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SYNTHESIS REPORT ON PARALLEL IMPORTS

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SYNTHESIS REPORT ON PARALLEL IMPORTS

I. Introduction

1. At its October 2000 meeting, the Joint Group on Trade and Competition Policy (Joint Group) focused on, *inter alia*, the interfaces among trade, competition and intellectual property rights (IPRs). Considerable discussion developed around the pros and cons of banning parallel imports. In this paper, such imports are defined as: "…genuine goods sold in the country of export with the permission of the rights holder, but imported by a reseller without the authority of the rights holder in the country of importation."[1] Parallel imports are banned from countries that do *not* practice "international exhaustion".

2. The October 2000 discussion highlighted the fact that the welfare effects of international exhaustion cannot be determined from economic reasoning alone. This helps explain why some countries have commissioned studies to investigate the welfare effects of alternative exhaustion policies. Three such studies were examined at the Joint Group's May 2001 meeting.[2]

3. The current paper synthesises and expands somewhat on the Joint Group's work on international exhaustion. It does this by identifying issues, arguments and some empirical work that governments might wish to consider in designing policies on parallel imports.

4. Although this paper contains no recommendations, it does point to four reasons why decisions on parallel import policy might be difficult to make and why nations could choose different policies. First, the degree of competition in the production and distribution of products embodying IPRs is critical to assessing the welfare effects of alternative exhaustion policies. At the same time, however, the vigour of such competition could partly depend on the presence or absence of bans on parallel imports. Second, changes in parallel import policies can produce changes in private arrangements affecting the existence and extent of parallel imports. These private sector reactions could in turn have important welfare effects. Third, *if* it can be shown that bans on parallel imports would probably increase welfare, this does not necessarily mean such bans should be adopted. This is because, as in any other policy domain, it is always wise to consider possibly superior methods of attaining the same public policy goals. Fourth, the optimal policy response to parallel imports depends on what is driving the phenomenon, and that issue will probably not be settled without more and better data.

5. Unless otherwise noted, in this paper "welfare" refers to *global* economic welfare. As short hand for changes in welfare in a particular market, economists commonly add together changes in producers' profits (net of a normal return on capital), plus changes in "consumers' surplus".[3] The latter can be loosely

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1 Australia (2000, 42).

2 Documentation for this meeting included Australia (2001), BIAC (2001), Denmark (2001), Ergas (2001), Ireland (2001), and OECD (2001).

3 Applying this definition, increases in welfare can be attained by: improving the efficiency with which innovation, production and distribution are carried on (i.e. static and dynamic productive efficiency - maximised when all costs are minimised); decreasing the gap, if any, between prices and the costs of producing and marketing products (i.e. allocative efficiency - maximised when price is set equal to marginal costs); and/or ensuring that consumers face the same tradeoffs in purchasing goods and services (i.e. distributive efficiency - maximised if all consumers face the same set of relative prices).

defined as the difference between what consumers as a group pay for a product and the maximum they would be willing to pay for that same product rather than go without it entirely.

6. To simplify exposition, we will refer to products offered by the authorised rights holders, in contrast to competing parallel importers, as "authorised" products or goods and the company selling them as the "authorised licensee". Authorised products include what IPR holders offer in markets where they directly exploit their IPRs, including markets where licensing arrangements permit competition from the IPR holder. Also in the interests of simplifying exposition, "national" markets includes regional markets in cases where the latter have their own international exhaustion policies.

7. This paper will not enter the debate over whether countries or regions are free, under current treaty obligations, to adopt or reject bans on parallel imports. Instead, we will simply presume they have such freedom.[4] Similarly, the paper will not deal in any depth with the differences between various kinds of IPRs and how their protection varies across nations.[5]

8. The next two sections of the paper examine the global and national welfare effects of bans on parallel imports. That will be followed with two sections considering pertinent empirical work and a short section containing some summary observations. *To ease the task of readers seeking a quick overview of the paper, the section summaries and the highlights of the summary observations are italicised.*

II. (Global) Welfare Effects of Bans on Parallel Imports

9. Before turning to the welfare effects that might result from changing parallel import policies, we present some background material concerning such imports.

10. Parallel imports typically do not arise unless and until the original IPR holder (hereafter referred to as simply "IPR holder") licenses his property rights to a number of different arms length licensees in different countries or regions.[6] The usual reason for such licensing would be a desire to tap foreign capital and market knowledge, but it may also include enlisting the support of indigenous businesses in prosecuting piracy, counterfeiting or other IPR violations occurring within their nation's boundaries. The licensing decision might also be influenced by the existence of bans on parallel imports.

11. The impact of parallel import bans on an IPR holder's licensing decision could be quite different depending on what the decision would have been absent the ban. Some IPR holders may want to separate national markets in order to practice international price discrimination, and/or to shield national licensees from free-riding. For such IPR holders, bans on parallel imports provide an extra incentive to enter

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4 For debate on this issue, readers are referred to: Abbott (1998); Barfield and Groombridge (1998); Bronckers (1998); Cottier (1998); and Maskus (2000). They might also wish to consider World Trade Organization (2001), i.e. a Ministerial Declaration on the TRIPs agreement and public health. Paragraph 5 (d) of that Declaration reads:

> The effect of the provisions in the TRIPS Agreement that are relevant to the exhaustion of intellectual property rights is to leave each Member free to establish its own regime for such exhaustion without challenge, subject to the MFN and national treatment provisions of Articles 3 and 4.

