

**THE ECONOMIC CONSEQUENCES OF  
THE CHOICE OF REGIME OF  
EXHAUSTION IN THE AREA  
OF TRADEMARKS**

**Executive Summary**  
**Final Report for DG XV of the  
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## 1. INTRODUCTION

This Executive Summary describes the results of a study into *The Economic Consequences of the Choice of a Regime of Exhaustion in the Area of Trademarks*, which has been commissioned by DGXV of the European Commission and undertaken by National Economic Research Associates (NERA). The main objective of the study is to examine the economic consequences for the European Union of alternative regimes for the exhaustion of trademark rights. NERA has carried out this study together with SJ Berwin, a leading London law firm with recognised expertise in intellectual property law and competition law, and with IFF Research, a market research firm with substantial experience of EU-wide business surveys.

Specifically the study is intended to analyse the effects of alternative exhaustion regimes on prices and trade volumes, product and market structures, consumers, and employment, and the impact on macro-economic indicators such as employment. It is explicitly not intended to provide definitive interpretations of the legislation that currently covers this subject or to investigate or comment on particular legal issues. Nor is it intended to develop economic arguments for or against particular points of view on the subject of international exhaustion, or to adjudicate on the case for or against the extension of an EEA exhaustion regime.

However it is necessary to summarise the main features of the current regime, both in the EEA and other countries, and this has necessitated some analysis and interpretation of the legal framework, including the identification of areas where there may be some uncertainties about the legal position and hence the actual nature of the current exhaustion regime operating in different countries.

We have also summarised what are in our view the essential economic arguments for and against international exhaustion, and this helps to set in context our assessment of the economic impact of possible changes to the exhaustion regime.

## 2. BASIC ELEMENTS OF TRADEMARK AND EXHAUSTION REGIMES

Trademarks fulfil two mutually dependent economic functions:

- they assist and protect the consumer in identifying the source of products and hence improving their ability to judge quality; and
- they provide a property right to the trademark holders, by limiting the rights of other parties to copy their products, specifically by prohibiting use of their trademark; this allows trademark holders to be rewarded for their investment in product development and product quality, and for their expenditure in creating brand image or "branding" of a product.

There is no dispute that trademarks are of fundamental importance in the market, and of particular importance for certain categories of consumer goods.

The rights conferred on holders by trademarks are, however, qualified by the principle of exhaustion. A decision to apply this principle means that once trademark holders have sold a product, then they cannot prohibit the subsequent re-sale of that product; their rights in respect of an individual item or consignment are "exhausted" by the act of selling it. In particular they cannot discourage re-sale by preventing use of the trademark.

Similar principles regarding exhaustion may be applied to other intellectual property rights (IPRs), such as copyright or patents. This report is concerned primarily with trademarks. Some goods may however be covered by more than one form of intellectual property protection, so that the patent and other regimes may also affect the outcome of changes made to the trademark regime.

The definition of an exhaustion regime is essentially a definition of the geographic area to which the principle of trademark exhaustion is deemed to apply. Thus the current exhaustion regime for the EEA relates to the territory of the Member States, so that trademark holders cannot legally prevent re-sale of products within the single market of the EEA, once those goods have been put on the market there. They *can* legally seek to prevent the re-sale within the EU of goods first sold outside the EEA; these latter are known as **parallel imports**.<sup>1</sup> This is the exhaustion regime implicit in the legal judgement in the recent *Silhouette* case, involving re-import of spectacle frames sold to a Bulgarian company.<sup>2</sup> In

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<sup>1</sup> The terms parallel imports and parallel trade will also be used to describe any trade that reflects re-sale that occurs without the consent of the trademark owner; this may include parallel trade between countries within the EU. A parallel import into the EU could be manufactured there and re-imported, or made in a third country and imported through an unauthorised channel.

<sup>2</sup> Case C-355/96, [1998] CEC 676

essence the court ruled that trademark rights are not exhausted by virtue of sale outside the EU.

The subject of this report is the examination of the potential economic effects of extension of the exhaustion regime beyond these boundaries, either unilaterally by the EU or on the basis of reciprocal/bilateral or multilateral agreements with other countries. This is sometimes described in general terms as a move towards **international exhaustion**. It may be noted that some countries already apply international exhaustion, at least to certain types of product. There has been some inconsistency in the past between EU member states, with some countries practising international exhaustion while others did not.

The exhaustion regimes that apply in other countries, such as the USA or Japan, affect the potential for **parallel exports** from the Community to those countries. Our report includes a brief description of the exhaustion regimes that currently apply in the EU/EEA, US and Japan. In some cases the regime is not clear cut, and an assessment of the legal position indicates an intermediate position with some degree of international exhaustion, applied only to IPRs relating to certain categories of product or on a case by case basis. Uncertainties regarding even the *current* legal position for some products adds to the uncertainties of assessing the economic impact of a change of regime.

### **3. DEFINING THE ECONOMIC ISSUES**

Parallel trade, ie parallel imports or parallel exports, arises primarily, but not necessarily exclusively, because of price differences that exist between different markets for a single product. Sometimes this may be due to relatively transient phenomena such as exchange rate movements, where parallel traders are able to react more quickly in trading than trademark holders or distributors can in altering selling prices. A more fundamental cause however is the likelihood that the trademark holder wishes, as a matter of commercial policy, to sell goods at different prices in different markets. This may reflect several different factors, including differences in production or distribution costs, differences in the ability or willingness of consumers to pay for the product, because of differences in wealth or tastes, and investment in "branding" for the local market.

From an economic point of view, there is nothing intrinsically bad about price discrimination. Some form of price discrimination is common and efficient in situations where fixed costs have to be covered, and as our brief description of related intellectual property issues in the pharmaceutical sector indicates, there may be significant benefits in terms of both economic efficiency and consumer welfare when firms are allowed to practise it. There can be no a priori presumption that prohibiting price discrimination in a particular case will result in prices in a particular market falling to the lowest of the different market prices. They may rise to higher levels, and the trademark holder may withdraw from the low price markets altogether.

