

Review of competition rules on supply and distribution agreements

An economic view on the proposed revision of the regulation of selective distribution

A Report for STANPA

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25 September 2009

1. Introduction and summary of conclusions

The European Commission released for consultation a revised block exemption Regulation ("VBER") and Guidelines on vertical restraints on July 28 2009, as the current Regulation is due to expire in May 2010. The main amendments are motivated by two developments: the increased buyer power of retailers and the evolution of online sales. In this respect, the draft Regulation modifies the thresholds for companies' activity to fall under the block exemption and propose modifications on how the EC intends to deal with some specific aspects of selective distribution agreements. The Guidelines develop in detail the Commission's approach to restrictions on internet sales. Interested third parties have been invited to submit comments until 28 September 2009.

In this context, the Spanish Cosmetic Toiletry and Perfumery Association (Stanpa) has asked LECG to carry out an economic assessment of the proposed Regulation and Guidelines and their impact on selective distribution systems. More specifically, we have been asked to examine from an economic perspective the new hardcore restriction in Article 4 (b) of the draft Regulation that excludes from the exemptions any restrictions on sales of authorized dealers to non-authorized ones in markets where the selective distribution system does not operate and the Guidelines' approach to online commerce restrictions.

Our analysis identifies some areas of concern. In particular, selective distribution systems and restrictions to Internet sales are typically motivated by the need to align the interests of the manufacturers with the interests of their downstream distributors when there is a risk of *free riding* problems. In the case of luxury fragrances and cosmetics, for example, the objective of these vertical restraints is to provide retailers with the incentives to exert efficient effort levels in pre-sales services at the retail level and to protect the manufacturers' brand image.

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The draft VBER and Guidelines, however, limit the scope for manufacturers to devise efficient selective distribution systems for several reasons.

First, the VBER limits restrictions to sales to unauthorized distributors in those markets where a manufacturer employs a selective distribution system. This is in contrast with the current approach, which permits restrictions on sales to unauthorized distributors regardless of where they operate. The proposed restrictions may undermine a manufacturer's ability to rely on selective distribution, because he would not have mechanisms to prevent unauthorized distributors active in a market where he does not operate a selective distribution system from selling to unauthorized distributors elsewhere and, in particular, in markets where he does adopt a selective distribution system.

Second, the proposed Guidelines adopt as a general principle that distributors must be free to advertise or sell their products online. This may lead to efficiencies in many industries, by lowering inventory, logistics and search costs and prices. However, the removal of all restraints on internet commerce may have welfare decreasing effects in other industries that should also be taken into consideration. More importantly, the inability to restrict or prevent internet sales may exacerbate free riding problems among distributors in the provision of pre-sales and service support services at the retail level and lead to inefficient outcomes in sectors in which those services are highly valued by consumers and increase demand.

Finally, the Guidelines accept certain restrictions whose goal is to ameliorate the inefficiencies stemming from the risk of free riding. For example, suppliers may require a minimum amount of their products to be sold offline, offer fixed fees to support sales efforts by online and offline retailers, or introduce requirements on the quality standards for an internet distributor to be able to resell its products. In our view, however, these solutions do not eliminate the scope for free riding behaviour, especially given that certain volume and wholesale price restrictions are viewed as hardcore.

The remainder of this report is structured as follows. First, we set out the context for the discussion with an overview of the economics of selective distribution and restrictions on online commerce in Section 2. In Section 3 we describe the main features of the proposed revision of the current Regulation and Guidelines. We then analyse the main novelties from an economic perspective in Section 4. Finally, Section 5 discusses some implications for the efficiency of the distribution systems employed in the luxury fragrances and cosmetics industry.

2. The context: the economic rationale for selective distribution

In this section we present an overview of the economic analysis of vertical restraints. We focus on the reasons that explain why in some circumstances manufacturers are willing to selectively distribute their products through specific outlets, including the rationale to limit distribution online.

What is a selective distribution system?

Selective distribution arrangements restrict the distributors that are entitled to sell a given product. In a selective distribution system the manufacturer sells its goods “*only to distributors selected on the basis of specified criteria and where these distributors undertake not to sell such goods or services to unauthorized distributors.*”² That is, the number of authorised distributors and the possibilities of resale are limited on the basis of specific criteria linked to the nature of the product or the retailer.

This type of restriction usually arises in branded products or products that are complex from a technical point of view and therefore require specific retail services by qualified staff. Classical examples include luxury good producers who may want to provide their products only to high level retailers, because selling them through other types of retailers, like supermarkets or discount stores, might undermine the quality or image associated with their products, and consumer electronics goods whose demand increases when pre-sales service is offered at the point of sale.³

Why would a manufacturer want to have a selective distribution network?

Selective distribution agreements are an example of the wide variety of vertical restraints observed in practice.⁴ These agreements and/or contractual provisions between vertically related firms are often motivated by economic efficiency reasons. This is because in a vertical relationship the companies produce complementary products, but they do not consider the impact of their decisions on the other firms’ profits when operating independently. Vertical restraints establish terms for payments or limit one of the party’s decisions and allow the participants to restore efficiency and increase overall profits and welfare.⁵

Pro-competitive explanations of selective distribution systems

Economists have long acknowledged that vertical restraints often solve coordination issues and are pro-competitive. We discuss here three examples of these pro-competitive motivations.⁶ *First*, vertical restraints may allow firms in a vertical relation to solve pricing coordination issues and avoid the *double marginalization problem*.⁷ This problem arises when both the manufacturer and the retailer add a margin to the final product because they enjoy some degree of market power. The final price is too high with respect to what is optimal from their joint point of view because both firms set their price without taking into account the impact on volume on the vertically related firm. If both firms coordinate on pricing, lowering the retail price and increasing output, the manufacturers’ profits and consumer welfare increase. This can be achieved by

² Commission Regulation (EC) No 2790/1999, Art. 1(d).

³ See Motta, M. 2004. *Competition Policy, Theory and Practice*. Cambridge University Press, p. 304.

⁴ Other examples include (i) non linear pricing, (ii) quantity discounts, (iii) resale price maintenance, (iv) quantity fixing, or (v) exclusivity clauses. See for example Motta 2004, op. cit. 3, chapter 6, for a more detailed description of these restraints.

⁵ Rey, P. and T. Vergé. 2008. “Economics of Vertical Restraints,” in *Handbook of Antitrust Economics*, P. Buccirossi, Boston, MA: MIT Press. This article provides a general overview of the pro- and anti- competitive effects of vertical restraints.

⁶ Additional examples of pro-competitive justifications for the application of vertical restraints can be found in the Draft Guidelines on Vertical Restraints, ¶ 103.

