

A S Watson Europe response to the Commission's review of the Block Exemption Regulation and Guidelines on vertical restraints

I. INTRODUCTION

This document is the response of A S Watson Europe to the Commission's public consultation on the Block Exemption Regulation and Guidelines on vertical restraints. A S Watson (ASW) is part of Hutchison Whampoa Limited, a leading international corporation with five core businesses: ports and related services; property and hotels; retail; energy, infrastructure, investments and others; and telecommunications.

ASW has over 8,400 retail stores in 34 countries worldwide. In Europe, the A S Watson Group operates over 4,600 stores in 23 countries under the following brands:

Health and Beauty

DC (Ukraine)
Drogas (Latvia and Lithuania)
Kruidvat (Belgium and Netherlands)
Rossmann (Czech Republic, Germany, Hungary and Poland)
Savers (United Kingdom)
Spektr (Russia)
Superdrug (Ireland and United Kingdom)
Trekpleister (Netherlands)

Luxury Perfumeries and Cosmetics

ICI PARIS XL (Belgium, Luxembourg and Netherlands)
Marionnaud (Austria, Czech Republic, France, Hong Kong, Hungary, Israel, Italy, Morocco, The Philippines, Poland, Portugal, Romania, Slovakia, Spain and Switzerland)
The Perfume Shop (Ireland and United Kingdom)

II. SUMMARY OF RESPONSE

ASW welcomes and supports the Commission's proposal to renew the block exemption for a further ten years, and agrees with the conclusion that *'the rules are working well overall and should not be fundamentally modified'*.

ASW is concerned however with the Commission's two main proposals for change concerning the introduction of a market share threshold on distributors and the treatment of on-line distribution. The proposals in both these areas do not seem to be motivated by an analysis of their competition effects, and would reduce legal certainty and prohibit agreements that improve distribution and, therefore, benefit consumers.

In summary, ASW comments on the proposed changes in both of these areas.

- **Market share threshold:** The introduction of a 30% market share threshold on distributors would introduce an extra layer of complexity leading to legal uncertainty for retailers. This lack of legal certainty would impose significant costs on businesses and lead them to take a cautious approach. The Commission has not fully explained the reason for its concern with the increased buyer power of large retailers, nor justified its departure from the current position. It is disproportionate to disapply the benefits of the block exemption to all vertical agreements where the buyer has a market share exceeding 30%, when the concerns identified are ill defined and would only apply to a limited class of agreements. Any such concerns could be dealt with by the Article 6 withdrawal procedure.
- **Restricting on-line sales:** Allowing suppliers to impose restrictions on bricks-and-mortar distribution but not equivalent restrictions on on-line distribution is no longer appropriate given the growth and increased sophistication of the internet. On-line distribution is now a mature sales channel and the Commission should treat it the same as any other distribution channel. Suppliers, within a selective distribution system or otherwise, should be free to restrict on-line distribution and impose qualitative criteria in the same way they can on bricks-and-mortar distribution, including the ability to determine which markets their distributors may target. The Commission should amend the Guidelines to be neutral between bricks-and-mortar and on-line distribution.

Minimum off-line sales: The draft Guidelines seem to be contradictory in that they recognise the reasonableness of suppliers restricting pure-internet distributors but then limit the permitted restrictions to the point that they are ineffective. The Commission should allow suppliers to require their distributors to make an appropriate investment in and commitment to their products by setting a minimum percentage of off-line sales.

- **Equivalence of criteria for authorized distributors on-line and off-line:** The Commission's recognition that 'equivalent' conditions for on-line and off-line distributors need not be identical is welcome, but the Commission must recognise that conditions that pursue the same objective may look very different.

III. DETAILED RESPONSE

ASW agrees with the Commission that *'the rules are working well overall and should not be fundamentally modified'*. For this reason, ASW welcomes and supports the Commission's proposal to renew the block exemption for a further ten years. There is much in the draft Regulation and Guidelines that ASW supports. For example, the treatment of upfront access payments and category management agreements, and the recognition of the efficiencies that can be gained from these arrangements.