A major dimension to the argument, therefore, surrounds the importance that should be attached, on the one hand, to the trademark holder's right to exploit the value of the intellectual property right constituted by the trademark and to discriminate in how the product is marketed, as against, on the other hand, the potential benefits that "freer trade" and parallel imports may induce in the form of increased intra-brand competition, with the consequence of lower consumer prices.

A second dimension is the question of how changes in the exhaustion regime might impact on the other fundamental role of trademarks, in protecting consumers by providing an assurance as to the origin and quality of a particular product. Consumers may for example be adversely affected by confusion over the origin and content of products which have the same trademark but have been produced to meet different national tastes, or to meet different technical requirements; or they may be affected by deterioration in quality in the course of transporting the goods, or by an adverse impact of a change in trademark regime in weakening the controls against counterfeit goods.

#### **3.1. The Case for Maintaining the Protection of Trademark Rights, and Limiting the Geographical Extent of the Exhaustion Regime**

Arguments for limiting exhaustion to the EEA derive from the belief that this provides a higher economic reward to firms that invest in the quality or style of their products, and that

this incentive is necessary in order to maintain the range of products and the quality of goods and associated service that EU consumers expect. International exhaustion would make it more difficult for EU firms to sell at a lower price outside the Community or for non-EU firms (which intend to use EU licensees) to sell at a higher price in the Community, and therefore have one or more of the following negative economic consequences:

- lower returns to the trademark holder; this would over time inhibit investment in new brands, or in some cases might cause the firm to retire existing products from the market, or to reduce the quality of goods and the provision of associated services; this would be contrary to the long term interests of consumers in tending to reduce quality and choice;
- specifically trademark holders may not be willing to make the investment in "branding" necessary in order to bring a particular existing brand to a local EU market;
- higher prices in markets outside the EEA, and the possible withdrawal from the market of products which the citizens of those countries value; and
- if firms exit from lower margin markets to prevent parallel trade, prices in EEA markets may even rise because fixed costs can no longer be spread over a larger volume of sales.

These arguments parallel those that can be made for other intellectual property rights, and assert that the best outcomes will occur when holders are allowed more freedom to exploit their rights, in this case predominantly through price discrimination between different national markets, and any associated measures (limiting supplies to more price sensitive markets, discouraging re-export, and others) that they see as necessary to sustain that strategy. Freedom to exploit the intellectual property right, without exhaustion, increases the incentives to innovate and develop new brands.

To counter the argument that trademark owners are exercising monopoly power, the proponents of maintaining the status quo would argue that there is generally substantial inter-brand competition, and that concerns about the possible abuse of monopoly power are more properly addressed through competition law rather than through further limiting the rights of trademark owners.

The second set of arguments in favour of limiting the geographical scope of exhaustion to the EEA is based on the view that a move towards international exhaustion would tend to disadvantage consumers by weakening the effectiveness of trademarks in assuring quality, identifying origin and protecting the consumer. There are several ways in which this could happen, although the relevance of each is likely to vary from sector to sector and from product to product. Relevant factors vary from product to product but include the following.

- Products tailored to different national markets, and correspondingly different needs, may be of different quality, composition or style, but bear the same trademark; this is potentially so for confectionery and soft drinks, for fashion goods, and for consumer appliances.
- Parallel imports also represent a weakening of the ability of the trademark holder to control the distribution chain and the conditions under which products are sold; this may result in a reduction in the quality of the product supplied and in the retail and after sales service associated with it; for some products such as vehicles this could be an important factor.
- Parallel imports may make it more difficult to enforce common technical or safety standards within the EU, with corresponding risks to consumers; again this may be of importance for particular products.

Harmonisation within the EU is intended to create a single market, so that these considerations are less important within the existing exhaustion regime. International exhaustion, however, would create these problems.

Proponents of a more limited exhaustion regime may argue that the future economic development of advanced economies relies heavily on sectors and products with a substantial content of intellectual property. Affording proper protection to the owners of those rights, such as trademarks, and maintaining incentives, are likely to be vital for the economic future of the EU.

Finally, the absence of a barrier to parallel imports may reduce ability to detect and prevent counterfeit imports; this may be directly damaging to consumers and further undermines the financial returns to trademark holders; this has been identified as of particular importance to musical recordings.

### **3.2. The Case for International Exhaustion**

The economic case for extending to international exhaustion is simply stated and rests on the proposition that this will deliver lower prices to consumers. The case is that trademark holders, or their authorised distributors, are in some cases exercising a degree of monopoly power in a particular brand. Parallel imports provide additional competition that reduces prices to the consumer, by reducing the ability of the trademark holder to exploit its position (in that brand) and to set higher prices in some markets than in others, *and* by increasing competition in the distribution of the product.

Proponents of this argument emphasise that the fundamental function of a trademarks regime is the protection of the consumer, not the assignment to the trademark holder of further rights that create elements of monopoly in the market for the product, and add further value to the property rights associated with ownership of the brand. International exhaustion, it may be argued, is consistent with the general trend towards liberalisation in

international trade. In some sectors retail trends such as purchasing over the internet, or other "personal imports", will make it increasingly difficult to sustain the existing regime.

As for the arguments that this would result in a loss of protection for consumers, it may be argued that parallel importers, or the retailers of parallel imports, would have exactly the same incentives to offer good service as authorised distributors. Many will do so to safeguard their own reputation as retailers. Further consumers might be prepared to forego the benefits of certain services in exchange for a lower price, rather than being forced to purchase at a particular combination of price and service. Technical and safety standards can also be seen as a barrier to the incidence of parallel imports, which will in practice limit their feasibility for many products, rather than as being protections put at risk from a change in regime.

Finally it can be argued that counterfeiting problems should be attacked directly, perhaps by improving detection and effective deterrence, rather than by inhibiting legitimate competitive activity.