5 See Annex I for a brief description of what motivates patent, trademark and copyright protection and what it consists of.

6 The notable exception to that arises if the IPR holder grants just one license and later acts as a parallel importer or directly supplies product to parallel importers. Such behaviour would amount to cheating on its license arrangement unless the authorised licensee was not given an exclusive territory.

licensing agreements with suitable foreign firms. That applies especially strongly to IPR holders who would otherwise face significant costs and risks (including possible attacks under competition laws) if they had to rely on contract and/or tort law (i.e. the tort of "unfair competition") to effect international market segmentation.

12. In contrast to IPR holders desiring international market segmentation and therefore welcoming bans on parallel imports, some IPR holders might wish to benefit from international *intra*-brand competition in order to keep their national licensees efficient and/or to prevent them engaging in double marginalisation.[7] For these IPR holders, bans on parallel imports are unwelcome and constitute a reason either to refuse to license their property, or to grant multiple rather than single licenses in each national or regional market, or to obligate their licensees to agree to authorise imports by other parties.[8] None of those options might be as profitable or economically efficient as granting a single license in each national or regional market. Moreover, the most desirable potential licensees may strongly oppose multiple national licensing.

13. The two previous paragraphs implicitly make a point that must be borne in mind in assessing the welfare effects of alternative parallel import policies. Such policies do not alone determine whether or not there will be international market segmentation. The market segmenting effects of bans on parallel imports can be avoided by IPR holders directly exploiting their property rights (e.g. refusing to license). In contrast, where there are no bans on parallel imports, IPR holders can try to segment international markets exclusively through reliance on contract and tort law.

14. Parallel imports sometimes consist of products qualitatively different from authorised products. Examples include lower quality but cheaper product variants (e.g. products with fewer bundled features), outmoded varieties, and products which, unlike those offered by the authorised licensee, have not been customised to suit local tastes and regulations. Such parallel imports could arise because the parallel importer is more efficient or is willing to accept lower profit margins than the authorised seller insists on.[9] In either case, global welfare would tend to be improved by permitting the parallel imports. There is, however, another possibility that must be considered. The authorised licensee might have decided not to offer the products because, although they are profitable, they compete with and lower the profits earned on products s/he currently sells. The effect of such "cannibalisation" could be a net loss in overall profits.

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7 Double marginalisation arises when both the IPR holder and his licensee have market power. The result is a final price reflecting two successive supra-competitive profit margins (i.e. a profit margin being added not just to the earlier seller's costs but also to his profit margin). Both consumers and IPR holders would be better off if the licensee took account of how his supra-competitive margin reduces profits earned by the IPR holder.

Double marginalisation plays a key role in the model and empirical work found in Maskus and Chen (2000), discussed later in connection with price discrimination.

8 The last option may be illegal as against public policy.

For further discussion of how bans on parallel imports could affect IPR holders' licensing decisions, see Gallini and Hollis (1999).

9 It could also happen that the authorised licensee and parallel importer have different information about the profitability of selling the qualitatively different goods. In that situation, however, it is not immediately obvious why the products are not imported or produced by the authorised licensee and then sold to the enterprise that would otherwise engage in parallel imports. Most such cases will probably reduce to situations where parallel importers have lower costs or profit margins compared with the authorised channel.

15. When fears of cannibalisation are the ultimate explanation for parallel imports, the effects of prohibiting such imports are ambiguous, i.e. greater product differentiation may or may not increase welfare.[10] What is clear, though, is that welfare is more likely to decline if the increased product differentiation is accompanied by consumer confusion concerning the properties of parallel imports versus authorised products, or leads to a reduction in product safety. We will re-visit this possibility later.

16. We now turn our attention to parallel imports that are virtually identical to products offered by authorised licensees. Such products provide *intra*-brand competition and will presumably gain market share primarily on the basis of price, including quality-adjusted prices of associated services such as after sales warranties. The welfare effects of banning such products will turn on why they enjoy a price advantage.

17. Price differences can be traced to four non-mutually exclusive causes. *First*, a parallel importer and/or its supplier might be more efficient than an authorised licensee and/or its supplier. The greater any such efficiency gap the better the chances, other things equal, that parallel imports will improve welfare. *Second*, the authorised licensee's higher price could simply reflect a higher profit margin for him and/or his supplier. *If* this can be traced to market power, parallel imports could be one way of reducing or checking it and thereby enhancing welfare. A parallel importer and its supplier could amount to maverick new competitors. Alternatively, the parallel importer's supplier could be cheating on some kind of collusive arrangement. Either way, parallel imports would be a threat to anti-competitive co-ordinated interaction among competitors and consequently a boon to consumers and to welfare.

18. Even when parallel imports reduce the market power of authorised licensees and/or their suppliers, this does not necessarily mean they are the best way to achieve that desirable objective. If parallel imports are also associated with certain welfare reducing effects, such as those explored below, it might be better to address competition problems through more vigorous application of competition laws.