⁷ This problem was first identified by Spengler, J. 1950. “Vertical Integration and Antitrust Policy,” *Journal of Political Economy* 58, pp.347-352.

introducing some types of vertical restraints, including resale price maintenance and non-linear pricing.

Second, vertical restraints can solve the *hold up* problem that emerges when each party in a contract worries that an investment that is tailored to a particular partner may be devalued by the actions of others.⁸ These concerns about problems of post-contractual opportunism may lead to inefficiencies, as firms refuse to make efficient investments *ex-ante* fearing that those investments will leave them vulnerable *ex-post*. For example, a producer may be deterred from investing in assets that improve a distributor's performance if there is a risk that the distributor switches to other brands. Exclusive dealing or exclusive territory clauses are examples of vertical restraints that eliminate this risk and as a result solve the underinvestment problem.

Third, vertical restraints are often motivated by the need to align the interests of a manufacturer with the interests of its downstream customers or distributors. In many instances, the actions of a retailer are optimal from his point of view, but not from the manufacturer's point of view or for the society in general. These situations typically arise when (i) a retailer cannot obtain all the benefits from an investment because of free riding problems among retailers or, alternatively, when (ii) competing manufacturers free ride on the efforts of other manufacturers using the same distributor (an example is manufacturer investment in retailer training that may not only benefit its own brand but also other brands sold by the same dealer.).⁹

Selective distribution systems help alleviate these coordination problems. Consider for instance some costly pre-sales services carried out at the points of sale that increase the demand for the products. These may include sales and promotion efforts that play an essential role in purchasing decisions for (i) complex products that require pre-sales advice, like consumer electronic products; (ii) experience goods that need to be tested prior to purchase, like fragrances; or (iii) brands with that feature a strong image (luxury goods, for instance). Manufacturers want retailers to offer these services, because consumers value them and their provision increases demand. These services, however, are costly for retailers because they must hire specialized staff or train them for that purpose.

Suppose some retailers provide these services but others do not. The latter could offer lower prices because their costs are lower. Consumers could then get the pre-sales services they value at those retailers that offer them and purchase the goods at the ones that offer lower prices. That is, pre-sales services would be subject to expropriation by competing retailers. As a result, the retailers that offer the pre-sales services would lose sales and the return they obtain for their investment in these services would decrease. Therefore, their incentives to offer pre-sales services would diminish and the overall level of services would decrease below the efficient levels, lowering manufacturer and retailer profits and overall welfare.

How can manufacturers ensure that retailers have the incentives to provide the pre-sales services and prevent free-riding among retailers? To enhance retailers' effort and investment, manufacturers can restrict the retailers that distribute their products to those

⁸ For a description of the hold up problem and several examples, see Milgrom P. and John Roberts. 1992. *Economics, Organization and Management*, New Jersey: Prentice Hall, chapter 5.

⁹ See for example Besanco, B. and Michael Perry. 1991. "Resale price maintenance and Manufacturer Competition for Exclusive Dealerships," *Journal of Industrial Economics* 39, pp. 517-544

that offer the specific pre-sales services they are interested in because of their effect on demand. This ensures that the selected distributors obtain a fair return from the extra costs of the provision of these services at the retail level, that they carry out the necessary investments, and that consumer demand for those services is met.

Furthermore, the implementation of a selective distribution system in these circumstances may give rise to additional dynamic efficiencies. This is because they may also have an indirect effect on the manufacturers' incentives to invest in research and development to increase product quality or to develop new goods. The reason is that the provision of an appropriate sales service increases demand for the improved products and increases the manufacturers' returns of those innovation efforts. Moreover, the provision of specialized pre-sales services may allow better information sharing between manufacturers and retailers. As downstream firms are closer to the customer, the degree of information asymmetry between producers and consumers may be reduced, which would allow manufacturers to develop products that more closely reflect consumer tastes.

Likewise, selective distribution may be used to prevent free riding among retailers on what are known as *quality certification* services.¹⁰ In this case, explicit services may not be provided, but consumers perceive that a product is high quality because it is stocked by certain retailers who have the reputation of carrying high quality products. Hence, those retailers provide a "quality certification", a service that involves certain costs like investment in location and appearance of the outlets and in the quality of their staff. For example, certain department stores are known for carrying high quality products.

These services are also subject to free riding, because other retailers can appropriate part of the benefits: they may carry the same merchandise as a prestigious retailer without investing in quality certification (for example, hiring less qualified staff), afford to charge lower prices and attract consumers away from those retailers that do invest. This, in turn, decreases the incentives for retailers to invest in brand image in the first place and harms the manufacturer and consumers, who attach value to the features of the outlet that carries the good. Eventually, this may lead to the collapse of the market for that good, as its brand image might disappear and consumers may not be willing to pay for the product without those features. To prevent this, a manufacturer may only entitle a specific type of shop, with particular characteristics, to sell a product.¹¹

Potential anti-competitive effects: impact on intra-brand competition

Whether a vertical restraint is anti-competitive or not mostly depends on its impact on competition at the horizontal level, and in particular, on whether it reduces inter-brand (between different brands) or intra-brand (between the same brand sold in different outlets) competition.

With respect to selective distribution systems, the potential concern is that they have anti-competitive effects because they lead to a reduction in the number of outlets that carry a manufacturer's products and therefore to lower intra-brand competition.¹² The net

¹⁰ See Motta, M. 2004. op. cit. 3, p. 334 and Howard P. Marvel and Stephen McCafferty. 1984. "Resale Price Maintenance and Quality Certification," *Rand Journal of Economics*, 13.

¹¹ These quality certification services may allow certain companies to enter the market and signal the quality of their goods if their products are distributed through these retailers.

¹² Bishop, S. and Mike Walker. 1999. *Economics of EC Competition Law: Concepts, Application and Measurement*, London: Sweet & Maxwell, chapter 4. The Guidelines also refer to the

effect of this reduction of intra-brand competition on prices is determined by (i) the efficiencies that the introduction of a selective distribution system generates, (ii) the extent to which intra-brand competition is affected (that is, the reduction in the number of outlets that carry the products that the selective distribution system leads to) and (iii) the strength of inter-brand competition.