### **3.3. The Differences Between Unilateral, Bilateral and Multilateral Extensions to International Exhaustion**

The effects of any extension to international exhaustion would depend on:

- the other countries that are included in the extension; the prices at which trademarked goods are sold in each country determines the likely scope for parallel trade that arises from an extension to include that country within the exhaustion regime; and
- whether the extension is unilateral, or whether it is made as part of a deal in which the other country agrees to extend its own exhaustion regime to include the EEA; the effect of this reciprocal arrangement is to allow parallel exports from the EEA and this may happen in cases where the prices of trademarked goods are generally lower in the EEA.

There are clearly many possible combinations that would constitute an extension to international exhaustion. We have confined our examination to a limited number of possibilities, concentrating on the US and Japan as major trading partners, and on the options of unilateral change, bilateral change, and change as part of a general multilateral agreement on international exhaustion.

In this context we note from our description of the legal position in other countries that some other countries (notably the US and Japan) already practise some degree of international exhaustion.

One should not assume a priori that reciprocal or multilateral agreements are more advantageous for individual EU firms, or for EU trademark holders collectively, than is unilateral change. EU trademark holders who would be disadvantaged by parallel imports *to* the EU may also hold trademark rights in other countries and might be disadvantaged by parallel exports *from* the EU. Similarly it will not necessarily be true that reciprocal or multilateral extensions are better for the EU economy as a whole than is unilateral extension.

With reciprocally or multilaterally agreed moves to international exhaustion, net changes in parallel imports and exports would depend mainly on the relative prices in different countries for a range of trademarked products. Extension of international exhaustion to countries such as the USA, where (post-tax) retail prices and probably (pre-tax) wholesale prices are generally lower, might, in the absence of other factors, be more likely to lead to increased parallel imports. Extension to countries such as Japan, where retail prices are generally higher, might, again in the absence of other factors, tend to favour parallel exports. The actual direction of flow may however vary from sector to sector or product to product. Current practice of at least partial application of international exhaustion in some other countries would tend to reduce the likelihood of any significant change in the level of parallel exports.

#### **4. FACTORS INFLUENCING AN ASSESSMENT OF THE ECONOMIC IMPACT**

This report does not adjudicate between these conflicting points of view. Instead it explores the economic impacts of extending the exhaustion regime. To do this we have focused on ten sectors in which trademarks are important, and which we believe cover a substantial proportion of international trade (and the potential for parallel trade) in consumer goods. The sectors are footwear and leather goods, musical recordings, motor cars, consumer electronics, domestic appliances, cosmetics and perfumes, clothing, soft drinks, confectionery and alcoholic drinks.

Our survey has attempted to collect views on the economic consequences of change and includes the perspective of trademark holders, import/export associations, consumer organisations and associations of small and medium size enterprises across the EU.

The immediate economic consequences that would flow from a change in trademark regime can be put into perspective by the following observations.

- Exhaustion regimes across the world may be of secondary importance in determining the location of production; much of the trademarked footwear and clothing sold under the trademark regimes of the EU or the US is for example sourced from South East Asia.
- Trademark holders within the EU include large numbers of US and Japanese firms whose perspective on the international exhaustion issue is likely to be broadly similar to that of EU firms, but whose earnings will ultimately accrue to US or Japanese investors. The converse will be true for trademark holders in the US or Japan.
- Increases in parallel imports of previously exported goods (so-called re-imports) are not net effects on the trade balance; nor are parallel imports that displace imports arriving by authorised channels.
- The fact that the EU is a large market will tend to dampen the potential for major price reductions on individual products; thus it is unlikely in any circumstances that Bulgarian parallel imports would determine the general level of prices for spectacle frames. Trademark holders will tend to sustain sales in larger and more profitable markets, abandoning if necessary those that are smaller and more price sensitive.

Nevertheless international exhaustion could have a significant impact on some sectors, and for particular firms or products in any sector. This could alter radically business strategies for these firms, leading to re-location of the firm's marketing or production base for example, and causing the firm to alter its pricing, marketing, product development and distribution strategies.

Our analysis shows that the consequences of change are complex, and may vary considerably both between sectors, and between products within a sector. In our analysis we have attempted to identify those factors that are likely to be important for different sectors. We have also made an uncomplicated assessment of the immediate economic impact, using simplifying assumptions and approximate judgements about the scope for parallel imports and the extent of their price effects.

In the long run however these effects are likely to be much less important than the dynamic effects of any change, as trademark holders and others react to any new regime. Dynamic effects may offset and reduce any immediate effects, as trademark holders find new commercial strategies which maintain their existing position (eg through exploiting other intellectual property protections). Or they may cause much more fundamental shifts in business strategy.

In the following sections we summarise the factors that will influence the scope for parallel trade, and the potential consequences of a change in the exhaustion regime.

#### **4.1. Current EU Impact of Parallel Trade**

A significant item of evidence is the extent of parallel trade that currently takes place within the EEA. The effects of extension to international exhaustion are likely to be similar in nature, although not necessarily in extent, to those that occurred in the evolution of a single market.

The tables below summarise the picture that emerges for the sectors that we have examined. The first covers price differences currently observed for branded products within the EU. The second summarises the impressions gained from our survey and from other sources about the current extent of parallel imports.

