost reductions.

62. Cost efficiencies may also result from economies of scale, i.e. declining cost per unit of output as output increases. To give an example: investment in equipment and other assets often has to be made in indivisible blocks. If an undertaking cannot fully utilise a block, its average costs will be higher than if it could do so. For instance, the cost of operating a truck is virtually the same regardless of whether it is almost empty, half-full or full. Agreements whereby undertakings combine their logistics operations may allow them to increase the load factors and reduce the number of vehicles employed. Larger scale may also allow for better division of labour leading to lower unit costs. Firms may achieve economies of scale in respect of all parts of the value chain, including research and development, production, distribution and marketing. Learning economies constitute a related type of efficiency. As experience is gained in using a particular production process or in performing particular tasks, productivity may increase because the process is made to run more efficiently or because the task is performed more quickly.

63. Economies of scope are another source of cost efficiency, which occur when firms achieve cost savings by producing different products on the basis of the same input. Such efficiencies may arise from the fact that it is possible to use the same components and the same facilities and personnel to produce a variety of products. Similarly, economies of scope may arise in distribution when several types of goods are distributed in the same vehicles. For instance, a producer of frozen pizzas and a producer of frozen vegetables may obtain economies of scope by jointly distributing their products. Both groups of products must be distributed in refrigerated vehicles and it is likely that there are significant overlaps in terms of customers. By combining their operations the two producers may obtain lower distribution costs per distributed unit.

64. Efficiencies in the form of cost reductions can also follow from agreements that allow for better planning of production, reducing the need to hold expensive inventory and allowing for better capacity utilisation. Efficiencies of this nature may for example stem from the use of "just in time" purchasing, i.e. an obligation on a supplier of components to continuously supply the buyer according to its needs thereby avoiding the need for the buyer to maintain a significant stock of components which risks becoming obsolete. Cost savings may also result from agreements that allow the parties to rationalise production across their facilities.

3.2.2.2. *Qualitative efficiencies*

65. Agreements between undertakings may generate various efficiencies of a qualitative nature which are relevant to the application of Article 7(3). In a number of cases the main efficiency enhancing potential of the agreement is not cost reduction; it is quality improvements and other efficiencies of a qualitative nature. Depending on the individual case such efficiencies may therefore be of equal or greater importance than cost efficiencies.

66. Technical and technological advances form an essential and dynamic part of the economy, generating significant benefits in the form of new or improved goods and services. By cooperating undertakings may be able to create efficiencies that would not have been possible without the restrictive agreement or would have been possible only with substantial delay or at higher cost. Such efficiencies constitute an important source of economic benefits covered by the first condition of Article 7(3). Agreements capable of producing efficiencies of this nature include, in particular, research and development agreements. An example would be A and B creating a joint venture for the development and, if successful, joint production of a cell-based tyre. The puncture of one cell does not affect other cells, which means that there is no risk of collapse of the tyre in the event of a puncture. The tyre is thus safer than traditional tyres. It also means that there is no immediate need to change the tyre and thus to carry a spare. Both types of efficiencies constitute objective benefits within the meaning of the first condition of Article 7(3).

67. In the same way that the combination of complementary assets can give rise to cost savings, combinations of assets may also create synergies that create efficiencies of a qualitative nature. The combination of production assets may for instance lead to the production of higher quality products or products with novel features. This may for instance be the case for licence agreements, and agreements providing for joint production of new or improved goods or services. Licence agreements may, in particular, ensure more rapid dissemination of new technology and enable the licensee(s) to make available new products or to employ new production techniques that lead to quality improvements. Joint production agreements may, in particular, allow new or improved products or services to be introduced on the market more quickly or at lower cost. In the telecommunications sector, for example, cooperation agreements have been held to create efficiencies by making available more quickly new global services. In the banking sector cooperation agreements that made available improved facilities for making cross-border payments have also been held to create efficiencies falling within the scope of the first condition of Article 7(3).

68. Distribution agreements may also give rise to qualitative efficiencies. Specialised distributors, for example, may be able to provide services

that are better tailored to customer needs or to provide quicker delivery or better quality assurance throughout the distribution chain.