19. The presence of higher than normal profit margins on one or more products does not always mean that, taken as a whole and over the long run, a company enjoys market power. It could happen that an IPR holder or an authorised licensee invests in developing the market for a number of different products embodying IPRs, not knowing which will turn out to be successful. In order to stay in business, the company undertaking the market development expenses may have to earn supra-competitive margins on the winners in order to off set lower than normal profit margins on the losers. Undoing such cross-subsidisation amounts to a type of free-riding (perhaps better described as "cherry picking") by either the parallel importer or its supplier. Free-riding on marketing expenses constitutes a *third* possible explanation for lower prices offered by parallel importers.[11]

20. The welfare implications of free-riding are more complex than advantages based on superior efficiency or lower profit margins. Before delving into that, the *fourth* explanation for a parallel import price advantage requires mention. It is that the IPR holder may be engaging in international price discrimination. In that case, the parallel importer is buying where the IPR holder is charging less and seeking to sell in one or more areas where the IPR holder is charging more. As with free-riding, careful analysis is required to determine the welfare implications of parallel imports arising because of international price discrimination.

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[10] It should be noted, however, that the fixed costs associated with adding more product variants to the market have been at least partly covered in the case of parallel imports. That will tilt things towards a positive welfare impact when greater product differentiation is provided through parallel imports. For a discussion of the welfare effects of product differentiation, see Eaton and Lipsey (1989).

[11] One could also imagine free-riding on the IPR itself, but this amounts to selling pirated or counterfeit goods, not parallel imports.

Free-riding

21. The opportunity to free-ride would not exist if IPR holders directly provided all necessary marketing support *and* did so at exactly the same cost per unit sold in all national markets. Marketing support includes things like advertising, demonstrating how a product could and should be used, and providing post-sale services, including warranty work. As soon as these costs vary across markets, there is a possibility of free-riding even if the IPR holder includes marketing costs in his prices. Parallel importers could buy the product from the IPR holder in the markets where his marketing costs and prices are lower and resell them in higher cost/price markets. This would amount to free-riding on the IPR holder's differentially higher marketing costs in the markets receiving the parallel imports.

22. There are four ways the IPR holder might be able to reduce or even eliminate free-riding in the above situation:

1. s/he could refuse to sell to buyers unwilling or unable to prevent significant free-riding through parallel imports;[12]

2. the IPR holder could, as much as commercially feasible, unbundle his marketing support, e.g. restrict post-sales services to customers who pay for it;

3. in the case of trademarked goods, the IPR holder could employ different trademarks or label designs so that parallel imports are no longer identical to products offered by authorised licensees;[13] and/or

4. the IPR holder could alter his distribution channels to take advantage of bans on parallel imports.[14]

23. It frequently happens that it is national licensees rather than IPR holders who provide marketing support. In that scenario, the associated expense is normally recovered in the price charged by the national licensees. [15] That tends to create significant free-riding opportunities. Parallel importers could buy where local marketing costs are lower and sell where they are sufficiently higher to cover cross shipping and various transactions costs (hereafter referred to as "trading costs"). This could not happen without the assistance, conscious or otherwise, of licensees in the exporting markets. When they share in the profits, the licensees might be willing to co-operate to the point of selling to parallel importers at prices excluding some or all of the local marketing expenses incurred in the exporting market. If that happens, the gains from free-riding grow considerably. There will also be a possibility that parallel imports will flow from markets with higher *retail* prices to markets with lower retail prices, instead of in the expected opposite direction.

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12 If an outright refusal would be prohibited under competition law as an abuse of dominance (assuming the IPR holder is a dominant supplier), the IPR holder will instead have to rely on contractual arrangements and/or prosecutions under the tort of unfair competition or some parallel legal protection.

13 These options may entail the loss of important economies of scale, such as those resulting from spillover effects in advertising.

14 This would normally require at least channelling foreign sales through a foreign subsidiary. More probably it would require licensing a company dealing at arms length with the IPR holder.

15 In theory, the IPR holder could sell his rights or products at the same unit price to all national licensees and then rebate different amounts intended to reflect differences in local marketing expenses. In practice, the IPR holder would probably prefer not to be involved in monitoring and checking local marketing expenses. In addition, s/he might not wish to risk prosecution for some kind of perceived international price discrimination.

24. The less direct the involvement of authorised licensees in free-riding, the more difficulties an IPR holder could face in trying to control parallel imports, i.e. monitoring costs will be higher and it may not be possible to take action based on breach of contract. In any case, the IPR holder might not want to stop the free-riding *if* s/he somehow shares in the resulting profits and is not much concerned about losing the good will of authorised licensees harmed by the practice. Licensees on the losing end of free-riding would naturally be willing to take action against the parallel imports. They too, however, could experience substantial difficulties in seeking to enforce legal rights even if the IPR holder had granted them an exclusive territory. The free-ridden licensees could be driven to rely as much as feasible on direct charges to recover their marketing support expenses. It is safe to assume, though, that they would prefer to address the problem through reliance on bans on parallel imports, provided it costs little or nothing to trigger such bans.

25. A case by case analysis is required to assess the welfare effects of free-riding. This essentially involves trading off the benefits of greater *intra*-brand competition offered by the free-riders against potential losses associated with possibly reduced *inter*-brand competition. Such a reduction might arise if free-riding makes it difficult or impossible to recover the marketing costs associated with introducing and sustaining new products. In markets where IPR holders face vigorous competition and potential licensees also lack market power (as buyers or sellers), exclusive territories would probably not exist *unless* they are needed to prevent free-riding from hampering IPR holders' abilities to compete.