**Table 4.1**  
**Price Differences Currently Observed for Branded Goods, Within the EU**

<b>Sector</b>	<b>Price differences</b>	<b>Comment</b>
Footwear and leather goods	Intermediate/large	e.g. Nike trainers or Timberland boots
Musical recordings	Intermediate	International full-price pop CDs
Motorcars	Large	Across most models
Consumer electronics	Large	Based on aggregated data (EIU data)
Domestic appliances	Large	Based on aggregated data (EIU data)
Cosmetics and perfumes	Large	e.g. CK 200 ml Eau de Toilette
Clothing	Intermediate	-
Soft drinks	Intermediate/large	-
Confectionery	Intermediate	-
Alcoholic drinks	Large	But mainly due to tax differences

*Source: see Appendix C of this report for the various sources*

**Table 4.2**  
**Extent of Current Parallel Trade Within the EU**

<b>Sector</b>	<b>Assessment</b>	<b>Comment</b>
Footwear and leather goods	Small	< 5%
Musical recordings	Large	Overall 5 to 10%; some releases up to 20%
Motorcars	Small	Estimates of up to 5%
Consumer electronics	Small	Around 5%
Domestic appliances	Small	< 5%
Cosmetics and perfumes	Large	Around 13% for upper end of market
Clothing	Intermediate	Survey mentions range 5 to 10%
Soft drinks	Intermediate	Between 0 and 15% of market (survey)
Confectionery	Small/intermediate	< 10 %
Alcoholic drinks	Small	< 5%

It is clear that the existing regime has not eliminated the potential for major retail price differences within the EU, nor has it eliminated parallel trade. Some of the observed price differences may of course reflect factors such as exchange rate movements or differences in transport and distribution costs, taxes, and retail margins, as well as price discrimination by the trademark holder. As a side remark regarding parallel trade within the EU: one would expect the introduction of the Euro as a single currency to be significant in its impact on price differences within the EU, increasing transparency within the single market and eliminating or reducing the effect of exchange rate fluctuations.

## 4.2. The Relative Importance of Intellectual Property Rights

The effect of a change in regime will also be influenced by how important trademarks and other intellectual property rights (IPRs) are for particular sectors. The following tables indicate our assessment of the relative importance of different intellectual property rights, and the extent to which investment is driven by the IPR related needs of branding and advertising, product development and research and development.

The potential for parallel trade may be reduced by the ability to continue to use the protections afforded by copyright or other IPRs besides trademarks. The adverse effect on profits, and potentially on the availability of products to consumers, is likely to be higher where IPR driven investments are the most important.

**Table 4.3**  
**Relative Importance of Different Intellectual Property Rights**

<b>Sector</b>	<b>Trademark</b>	<b>Copyright</b>	<b>Design</b>	<b>Patent</b>
Footwear and leather goods	High	Low	High	Low
Musical recordings	High	High	Low	Low
Motorcars	High	Low	High	Only for components
Consumer electronics	High	Generally low	Medium/high	Only for components
Domestic appliances	High	Low	Medium/high	Only for components
Cosmetics and perfumes	High	Low	Medium/high	Low/medium
Clothing	High	Low	Low	Low
Soft drinks	High	Low	Low	Low
Confectionery	High	Low	Low	Low
Alcoholic drinks	High	Low	Low	Low

**Table 4.4**  
**Relative Importance of IPR Driven Investment**

<b>Sector</b>	<b>Branding / Advertising</b>	<b>Product development and design</b>	<b>Research and Development</b>
Footwear and leather goods	High	Intermediate/high	Low
Musical recordings	Intermediate	High	Low
Motorcars	High	High	Intermediate
Consumer electronics	High	High	Intermediate/high
Domestic appliances	High	Intermediate/high	Low
Cosmetics and perfumes	Very high	High	Intermediate/high
Clothing	High	Intermediate	Low
Soft drinks	High	Low	Low
Confectionery	High	Intermediate	Low
Alcoholic drinks	High	Low/intermediate	Low

Trademarks are clearly the most important form of intellectual property protection for the sectors we have examined, with the exception of musical recordings, where copyright is for obvious reasons also of great importance. Even for musical recordings, trademark holders tend to regard trademarks as important because trademark rights are often easier to enforce. Design protection is also fairly important in a number of sectors. Overall the availability of other forms of intellectual property protection would appear to offer only limited comfort, even if these operated with different and more restricted exhaustion regimes. For analytical convenience we make the working assumption that trademarks are the dominant form of protection, and that possibly different regimes for the other forms of protection will not alter the effects we describe.

In the context of intellectual property protection, counterfeiting is also an important issue affecting products in some of the sectors we have examined. As a subject it is not part of this study, but it has been noted by trademark holders that allowing parallel imports would in practice weaken a number of the defences against counterfeiting and piracy, particularly for goods originating from outside the EEA. While this is likely to be a significant issue for a number of products (including fine fragrances and trainers), it is clear that it is of particular commercial importance for the musical recordings sector, both because of the prevalence of piracy and its economic impact on earnings from copyright.

Investment in branding and advertising is high for at least some firms in all the ten sectors we have examined, with investment in product development and design also of substantial importance in most cases. This emphasises the importance of branding in those markets for which trademarks are most important.

### 4.3. Barriers to Parallel Trade Created by Transport Costs, and Other Transaction Costs

Parallel trade may also be rendered more difficult by factors such as the cost of transport (in relation to potential price differences), and other potential barriers to trade such as health and safety legislation, technical standards and labelling differences. Our assessment of the significance of these factors, which create what we refer to as transaction costs, for the ten sectors is as follows.

**Table 4.5**  
**Obstacles and Transaction Costs**

<b>Sector</b>	<b>Transport</b>	<b>Health/safety</b>	<b>Labelling</b>	<b>Technical</b>
Footwear and leather goods	Low	Not present	Low	Not present
Musical recordings	Low	Not present	Not present	Not present
Motorcars	High	High	Not present	High
Consumer electronics	High	Intermediate/ High	Intermediate/ High	Intermediate/ High
Domestic appliances	High	High	Intermediate	Intermediate
Cosmetics and perfumes	Low	Intermediate	Intermediate	Not present
Clothing	Low	Not present	Low	Not present
Soft drinks	High	Low	Intermediate/ Low	Low
Confectionery	Intermediate	Low	Low/ Intermediate	Low
Alcoholic drinks	Mixed	Low	Low/ Intermediate	Low

This suggests that transaction costs are of most importance in respect of motor cars, consumer electronics and domestic appliances. They are relatively unimportant, and therefore will not constitute a significant obstacle to parallel trade, for footwear and leather goods, musical recordings, clothing, confectionery and for spirits and fine wine.

