Joint production agreements
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Joint production agreements, whereby two or more parties agree the terms under which a product may be produced, are capable of giving rise to significant benefits for consumers and markets. For example, by producing goods together, companies can save costs that can be passed on to customers. Producing jointly can also help companies pool their complementary skills and know-how, or jointly invest more than they would be able to individually, thus leading to improved product quality or variety.

However, in certain circumstances joint production agreements can also give rise to serious competition law concerns, in particular where the parties have significant market power.

What is a joint production agreement?

Joint production agreements vary in form and scope, and can provide that production is carried out by only one party or by two or more parties jointly.

Where production is carried out jointly by two or more parties, this can be by way of either a joint venture (ie a jointly controlled company) or under a looser form of cooperation, such as a so-called ‘subcontracting agreement’, which may be horizontal or vertical in nature.

Under a horizontal subcontracting agreement, one party (the ‘contractor’) entrusts to another party operating at the same level of the market (the ‘subcontractor’) the production of a product. The parties need not be actual or potential competitors for the agreement to qualify as ‘horizontal’. By contrast, vertical subcontracting agreements are concluded between companies operating at different levels of the market.

Horizontal subcontracting agreements comprise three types of agreements, namely:
- unilateral specialisation agreements: agreements between two parties which are active in the same product market or markets, by virtue of which one party agrees to fully or partially cease production of certain products or to refrain from producing those products and to purchase them from the other party, which agrees to produce and supply the products
- reciprocal specialisation agreements: agreements between two or more parties which are active in the same products market or markets, by virtue of which two or more parties agree, on a reciprocal basis, to fully or partly cease or refrain from producing certain but different products and to purchase those products from the other parties, which agree to produce and supply them, and
- subcontracting agreements with a view to expanding production: agreements under which the contractor entrusts the subcontractor with the production of a good, while the contractor does not at the same time cease or limit its own production of the good

It is important to identify what category the particular agreement being drafted or reviewed falls under, as this will impact on the competition law rules applicable. See further, Applying EU competition law to cooperation between competitors--worked examples.

Underlying competition law principles and main competition concerns

Joint production agreements which may affect trade between EU Member States are subject to the rule contained in Article 101(1) TFEU, which prohibits agreements, the object or effect of which is to restrict competition.

References:
Article 101 TFEU

Joint production agreements may be designed to, or have the effect of, restricting competition in several markets, namely:
Joint production agreements

- the market(s) to which the products manufactured under the production agreement belong (ie directly affected by the cooperation), and/or
- so-called ‘spill-over markets’, such as the markets upstream or downstream to the market(s) directly concerned by the agreement. A spill-over market is likely to be relevant if the markets are interdependent and the parties are in a strong position on that spill-over market

Production agreements can restrict competition on these markets in several ways. For example:

- in particular in the case of a production joint venture, they may lead to a direct limitation of competition between the parties, such as limitations on or alignment between the parties concerning the output, quality, prices or other competitively important parameters of the joint venture’s sales
- where the parties have market power and the market characteristics are conducive to coordination, they may result in the coordination of the parties’ competitive behaviour as suppliers (ie a collusive outcome), which can result in higher prices or reduced output, product quality, product variety or innovation, and
- they can lead to anti-competitive foreclosure of third parties in a related market—for example, by gaining enough market power, the parties engaging in joint production in an upstream market may be able to raise the price of a key component for a market downstream. They can thus use the joint production to raise the input costs of their rivals downstream and ultimately force them off the market

Framework for assessing joint production agreements under EU competition law

In order to determine whether a joint production agreement might have the object or effect of giving rise to one or more of the above anti-competitive outcomes, the following steps need to be applied:

- first, all horizontal agreements between the companies engaging in joint production need to be assessed according to the European Commission’s guidelines on assessing the compatibility of an individual horizontal agreement with Article 101(1) TFEU (the ‘Horizontal Guidelines’) These guidelines apply to all forms of joint production agreements and horizontal subcontracting agreements

In addition, certain joint production agreements as well as unilateral and reciprocal specialisation agreements may benefit from automatic exemption under the European Commission’s Specialisation Block Exemption Regulation if the parties’ combined market share falls under specified thresholds and certain conditions are met.

References:
Regulation 1218/2010
- secondly, even if the above assessment leads to the conclusion that the joint production arrangement does not give rise to competition law concerns, a further assessment will be necessary to examine all relevant vertical agreements between the parties (if any)

This assessment will follow the rules of the European Commission’s Block Exemption Regulation on Vertical Restraints (the ‘Vertical Block Exemption’) and accompanying guidelines (the ‘Guidelines on Vertical Restraints’).