Impact on welfare: the overall balance

Many empirical studies have analysed the consequences of vertical restraints on own and rivals' prices, costs, profits and measures of consumer welfare. The conclusions of this research are summarized in a recent paper by Professors Lafontaine and Slade which survey the findings of the studies that analyse the consequences of vertical restraints.¹³ They find that the evidence supports the conclusion that the efficiencies of privately agreed vertical restraints outweigh any harm from their potential anticompetitive effects. These findings lead Lafontaine and Slade to conclude that

The evidence thus supports the conclusion that in these markets, manufacturer and consumer interests are apt to be aligned, while interference in the market is accomplished at the expense of consumers (and of course manufacturers). This is probably true because manufacturers have every incentive to develop lean and efficient distribution systems to reach ultimate consumers, which entails imposing vertical restraints on retailers when such restraints enhance dealer services and efficiency more generally, and encouraging retailer competition by eschewing restraints when such competition yields lower distribution and sales costs.

In sum, the data shows that efficiencies of vertical restraints outweigh anticompetitive effects in most contexts. In particular, these authors conclude they are more likely to be efficient when retail markets are relatively competitive, and upstream firms face many problems in providing their wholesalers and retailers with appropriate incentives.¹⁴

On the basis of these findings and the discussion above, economic analysis predicts that selective distribution is more likely to enhance economic efficiency and welfare when:¹⁵

- The inefficiencies of an unconstrained distribution system are larger because of the value that consumers attach to retailer sales efforts, pre-sales advice or brand image and their impact on consumption decisions;
- The restrictions do not have significant effects on intra-brand competition; and/or

possibility that in some circumstances selective distribution has an impact on interbrand competition; by facilitating collusion or foreclosing certain types of distributors (see draft Guidelines on Vertical restraints, ¶171). The Guidelines acknowledge, however, that this possibility arises in case of a cumulative effect.

¹³ Lafontaine, F. and M. Slade. 2008. "Exclusive contracts and Vertical Restraints: Empirical Evidence and Public Policy," in *Handbook of Antitrust Economics*, Paolo Buccirossi (ed.) Cambridge: MIT Press.

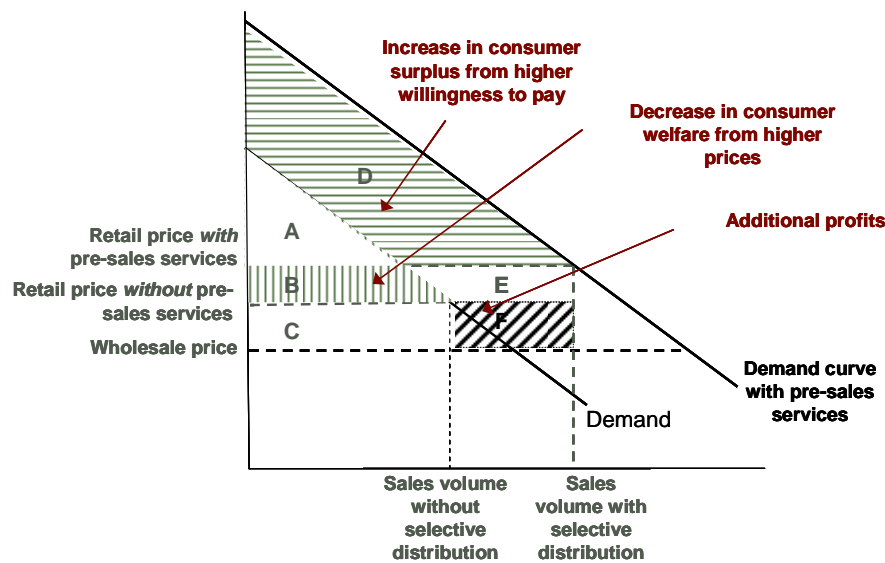
¹⁴ These results are not surprising. Note that it is not in the interest of the manufacturer to limit competition between retailers of its product. For a given wholesale price, the manufacturer is interested in increased competition at the retail level, which leads to a higher volume of sales. Limiting retail competition thus decreases its profits. This implies that a manufacturer will only have an interest in limiting retail competition when it leads to other benefits, by solving the potential free riding problems that would arise if the vertical restraints were not imposed.

¹⁵ Bishop, S. and Mike Walker, 1999, op. cit. 12, chapter 4.

- Inter-brand competition is strong, because this competitive constraint would limit the effects from the reduction in intra-brand competition, which would in turn be compensated by the increase in sales, promotion, and R&D efforts.¹⁶

Figure 1 provides a simple illustration of the welfare effects of selective distribution. The initial demand curve is downward sloping and can be interpreted as the maximum price consumers would be willing to pay for each quantity of the product. We also represent the level of wholesale prices and the initial sales volume and quantity. In these market conditions, consumer surplus is given by the triangular areas below the demand curve but above the equilibrium price, A and B, which captures the value that consumers place on the goods they buy over and above the costs they incur for those goods.

Figure 1: The welfare impact of selective distribution



Source: Author's elaboration.

We can consider the effects on welfare of the introduction of changes in the perceived quality of a product—including the provision of additional or improved retail services that consumers value through of the implementation of a selective distribution system. When the quality of the product improves from the consumer perspective, the demand curve shifts to the right, reflecting the fact that consumers are willing to pay more for every quantity because of the higher quality.

Figure 1 shows this situation. The demand curve shifts to the right, reflecting for each quantity level the increased willingness to pay for the good. The new equilibrium price is higher, following from the increase in marginal costs because of the provision of the additional services and the potential reduction in intra-brand competition. Consumer surplus increases by the difference between the two demand curves above the new equilibrium price (Region D) minus the loss in consumer surplus resulting from the price increase if demand remained constant (Region B).

¹⁶ Draft Commission Notice, Guidelines on vertical restraints ¶ 173. "The market position of the supplier and his competitors is of central importance in assessing possible anti-competitive effects, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited."

In sum, the change in consumer welfare resulting from the introduction of the selective distribution system, is determined by (a) its impact on prices because of the costs of providing the additional services and the potential impact on competition, (b) the elasticity of demand, and, finally, (c) the increase in the consumer's willingness to pay due to the increase in quality (that is, the extent of the demand shift). When the restrictions do not have significant effects on intra-brand competition, or inter-brand competition remains strong, and retailer sales efforts, pre-sales advice or brand image are valuable for consumers, so that the shift in the demand curve is more significant, the efficiencies of a selective distribution are likely to be larger.

One example of an industry in which manufacturers have incentives to employ vertical restraints and, more specifically, selective distribution systems, is the luxury goods industry. The demand for these goods does not depend exclusively on their price. Consumers attach value to non-price factors, like brand image and the shopping experience (including the quality of the sales assistants, who may facilitate a better match between their preferences and the range of products offered, and the environment in which the good is sold). These features are key from the consumer perspective, so that any deterioration in brand image or in the shopping experience decreases their willingness to pay for these products. It is therefore not surprising that manufacturers invest in these features and the market for their products by distributing them through select outlets to ensure that retailers have the incentives to carry out those services.