### 4.4. Trade Barriers

Formal trade barriers, including import duties and import quotas, are also significant. Import duties imposed on parallel trades will reduce the impact of price differentials between countries for a particular product. Import restrictions may eliminate parallel trade altogether.

For the sectors we have examined, trade barriers are most likely to be important for motor cars.

**Table 4.6**  
**Trade Barriers**

<b>Sector</b>	<b>Import duties</b>	<b>Anti-dumping action</b>	<b>Import quota</b>
Footwear and leather goods	From 3.5% to 17%	Certain footwear from some South-east Asian countries	Not present, except China
Musical recordings	3.5%	Not present	Not present
Motorcars	2.5%	Low - not used	High - Japanese made cars
Consumer electronics	4%	East-Asian countries for TV sets	Not present
Domestic appliances	Low	Not present	Not present
Cosmetics and perfumes	Free to 6.5%	Not present	Not present
Clothing	Mostly 13.8%		Quotas on trade with developing countries
Soft drinks	Relatively high	Not present	Not present
Confectionery	9.5% plus agricultural components	Not present	Not present
Alcoholic drinks	9% for beer; various for wine	Not present	Not present

#### 4.5. The Importance of Vertical Relationships

**Table 4.7**  
**Vertical Relationships Within Sector**

<b>Sector</b>	<b>Vertical restraints</b>	<b>Relative importance long-term relationship</b>
Footwear and leather goods	Becoming tighter	Intermediate
Musical recordings	Intermediate	High
Motorcars	High	High
Consumer electronics	High	High
Domestic appliances	High	High
Cosmetics and perfumes	High	High
Clothing	High	High
Soft drinks	Mixed	Mixed
Confectionery	Low	Low
Alcoholic drinks	Intermediate/slackening	Intermediate

Relationships between trademark holders and manufacturers and retailers are particularly important because their nature will affect the ability of trademark holders to maintain price

discrimination while limiting the impact of parallel trade. The nature of these relationships varies widely between sectors, but appears to be relatively weak in soft drinks and confectionery.

The reaction of trademark holders to a change in exhaustion regime may well include efforts to tighten their control over the vertical chain through to distribution and retail. In our assessment we assume that such responses are always compatible with current competition law. However possible responses, and the further responses of the competition authorities in monitoring and controlling them, together with the prospective removal of a number of block exemptions (eg motor vehicles), constitute a further uncertainty.

#### **4.6. Responses to the Survey**

Our survey indicated that parallel traders and the transport sector are generally seen as the gainers from parallel trade, and official importers/exporters and manufacturers as the losers. More surprising is that the effect on retailers and on consumers was largely seen as neutral, or there were divergent views. This was so even among consumer organisations. This appears to reflect perceptions that price reductions could be offset by adverse effects on after-sales service, guarantees, product information and other aspects of service quality.

The survey also obtained the views of the different interest groups on the likely response of trademark owners to unilateral and reciprocal exhaustion. There was general agreement that there would be a response to curb an increase in parallel trade, though the importance of measures cited varied between interest groups and between the postulated exhaustion regimes.

Trademark owners emphasised "approaching parallel traders" and enacting or enforcing selective distribution networks as general responses to parallel trade, including current intra EEA trade. With unilateral exhaustion, price adjustment and withdrawal from the source market were mentioned frequently. With reciprocal exhaustion, selective distribution networks and price adjustment were again most often mentioned. Cutting R&D or other forms of product improvement did not rank high among responses.

#### **4.7. Relative Prices**

Relative retail prices are the probably the most important single indicator in determining the potential scope for parallel trade. The table below indicates relative prices (including taxes) for a variety of products corresponding to the ten sectors. Generally prices are significantly lower in the US, with the exception of cosmetics and perfumes and some alcoholic drinks. Prices are generally higher in Japan, except for motor cars and consumer electronics.

**Table 4.8**  
**Dollar Price Relatives in OECD 1996 (Retail Prices Including Tax)**

	<b>Ratio US : EU</b>	<b>Ratio Japan : EU</b>
Men's footwear	0.57	2.19
Ladies' footwear	0.59	1.69
Children's footwear	0.64	0.67
Records, tapes cassettes	0.74	0.97
Motor cars	0.72	0.75
Tyres, tubes, parts	0.67	0.89
Radio sets	0.82	0.92
TVs, VCRs	0.52	0.77
Record players etc	0.59	0.56
Refrigerators	0.80	1.96
Washing machines	1.02	1.27
Cookers	0.48	2.44
Heaters and air cond	0.37	1.57
Vacuum cleaners	0.55	1.13
Toiletries	1.05	1.50
Men's clothing	0.65	0.97
Ladies' clothing	0.59	1.48
Children's clothing	0.55	1.04
Infants' clothing	0.55	1.69
Mineral water	0.59	2.17
Other soft drinks	0.61	1.79
Chocolate preparations	0.73	1.59
Confectionery	0.61	1.52
Spirits and liqueurs	0.62	1.14
Wine	1.25	2.20
Beer	1.04	2.71
Other	0.82	1.12

*Source: OECD; NERA Analysis; These ratios are in retail prices including VAT and other taxes. Generally speaking, taxes in the EU are higher than USA taxes. Price differences, excluding taxes, between the EU and the USA are smaller (so the USA : EU ratio will be closer to 1 in most cases). The Japan EU ratio is much less affected when excluding taxes.*

## 4.8 Overall Assessment of Factors Affecting Parallel Trade

Overall our assessment of the scope for parallel trade can be summarised as follows