References:
Regulation 330/2010
EU vertical restraints guidelines

See further Competition issues impacting vertical commercial agreements.

Finally, be aware that a vertical subcontracting agreement might be subject to the European Commission’s Subcontracting Notice, which should therefore be consulted when dealing with that form of agreement.

References:
Commission subcontracting agreements notice

Application of specific assessment criteria under Horizontal Guidelines

Assessment under Article 101(1) TFEU

Article 101(1) TFEU prohibits restrictions of competition by object or effect.

Restrictions of competition by object

Generally-speaking, an agreement which involves price-fixing, limiting output or sharing markets or customers will be deemed to restrict competition by object.

However, the Horizontal Guidelines provide two exceptions to this rule in the context of production agreements, namely:

- where the parties agree on the output directly concerned by the production agreement (for example, the capacity and production volume of a joint venture or the agreed amount of outsourced products), provided that the other parameters of competition are not eliminated, or
- where a production agreement that also provides for the joint distribution of the jointly manufactured products envisages the joint setting of the sales prices for those products, and only
those products, provided that that restriction is necessary for producing jointly (meaning that the parties would not otherwise have an incentive to enter into the production agreement in the first place)

In these limited circumstances, the restrictions will not be considered restrictions by object. However, an assessment will still be required as to whether the agreement gives rise to likely restrictive effects on competition within the meaning of Article 101(1) TFEU.

See further, What is the object test?.

Restrictions of competition by effect

The key consideration in this assessment is whether the parties to the agreement have market power in any affected markets. Absent market power, the Horizontal Guidelines accept that a production agreement is unlikely to lead to restrictive effects on competition, as it is only market power that can enable the parties to (for example) profitably maintain prices above the competitive level, or profitably maintain output, product quality or variety below what would be dictated by competition.

The following factors need to be taken into account in determining the presence or absence of market power:

• as a starting point, the parties’ combined market share(s) in the market(s) concerned
• the degree of concentration in the market(s)
• how dynamic the market(s) is/are, having regard to whether and how frequently entry occurs and market positions change, and
• other variables impacting on the likely effects of a production agreement on competition

The parties’ combined market share(s)

EU competition law accepts that companies are unlikely to have market power below a certain level of market share. Therefore it provides two possible ‘safe harbours’ for joint production agreements where the parties’ market share falls below specified thresholds:

• firstly, unilateral specialisation agreements, reciprocal specialisation agreements and joint production agreements which include certain integrated commercialisation functions such as joint distribution may benefit from automatic exemption under the Specialisation Block Exemption Regulation if they are concluded between parties with a combined market share not exceeding 20% in the relevant market or markets, and they do not contain any ‘hardcore restrictions’. These are restrictions with the following object:
  • the fixing of sales prices (except that in the context of a joint distribution arrangement or production joint venture, it is generally permissible to fix prices charged to immediate customers)
  • the limitation of output or sales (except that in the case of a unilateral or reciprocal specialisation agreement, the parties can generally agree the amount of products to be supplied; and in the case of a joint production agreement, the parties can agree to set the capacity and production volume of a production joint venture and sales targets); or
  • the allocation of markets or customers
  • similarly, horizontal subcontracting agreements with a view to expanding production may benefit from a safe harbour under the Horizontal Guidelines if the parties’ combined market share does not exceed 20%

References:
EU Horizontal cooperation guidelines, para 169

However, if the parties’ combined market share exceeds 20%, the following factors need to be considered in determining the extent of their market power (if any).

The degree of market concentration

Generally, a production agreement will be more likely to have restrictive effects on competition in a concentrated market than in a market which is not concentrated.

The Horizontal Guidelines indicate that a ‘moderately higher market share’ than 20% does not necessarily imply a highly concentrated market, and may occur in a market with a moderate concentration.

Conversely, a production agreement in a concentrated market may increase the risk of a collusive outcome even if the parties only have a moderate combined market share.

How dynamic the market is

Even if the market shares of the parties to the agreement and the market concentration are high, the risks of restrictive effects on competition may still be low if the market is dynamic, that is, entry into the market occurs and market positions change frequently.