3.3. Third condition of Article 7(3): Indispensability of the restrictions

69. According to the third condition of Article 7(3) the restrictive agreement must not impose restrictions, which are not indispensable to the attainment of the efficiencies created by the agreement in question. This condition implies a two-fold test. Firstly, the restrictive agreement as such must be reasonably necessary in order to achieve the efficiencies. Secondly, the individual restrictions of competition that flow from the agreement must also be reasonably necessary for the attainment of the efficiencies.

70. In the context of the third condition of Article 7(3) the decisive factor is whether or not the restrictive agreement and individual restrictions make it possible to perform the activity in question more efficiently than would likely have been the case in the absence of the agreement or the restriction concerned. The question is not whether in the absence of the restriction the agreement would not have been concluded, but whether more efficiencies are produced with the agreement or restriction than in the absence of the agreement or restriction.

71. The first test contained in the third condition of Article 7(3) requires that the efficiencies be specific to the agreement in question in the sense that there are no other economically practicable and less restrictive means of achieving the efficiencies. In making this latter assessment the market conditions and business realities facing the parties to the agreement must be taken into account. Undertakings invoking the benefit of Article 7(3) are not required to consider hypothetical or theoretical alternatives. The Commission for Protection of Competition will not second guess the business judgment of the parties. It will only intervene where it is reasonably clear that there are realistic and attainable alternatives. The parties must only explain and demonstrate why such seemingly realistic and significantly less restrictive alternatives to the agreement would be significantly less efficient.

72. It is particularly relevant to examine whether, having due regard to the circumstances of the individual case, the parties could have achieved the efficiencies by means of another less restrictive type of agreement and, if so, when they would likely be able to obtain the efficiencies. It may also be necessary to examine whether the parties could have achieved the efficiencies on their own. For instance, where the claimed efficiencies take the form of cost reductions resulting from economies of scale or scope the undertakings concerned must explain and substantiate why the same efficiencies would not be likely to be attained through internal growth and price competition. In making this assessment it is relevant to consider, inter alia, what is the minimum efficient scale on the market concerned. The minimum efficient scale is the level of output required to minimise average cost and exhaust economies of scale[9]. The larger the minimum efficient scale compared to the current size of either of the parties to the agreement, the more likely it is that the efficiencies will be deemed to be specific to the agreement. In the case of agreements that produce substantial synergies through the combination of complementary assets and capabilities the very nature of the

[9] Scale economies are normally exhausted at a certain point. Thereafter average costs will stabilise and eventually rise due to, for example, capacity constraints and bottlenecks.

efficiencies give rise to a presumption that the agreement is necessary to attain them.

73. These principles can be illustrated by the following hypothetical example:

A and B combine their respective production technologies in a joint venture to achieve higher output and lower raw material consumption. The joint venture is granted an exclusive licence to their respective production technologies. The parties transfer their existing production facilities to the joint venture. They also transfer key staff in order to ensure that existing learning economies can be exploited and further developed. It is estimated that these economies will reduce production costs by a further 5 %. The output of the joint venture is sold independently by A and B. In this case the indispensability condition necessitates an assessment of whether or not the benefits could be substantially achieved by means of a licence agreement, which would be likely to be less restrictive because A and B would continue to produce independently. In the circumstances described this is unlikely to be the case since under a licence agreement the parties would not be able to benefit in the same seamless and continued way from their respective experience in operating the two technologies, resulting in significant learning economies.

74. Once it is found that the agreement in question is necessary in order to produce the efficiencies, the indispensability of each restriction of competition flowing from the agreement must be assessed. In this context it must be assessed whether individual restrictions are reasonably necessary in order to produce the efficiencies. The parties to the agreement must substantiate their claim with regard to both the nature of the restriction and its intensity.

75. A restriction is indispensable if its absence would eliminate or significantly reduce the efficiencies that follow from the agreement or make it significantly less likely that they will materialise. The assessment of alternative solutions must take into account the actual and potential improvement in the field of competition by the elimination of a particular restriction or the application of a less restrictive alternative. The more restrictive the restraint the stricter the test under the third condition. Restrictions that are black listed in the regulations for block exemption are unlikely to be considered indispensable.