This reasoning has been recognised by the competition authorities: in its Decision in the *Yves Saint Laurent* case, the European Commission acknowledged that the maintenance of a prestige brand image is “an essential factor in competition” and that by using selective distribution, luxury good producers try to preserve their brand image with a special way of marketing their products in combination with high quality retail services and specialized sales advice.¹⁷

Luxury cosmetic products differ from similar products that meet other consumer requirements, inter alia, through the image of exclusivity and prestige which, in the consumer's mind, is associated with the brand under which they are sold. The manufacturer's capacity to create and maintain an original and prestigious brand image is thus a key factor in competition. It follows that a luxury cosmetics brand must be distributed on an exclusive basis. Experience shows that generalized distribution of a luxury cosmetic product can affect the consumer's perception of it and in the long term reduce demand for it.

Moreover, the Decision concludes that consumers “derive a direct advantage” from the benefits of the selective distribution system, because it protects the features that consumers value, like their exclusive character, the provision of advisory services or the constant availability of the products.

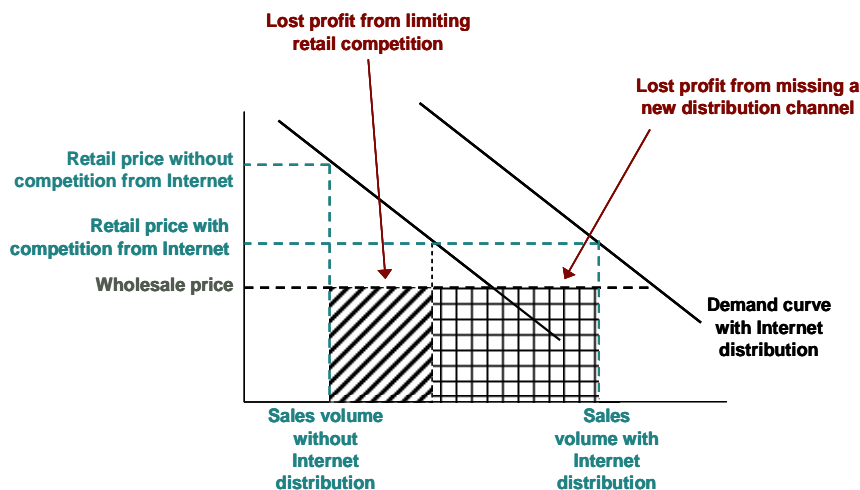
¹⁷ Commission Decision of 16 December 1991 relating to a proceeding under Article 85 of the EEC Treaty (IV/33.242 - Yves Saint Laurent Parfums), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992D0033:EN:HTML>.

Why would a manufacturer want to limit online distribution?

The advent of internet commerce raises the question of whether contractual restrictions that prevent or limit the distribution of goods online have the same rationality as selective distribution and what their impact on welfare is.

A widespread view of Internet retailing is that the Internet allows consumers to shop a wide variety of products at lower search costs than through traditional offline retailers, that it increases competition, leading to lower prices and better matches between consumers and goods.¹⁸ This argument is illustrated graphically in the diagram below (Figure 2), in which we assume that by lowering search costs and increasing product variety the new online distribution channel increases the demand for the products (a shift of the demand curve to the right), and leads to lower prices, and higher output and welfare.

Figure 2: Economic impact of online distribution in some industries



Source: Author's elaboration.

This view, however, misses some of the effects of allowing the sale of certain products on the Internet. In particular, limiting online distribution is actually efficient in some industries because it encourages brick-and-mortar retailers to support their brand values, to invest in the shopping environment and to make the necessary effort to try to sell units.

This motivation is intimately related with the *free riding* and *quality certification* problems we mentioned above, which also arise among the online and offline distribution channels.¹⁹ In industries in which (i) it is efficient that sales and service support are provided at the retail level and (ii) those services are an intrinsic part of the product itself and therefore highly valued by consumers, online distributors can benefit from the promotion investments and the sales and service effort made by selective brick-and-mortar retailers. An online shop that does not invest in a physical outlet, in the training of

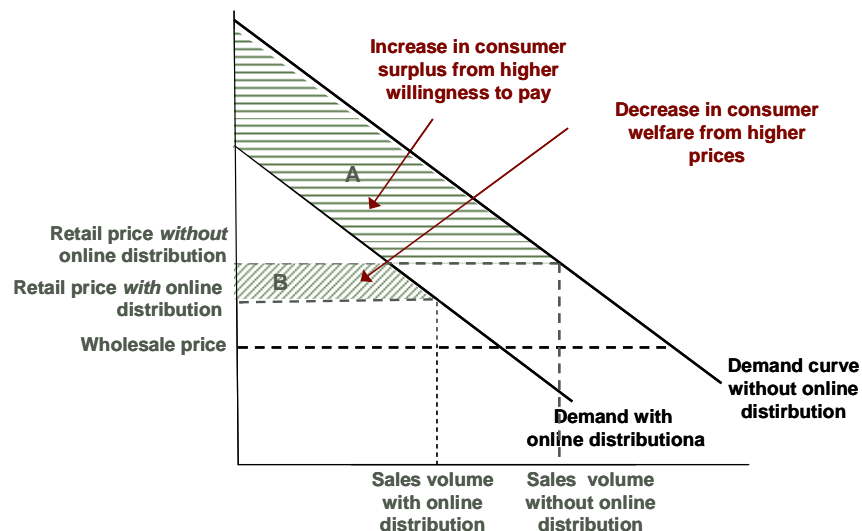
¹⁸ Brynjolfsson, E., Hu, Y. and D. Smith. 2006. "From Niches to Riches: The Anatomy of the Long Tail", *Sloan Management Review*, Summer 2006, 47(4), 67-71 and Brynjolfsson, E., Hu, Y. and D. Simester. 2007. "Goodbye Pareto Principle, Hello Long Tail: the Effect of Search Costs on the Concentration of Product Sales", MIT Sloan School Working Document.

¹⁹ The same incentives apply when the online distributor has a brick and mortar point of sale that may belong to a physical selective distribution network.

its personnel or in additional exclusive services has lower costs that allow them to charge lower consumer prices. As a result, if online sales are not restricted, (some or all) consumers would likely use the advice and services offered in physical stores to make their choices and order online afterwards. This, however, would undermine the incentives of physical retailers to exert effort in (costly) sales and marketing. Brick-and-mortar retailers would reduce their service quality or disappear completely as any additional investment would not pay off, damaging the consumers' sale experience, the manufacturers' brand image, and ultimately, reducing the demand for these products and consumer welfare.