Fundamentally, the Commission should ensure the block exemption allows restrictions that achieve the positive effects described at paragraphs 102 to 105 of the draft Guidelines. The purpose of the Regulation and Guidelines is to ensure that vertical agreements that give rise to those positive effects are exempted from competition law scrutiny and that parties to such agreements have legal certainty.

The introduction of a market share threshold on distributors and the inconsistency in treatment between the internet and bricks-and-mortar are of particular concern. Restrictions that the Commission recognizes are justified in the bricks-and-mortar world are not permitted on the internet, simply because it is the internet. No justification is offered for this different treatment.

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The Regulation and Guidelines are not tools of industrial policy and should not be used as such. The consequences of engineering a particular policy through a competition law Regulation that will be in force for 10 years could be detrimental to Europe's distribution sector and, ultimately, consumers.

These points are described in detail below.

Buyer power of large retailers

Market share threshold

Article 3 of the draft revised Regulation would restrict the exemption to situations where *'the market share held by each of the undertakings party to the agreement does not exceed 30% on any of the relevant markets affected by the agreement.'* This contrasts with the current Regulation which restricts the exemption to situations where the market share of the supplier does not exceed 30%, except for exclusive supply obligations, where the market share of the buyer (on the market in which it purchases the goods) must also not exceed 30%.

The introduction of a 30% market share threshold on distributors would introduce an extra layer of complexity leading to legal uncertainty for retailers. This assumes that the parties to a distribution system all have access to reliable information, and understand clearly the scope of the relevant market (product and geographic) at issue. Suppliers may not know the market share of their distributors, and one distributor within a distribution system may not know with sufficient certainty the market shares of other distributors. The result is that parties to a distribution system (particularly a European-wide system) could not be sure whether or not they benefit from the block exemption. This lack of legal certainty could impose significant costs on businesses and lead them to take a cautious approach, thus denying the market and consumers the benefits of vertical agreements.

The Regulation as originally conceived allowed parties a considerable degree of freedom of contract, and legal certainty. This would be undermined if this proposal were to be adopted, for what appears to be an ill-defined purpose.

According to the press release, the purpose of this change is to address *'the increased buyer power of big retailers'*. The Commission does not, however, explain the reason for its concern. At the very least, a change of this magnitude to the Regulation should be properly explained and thorough analysis provided of how the change satisfies the underlying competition law concern, including an assessment of its costs and benefits.

Paragraph 190 of the draft Guidelines does identify a potential foreclosure concern and points to the relevance of the 30% market share threshold for both the buyer's upstream and downstream markets in the context of exclusive supply agreements. Similarly, paragraph 152 identifies a potential concern in the context of exclusive distribution agreements where *'the exclusive distributor becomes the exclusive buyer for a whole market'*, leading to the foreclosure of other distributors. The draft Guidelines give the example of a supermarket chain becoming the only distributor of a leading brand. Both of these instances are where the supplier is obliged to sell the product to a single buyer only.

These paragraphs indicate that the Commission's concern may be the foreclosure of other distributors. This concern would, however, only apply to a limited class of agreements. It is disproportionate to disapply the benefits of the block exemption to all vertical agreements where

the buyer has a market share exceeding 30%, when the identified concerns relate only to a small class of agreements.

In many cases where suppliers have market power, economic theory suggests that the exercise of buyer power by distributors will lead to lower input prices and a higher quantity of the input purchased than where buyer power is absent. Therefore, the market share threshold on buyers may remove the benefits of the block exemption from markets where consumers are benefiting from the effects of buyer power.