76. The assessment of indispensability is made within the actual context in which the agreement operates and must in particular take account of the structure of the market, the economic risks related to the agreement, and the incentives facing the parties. The more uncertain the success of the product covered by the agreement, the more a restriction may be required to ensure that the efficiencies will materialise. Restrictions may also be indispensable in order to align the incentives of the parties and ensure that they concentrate their efforts on the implementation of the agreement. A restriction may for instance be necessary in order to avoid hold-up problems once a substantial sunk investment has been made by one of the parties. Once for instance a supplier has made a substantial relationship-specific investment with a view to supplying a customer with an input, the supplier is locked into the customer. In order to avoid that ex post the customer exploits this dependence to obtain more favourable terms, it may be necessary to impose an obligation not to purchase the component from third parties or to purchase minimum quantities of the component from the supplier.

77. In some cases a restriction may be indispensable only for a certain period of time, in which case the exception of Article 7(3) only applies during

that period. In making this assessment it is necessary to take due account of the period of time required for the parties to achieve the efficiencies justifying the application of the exception rule. In cases where the benefits cannot be achieved without considerable investment, account must, in particular, be taken of the period of time required to ensure an adequate return on such investment, see also paragraph 40 above.

3.4. Second condition of Article 7(3): Fair share for consumers

3.4.1. General remarks

78. According to the second condition of Article 7(3) consumers must receive a fair share of the efficiencies generated by the restrictive agreement.

79. The concept of "consumers" encompasses all direct or indirect users of the products covered by the agreement, including producers that use the products as an input, wholesalers, retailers and final consumers, i.e. natural persons who are acting for purposes which can be regarded as outside their trade or profession. In other words, consumers within the meaning of Article 7(3) are the customers of the parties to the agreement and subsequent purchasers. These customers can be undertakings as in the case of buyers of industrial machinery or an input for further processing or final consumers as for instance in the case of buyers of impulse ice-cream or bicycles.

80. The concept of "fair share" implies that the pass-on of benefits must at least compensate consumers for any actual or likely negative impact caused to them by the restriction of competition found under Article 7(1). In line with the overall objective of Article 7 to prevent anti-competitive agreements, the net effect of the agreement must at least be neutral from the point of view of those consumers directly or likely affected by the agreement. If such consumers are worse off following the agreement, the second condition of Article 7(3) is not fulfilled. The positive effects of an agreement must be balanced against and compensate for its negative effects on consumers. When that is the case consumers are not harmed by the agreement. Moreover, society as a whole benefits where the efficiencies lead either to fewer resources being used to produce the output consumed or to the production of more valuable products and thus to a more efficient allocation of resources.

81. It is not required that consumers receive a share of each and every efficiency gain identified under the first condition. It suffices that sufficient benefits are passed on to compensate for the negative effects of the restrictive agreement. In that case consumers obtain a fair share of the overall benefits. If a restrictive agreement is likely to lead to higher prices, consumers must be fully compensated through increased quality or other benefits. If not, the second condition of Article 7(3) is not fulfilled.

82. The decisive factor is the overall impact on consumers of the products within the relevant market and not the impact on individual members of this group of consumers. In some cases a certain period of time may be required before the efficiencies materialise. Until such time the agreement may have only negative effects. The fact that pass-on to the consumer occurs with a certain time lag does not in itself exclude the application of Article 7(3). However, the greater the time lag the greater

must be the efficiencies to compensate also for the loss to consumers during the period preceding the pass-on.

83. In making this assessment it must be taken into account that the value of a gain for consumers in the future is not the same as a present gain for consumers. The value of saving 100 euro today is greater than the value of saving the same amount a year later. A gain for consumers in the future therefore does not fully compensate for a present loss to consumers of equal nominal size. In order to allow for an appropriate comparison of a present loss to consumers with a future gain to consumers, the value of future gains must be discounted. The discount rate applied must reflect the rate of inflation, if any, and lost interest as an indication of the lower value of future gains.

84. In other cases the agreement may enable the parties to obtain the efficiencies earlier than would otherwise be possible. In such circumstances it is necessary to take account of the likely negative impact on consumers within the relevant market once this lead-time has lapsed. If through the restrictive agreement the parties obtain a strong position on the market, they may be able to charge a significantly higher price than would otherwise have been the case. For the second condition of Article 7(3) to be satisfied the benefit to consumers of having earlier access to the products must be equally significant. This may for instance be the case where an agreement allows two tyre manufacturers to bring to market three years earlier a new substantially safer tyre but at the same time, by increasing their market power, allows them to raise prices by 5 %. In such a case it is likely that having early access to a substantially improved product outweighs the price increase.