In the framework provided by the chart above, allowing distribution of these types of goods online does not increase their demand; in fact, the effect is completely the opposite. Unrestricted online distribution leads to a lower provision of retail services like sales and service support or an exclusive retail environment and therefore lowers demand for the products, shifting the demand curve to the left. The new equilibrium price is lower, which corresponds to the decrease in marginal costs because less retail services are provided. Consumer surplus decreases by the difference between the two demand curves above the new equilibrium price (Region A) minus the increase in consumer surplus resulting from the price decrease if demand remained constant (Region B). The net effect is likely to be a reduction in consumer welfare if the value that consumers attach to the retail services in question is significant.

Figure 3: Impact of online distribution when there is scope for free riding



Source: Author's elaboration.

This explains why some manufacturers adopt strategies that limit the possibility of free-riding by Internet retailers, including limits to the distribution of their products online and suggests that these restrictions increase consumer welfare and restore economic efficiency.

In practice, restrictions to online commerce often arise in contexts in which the efficiency issues described are their likely motivation²⁰ and the empirical evidence supports the

²⁰ Some examples include Lancaster v Beautynet (in which the German authorities analysed Lancaster's policy towards online distribution, that allows brick-and-mortar authorized stores to sell

intuition that restrictions on internet retailing serve the same purpose as the restrictions on brick-and-mortar retailers; namely, controlling free riding on sales and promotional efforts across retailers. For example, Carlton and Chevalier find that manufacturers that limit distribution among brick-and-mortar retailers (fragrance, DVD players and high-end refrigerators) also employ mechanisms to limit distribution of their products online.²¹

3. The review of the regulation on vertical restraints

The application of Article 81 to vertical agreements is currently governed by (i) the Commission Regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (the vertical Block Exemption regulation, VBER), which automatically exempts a wide range of vertical agreements from the application of Article 81;²² and (ii) the Commission Guidelines on Vertical Restraints, which explain how the Commission interprets the VBER and set out the principles for the assessment of vertical agreements.²³

The current VBER establishes a safe harbour from the application of Article 81(1) for vertical agreements in which the supplier does not hold more 30% of the relevant product market, as long as the agreement does not contain certain hardcore restraints listed in Article 4 of the Regulation. When the vertical agreement contains an exclusive supply obligation causing the supplier to sell its goods only to one buyer in the EU, the Regulation applies provided the buyer does not hold more than 30% on the market on which it purchases the contract goods.²⁴

The present regulation is due to expire on 31 May 2010 and the European Commission is currently working on its revision. In this section we describe the main novelties introduced in the draft VBER and Guidelines and the proposed approach regarding the treatment of online commerce.

Novelties in the draft Regulation and Guidelines

The proposed VBER introduces two main amendments. The first one concerns the market share threshold to benefit from the safe harbour. In the proposed draft of Article 3 of the VBER, the market shares of both the supplier and the buyer must not exceed 30% in any of the relevant markets affected by the agreement to benefit from the exemption, regardless of whether the agreement contains an exclusive supply obligation.²⁵ The

on the internet, as long as they have internet sales lower than half of their normal physical sales and does not allow pure internet players to distribute its products, see Case KZR 2/02, 4 November 2003, Germany, Bundesgerichtshof) or Festina in France (which concerns Festina's refusal to sell its high quality watches to Bijourama, a pure online retailer for watches, jewelry and accessories, Case No. 06-S-01, 3 February 2006, Conseil de la Concurrence).

²¹ Carlton, D. and J. Chevalier. 2001. "Free Riding and Sales Strategies for the Internet," *The Journal of Industrial Economics*. Vol XLIX, No. 4, pp: 441-461.

²² Commission Regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, OJ L 336, 29.12.1999, pp. 1-25.

²³ Commission Notice, Guidelines on Vertical Restraints, OJ C 291, 12.10.2000, pp. 1-44.

²⁴ Agreements falling outside its scope are not automatically contrary to Article 81: their compatibility with that Article must be assessed on a case by case basis, with the aid of the Commission guidelines on vertical restraints.

²⁵ Draft Commission Regulation, op. cit. 22, Article 3, p. 6.

Commission explains that this proposal is triggered by the increase in large distributors' market power.²⁶

The second amendment is the introduction of a new hardcore restriction in Article 4 in relation with selective distribution agreements. The current VBER allows restrictions on sales that to all unauthorized distributors by the members of a selective distribution system. According to the draft, however, the Article 2 exemption will not apply to vertical agreements that impose any limitation on the members of a selective distribution system to sell to unauthorised distributors *in markets where such a system does not operate*.²⁷

In addition to the changes in the VBER, the Guidelines on vertical restraints have been thoroughly revised. They discuss the application of Article 81 to new practices and introduce modifications in the interpretation of the anticompetitive effects of different activities. For example, the new Guidelines view resale price maintenance as a hardcore restriction, but they also explicitly recognize that RPM might lead to efficiencies and satisfy the Article 81(3) criteria for new brand launches, market entry, or in the context of promotional efforts.²⁸ Furthermore, the draft Guidelines discuss new retail practices such as slotting allowances and category management and they provide some guidance in the assessment of their potential anticompetitive effects.²⁹ Other changes include (i) a revision of the definition of agency agreements;³⁰ (ii) the fact that they allow for the existence of tacit acquiescence;³¹ and (iii) an increased emphasis on the effective assessment (and not just presumption) of anticompetitive effects.³²

Some of the most relevant aspects of the new draft Guidelines concern the application of Article 81 to restrictions of online retailing in vertical contracts. In particular, the draft includes several proposals on how the hardcore restrictions of Article 4 of the VBER will apply in the specific case of internet sales. We describe the main features of the proposals below.

Novelties in the Guidelines related with online commerce

Most of the novelties contained in the proposed draft guidelines on vertical restraints concern internet sales. The draft Guidelines establish as a general principle that "every distributor must be free to use the internet to advertise or to sell products".³³

The draft Guidelines indicate that only limitations to active selling in other distributors' exclusive territory or customer group are compatible with the VBER. Online sales are considered a form of passive selling, except when the website carries out online

²⁶ See the Commission's press release, IP/09/1197.

²⁷ Draft Commission Regulation, Article 4(b), p. 6.

²⁸ Draft Guidelines, ¶221, p. 60.

²⁹ Draft Guidelines, ¶¶ 199-204 and ¶¶ 205-209, pp. 55-57.