ASW sees no reason for the Commission to depart from the statement in paragraph 22 of the current Guidelines:

"... The simplified approach of the Block Exemption Regulation, which only takes into account the market share of the supplier or the buyer (as the case may be) on the market between these two parties, is justified by the fact that below the threshold of 30% the effects on downstream markets will in general be limited. In addition, only having to consider the market between supplier and buyer makes the application of the Block Exemption Regulation easier and enhances the level of legal certainty, while the instrument of withdrawal (see paragraphs 71 to 87) remains available to remedy possible problems on other related markets. "

ASW urges the Commission to reconsider this proposal. The adoption of a blanket approach to deal with a theoretical problem that may arise (and which could be dealt with by the Article 6 withdrawal procedure) is disproportionate and would lead to legal uncertainty.

The introduction of a 30% market share threshold on distributors would introduce an extra layer of complexity leading to legal uncertainty for retailers. This lack of legal certainty would impose significant costs on businesses and lead them to take a cautious approach. The Commission has not fully explained the reason for its concern with the increased buyer power of large retailers, nor justified its departure from the current position. It is disproportionate to disapply the benefits of the block exemption to all vertical agreements where the buyer has a market share exceeding 30%, when the concerns identified are ill defined and would only apply to a limited class of agreements. Any such concerns could be dealt with by the Article 6 withdrawal procedure.

On-line distribution

The Commission recognises that it needs to balance the ability of consumers to purchase across borders with the need to prevent on-line distributors from free-riding on the investments of other distributors. However, rather than striking a balance, the proposals would prevent many of the restrictions that the Commission recognises have positive effects and that are justified in the bricks-and-mortar world from being applied to on-line distribution.

The problem is the combination of (i) the effective prohibition of restrictions on internet sales, including the continued characterization of internet distribution as largely passive (and, therefore, unrestricted) and (ii) new text effectively forcing suppliers to supply on-line distributors subject to them having a bricks-and-mortar store or showroom. The result is that any on-line distributor with a single store or showroom somewhere in the EU would be able to sell throughout the EU.

The Commission's proposed treatment of on-line distribution is in complete contrast to the permitted restrictions on bricks-and-mortar distribution. There the draft Guidelines recognise that suppliers should be able to supply only a limited number of dealers in a territory and be able to

determine their location. They recognise that the free-rider, hold-up and vertical externality problems justify these restrictions. In contrast, on-line distribution is afforded special treatment that denies suppliers the possibility of managing their on-line distribution so as to overcome those problems.

There is no obvious justification for this difference in treatment between bricks-and-mortar distributors and on-line distributors, other than deliberately to promote unrestrained internet distribution. However, the purpose of the Regulation and Guidelines should not be to promote one form of distribution over another. Instead they should ensure the block exemption permits (objectively justifiable) restrictions that achieve the positive effects described at paragraphs 102 to 105 of the draft Guidelines. Severely limiting the restrictions that suppliers can place on online distribution will not do that. Instead it will distort market outcomes and undermine the positive effects of vertical agreements.

Treating bricks-and-mortar and on-line distribution differently is not appropriate. First, there is not the clear distinction between bricks-and-mortar and on-line that the Commission seems to draw. Most bricks-and-mortar retailers also sell on-line but by having a significant bricks-and-mortar presence they have invested in providing a quality environment and the customer service that goes along with it. Vertical restrictions on on-line sales do not mean that consumers are denied the opportunity to purchase on-line. Rather, they mean that consumers can purchase online from retailers with a record of and a commitment to providing quality products with a high quality of service. The Commission recognizes this as a legitimate objective and one it permits in the bricks-and-mortar world. Equally, it is not necessary to change the existing Regulation and Guidelines by skewing the rules to require unrestrained internet distribution in order to promote on-line sales, since on-line selling is already common practice.¹

Second, internet distribution carries its own unique risks. It is far more difficult to control the on-line supply chain and so consumers are more exposed to the risks of counterfeit products. With some products this could have consequences for the health and safety of consumers. Experience of e-Commerce to date has revealed concerns that do not arise with bricks-and-mortar retailing, for example, the protection of minors, spam, misleading advertising and piracy. These concerns suggest that consumers can be exposed to risks from on-line distribution that justify a cautious approach. It is certainly legitimate for suppliers to adopt a cautious approach to on-line distribution to protect the reputation of their products.