85. The second condition of Article 7(3) incorporates a sliding scale. The greater the restriction of competition found under Article 7(1) the greater must be the efficiencies and the pass-on to consumers. This sliding scale approach implies that if the restrictive effects of an agreement are relatively limited and the efficiencies are substantial it is likely that a fair share of the cost savings will be passed on to consumers. In such cases it is therefore normally not necessary to engage in a detailed analysis of the second condition of Article 7(3), provided that the three other conditions for the application of this provision are fulfilled.

86. If, on the other hand, the restrictive effects of the agreement are substantial and the cost savings are relatively insignificant, it is very unlikely that the second condition of Article 7(3) will be fulfilled. The impact of the restriction of competition depends on the intensity of the restriction and the degree of competition that remains following the agreement.

87. If the agreement has both substantial anti-competitive effects and substantial pro-competitive effects a careful analysis is required. In the application of the balancing test in such cases it must be taken into account that competition is an important long-term driver of efficiency and innovation. Undertakings that are not subject to effective competitive constraints - such as for instance dominant firms - have less incentive to maintain or build on the efficiencies. The more substantial the impact of the agreement on competition, the more likely it is that consumers will suffer in the long run.

88. The following two sections describe in more detail the analytical framework for assessing consumer pass-on of efficiency gains. The first section deals with cost efficiencies, whereas the section that follows covers other types of efficiencies such as new or improved products (qualitative efficiencies). The framework, which is developed in these two

sections, is particularly important in cases where it is not immediately obvious that the competitive harms exceed the benefits to consumers or vice versa[10].

89. In the application of the principles set out below the Commission for Protection of Competition will have regard to the fact that in many cases it is difficult to accurately calculate the consumer pass-on rate and other types of consumer pass-on. Undertakings are only required to substantiate their claims by providing estimates and other data to the extent reasonably possible, taking account of the circumstances of the individual case.

3.4.2. Pass-on and balancing of cost efficiencies

90. When markets, as is normally the case, are not perfectly competitive, undertakings are able to influence the market price to a greater or lesser extent by altering their output[11]. They may also be able to price discriminate amongst customers.

91. Cost efficiencies may in some circumstances lead to increased output and lower prices for the affected consumers. If due to cost efficiencies the undertakings in question can increase profits by expanding output, consumer pass-on may occur. In assessing the extent to which cost efficiencies are likely to be passed on to consumers and the outcome of the balancing test contained in Article 7(3) the following factors are in particular taken into account:

(a) The characteristics and structure of the market,
(b) The nature and magnitude of the efficiency gains,
(c) The elasticity of demand, and
(d) The magnitude of the restriction of competition.

All factors must normally be considered. Since Article 7(3) only applies in cases where competition on the market is being appreciably restricted, there can be no presumption that residual competition will ensure that consumers receive a fair share of the benefits. However, the degree of competition remaining on the market and the nature of this competition influences the likelihood of pass-on.

92. The greater the degree of residual competition the more likely it is that individual undertakings will try to increase their sales by passing on cost efficiencies. If undertakings compete mainly on price and are not subject to significant capacity constraints, pass-on may occur relatively quickly. If competition is mainly on capacity and capacity adaptations occur with a certain time lag, pass-on will be slower. Pass-on is also likely to be slower when the market structure is conducive to tacit collusion[12]. If competitors are likely to retaliate against an increase in output by one or more parties to the agreement, the incentive to increase output may be tempered, unless the competitive advantage conferred by the efficiencies is such that the undertakings concerned have an incentive to break away from the common policy adopted on the market by the

[10] The competitive harm is referred to in terms of: higher prices,lower quality, less variety or lower innovation.
[11] In perfectly competitive markets individual undertakings are price-takers. They sell their products at the market price, which is determined by overall supply and demand. The output of the individual undertaking is so small that any individual undertaking's change in output does not affect the market price.
[12] Undertakings collude tacitly when in an oligopolistic market they are able to coordinate their action on the market without resorting to an explicit cartel agreement

members of the oligopoly. In other words, the efficiencies generated by the agreement may turn the undertakings concerned into so-called "mavericks"[13].