³⁰ Draft Guidelines, ¶¶ 12-21, pp.5-8. A new type financial risk in the principal-agent relationship derived from after sales or repair services is defined. This is relevant since for the purposes of applying Article 81(1) the agreement will be qualified as an agency agreement if the agent does not bear any risk.

³¹ Draft Guidelines, ¶ 25, pp. 9-10. To this end it has to be shown: (1) that one party requires explicitly or implicitly the cooperation of the other party for the implementation of its unilateral policy; and (2) that the other party complied with that requirement by implementing that unilateral policy in practice.

³² Draft Guidelines, ¶ 47, p. 16.

³³ Draft Guidelines, ¶ 52, p. 18.

advertisement specifically oriented to certain targeted customers.³⁴ Under these conditions, restrictions to online sales therefore constitute the object of certain “hardcore restrictions”.

In particular, the draft contains new examples of internet selling restrictions that, if imposed on the distributors, would render the regulation inapplicable and would very likely not satisfy the conditions of Article 81(3):³⁵

- i. requiring a (exclusive) distributor to prevent customers located in another (exclusive) territory from viewing its website or requiring the distributor to put on its website automatic re-routing of customers to the manufacturer’s or other (exclusive) distributors’ websites;
- ii. requiring a (exclusive) distributor to terminate consumers’ transactions over the internet once their credit card data reveal an address that is not within the distributor’s (exclusive) territory;
- iii. requiring a distributor to limit the proportion of overall sales made over the internet; or
- iv. requiring a distributor to pay a higher price for products intended to be resold by the distributor online than for products intended to be resold off-line.

The draft Guidelines provide some guidance as to the permissibility of certain restrictions in relation with online distribution. For example, suppliers may require their distributors to have a brick-and-mortar shops or showrooms in order to allow them to distribute the goods online. In addition, suppliers can offer the buyer a fixed fee to support off-line and online sales efforts. Finally, a seller can require certain quality standards an internet site to be authorized to resell his products.³⁶ However, these standards must be “*equivalent*” to those established in the brick-and-mortar shops so they could no prevent the use of internet. This means that the criteria should “*pursue the same objectives and the differences must be justified by the different nature of the distribution models*”.³⁷

The new Guidelines also point out that a ban on internet will not be considered a hardcore restriction if it is objectively necessary and does not restrict competition. One example is the existence of a public ban on selling those products over the internet or by mail order for safety or health reasons.³⁸ In addition, restrictions to passive sales can be permitted during two years in those cases in which distributors must accomplish significant investments to start up and/or develop a new market.³⁹

4. An economic assessment of the proposed regulation and Guidelines on selective distribution systems

In this section we discuss the approach adopted in the draft VBER and Guidelines in relation with selective distribution systems. More specifically, we focus on how the hardcore restrictions of Article 4(b) of the VBER will apply in the case of Internet sales

³⁴ Draft Guidelines, ¶ 53, p. 19.

³⁵ Draft Guidelines, ¶ 52, p. 18.

³⁶ Draft Guidelines, ¶ 54, p. 19.

³⁷ Draft Guidelines, ¶ 57, p. 20.

³⁸ Draft Guidelines, ¶ 54, p. 19.

³⁹ Draft Guidelines, ¶ 56, p. 19.

and their impact on the efficiency of selective distribution systems and briefly discuss some implications of the proposed removal of the exemption for buyers with significant market share (Article 3).

The proposed revision of Article 3

The draft of the revised VBER proposes that any agreement where either the seller or buyer has a market share of 30% or more is excluded from the Block Exemption. For these purposes, the relevant market share of the buyer is the buyer's share of any downstream market in which it resells the contract goods or services.

This approach would entail significant transaction costs. On the one hand, many agreements that currently enjoy a block exemption would no longer be covered and will need to be assessed more carefully, increasing compliance costs. On the other hand, from the suppliers' perspective, information on downstream market shares will often not be perfectly observable. This will have an impact on the negotiations with their potential partners with respect to proposed vertical restraints and will introduce additional monitoring costs once the contract has been signed to ensure compliance. In addition, the difficulty in defining the relevant market in many contexts will also increase legal uncertainty to the parties of these contracts.

The new hardcore restriction undermines the efficiency of selective distribution systems

The current VBER allows suppliers to adopt criteria that their retailers must satisfy and to restrict sales to unauthorized retailers by the members of their selective distribution system, as long as the market share thresholds are satisfied and the agreements do not contain certain hardcore restrictions. The current draft proposes a significant amendment in this respect. In particular, it revises the approach towards sales to unauthorized distributors by the members of a selective distribution system. The revised text limits restrictions to sales to unauthorized distributors in the markets where the manufacturer operates through a selective distribution system.

This new hardcore restriction may undermine the efficiency of a selective distribution system. The reason is the following. Consider a supplier who decides that, because of differences in consumer tastes across markets, a selective distribution system would be appropriate in certain markets but not in others. This supplier would not be able to restrict sales to unauthorized retailers operating in the markets where his distribution system is not selective. As a result, these unauthorized distributors may sell to other unauthorized distributors operating elsewhere (including those markets where the selective distribution was adopted). Selective distributors would then find that these unauthorised distributors can free ride on the services they provide.

In effect, the efficiencies that motivated the introduction of the selective distribution system in certain markets would vanish, because the free riding problems that such a system attempted to ameliorate would arise again.⁴⁰ In practice, the manufacturer would have to choose between operating a selective distribution system across all markets in the EU, or give up on the possibility of a selective distribution system in certain markets, regardless of whether the underlying market features would justify differences in the

⁴⁰ These effects are independent of the possibility to restrict online commerce, but the possibility of online commerce may exacerbate them.

distribution system applicable in each country or region and at the expense of welfare. Furthermore, some commentators argue that the negative effect of this new hardcore restriction may be particularly strong for smaller suppliers, who likely do not distribute their products across Europe.⁴¹

In sum, the introduction of the new hardcore restriction that limits the ability of a supplier to restrict sales to unauthorized distributors undermines the motivation for the adoption of a selective distribution in the first place and risks eliminating the efficiencies that such a system generates.