A recent investigation by the Commission highlighted the often poor service provided by on-line distributors.² It found that *'55% of the websites investigated showed irregularities in particular relating to: misleading information about consumer rights; misleading information about the total cost of the product; or incomplete contact details for the trader.'* Although the investigation concerned electrical goods it highlights the legitimate concern suppliers may have to ensure on-line distribution is undertaken only by distributors with a reputation for selling quality products in a high quality environment and by distributors that have invested in the products. If consumers have a poor experience buying a product on-line it will often be the supplier that suffers the

A recent article in the Wall Street Journal ("P&G looks to the Web", 3 September 2009) reports on the growth of on-line sales and suppliers' interest in promoting those sales. It notes, *"The shift online can be traced partly to demographic changes and younger consumers, who are increasingly comfortable online.... Some shoppers are also drawn to Web shopping because of the online product ratings and reviews."*

Consumers: EU crackdown on websites selling consumer electronic goods, Brussels, 9 September 2009

consequences, either through the adverse impact on the brand image or the direct costs of remedying complaints.

Further, the Commission should examine existing vertical restrictions on off-line distributors before it changes the rules to favour on-line distribution. Some of the restrictions suppliers impose on distributions place a disproportionate burden on bricks-and-mortar distributors and already distort competition. For example, requirements to stock a supplier's full range must normally be satisfied in every bricks-and-mortar store but in only one central warehouse for an on-line distributor. The Commission should be aiming for undistorted competition and this may mean re-examining the permitted restrictions on bricks-and-mortar distributors as well as on on-line distributors.

The draft Regulation and Guidelines are intended to be in force for 10 years and it is difficult to predict how markets and consumer habits will evolve over that period. 10 years ago internet sales barely existed but, with very little promotion by on-line retailers, have grown to become a significant part of total retailing activity. The Commission should not use a Regulation and Guidelines that are intended to be in force for 10 years to try to engineer short term changes in markets and consumer habits. The consequences for consumers and the wider economy could be significant and detrimental. Skewing the market in favour of on-line distribution could lead to a loss of bricks-and-mortar retailing, with a likely significant impact on employment and society. Distorting markets in this way to achieve a political outcome is not the role of competition policy.

Restricting on-line sales

Given the developments in internet distribution outlined above, it is timely for the Commission to review its treatment of on-line distribution to ensure equal treatment of on-line and off-line distribution. Within a selective distribution system, suppliers are not allowed to restrict the online distribution activities of authorized dealers. This contrasts with the restrictions they are allowed to place on bricks-and-mortar distributors. More generally, key to the balance the Commission strikes with on-line distribution is the distinction between active and passive selling. This distinction is no longer relevant given developments in internet distribution.

Selective distribution

Within a selective distribution system, suppliers are allowed to manage the location of their distributors' bricks-and-mortar stores. They are also allowed to limit the number of distributors within a territory. This is clearly explained in paragraph 58 of the draft Guidelines. These restrictions are permitted to enable suppliers to secure an appropriate environment for their products but also, crucially, to enable suppliers to manage their distribution networks to overcome, *inter alia*, the hold-up and vertical externality problems.

The positive effects of these restrictions in bricks-and-mortar distribution are undermined by requiring unrestricted distribution on-line. How can suppliers limit the number of distributors in a territory to protect relationship-specific investments if there must be unrestricted on-line distribution? Suppliers must be allowed to restrict active sales on-line just as they do off-line in the context of selective distribution.

Active v. passive sales

The distinction between active and passive sales is central to the Commission's approach to on-line distribution. As explained in the press release, *'The Commission's suggested approach*

therefore refines, in the on-line context, the distinction between sales made as a result of active marketing and sales made as a result of the consumer taking the initiative (i.e. between active and passive sales),...'