93. The nature of the efficiency gains also plays an important role. According to economic theory undertakings maximise their profits by selling units of output until marginal revenue equals marginal cost. Marginal revenue is the change in total revenue resulting from selling an additional unit of output and marginal cost is the change in total cost resulting from producing that additional unit of output. It follows from this principle that as a general rule output and pricing decisions of a profit maximising undertaking are not determined by its fixed costs (i.e. costs that do not vary with the rate of production) but by its variable costs (i.e. costs that vary with the rate of production). After fixed costs are incurred and capacity is set, pricing and output decisions are determined by variable cost and demand conditions. Take for instance a situation in which each of two companies produces two products on two production lines and operating only at half of their capacities. A specialisation agreement may allow the two undertakings to specialise in producing one of the two products and scrap their second production line for the other product. At the same time the specialisation may allow the companies to reduce variable input and stocking costs. Only the latter savings will have a direct effect on the pricing and output decisions of the undertakings, as they will influence the marginal costs of production. The scrapping by each undertaking of one of their production lines will not reduce their variable costs and will not have an impact on their production costs. It follows that undertakings may have a direct incentive to pass on to consumers in the form of higher output and lower prices efficiencies that reduce marginal costs, whereas they have no such direct incentive with regard to efficiencies that reduce fixed costs. Consumers are therefore more likely to receive a fair share of the cost efficiencies in the case of reductions in variable costs than they are in the case of reductions in fixed costs.

94. The fact that undertakings may have an incentive to pass on certain types of cost efficiencies does not imply that the pass-on rate will necessarily be 100 %. The actual pass-on rate depends on the extent to which consumers respond to changes in price, i.e. the elasticity of demand. The greater the increase in demand caused by a decrease in price, the greater the pass-on rate. This follows from the fact that the greater the additional sales caused by a price reduction due to an increase in output the more likely it is that these sales will offset the loss of revenue caused by the lower price resulting from the increase in output. In the absence of price discrimination the lowering of prices affects all units sold by the undertaking, in which case marginal revenue is less than the price obtained for the marginal product. If the undertakings concerned are able to charge different prices to different customers, i.e. price discriminate, pass-on will normally only benefit price-sensitive consumers[14].

95. It must also be taken into account that efficiency gains often do not affect the whole cost structure of the undertakings concerned. In such event the impact on the price to consumers is reduced. If for example an agreement allows the parties to reduce production costs by 6 %, but production costs only make up one third of the costs on the basis of which prices are determined, the impact on the product price is 2 %, assuming that the full amount is passed-on.

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[13] This term refers to undertakings that constrain the pricing behaviour of other undertakings in the market who might otherwise have tacitly colluded.
[14] The restrictive agreement may even allow the undertakings in question to charge a higher price to customers with a low elasticity of demand.

96. Finally, and very importantly, it is necessary to balance the two opposing forces resulting from the restriction of competition and the cost efficiencies. On the one hand, any increase in market power caused by the restrictive agreement gives the undertakings concerned the ability and incentive to raise price. On the other hand, the types of cost efficiencies that are taken into account may give the undertakings concerned an incentive to reduce price, see paragraph 93 above. The effects of these two opposing forces must be balanced against each other. It is recalled in this regard that the consumer pass-on condition incorporates a sliding scale. When the agreement causes a substantial reduction in the competitive constraint facing the parties, extraordinarily large cost efficiencies are normally required for sufficient pass-on to occur.

3.4.3. *Pass-on and balancing of other types of efficiencies*

97. Consumer pass-on can also take the form of qualitative efficiencies such as new and improved products, creating sufficient value for consumers to compensate for the anti-competitive effects of the agreement, including a price increase.

98. Any such assessment necessarily requires value judgment. It is difficult to assign precise values to dynamic efficiencies of this nature. However, the fundamental objective of the assessment remains the same, namely to ascertain the overall impact of the agreement on the consumers within the relevant market. Undertakings claiming the benefit of Article 7(3) must substantiate that consumers obtain countervailing benefits (see in this respect paragraphs 53 and 81 above).

99. The availability of new and improved products constitutes an important source of consumer welfare. As long as the increase in value stemming from such improvements exceeds any harm from a maintenance or an increase in price caused by the restrictive agreement, consumers are better off than without the agreement and the consumer pass-on requirement of Article 7(3) is normally fulfilled. In cases where the likely effect of the agreement is to increase prices for consumers within the relevant market it must be carefully assessed whether the claimed efficiencies create real value for consumers in that market so as to compensate for the adverse effects of the restriction of competition.