26. At this point in the analysis things get somewhat more complicated. This is because the means used to reduce free-riding, notably exclusive national territories and/or licensing in countries where the licensee would be protected by a ban on parallel imports, could themselves reduce competition at both distributor and producer levels. This important point is further developed in Annex II.[16]

27. It might be objected that potentially diminished *inter*-brand competition occasioned by permitting parallel imports is not worth worrying about since such competition would not be vigorous in any event. That argument is based on improperly assuming that IPRs always grant market power. In fact, IPRs protect against mis-appropriation much more effectively than they insulate against competition. Products embodying significant IPRs could well have substitutes. For example, a patented anti-depressant could face competition from other patented anti-depressants as well as from non-drug therapies.

28. *Summing up concerning free-riding, we note that* ***if*** *there is vigorous competition in all pertinent markets, free-riding on marketing support can be presumed to have a negative effect on welfare. Where competition is considerably less vigorous, free-riding could have ambiguous effects. This means that assessing the welfare effects of reducing free-riding through bans on parallel imports requires considering prevailing levels of competition* ***and*** *how parallel import bans might affect such competition. A full assessment would also have to examine the welfare effects of whatever business strategies IPR holders might use to curtail free-riding in the absence of bans on parallel imports, bearing in mind that such alternatives might be open to challenge under competition law while government bans on parallel imports generally are not.*

International Price Discrimination by IPR Holder

29. International price discrimination (hereafter "price discrimination", where price includes royalties) is defined to occur when an IPR holder sets different profit margins, i.e. price minus average

[16] The direct and indirect effects that bans on parallel imports could have on competition are also discussed in Australia (2000, 60-69). A survey and critique of that discussion can be found in OECD (2001, 9-10 & 17-18)

cost, in different markets for his products or the use of his property rights.[17] This definition is adopted in order to screen out instances where prices vary across nations merely because of differences in product/service bundles and/or variation in the cost of such services.

30. Price discrimination in excess of cross-shipping and other pertinent trading costs cannot be maintained unless it is either secret (i.e. there is a significant lack of price transparency) or international arbitrage is somehow prevented. Because we are more interested in long run than in short run effects, and because price transparency may well increase over time, we confine our analysis to cases where international arbitrage is somehow blocked. A ban on parallel imports would normally constitute such a block.[18]

31. Again because we are more interested in long instead of temporary or short run effects, we will for the most part ignore the possibility that price discrimination is occurring due to IPR holders failing to immediately adjust their prices to changes in exchange rates.[19] The welfare effects of temporary price discrimination are at any rate likely to be the same but smaller than those associated with longer lasting price discrimination.

32. Defining the short run as a period of time over which the stock of IPRs can be taken as given, and *assuming the IPR holder has market power in one or more markets*, the short run or *static* welfare effects of price discrimination are ambiguous.[20] The consumers charged the lower prices may or may not gain more than what those charged higher prices lose. About the only generalisation that can be made is that price discrimination will *not* increase welfare unless it increases the number of units sold. It is also worth bearing in mind that the gains from output expanding price discrimination could be considerably augmented if it leads to cost savings linked to economies of scale or learning economies.[21] In any case, an output expansion is only a necessary, not a sufficient condition for price discrimination to have a welfare improving effect.[22]

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17 In an article on price discrimination, Varian (1989, 598) states that in place of defining price discrimination as "…the same commodity being sold at different prices to different customers", he prefers a definition attributed to Stigler. Varian paraphrased this as: "…price discrimination is present when two or more similar goods are sold at prices that are in different ratios to marginal costs." This is very similar to the definition we have adopted, in fact it is identical if marginal costs are equal to average costs.

18 Exceptions to this general rule would occur if IPR holders were able and willing to compel their licensees to authorise what would otherwise be parallel imports.

19 See Hilke (1988, 82) for a brief discussion of why such price stickiness might exist and help explain parallel imports.

20 For a detailed analysis of the welfare effects of price discrimination, including "third degree" price discrimination (under which geographic price discrimination falls), see Varian (1989, especially 619-624). See also Armstrong and Vickers (2001) who examined price discrimination in an oligopoly rather than monopoly setting and concluded, *inter alia*, that: "…freedom to engage in price discrimination tends to be desirable in sufficiently competitive conditions…." They went on to note that: "The main exception to this rule was when consumers were segmented into identifiably separate markets…." This exception would appear to apply to the kind of price discrimination of relevance to the international exhaustion debate.

21 See Hausman and MacKie-Mason (1988, 257).

22 Hausman and MacKie-Mason (1988, 255) express this as follows:

> With fairly general assumptions one can show that, aside from any incentive externalities, a *necessary* (not *sufficient*) condition for price discrimination to increase static Marshallian welfare (the sum of consumers' and producers' surpluses) is that total output of the product increase. The

33. Price discrimination is more likely to increase output if uniform pricing would result in some markets not being served.[23] That possibility is in turn more likely, the greater the variation in demand conditions (due to differences in things like per capita incomes, competitive conditions and tastes and preferences) across pertinent markets. Malueg and Schwartz (1994) deduce from this that regional exhaustion policies, and the intra-regional uniform pricing they foster, are more likely to improve welfare the more homogeneous are demand conditions across member states.