**Table 4.9**  
**Qualitative Assessment: Scope for Increase in Parallel Trade**

<b>Sector</b>	<b>Price differences</b>	<b>Transaction costs</b>	<b>Technical barriers</b>	<b>Trade policy</b>	<b>Vertical constraints</b>	<b>Current parallel trade</b>	<b>Overall scope</b>
Footwear and leather goods	++	+	+	-	-	-	+
Musical recordings	+	++	++	-	-	++	++
Motorcars	+	+	-	++	-	-	+
Consumer electronics	++	-/+	-	-	-	+	+
Domestic appliances	++	-	-	+	-	-	+
Cosmetics and perfumes	+	-	-	++	-	++	++
Clothing	+	+	+	--	-	+	+
Soft drinks	++	---	+	-	+	+	+
Confectionery	+	--	+	-	+	+	+
Alcoholic drinks	---	--	+	-	-	+	-

*++ and + indicate strong and moderate positive influence tending to promote parallel trade; -- and - indicate negative influences tending to reduce parallel trade; blank denotes neutral effect*

## **5. SUMMARY FOR THE TEN SECTORS**

### **5.1. Footwear and Leather Goods**

Despite the recent trend towards producing footwear in newly industrialised countries the EU retains a strong footwear and leather industry with a positive balance of trade. Trade is an important part of the economy of the sector with about a third of EU production being exported. Footwear is not a high technology sector and trademarks, together with design rights in some cases are the dominant form of intellectual property. Trademarks play a crucial role in advertising and developing brands. Depending on data sources, shoes are more expensive in the EU than the USA, but cheaper than Japan. While price differentials are on average moderate, larger price differentials, sufficient to generate incentives to parallel trade are present for parallel trade. Transaction costs appear unlikely to form a significant barrier to parallel trade although import duties and quotas are present in the sector. Strengthening manufacturer control over the distribution system suggests that parallel imports would be likely to retail in non-traditional outlets.

Our analysis suggests that the sector is moderately susceptible to parallel trade. The consequences for trademark owners as a whole appear likely to be moderate, although individual trademark holders may be more strongly affected, and since parallel trade tends to reduce revenue without affecting costs, small effects on the market can affect profitability significantly. However, to the extent that major footwear brands use global marketing (as opposed to local marketing by region or country), it is less likely that promotion would be much reduced. Consumers may benefit to some extent from lower prices, but authorised dealers and retailers would be disadvantaged.

### **5.2. Musical Recordings**

The world market for music recordings amounts to nearly ECU 30 billion, of which the EU accounts for about 30 per cent. The sector contains a mix of large multinational companies and smaller independent (generally local) firms. Although the industry relies more on copyright than trademarks, allowing parallel importation may make it more difficult to prevent counterfeiting. Prices are somewhat higher in many EU countries than in the USA, although the difference, after taking account of sales taxes is moderate, and not necessarily due to the absence of parallel importation (that is, in the presence of parallel trade price differentials would be likely to remain). Technical barriers and transaction costs appear very low and parallel trade within the EU is an important factor for at least some releases. Vertical restraints are not sufficiently tight to prevent parallel trade, although retailers' desire to maintain good relationships with record companies may be a limiting factor.

Overall, our analysis suggests that a moderate to large increase in parallel trade in this sector could be expected if all IP rights were to be internationally exhausted. The effect would be concentrated in full price recordings of international pop music (especially recent releases). While consumers may gain some benefit from discounting, producers would suffer a

reduction of profitability, with incentives to invest in new acts being correspondingly reduced. If copyright were to maintain a Community exhaustion regime, the effects would be **far** less pronounced.

### **5.3. Motor Vehicles**

Our analysis focuses on the market for motor cars, although we note that the parallel importation of motor cycles into the UK from outside the EEA has been a major topic of recent debate. The motor vehicle industry (assembly) is a net exporter and an important contributor to the EU economy, employing over a million people. Globalisation has enhanced concentration within the industry. The industry relies on trademarks to market company names and specific products and trademarks also help to encourage product development and design and R&D. Design rights are important in the industry and patents will also be important (albeit for components rather than “whole vehicles”). Prices tend to be higher in the EEA than in Japan, even after allowing (broadly) for sales taxes and they appear to be higher than in the USA on particular models. Technical barriers constitute a significant factor in parallel importation, however, with both health and safety factors and emissions standards potentially constraining trade. Strong ties between manufacturers and retailers may also constrain opportunities to undertake parallel trade.

Prices and the dismantling of trade barriers will encourage parallel imports from Japan after 1999 and low to moderate penetration could be expected. Consumers would benefit to some extent from lower prices but other considerations are also important – the current block exemption within the EEA is provided precisely in order to encourage dealer investment in service, guarantees etc and it is unclear to what extent purchasers of parallel imports will enjoy such benefits.

### **5.4. Consumer Electronics**

The consumer electronics industry is supplied predominantly by Japanese firms, who control almost their entire domestic market, and exports 33 per cent of production. The EEA is a net importer, although it also maintains a substantial manufacturing base. Trademarks are likely to be the main relevant IP right (although components may be patentable, design may be of some importance, and copyright is relevant for computer games). Branding is an important element of marketing and trademarks also encourage product development and R&D. Prices in Europe tend to be substantially higher than those in the USA or Japan. Transaction costs of parallel trade may be important, for reasons including the fragility of products, and different technical standards present a further barrier to be overcome. The apparent strength of manufacturer control over the distribution system makes it likely that parallel imports would be sold (at discounted prices) in non-standard outlets.

Our analysis and the survey results suggest that there may be a moderate level of parallel trade. Consumers could benefit in terms of discounted prices (and perhaps through dynamic effects on the prices of direct route products), but may lose out in terms of service

quality. Official retailers are likely to be disadvantaged, and parallel trade appears to have the potential seriously to affect manufacturers' profitability, more so than in most sectors.

### **5.5. Domestic Appliances**

The EU maintains positive balance of trade in this sector, although EU industry is relatively stronger in the non-electrical goods sector. Trademarks are of fundamental importance in this sector, where the quality of a product may not become evident for some years after purchasing, and they are used for advertising and for product development purposes. Use is also made of design rights. Pricing varies between appliances and after taking account of taxes the EEA has relatively cheap prices for refrigerators and washing machines. Prices for cookers and heaters are, however, substantially higher in the EU than the USA. Barriers to parallel trade include technical issues and product suitability issues.