3.5. Fourth condition of Article 7(3): No elimination of competition

100. According to the fourth condition of Article 7(3) the agreement must not afford the undertakings concerned the possibility of eliminating competition in respect of a substantial part of the products concerned. Ultimately the protection of rivalry and the competitive process is given priority over potentially pro-competitive efficiency gains which could result from restrictive agreements. The last condition of Article 7(3) recognises the fact that rivalry between undertakings is an essential driver of economic efficiency, including dynamic efficiencies in the shape of innovation. In other words, the ultimate aim of Article 7 is to protect the competitive process. When competition is eliminated the competitive process is brought to an end and short-term efficiency gains are outweighed by longer-term losses stemming inter alia from expenditures incurred by the incumbent to maintain its position (rent seeking), misallocation of resources, reduced innovation and higher prices.

101. The concept in Article 7(3) of elimination of competition in respect of a substantial part of the products concerned is an autonomous concept in principle. However, in the application of this concept it is necessary to take account of the relationship between Article 7 and Article 11. Moreover, since Articles 7 and 11 both pursue the aim of maintaining effective competition on the market, consistency requires that Article 7(3) be interpreted as precluding any application of this provision to restrictive agreements that constitute an abuse of a dominant position. However, not all restrictive agreements concluded by a dominant undertaking constitute an abuse of a dominant position. This is for instance the case where a dominant undertaking is party to a non-full function joint venture, which is found to be restrictive of competition but at the same time involves a substantial integration of assets.

102. Whether competition is being eliminated within the meaning of the last condition of Article 7(3) depends on the degree of competition existing prior to the agreement and on the impact of the restrictive agreement on competition, i.e. the reduction in competition that the agreement brings about. The more competition is already weakened in the market concerned, the slighter the further reduction required for competition to be eliminated within the meaning of Article 7(3). Moreover, the greater the reduction of competition caused by the agreement, the greater the likelihood that competition in respect of a substantial part of the products concerned risks being eliminated.

103. The application of the last condition of Article 7(3) requires a realistic analysis of the various sources of competition in the market, the level of competitive constraint that they impose on the parties to the agreement and the impact of the agreement on this competitive constraint. Both actual and potential competition must be considered.

104. While market shares are relevant, the magnitude of remaining sources of actual competition cannot be assessed exclusively on the basis of market share. More extensive qualitative and quantitative analysis is normally called for. The capacity of actual competitors to compete and their incentive to do so must be examined. If, for example, competitors face capacity constraints or have relatively higher costs of production their competitive response will necessarily be limited.

105. In the assessment of the impact of the agreement on competition it is also relevant to examine its influence on the various parameters of competition. The last condition for exception under Article 7(3) is not fulfilled, if the agreement eliminates competition in one of its most important expressions. This is particularly the case when an agreement eliminates price competition or competition in respect of innovation and development of new products.

106. The actual market conduct of the parties can provide insight into the impact of the agreement. If following the conclusion of the agreement the parties have implemented and maintained substantial price increases or engaged in other conduct indicative of the existence of a considerable degree of market power, it is an indication that the parties are not subject to any real competitive pressure and that competition has been eliminated with regard to a substantial part of the products concerned.

107. Past competitive interaction may also provide an indication of the impact of the agreement on future competitive interaction. An undertaking may be able to eliminate competition within the meaning of Article 7(3) by concluding an agreement with a competitor that in the past has been a "maverick". Such an agreement may change the

competitive incentives and capabilities of the competitor and thereby remove an important source of competition in the market.

108. In cases involving differentiated products, i.e. products that differ in the eyes of consumers, the impact of the agreement may depend on the competitive relationship between the products sold by the parties to the agreement. When undertakings offer differentiated products the competitive constraint that individual products impose on each other differs according to the degree of substitutability between them. It must therefore be considered what is the degree of substitutability between the products offered by the parties, i.e. what is the competitive constraint that they impose on each other. The more the products of the parties to the agreement are close substitutes the greater the likely restrictive effect of the agreement. In other words, the more substitutable the products the greater the likely change brought about by the agreement in terms of restriction of competition on the market and the more likely it is that competition in respect of a substantial part of the products concerned risks being eliminated.