34. Before leaving the static welfare effects of price discrimination, we must touch on the important difference that market power at both the IPR holder and licensed distribution levels could make. Such sequential market power creates a double marginalisation that reduces both private profit and social welfare.[24] The IPR holder in this position will have a strong incentive to either vertically integrate forward into distribution, or to charge its licensee a fixed franchise fee and a per unit producer price that reflects the IPR holder's marginal costs. For reasons already explored, the latter route might be best. The problem with that approach is that a low producer price puts the licensed distributor in a good position to engage in parallel exporting and thereby undo the effects of privately (and perhaps socially) desirable price discrimination. To counter that, as Maskus and Chen (2000) have explained, the IPR holder will set prices to licensed distributors higher than he otherwise would, *unless* parallel imports are effectively banned or inhibited by high trading costs (i.e. chiefly tariffs and transportation costs). Maskus and Chen concluded from both their model and empirical work that:

> …our analysis suggests that given any two countries, there exists some critical value of trade costs such that parallel trade increases (or decreases) global welfare when the cost of engaging [in] it is below (or above) the critical value. Pricing behaviour by U.S. exporters in the face of low American tariffs suggests that they increase export prices in an attempt to deter parallel trade. But in the presence of low trade costs our analysis suggests that allowing parallel imports is likely to increase welfare. This may be particularly true within a region, such as the European Union or NAFTA. However, restricting parallel imports may be desirable between countries involving significant trade costs. (31-32)

> intuition is straightforward. If different customers are paying different prices for a product, their marginal valuations are driven apart. Thus, price discrimination necessarily leads to allocative inefficiencies. For welfare to increase, total output must increase sufficiently for the resulting surplus gains to exceed the allocative losses.

By "allocative losses", the authors intend the inefficiency that results when buyers assign different relative values to pairs of goods, i.e. what we would characterise as "distributive inefficiency" – see note 3 supra. Price discrimination would almost always create distributive inefficiency.

23 Besides its effect in tending to undo price discrimination, there is another reason that repealing bans on parallel imports could lead to some markets not being served. Some countries could give significantly lower levels of protection to IPRs, e.g. shorter patent terms. With bans on parallel imports, IPR holders could decide to serve such markets even though they are aware that when patent protection runs out, prices there could drop considerably. That *might* not be the case if there were no bans on parallel imports. The difference in result would turn on whether or not authorised licensees in countries practising international exhaustion would be able to exclude imports from countries in which IPR protection has lapsed, or never existed, regardless of who produced the goods in the exporting country. In any event, it is sometimes argued that repealing bans on parallel imports would tend to exert downward pressure on the level of IPR protection offered in the countries currently offering stronger or longer lasting IPR protection.

24 See n. 7, supra.

35. It is often thought that price discrimination cannot occur in the absence of market power. It turns out, however, that this may not be true provided there are sufficient economies of scale.[25] This is a highly pertinent proviso given that the high fixed costs associated with IPR creation are a potential source of significant economies of scale. In any event, the lower the level of market power, the more likely is price discrimination to be welfare enhancing.[26] Further investigation of the static welfare effects of price discrimination can be found in Annex III.

36. The *dynamic* welfare effects of price discrimination depend on how it alters rewards to innovation, hence affects levels of investment in creating IPRs. If voluntarily adopted, price discrimination can be presumed to increase or leave unchanged both the rewards to innovation and the resulting stock of IPRs. It follows that the dynamic welfare effects of price discrimination will normally depend on whether profit levels without price discrimination would have been sufficient to produce the socially optimal level of investment in IPR creation. The answer to that question depends partly on the adequacy of IPR protection, a topic lying beyond the scope of this paper.[27] The other part of the answer turns on whether profit levels without price discrimination are, in the short run, below, equal to, or greater than the (risk-adjusted) competitive rate.[28]

37. If short run rates of return to IPR creation are at or below competitive levels, a reduction/increase in expected profitability, would probably reduce/increase IPR production. If the relevant current rates of return are instead above competitive rates, i.e. IPR holders have market power, changes in those rates have less certain effects on IPR production, though reductions/increases in profit rates should still tend to be associated with reduced/increased IPR production.

38. *Summing up the welfare effects of price discrimination related to bans on parallel imports, we re-iterate that from both the static and dynamic points of view those effects are ambiguous. They are more likely to be positive, however, the more vigorous the competition in the affected markets. The welfare effects are also more likely to be positive if voluntarily adopted instead of being induced by governmental price regulation. An assessment of the welfare effects of price discrimination linked to bans on parallel imports would be incomplete unless it considers the effects of other means IPR holders could feasibly use to segment markets in the absence of bans on parallel imports. Finally, if it is presumed that there is a need to increase profits in order to nudge IPR related investment closer to socially optimal levels, the welfare analysis of bans on parallel imports should extend to considering alternatives to facilitating price*

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25 For discussion of why market power many not be necessary for price discrimination, see Frank (1983) and Levine (2000).

26 Essentially this is because voluntary (in contrast to government engineered) price discrimination will normally lead to increased prices for consumers who cut back less in response to such increases. Reductions in quantity consumed occasioned by prices set above marginal costs create what economists refer to as "deadweight loss", i.e. losses to consumers unmatched by gains in profits. Since welfare is maximised when deadweight loss is minimised, voluntary price discrimination can increase welfare.

27 We note, however, that trademark protection is more likely to be fully adequate than patent and copyright protection for example. When trademarks are legally protected, the trademark owner may have an incentive to raise and/or maintain the consistent quality of his goods. To the extent higher and/or consistent quality is valued by consumers, trademark owners should be able to charge more for their goods than sellers of non-trademarked goods. This ability to obtain a return on welfare enhancing investments in quality persists through time because trademarks are non-time limited. In contrast, patents and copyrights both expire after a certain number of years.