Unrestricted online commerce is not always efficient

A second area of concern is the Guideline's approach to internet commerce. As we discussed above, the premise of the current review of vertical restraints is that every distributor must be free to use the Internet to advertise or sell its products.⁴² Therefore, as a general rule, the Guidelines advocate that online selling is regarded as a form of passive selling and very few restrictions to this type of distribution are allowed. They establish that "a restriction on the use of Internet by distributors party to the agreement could only be compatible with the VBER to the extent that promotion on the Internet or sales over the internet would lead to active selling into, for instance, other distributors' exclusive territories or customer groups".⁴³ An example on active sales would involve "online advertisement specifically addressed to certain customers".⁴⁴

This approach is based on the presumption that the removal of all restraints on internet commerce would unambiguously increase welfare. According to this view, this distribution system lowers inventory and logistics costs, facilitates offering a broader variety of products and reduces search costs for consumers. These effects are indeed supported by the economic literature in certain contexts,⁴⁵ but as we discussed in Section 2 above, the unconditional removal of restraints on online sales may not have welfare enhancing effects in all industries. While the Internet has the potential to reduce search costs by allowing consumers to engage in price comparisons online, these cost savings are likely not relevant in the context of experience goods that consumers want to inspect and test prior to the purchase or goods that require customer-specific pre-sales advice to ensure a good match between the products and consumer preferences. Similarly, the savings in inventory and logistics costs are likely to be material for digital products that can be sent over the Internet, but not necessarily for perishable products that cannot be stored for long period of time.

Furthermore, the removal of all constraints on online distribution has consequences on market structure that affect equilibrium outcomes. For example, in a recent paper,

⁴¹ Emily Clark, Mat Hughes and Denis Waelbroeck. 2009. "Selective Distribution and Luxury Goods: The Challenge of the Internet?," *Global Competition Policy*, August.

⁴² Draft Guidelines, ¶ 52, p. 18.

⁴³ Draft Guidelines, ¶ 52.

⁴⁴ Draft Guidelines, ¶ 53. The Guidelines do not define clearly the limits between active and passive selling. This raises some concerns, as online advertising is highly sophisticated and innovative.

⁴⁵ Brynjolfsson, Erik and Michael Smith. 2000. "Frictionless Commerce? A Comparison of Internet and Conventional Retailers." *Management Science*, 46(4), pp. 563-585; Morton, Fiona Scott, Florian Zettelmeyer, and Jorge Silva-Risso. 2001. "Internet Car Retailing." *Journal of Industrial Economics*, 49(4), pp. 501-519; Brown, Jeffrey R. and Austan Goolsbee. 2002. "Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry." *Journal of Political Economy*, 110(3), pp. 481-507.

Loginova makes the case that goods sold online are not perfect substitutes for otherwise identical goods sold by offline retailers.⁴⁶ In particular, online purchases are associated with waiting costs and, more importantly, do not allow consumers to inspect the product prior to the purchase. She shows that in some circumstances, conventional stores actually raise prices in response to entry by electronic firms and economic welfare goes down.

Finally, and more importantly, the inability to restrict internet sales may exacerbate the free rider problem for manufacturers. As we discussed above, when some of the services provided at the retail level are not separable from the physical product and are valued by consumers, Internet sellers can free ride off the promotional effort and retail services provided by brick-and-mortar retailers. In this context, imposing limits on the availability of products online would be efficient, as it would help mitigate these free riding problems and ensure that consumer demand is met.

Hardcore restrictions to online commerce: some concerns

The Guidelines incorporate examples of internet selling restrictions that are viewed as hardcore.⁴⁷ The Guidelines indicate that requiring a (exclusive) distributor to prevent customers located in another (exclusive) territory from viewing its website or requiring the distributor to put on its website automatic re-routing of customers to the manufacturer's or other (exclusive) distributors' websites or to terminate consumers' transactions over the internet once their credit card data reveal an address that is not within the distributor's (exclusive) territory are hardcore restrictions. Similarly, the Guidelines preclude certain volume and price restrictions across brick-and-mortar and online distributors. In particular, contractual provisions that require a distributor to limit the proportion of overall sales made over the internet or to pay a higher price for products intended to be resold online than off-line are regarded as hardcore restrictions.

These proposals fundamentally undermine the ability of certain manufacturers to solve the risk of free riding problems among their distributors. The intuition is the following. Consider a situation in which (i) there are no restrictions on Internet reselling, (ii) online and brick-and-mortar retailers pay the same wholesale price and (iii) there are no limitations on the proportion of online sales relative to sales by offline distributors, as the Guidelines predicate. In this context, consumers would be free to compare the prices offered at brick-and-mortar retailers with those offered by online retailers located *anywhere*. In addition, consumers could obtain pre-sales advice and inspect the alternatives in a physical retail environment.

Note that, as online prices would be lower than those offered by the physical retailers because Internet distributors would benefit from cost advantages (they would not provide the same services as brick-and-mortar retailers, but would face the same wholesale prices), consumers would make their choice in a brick-and-mortar store and then purchase the goods online. This, in turn, would erode the physical retailers' incentives to

⁴⁶ Loginova, O. 2009. "Real and Virtual Competition," *The Journal of Industrial Economics*, Vol. LVII, No. 2, June.

⁴⁷ Draft Guidelines, ¶ 52, p. 18.

invest in the retail services that consumers value and would exacerbate the free-riding risks that selective distribution systems try to avoid in the first place.⁴⁸

Manufacturers could devise ways to ameliorate these free riding problems while maintaining some degree of online distribution.⁴⁹ For instance, manufacturers could charge different wholesale prices to brick-and-mortar and Internet retailers. Wholesale pricing could be designed so that online retailers internalize the externality they impose on the offline ones or a supplier could grant additional discounts to brick-and-mortar retailers that incur in additional retailing costs.⁵⁰ The Guidelines, however, regard this solution as a hardcore restriction and therefore will likely prevent efficient solutions to the free riding problems discussed above.⁵¹

Proposed solutions to free riding

The draft Guidelines allow for some limitations to online commerce, including the possibility that suppliers require that a minimum amount of their products is sold offline (as long as online sales are not limited), that suppliers offer buyers fixed fees to support their sales efforts, or that they make certain requirements on the quality standards for an internet distributor to be able to resell its products. However, as we discuss below, this approach does not leave scope for manufacturers to solve efficiently the free riding problems that selective distribution systems are intended to ameliorate.

Minimum volume restrictions

For simplicity, most of our discussion distinguishes between online and offline distributors. The Guidelines, however, do not restrict the possibility that manufacturers require that authorized online dealers have brick-and-mortar shops and that a minimum of sales is made offline (as long as no limits to online sales are imposed).⁵²

This requirement does not eliminate the scope for free riding on other distributors' investments, given that requiring a distributor to limit *the proportion* of overall sales made over the internet is considered a hardcore restriction. The reason is that these "dual" retailers could focus almost exclusively on their internet sales, regardless of whether they also have a brick and mortar network. To take the example to the extreme, the retailer could make 99% of its sales through the internet and 1% through its physical outlets. A supplier may wish retailers to focus on their sales through their physical outlets, but from these retailers' perspective, it may be more advantageous to focus on online sales given the cost savings that entails. The incentives would therefore not be aligned and suppliers would not be able to exclude from their distribution network those retailers who disproportionately invest in online retailing.