109. While sources of actual competition are usually the most important, as they are most easily verified, sources of potential competition must also be taken into account. The assessment of potential competition requires an analysis of barriers to entry facing undertakings that are not already competing within the relevant market. Any assertions by the parties that there are low barriers to market entry must be supported by information identifying the sources of potential competition and the parties must also substantiate why these sources constitute a real competitive pressure on the parties.

110. In the assessment of entry barriers and the real possibility for new entry on a significant scale, it is relevant to examine, inter alia, the following:

(i) The regulatory framework with a view to determining its impact on new entry.

(ii) The cost of entry including sunk costs. Sunk costs are those that cannot be recovered if the entrant subsequently exits the market. The higher the sunk costs the higher the commercial risk for potential entrants.

(iii) The minimum efficient scale within the industry, i.e. the rate of output where average costs are minimised. If the minimum efficient scale is large compared to the size of the market, efficient entry is likely to be more costly and risky.

(iv) The competitive strengths of potential entrants. Effective entry is particularly likely where potential entrants have access to at least as cost efficient technologies as the incumbents or other competitive advantages that allow them to compete effectively. When potential entrants are on the same or an inferior technological trajectory compared to the incumbents and possess no other significant competitive advantage entry is more risky and less effective.

(v) The position of buyers and their ability to bring onto the market new sources of competition. It is irrelevant that certain strong buyers may be able to extract more favourable conditions from the parties to the agreement than their weaker competitors. The presence of strong buyers can only serve to counter a prima facie finding of elimination of competition if it is likely that the buyers in question will pave the way for effective new entry.

(vi) The likely response of incumbents to attempted new entry. Incumbents may for example through past conduct have acquired a reputation of aggressive behaviour, having an impact on future entry.

(vii) The economic outlook for the industry may be an indicator of its longer-term attractiveness. Industries that are stagnating or in decline are less attractive candidates for entry than industries characterised by growth.

(viii) Past entry on a significant scale or the absence thereof.

111. The above principles can be illustrated by the following hypothetical examples, which are not intended to establish thresholds:

Firm A is brewer, holding 70 % of the relevant market, comprising the sale of beer through cafés and other on-trade premises. Over the past 5 years A has increased its market share from 60 %. There are four other competitors in the market, B, C, D and E with market shares of 10 %, 10 %, 5 % and 5 %. No new entry has occurred in the recent past and price changes implemented by A have generally been followed by competitors. A concludes agreements with 20 % of the on-trade premises representing 40 % of sales volumes whereby the contracting parties undertake to purchase beer only from A for a period of 5 years. The agreements raise the costs and reduce the revenues of rivals, which are foreclosed from the most attractive outlets. Given the market position of A, which has been strengthened in recent years, the absence of new entry and the already weak position of competitors it is likely that competition in the market is eliminated within the meaning of Article 7(3).

Shipping firms A, B, C, and D, holding collectively more than 70 % of the relevant market, conclude an agreement whereby they agree to coordinate their schedules and their tariffs. Following the implementation of the agreement, prices rise between 30 % and 100 %. There are four other suppliers, the largest holding about 14 % of the relevant market. There has been no new entry in recent years and the parties to the agreement did not lose significant market share following the price increases. The existing competitors brought no significant new capacity to the market and no new entry occurred. In light of the market position of the parties and the absence of competitive response to their joint conduct it can reasonably be concluded that the parties to the agreement are not subject to real competitive pressures and that the agreement affords them the possibility of eliminating competition within the meaning of Article 7(3).

A is a producer of electric appliances for professional users with a market share of 65 % of a relevant national market. B is a competing manufacturer with 5 % market share which has developed a new type of motor that is more powerful while consuming less electricity. A and B conclude an agreement whereby they establish a production joint venture for the production of the new motor. B undertakes to grant an exclusive licence to the joint venture. The joint venture combines the new technology of B with the efficient manufacturing and quality control process of A. There is one other main competitor with 15 % of the market. Another competitor with 5 % market share has recently been acquired by C, a major international producer of competing electric appliances, which itself owns efficient technologies. C has thus far not been active on the market mainly due to the fact that local presence and servicing is desired by customers. Through the acquisition C gains access to the service organisation required to penetrate the market. The entry of C is likely to ensure that competition is not being eliminated.