28 Provided barriers to entry and exit with regard to innovation activities are sufficiently low, long run profitability would be driven to competitive levels.

discrimination. It might be more efficient, for example, to raise the expected profitability of IPR creation by granting longer or broader patents.[29]

Other Issues

39. Free riding and price discrimination are probably the main issues to examine in assessing the global efficiency of bans on parallel imports, but they are not the only issues. Here are four more.

1. Effects on piracy and counterfeiting

40. If parallel imports are banned, only authorised licensees and persons they in turn authorise are permitted to import products embodying IPRs. Such a restriction on the number and identity of importers could facilitate detecting piracy and counterfeiting.[30] Parallel import bans could also facilitate keeping pirated and counterfeit goods out of the market because they dispense with the need to prove that such goods have been illegally produced. It would be sufficient to show that their importation was unauthorised. It could be argued, however, that bans on parallel imports are not the optimal solution, i.e. higher sanctions and increased enforcement resources might achieve the same effect without risking welfare losses related, for example, to anti-competitive price discrimination. This issue cannot be resolved through appeal to economic theory. What is needed is empirical evidence.

2. Safety and consumer confusion issues

41. As already noted, some IPR owners may want licensees to invest in adapting products to local circumstances. That could lead to the argument that exclusive territories are needed to prevent consumer confusion, and bans on parallel imports may be a particularly effective and inexpensive way to enforce exclusive territories.[31] As Gallini and Hollis (1999, 5 - reference omitted) point out:

> Many goods with identical TMs [trademarks] are produced in different locations under different specifications, vary according to local tastes, have different packaging and instructions, and comply with different safety standards. A common TM may be used because of economies of scale in brand development, or because information flows easily between countries through newspapers, television, and travel. However, if a common TM is used and prices differ between countries, then gray markets may emerge as unauthorised importers try to pass off one product for another. This undoubtedly will cause confusion and may cause distributors to reduce their investment. Hence, market segmentation is needed to ensure that their efforts will not be undermined by gray marketers.

42. This time there is an obvious and seemingly superior policy alternative to bans on parallel imports. It is simply to require adequate labelling. Properly informed consumers could presumably be relied on to make welfare maximising choices among different versions of essentially the same good. If safety is the issue, however, stringent labelling may not be enough. Improved safety regulations, including better enforcement, may be needed.

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29 See Hausman and MacKie-Mason (1988, 253-254 and 263-264).

30 It seems safe to presume that authorised licensees are unlikely to handle or countenance the importation of pirated or counterfeit goods.

31 For arguments along these lines, see BIAC (2001, 2-3 & 8) and France (2001, 6-7).

3. Possible effects on employment

43. Abbott (1998) attempts to strengthen the case for international exhaustion by arguing that blocking parallel imports reduces the gains from trade that could be reaped by locating production based on comparative advantage. Anderson et al. (1998, 425) and Ireland (2001, 13) have argued against that view. In the words of the latter, written in the context of criticising the European Court of Justice's decision in *Silhouette*:

> The exhaustion regime and the location of production are, in any case, independent of each other. It is clear that producers will produce goods in the lowest cost location. However, the location, for the purposes of trademark exhaustion, is the country where the goods were first sold by the manufacturer. Much has been made of this point by opponents of international exhaustion. It is worth reminding ourselves that most of the same manufacturers of trademark goods choose not to locate their production plants within the EU in any case. In the light of this fact, it is misleading for manufacturers of trademark goods to use scare tactics over the employment consequences of overturning Silhouette. This is to cause concern for jobs that the EU overwhelmingly does not even currently have in any case.

44. The above paragraph focuses on employment in producing goods embodying IPRs, but there are also potential effects on employment in IPR creation that should be considered. Those effects would presumably depend on whether parallel import policies reduce the profitability of creating IPRs.

4. Impact of e-commerce and other technological developments

45. With or without bans on parallel imports, many countries permit consumers to import goods for personal use. As regards such countries, the development of e-commerce might make bans on parallel imports an increasingly less effective means of separating national markets. This is an empirical question that will be touched on briefly later. In any case, there are other technological developments that may make it easier rather than harder to separate national markets. For example, Version 6 of the Internet Protocol will apparently permit identifying the geographical location of buyers. This has hitherto been impossible, i.e. electronic commerce vendors could not determine the location of buyers unless the buyers provided that information.[32] There is also the example of DVD players built to play only the DVDs intended for a specific area defined through agreements among content providers and DVD player manufacturers. This is especially disconcerting given that recent copyright law amendments in some nations could make it very difficult for market forces to undo the effects of this system.[33]

Summing up concerning (global) welfare effects of bans on parallel imports

46. *The welfare effects of bans on parallel imports cannot be determined on the basis of economic reasoning alone. Theory merely indicates three important factors to consider. The* ***first*** *is that the less vigorous the competition among IPR holders and among those distributing pertinent goods, and the more bans on parallel imports reduce such competition, the less likely are bans to improve welfare.* ***Second****, a complete assessment of welfare effects should include what would happen in the absence of bans on parallel imports, i.e. how easy would it be for IPR holders and authorised licensees to prevent parallel imports if the bans were repealed. The answer to that would partly depend on how competition laws would*

[32] This point was mentioned by Henry Ergas during his presentation to the OECD's Joint Group on Trade and Competition on May 30, 2001 in Paris.