Other variables

The Horizontal Guidelines identify additional variables that should be analysed in determining the likely effects of a production agreement on competition and thereby the applicability of Article 101(1) TFEU. These include:

• the characteristics of the parties, product or market in which the agreement takes place
• where one party has market power and the other party is a potential market entrant (eg a supplier of the same product in a neighbouring geographical or product market), the agreement can potentially increase the market power of the incumbent. This can lead to restrictive effects on competition if actual competition in the incumbent’s market is already weak and the threat of entry is a major source of competitive constraint
• In some industries where production is the main economic activity, even a pure production agreement can in itself eliminate key dimensions of competition, thereby directly limiting competition between the parties
• generally-speaking, EU competition law recognises that
horizontal production agreements are not likely to have restrictive effects on competition if the cooperation gives rise to a new market, that is, it enables the parties to launch a new product or service, which, on the basis of objective factors (eg the parties' technical capabilities) they would otherwise not have been able to do

• the nature of the cooperation
• production agreements which also involve commercialisation functions, such as joint distribution or marketing, carry a higher risk of restrictive effects on competition than pure joint production agreements. This is because joint commercialisation brings the cooperation closer to the consumer and usually involves the joint setting of prices and sales (ie practices that carry the highest risks for competition)
• however, joint distribution agreements for products which have been jointly produced are generally less likely to restrict competition than stand-alone joint distribution agreements. Also, a joint distribution agreement that is necessary for the joint production agreement to take place in the first place is less likely to restrict competition than if it were not necessary for the joint production.
• a collusive outcome can result from commonality of costs. The Horizontal Guidelines explain that a production agreement is more likely to lead to a collusive outcome if, prior to the agreement, the parties already had a high proportion of variable costs in common. This is because the additional increment (ie the production costs of the product subject to the agreement) can ‘tip the balance’ towards a collusive outcome. Conversely, if the increment is large, the risk of a collusive outcome may be high even if the initial level of commonality of costs is low
• a production agreement can also give rise to restrictive effects on competition if it involves an exchange of commercially strategic information that can lead to a collusive outcome or anti-competitive foreclosure. Whether the exchange of information in the context of a production agreement is likely to lead to restrictive effects on competition should be assessed according to the guidance given in Chapter 2 of the Horizontal Guidelines, which deals with Information Exchange specifically (see further, Information exchange and disclosure-managing heightened competition risk)

References:
EU Horizontal cooperation guidelines, chapter 2
See further, Assessing the anti-competitive effect of an agreement

Assessment under Article 101(3)TFEU

If an agreement is found to be restrictive of competition within the meaning of Article 101(1) TFEU, it is necessary to determine whether it produces any pro-competitive benefits and to assess whether those pro-competitive benefits outweigh the restrictive effects on competition.

The balancing of restrictive and pro-competitive effects is conducted exclusively within the framework laid down by Article 101(3) TFEU. If the pro-competitive effects do not outweigh a restriction of competition, Article 101(2) TFEU stipulates that the agreement shall be automatically void. For the general principles as to how to assess an agreement under Article 101(3) TFEU, see further Competition issues impacting horizontal commercial agreements. With respect to the specific principles applicable to joint production agreements, the Horizontal Guidelines provide the following:

• production agreements can be pro-competitive if they provide efficiency gains in the form of cost savings or better production technologies or quality
• however, restrictions that go beyond what is necessary to achieve the efficiency gains generated by a production agreement do not fulfil the criteria of Article 101(3) TFEU. For example, the following will generally not be considered indispensable:
  • restrictions on the parties’ competitive conduct with regard to output outside the cooperation
  • the joint setting of prices, if the production agreement does not also involve joint commercialisation
  • in addition, where the cooperation involves the exchange of information, it should not exceed the sharing of data necessary for the joint production of the goods subject to the agreement
• in addition, efficiency gains attained by indispensable restrictions need to be passed on to consumers in the form of lower prices or better product quality or variety to an extent that outweighs the restrictive effects on competition. Efficiency gains that only benefit the parties or cost savings that are caused by output reduction or market allocation are not sufficient to meet the criteria of Article 101(3) TFEU
• the criteria of Article 101(3) TFEU will not be met if the parties are afforded the possibility of eliminating competition in respect of a substantial part of the products in question

Joint production agreements can be hugely beneficial for consumers and markets, as well as the parties concerned. However, a joint production agreement found to be restrictive of competition within the meaning of Article 101(1) TFEU, which is not saved by Article 101(3) TFEU, will be automatically void and unenforceable.