The Commission's approach is to allow suppliers to restrict active sales but not passive sales. The definitions of 'active' and 'passive' are to be found at paragraph 51. Active is described as approaching individual customers or customer groups through advertisements, targeted promotions or establishing a distribution outlet. Paragraph 52 further clarifies that distributors must be free to use the internet to advertise or sell and that, *'In general, the use of the internet is not considered a form of active sales into such territories or customer groups, since it is a reasonable way to reach every customer.'* Further, *'The language options used on the website or in the communication play normally no role in that respect.'* The draft revised Guidelines are little changed from the current Guidelines in these respects.

However, over the last 10 years on-line sales have grown massively and on-line selling techniques have evolved and are now more sophisticated. Global internet-only distributors were only just emerging 10 years ago whereas now they are household names throughout the world. Unlike 10 years ago, on-line distribution is now a mature business and will further mature over the next 10 years, the life of the revised Regulation and Guidelines. The Commission should revise its approach to on-line distribution to take account of this.

It is now clear that the definition of passive sales is too wide and encompasses activities that should properly be characterized as active. It is no longer appropriate to characterize the use of the internet as generally a form of passive selling. There are many on-line selling techniques that actively target certain markets. For example, a distributor may pay an on-line search engine outside of its own territory to be at the top of its list of results for specified search criteria. Since search engines sell these positions by national market, this is clearly an active selling technique because the distributor is paying for a targeted advertisement to be seen by consumers outside of its own territory.

In addition, language is a relevant consideration, even if it is not decisive. No business will voluntarily invest in a foreign language website unless it believes it will make a return on that investment, typically through the additional sales it generates.

Furthermore, the brand awareness and strength of some global on-line retailers is so great that they need not promote themselves actively to attract sales. Much internet use is viral and many websites become huge global businesses without actively promoting themselves. The idea that these sites are active in some markets but passive in others does not reflect reality. These internet-only distributors are very different from a bricks-and-mortar retailer that also has a website offering on-line sales. The latter may be active primarily in one national market and only passively selling into others.

In view of the developments in on-line distribution the Commission should treat on-line distribution in the same way as it treats bricks-and-mortar distribution. It is simply another distribution channel and suppliers should be free to put restrictions and qualitative criteria on on-line distributors that achieve the same objectives as with bricks-and-mortar distribution. This would include, for example, the ability to determine which markets the distributor can target.

Allowing suppliers to impose restrictions on bricks-and-mortar distribution but not equivalent restrictions on on-line distribution is no longer appropriate given the growth and increased sophistication of the internet. On-line distribution is now a mature sales channel

and the Commission should treat it the same as any other distribution channel. Suppliers, whether within a selective distribution system or otherwise, should be free to restrict on-line distribution and impose qualitative criteria in the same way they can on bricks-and-mortar distribution, including the ability to determine which markets they may target. The Commission should amend the Guidelines to be neutral between bricks-and-mortar and on-line distribution.

Minimum off-line sales

The draft revised Guidelines allow suppliers to require their distributors to have a bricks-and-mortar shop or showroom before engaging in on-line distribution (paragraph 54). They are not, however, allowed to restrict the proportion of sales made over the internet (paragraph 52), although they may require a certain minimum absolute amount of off-line sales '*to ensure an efficient operation of [the distributor's] brick and mortar shop*' (footnote 29).

Taken together these statements are contradictory and contradict the purpose of the block exemption, which is to exempt agreements that provide the positive benefits described at paragraphs 102 to 105.

The Commission itself recognizes that vertical restraints may benefit consumers because of, *inter alia*, the free-rider, hold-up and vertical externality problems. These problems arise in particular in markets where on-line and off-line distributors compete.