[33] The DVD player issue is presented in Ergas (2001, 16-17).

likely be applied to such restraints.[34] ***Third****, a thorough welfare assessment should also consider less competition inhibiting alternative government policies that might be available to attain the same public benefits as are sometimes argued for bans on parallel imports. Included among such benefits are things like higher levels of investment in IPR creation, lower levels of piracy and counterfeiting, reduced consumer confusion and safer products. Examples of alternative government policies worth considering are enhanced IPR protection, heavier sanctions against piracy, and improved labelling and safety regulation.*

III. National Welfare Analysis

47. The previous section took a global approach to assessing the welfare effects of bans on parallel imports. Policies affecting exhaustion are adopted, however, at the national level, again defining "national" to include regional in the case of countries belonging to certain regional trade arrangements. It is therefore necessary to examine how and why bans on parallel imports might have different effects across nations.

48. Looking solely, for the moment, at the free-riding issue, there could be significant international differences in welfare effects if the intra- and inter-brand competition trade-off varies considerably across nations. That would be the case, for example, if parallel imports could significantly improve competition in the distribution sectors of certain countries, but would have little impact in others where distribution is already sufficiently competitive. In contrast, it is unlikely there would be significant international differences in how bans on parallel imports may affect piracy and counterfeiting, or impact on consumer confusion and safety issues. Employment effects, though, could diverge significantly because IPR creation tends to be concentrated in certain nations. That leaves the price discrimination issue. It is here that the greatest differences in welfare effects of bans on parallel imports would likely emerge.

49. If Country A repeals its bans on parallel imports, this will tend to make it more difficult for IPR holders to charge relatively high prices in that country and that in turn could produce several welfare effects in Country A and beyond. To simplify exposition of those effects, we will presume that parallel import bans affect welfare only as they impact on price discrimination, i.e. there are no free-riding or other issues to consider. We will also make the following simplifying assumptions:

1. competition is unaffected by the presence or absence of bans on parallel imports into Country A;

2. without a ban on parallel imports, it will not be possible for IPR holders to charge significantly higher prices in Country A than are charged in other markets, i.e. alternative means of segmenting markets are unworkable or prohibitively expensive, and trading costs are relatively low;

3. the subject country's international exhaustion policy choice will not affect other nations' policy choices; and

4. there is just one IPR embodying product (i.e. "widgets") that might be parallel traded.

50. Under the above four assumptions, the welfare effects in a country unilaterally abolishing bans on parallel imports (i.e. Country A), will depend on whether or not:

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[34] The usual presumption would be that the application of competition law should increase welfare, i.e. only anti-competitive arrangements would be liable to attack under competition law.

5. IPR holders charge relatively high prices in regard to Country A;

6. economies of scale and learning economies are important;

7. any overall decline in profits occasioned by Country A's policy change is significant enough to reduce future IPR creation; and

8. IPR holders are mostly foreign companies.

51. A safe initial generalisation is that Country A's welfare is unlikely to be affected if it was a relatively low price country prior to its repeal of bans on parallel imports. If Country A were instead a relatively high price country, it could reap net benefits from price drops brought about by actual or potential parallel imports from lower price countries. These generalisations require some fine tuning, however.

52. Even if Country A initially had been a higher priced country, its welfare might decline *if* its new parallel import policy leads to a significant *decline* in world-wide output. In markets characterised by important economies of scale, a drop in world-wide production could so increase unit costs that Country A widget prices rise above pre-repeal levels even though Country A ceases to be a relatively higher price country. A similar concern could arise in regard to the long term production of IPRs. If Country A's policy change results in a significant decline in the expected profits of IPR creation, i.e. Country A was a higher price country when the bans were in place, *all* consumers could eventually suffer some loss of welfare if investment in IPR creation falls substantially below what it would otherwise have been. The likelihood of adverse effects arising from foregone economies of scale or reduced IPR creation is respectively less or greater the larger the world-wide share of the market accounted for by Country A.

53. It is important to understand why world-wide production *might* decline if Country A, assumed to be a relatively high price area, repeals its bans on parallel imports. Such a result may seem unlikely given that quantities consumed in Country A would normally rise in response to a drop in prices linked to a potential or actual increase in parallel imports. One must also consider, however, what will probably happen to prices and quantities demanded in other countries. After the bans are repealed, profit maximising IPR holders will have to set their prices in formerly lower priced countries taking account of the possibility that they could become sources of parallel imports into Country A.[35] It is as if all the countries that formerly had lower prices than Country A move in the direction of being a single market with Country A.[36] In the absence of tariffs and other trading costs, prices charged by IPR holders would tend to equality throughout that area. That means they will eventually probably be lower than what they initially were in Country A, and higher than initially in all the formerly lower priced countries. The effects of this equilibrating tendency on world-wide output are ambiguous, i.e. they could be negative or positive depending on the pertinent price elasticities of demand, and on the size of Country A's market compared with the formerly lower priced market(s)..

54. To estimate the size rather than simply the direction of welfare effects in Country A caused by repealing its bans on parallel imports, one must consider the nationality of IPR holders. Assuming Country A were a higher price market in the pre-repeal days, IPR holders would suffer profit declines from the policy change. Other than the already mentioned possible impact on IPR creation, lower profits will negatively impact on Country A only to the extent the IPR holders are domestic. It should be noted,

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35 Our assumption that price discrimination cannot be sustained without bans on parallel imports is critical here.