Price differences appear likely to encourage parallel imports to the EEA for at least some products. We consider that parallel traded items will most likely be sold outside current retail outlets eg in hypermarkets. Customers may benefit from trading quality of service against price, and there seems no reason to believe that such establishments would eg fail to honour guarantees. We would expect that in most cases and under certain conditions, guarantees are the responsibility mainly of manufacturers rather than retailers.

### **5.6. Cosmetics and Perfumes**

The EU is the largest producer of these products in the world, and maintains a positive trade balance. Trademarks are the main IP right utilised by the industry, although design rights for items such as perfume containers may be relevant. The main use of trademarks is for branding and advertising, although they also serve product development and R&D purposes. Counterfeiting of premium priced fragrances is an issue for the sector. On average, the EEA and US seem to have similar prices for cosmetics and perfumes, while Japanese prices are higher. However, this picture is not necessarily representative of individual perfumes, especially at the high end of the market. Transport costs may be low, although some care for the condition of the product is required, and health and safety and product labelling are also a relevant factor. Premium products tend to be distributed through selective distribution, with very tight vertical restraints. Restraints are looser for other products.

Our analysis suggests relatively high parallel import penetration for premium products, which account for a significant proportion of the market by value. Consumers may benefit from lower retail prices for such products, and the direct effects on manufacturers may be limited, since ex-manufacturer prices in countries of export may not be significantly lower. These savings result from avoiding the cost of retailing in a luxury setting and selling products through non-traditional outlets. This might damage the luxury image of products in this sector. Little parallel trade in non-premium products is expected.

## **5.7. Clothing**

The EU clothing industry has been facing fierce competition from developing countries, and has been in decline despite the protection afforded by the Multi Fibre Agreement. Production tends to be a labour intensive process. Trademarks are the only IP right of substantial importance to the sector, predominantly through facilitating the advertising and branding of clothes. Trademarks may also facilitate the design of new products. Prices of clothes, especially premium brand names, are higher in the EU than in the USA, although consumer tax rates go some way towards explaining the difference. The main costs involved in parallel trade include a 13.8 per cent tariff, and quotas with regard to imports from NIEs and certain developing countries. Relatively tight vertical restraints characterise the market for luxury clothes.

For the market as a whole, parallel imports may be very limited, although focussed in a small number of premium brands. These may retail in a range of establishments, probably at a discount to direct route products.

## **5.8. Soft Drinks**

The market for soft drinks is dominated by domestic production, with both imports and exports being low by comparison with the market size. Trademarks appear to be the only IP right of substantial importance to the sector, which is characterised by a high degree of consumer brand awareness. Trademarks are used for branding and advertising purposes rather than particularly to encourage product development or R&D. EU prices are substantially above prices in the USA, but below those in Japan. However, there is also striking variation in prices within Europe (and parallel trade). Given that transport costs are likely to be significant parallel trade between nearby countries appears likely to be of greater significance.

While there would be scope for some parallel imports in this sector, overall, the dispersion of prices within Europe, and the transport costs involved in undertaking trade from far afield mitigate against there being large increases in parallel imports from outside the EU. Since parallel imports would tend to mingle with direct route products, there is less likelihood than in most sectors of consumers benefiting from discounting.

## **5.9. Confectionery**

The EU is the largest producer and consumer of confectionery in the world, and maintains a positive balance of trade in this sector. Trademarks appear to be the only IP right of substantial importance to the sector, where they are generally used for branding and advertising purposes. However, they may also play a role in encouraging product development in a sector which has shown significant innovation (eg developing low calorie products) in response to changing market conditions. The EU tends to have higher prices

than the USA, even after taking account of consumer taxes, and transaction costs and barriers to parallel trade seem to be no higher than moderate.

Moderate penetration rates for parallel trade, with source countries being the USA, and other countries (unilateral case only) might be expected. Retailers and intermediaries, rather than consumers, could be expected to benefit from higher margins, with manufacturers losing out in terms of profitability.

### **5.10. Alcoholic Drinks**

This sector covers a range of products, including spirits, wine and beer. In each case the EU industry contributes a positive balance of trade. Trademarks are the main traditional intellectual property right although systems such as appellation contrôlée may put some limits on their need. Nonetheless, competition through branding remains an important part of the sector, perhaps more so for spirits and beer than for wine. Examination of price differences is complicated by the presence of substantially differing tax rates, but after making a crude attempt to take account of such taxes we find that the EU tends to have relatively low prices for these products. Although for reasons of data availability, we have not had the opportunity to examine every potential source country, on the basis of the analysis we have undertaken, an appreciable level of parallel importation to the EU appears unlikely. Parallel exports could be possible, especially in the case of wine, and especially to Japan. Practical factors may limit the size of this trade, which we have not been able to quantify.

## 6. QUANTIFYING THE EFFECTS

### 6.1. Defining Scenarios of Unilateral and International Exhaustion

For the purpose of illustrating the economic impact of changes in regime, we have chosen two scenarios, of unilateral extension to an international exhaustion regime, and bilateral extension.

**Scenario 1. Unilateral extension.** By unilateral extension we mean simply that the EEA operates an international exhaustion regime regardless of what other countries choose to do. This means that parallel imports are permitted from all other countries. In this scenario one would expect an increase in parallel imports but no change in parallel exports.

**Scenario 2. Bilateral extension.** In this case it is assumed that the EU exhaustion regime is extended to cover the US and Japan only, but with reciprocal arrangements which would tend to increase parallel exports to the US and Japanese markets.

Our assessments indicate that under Scenario 1, with unilateral exhaustion, the main source of parallel imports would tend to be from the countries of South East Asia and from the USA. They also suggest that the scope for parallel exports is generally likely to be small whatever regimes are in place in other countries; parallel exports to South East Asia or the US are unlikely since prices there tend to be lower; there is in principle potential for parallel exports to Japan, but other factors are likely to militate against this.