Bricks-and-mortar distributors provide personalized advice on a large range of complex products. In order to do that they must train their staff to have knowledge of the full range of products they sell and their suitability for different customers. Furthermore, a network of bricks-and-mortar shops providing a stylish setting is a major investment that provides street level promotion of products and an environment that reinforces the image and reputation of the products being sold. Pure or almost-pure-internet distributors do not make these investments but can free ride on the significant promotional investment that bricks-and-mortar shops make. The same applies to the vertical externality problem that the Commission identifies as a justification for vertical restraints. No retailer will invest in the ambience of a bricks-and-mortar shop and the specialist staff training if it cannot capture the benefit of that investment.

To counter these problems, suppliers ought to be able to use objective criteria to ensure an optimum distribution network. The Commission recognises that suppliers should not be required to authorise internet-only distributors. It also recognises that it may be reasonable for suppliers to require a distributor's bricks-and-mortar store(s) to have a certain minimum significance. However, these restrictions are undermined by the Commission severely limiting the extent to which suppliers can manage the balance between on-line and off-line sales.

So, the Commission recognises that suppliers should not be required to supply pure-internet distributors, but then it insists that suppliers can only require their distributors to have '*a*' (that is, one) bricks-and-mortar shop or showroom. If it is reasonable for suppliers to insist on a bricks-and-mortar presence, why can they only insist on one bricks-and-mortar store? Clearly, this undermines the effectiveness of a criterion the Commission otherwise recognises as reasonable.

Similarly, only being allowed to specify an absolute minimum sales for the (one) bricks-and-mortar store undermines the otherwise legitimate and reasonable insistence that distributors make a sufficient investment in and commitment to the products. Suppliers should be allowed to insist that on-line sales are an adjunct to bricks-and-mortar stores so as to maintain incentives for

distributors to invest. Suppliers should be allowed to specify a minimum percentage of sales off-line.

It is not the case that requiring distributors to have a significant bricks-and-mortar presence will reduce consumers' ability to buy on-line. As explained above, most bricks-and-mortar distributors are also on-line distributors. Requiring on-line distributors to have a significant bricks-and-mortar presence is a reasonable way of ensuring that end-customers get the same high quality service on-line as they do off-line. Internet-only distributors, or those with only a limited bricks-and-mortar presence, rarely provide the same quality of service and specialist advice and do not have the option of advising their clients to visit their local store to get that advice.

The draft Guidelines seem to be contradictory in that they recognise the reasonableness of suppliers restricting pure-internet distributors but then limit the permitted restrictions to the point that they are ineffective. The Commission should allow suppliers to require their distributors to make an appropriate investment in and commitment to their products by setting a minimum percentage of off-line sales.

Equivalence of criteria for authorized distributors on-line and off-line

ASW welcomes the recognition in paragraph 57 that '*equivalent*' obligations for bricks-and-mortar and on-line sales need not be identical but '*should pursue the same objectives and achieve comparable results*'. The Commission should recognise that obligations that pursue the same objective may look very different. For example, '*equivalent*' criteria for on-line distributors could include:

- Only selling products of a similar nature and quality: Off-line distributors often have restrictions on the other goods they may sell and even the locations they may sell from, in order to ensure that their bricks-and-mortar shops provide an overall appropriate environment for the sale of the suppliers' goods. For on-line distributors similar restrictions on proximity would relate to the image of the distributor and the other products it sells, including whether it has a reputation of only selling genuine (that is, not counterfeit) goods of a similar quality.
- The ability to provide advice and customer support in all languages the website offers, which is again a basic requirement on bricks-and-mortar distributors.
- To be available 24 hours a day, 7 days a week, whereas the equivalent requirement for a bricks-and-mortar store would be to be open from 09.00 to 20.00 for example.

ASW welcomes the Commission's recognition that '*equivalent*' conditions for on-line and off-line distributors need not be identical, but the Commission must recognise that conditions that pursue the same objective may look very different.

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