⁴⁸ The same argument applies if we consider the incentives of offline distributors who also have an online outlet.

⁴⁹ Such a dual distribution system would open the possibility for manufacturers to address different consumer segments through online and offline distribution. For example, they may address repeat customers who already know their preferred choice through the online channel and those customers who value personalized sales services through the brick-and-mortar stores.

⁵⁰ It is interesting to note that along the same lines, Carlton and Chevalier (2001) find that manufacturer websites tend to charge higher prices, which these authors interpret as their way to internalize free rider issues. See Carlton, D. and J. Chevalier, *op. cit.* 21.

⁵¹ Restrictions to the proportion of sales carried out through the Internet may play a similar role.

⁵² Draft Guidelines, ¶ 54 and footnote 29.

Fixed payments to support sales efforts

The Guidelines allow manufacturers to make fixed payments to online and offline retailers to support their sales efforts. Such a system of payments, however, is not likely to compensate (i) brick-and-mortar retailers from the possibility that Internet sellers free ride on their sales and promotion efforts or (ii) prevent that online distributors who also have brick-and-mortar outlets focus their efforts on Internet sales.

The reason is that there are some fundamental asymmetries between the sales and service effort provided offline and the services provided online. For example, Carlton and Chevalier explain that:

- The sales and service efforts exerted by an internet retailer largely take the form of fixed costs (product reviews, photographs, etc), while the promotional efforts of brick-and-mortar retailers take the form of a per-customer cost through personal interactions between customers and sales people; and
- Promotional efforts of internet retailers are more likely to be easily verifiable.

This has several consequences.

- First, compensation for online promotional and sale efforts is easier (and may simply entail a fixed fee).
- Second, the design of a compensation scheme that encourages these efforts from brick-and-mortar retailers is more challenging. In particular, a fixed fee (i) does not provide the right incentives for retailers to engage in a service that is provided on customer per customer basis and (ii) does not protect retailer margins from the possibility of free riding by their online counterparts.
- Moreover, manufacturers are likely to be more concerned about free riding by internet retailers off the sales and effort of brick-and-mortar retailers; and for those retail-service intensive products, manufacturers may have an interest in adopting sales strategies on the Internet that protect the margins of brick-and-mortar retailers.

In sum, different sales channels have different retailing costs per unit sold. The possibility that manufacturers exclusively offer fixed payments to support sales efforts may increase online distributor's incentives to carry out those investments, but is unlikely to provide adequate incentives to offline distributors. Moreover, for those selected distributors who operate both online and offline outlets, this system of payments may actually increase the incentives to engage in online sales and promotional efforts at the expense of the brick-and-mortar distribution channel.

Comparable quality standards

The draft Guidelines also indicate that suppliers may establish certain quality standards on their distributors' websites. However, where a supplier is operating a selective distribution system, it must ensure that those standards are "equivalent to" those that apply to sales from physical outlets. Hence, in order to remain within the Draft Block Exemption, suppliers' standards for online sales would need to "pursue the same objectives and achieve comparable results, and any differences between the criteria for

online and offline sales must be justified by the different nature of the distribution models".⁵³

The difficulty with this approach is that some quality standards and/or sales services that brick-and-mortar distributors provide are not perfectly replicable or analogous to those provided by online distributors. Examples include investments in the appearance and location of physical outlets, which are not easily comparable with investments in Internet retail sites, or the provision of personalized retail services, hardly analogous to the provision of customer services through call centres or by email.

As a result, some goods sold online are not perfect substitutes for otherwise identical goods sold by their offline competitors. For example, (i) online sales cannot provide a proper presentation of luxury products; (ii) internet retailing does not facilitate optimal matching between a consumer tastes and a specific product, because it does not allow consumers to test the products before purchasing them; and (iii) personalised advice is part of the shopping experience. Therefore, the Guidelines approach restricts suppliers' ability to replicate the offline quality standards in the online environment.

5. Conclusions: implications of the review for the efficient distribution of luxury fragrances and cosmetics

The incentives to employ selective distribution systems and to restrict online distribution well understood in the luxury fragrances and cosmetics industry. This is because these products exhibit some features that make them particularly prone to free riding concerns. In particular:

- Their product and brand image are an integral part of the product, and determine consumers' willingness to pay for them.
- This image is partly conveyed through the product's presentation and retail experience in a luxury environment.
- Moreover, sales and promotion efforts, and more specifically, a personalized retail service are key determinants of purchasing decisions. This is because they are experience goods, so that consumers are likely to want to inspect them prior to the purchase to ensure a good match between their tastes and the specific attributes of the product. In the case of cosmetics and perfumes, online commerce faces some intrinsic limitations to reach the same quality standards in some of these pre-sales services. For example, testers cannot be provided through the internet, so consumers cannot perceive the fragrance or see the real colour of a lipstick or make-up when purchasing online. This reduces the probability of a good match between consumer tastes and the product that is purchased and makes the personalized service that physical retailers provide more likely to be subject to free riding.⁵⁴

As a matter of economics, for products with these characteristics, selective distribution systems guarantee that retailers have the incentives to engage in the sales effort and

⁵³ Draft Guidelines, ¶ 57. An example of justified differences is differences in delivery times (given that sales through a physical outlet are, in effect, delivered instantly).

⁵⁴ This explains why the manufacturers of these products propose that internet retailers offer physical services as well.

services that are optimal from the manufacturers' and the consumers point of view. For the same reason, manufacturers of these luxury products have incentives to limit to some extent the distribution of their products online. Otherwise, as we discuss in detail above, Internet retailers would free ride on these sale efforts and their brick-and-mortar retailers would lack the incentives to carry them out, to the detriment of consumers (whose demand for certain product features would not be met) and manufacturers.

We should also stress the limitations of other types of contractual solutions to these free riding concerns. The reason is that the retailer sales effort and quality of service is not directly observable by the manufacturer in each purchase occasion. To ensure that retailers have the incentives to provide these services, manufacturers must provide some monetary incentives to their retailers, like guaranteeing an extra margin for each sale, which is exactly what a selective distribution system accomplishes by imposing certain limits on intra-brand competition.

Therefore, this is an industry in which the restrictions that the proposed VBER and Guidelines impose on the design of selective distribution systems and the treatment of online retailers are likely to harm consumer welfare. In particular, there is a risk that, as a result of the constraints imposed by the new regulation, retail services that are valuable for consumers are no longer provided at efficient levels.