It follows that the difference between the two scenarios reflects mainly the fact that in Scenario 2 parallel imports are largely confined to those likely to take place from the US. It also follows from the relatively low potential for parallel exports that the case of full multilateral international exhaustion would tend to approximate to Scenario 1 in its broad economic impacts. For any particular product, of course, this or other alternative combinations might have distinctive effects.

### 6.2. Short Term and Long Term Effects

Any effort to quantify the impact of changes to the exhaustion regime, under either of the above scenarios, must distinguish between potential short term (say one to two years) and long term effects, as parties respond in more fundamental ways.

In the short term, the economic consequences can be summarised as follows. Extending the exhaustion regime will tend to increase parallel imports. This will tend to reduce retail prices to a greater or lesser degree, which we have attempted to estimate, typically on the basis of the survey data, knowledge of existing price differentials and a number of approximate judgements and estimates. The effect on prices can be translated, using previously estimated price elasticities, into an increase in volume, and hence into an increase in employment to produce the additional sector output. The change in employment is

assumed to be pro rata to the change in volume. There may also be effects on supplier industries which we do not estimate. The effect on sectoral profits is driven mainly by the estimated price reduction in relation to profit margins. For a given price change, the effect on profit is higher when margins are already low.

Implicit in this analysis are a large number of assumptions. We have not quantified net changes in employment in retail and distribution. In reality of course one should expect some losses of jobs in official retail outlets for a product, but a corresponding increase in jobs in "unofficial" outlets. More generally our estimates of the effects on production and employment should be regarded as indicative only. Significant uncertainty surrounds the magnitude and direction of these effects, in particular with regard to whether parallel imports will be parallel reimports, will displace direct route imports, or will displace European production.

The short term effects, even in aggregate, appear small in macro-economic terms. This reflects the analysis of the numerous factors, described earlier and in the main body of the report, which will tend to reduce the impact that might in principle be expected from allowing parallel imports in markets where very large price divergences can be observed.

However, the longer term dynamic consequences of a change in regime are likely to be both more important and more difficult to predict. They are most likely in sectors where there is a significant short term effect on profits. The need to restore profits may affect the location of production as well as pricing, product and distribution strategies, with consequent economic impacts.

The potential scale of these effects can be evaluated by looking at the macro-economic contribution of the sectors where we have estimated a moderate or large impact on profits in the short term. The impacts may affect all firms in a sector, or individual firms only but with a large impact. A selective impact on some firms may have disproportionate consequences for the sector as a whole.

**Table 6.1**  
**Quantitative Assessment I: Unilateral Change of Exhaustion Regime**

<b>Sector</b>	<b>PI penetration</b>	<b>Decrease in retail prices</b>	<b>Increased EU production</b>	<b>Increased EU employment<sup>3</sup></b>	<b>Potential impact on profits in EU</b>
Footwear and leather goods	Moderate (around 5%)	Small (< 1%)	Very small (around .5%)	Very small (around 0.5% or 1,000 jobs)	Medium reduction (about 15 %)
Musical recordings	Moderate (around 4%)	Small (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 1,800 jobs)	Medium reduction (about 14%)
Motorcars	Moderate (< 5%)	Small (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 3,000 jobs)	Medium reduction (about 16%)
Consumer electronics	Medium (10%), most goods affected	Moderate (around 2%)	Small (< 1.0%)	Small (< 1.0% or 3,100 jobs)	Large reduction (about 35%)
Domestic appliances	Medium (8%), most goods are affected	Moderate (< 2.0%)	Small (< 1.0%)	Small (< 1.0% or 1,300 jobs)	Large reduction (about 25%)
Cosmetics and perfumes	Moderate (< 5%)	Small (< 1.5%)	Negligible	Negligible	Small reduction (about 3%)
Clothing	Small (about 1.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 450 jobs)	Small reduction (less than 5%)
Soft drinks	Small (0 to 5%)	Negligible	Very small	Negligible	Medium reduction (around 15%)
Confectionery	Moderate (around 5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small	Medium reduction (around 15%)
Alcoholic drinks	Negligible	Negligible	Negligible	Negligible	Negligible

<sup>3</sup> Indicative and subject to significant uncertainty for reasons described in the text.

**Table 6.2**  
**Quantitative Assessment II: Reciprocal Change of Exhaustion Regime**

<b>Sector</b>	<b>PI penetration</b>	<b>Decrease in retail prices in sector</b>	<b>Increase in EU production</b>	<b>Increase in EU employment<sup>4</sup></b>	<b>Impact on profits in EU</b>
Footwear and leather goods	Small (c. 1%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 250 jobs)	Small reduction (about 3%)
Musical recordings	Small (around 2%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 900 jobs)	Moderate reduction (about 7%)
Motorcars	Moderate (around 5%)	Small reduction (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 3,000 jobs)	Medium reduction (about 16%)
Consumer electronics	Small (around 5%)	Small (around 1%)	Very small (< 0.5%)	Very small (< 0.5% or 1,400 jobs)	Medium reduction (about 19%)
Domestic appliances	Small (around 5%)	Small (around 1%)	Very small (< 0.5%)	Very small (< 0.5% or 850 jobs)	Medium reduction (about 15%)
Cosmetics and perfumes	Moderate (< 5%)	Small (< 1.5%)	Negligible	Negligible	Small reduction (about 3%)
Clothing	Small (around 1.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 450 jobs)	Small reduction (< 5%)
Soft drinks	Negligible	Negligible	Negligible	Negligible	Negligible
Confectionery	Small (around 2%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Small reduction (around 6%)
Alcoholic drinks	Negligible	Negligible	Negligible	Negligible	Negligible

<sup>4</sup> Indicative and subject to a range of uncertainty for reasons described in the text.