36 Somewhat paradoxically, this is true even if all the other affected countries have and retain bans on parallel imports.

however, that even if all the affected IPR holders were domestic, their profit losses related to sales in Country A would be less than what Country A's consumers would gain from any drop in the price of widgets.[37]

55. We turn now to each of our preliminary four assumptions to see how national welfare effects might be affected by relaxing them one by one.

56. If one relaxes the assumption that parallel imports have no effect on competition, even relatively low price countries might benefit from repealing bans on parallel imports. This is linked to what we earlier noted about parallel imports probably improving competition both among IPR holders and at the level of their authorised licensees. The strength of the effect on IPR holder competition would tend to increase with the share of the world market accounted for by Country A, and the degree of market power formerly enjoyed by the IPR holders (i.e. little improvement would be expected if market power were already quite low). To the degree competition among IPR holders were increased, all countries would draw some benefits from Country A's repeal of its bans on parallel imports. As for competition improving effects at the level of authorised licensees, the resulting benefits would be concentrated in Country A and would tend to be higher the greater the market power enjoyed while the bans were in place.

57. If the second assumption does not hold, i.e. price discrimination does not depend on bans on parallel imports, one would predict reduced welfare changes. The strength of the attenuating effect would depend in the first instance on the significance of trading costs. If these are high enough, Country A could remain a higher price country even if bans on parallel imports were repealed. It would also depend on the profitability of alternative means IPR holders might employ to prevent price arbitrage through parallel imports. It is fair to expect that nations accounting for significant percentages of world trade in affected products would have to pay special attention to gauging how IPR holders might change their distribution systems in response to profit eroding changes in parallel import policies.[38]

58. So far we have simply assumed that Country A need not consider how other countries might react to Country A repealing its bans on parallel imports.[39] The probability of such reactions depends on the relative size of Country A's market, whether it was a relatively high or low price market when the bans were in place, and the degree to which negatively affected IPR holders are residents of other countries. To explore this further, let us assume that there are just two countries in the world (Countries A and B), both initially ban parallel imports, and Country A initially has the relatively higher widget prices.[40] Country B might benefit from Country A abolishing its bans on parallel imports if that leads to an increase in world production and a consequent fall in production costs resulting from significant economies of scale. Aside

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37 This is analogous to saying that the exercise of market power always harms buyers more than it helps sellers. A complete analysis, however, must also take account of reduced profits Country A's IPR holders will probably experience in relation to a lower volume of sales in formerly relatively lower priced markets outside Country A.

38 This point was brought out during the presentation of NERA (1999) at the May 30, 2001 meeting of the Joint Group – see OECD (2002, paras. 46 and 47). NERA (1999, 41-47) contains a discussion of how trademark holders might react to a repeal of EEA bans on parallel imports from countries outside the EEA.

39 Such reactions by trading partners are far from being mere theoretical concerns. According to Maskus (2000, 1274), the United States initiated a "…Special 301 'out of cycle' review of New Zealand…" in response to New Zealand removing restrictions on the parallel importation of copyright goods. Maskus also stated that the United States placed South Africa "…on its Special 301 Priority Watch list in 1998…" after South Africa took a series of measures to lower the prices of patented medicines including legalising parallel imports of patented and trademarked medicines.

40 If Country A initially has the lower instead of higher prices, its repeal of bans on parallel imports would not necessarily cause any price or profit changes anywhere.

from that possibility, however, it is difficult to see how Country B could benefit from Country A repealing its bans on parallel imports. It would instead probably be harmed through a rise in what its consumers pay for widgets, or through a decline in investment in IPR creation. Any such harms might be aggravated by effects on Country B's IPR holders (presuming they have interests in widgets).

59. The possibility of other countries being harmed by Country A's repeal of its parallel import bans raises the possibility of some international gaming with respect to international exhaustion, including various threats of retaliation if bans are removed. This is better appreciated after relaxing the assumption that there is only one product that could be affected by parallel imports. Country A could be a net loser from price discrimination on widgets but a net winner in welfare terms from price discrimination on "gidgets". It would consequently favour permitting parallel imports on widgets and be indifferent to changing its policy *vis-à-vis* gidgets. Its enthusiasm for allowing parallel imports in widgets would be reduced, however, if it believed that other countries would respond by repealing their bans on the parallel imports of gidgets.[41]

60. It is possible that Country A's decision to repeal its parallel import bans could start a kind of chain reaction of other higher price countries following Country A's example. If that happens, the result could be to leave all countries worse off than if they had jointly agreed to maintain a ban on parallel imports. This possibility could warrant serious attention if two conditions are *both* met. The first is that Country A be so large relative to the rest of the world that its actions have a significant effect on other nations. Once such a country permits parallel imports, other countries may well suffer some harm. Whether or not that happens, the other countries are no worse off if they go ahead and imitate Country A. Previously, they may have held back from repealing their bans precisely out of fear that Country A might react by ceasing to be co-operative and instead taking a narrowly self-interested approach. The second condition is that bans on parallel imports would be economically efficient as regards the countries contemplating a joint ban. This condition is more likely to be satisfied the more diverse are market characteristics across the nations concerned.[42] In any case, even when a multi-national approach might make sense, it may have to involve more than simply international exhaustion policies in order to ensure that all participating nations are better off. Some countries might be worse off with bans on parallel imports regardless of what the other participants decide to do. This is particularly likely to apply to smaller, higher per capita income, net importers of IPRs, especially if their distribution systems would benefit from the competition parallel imports could bring.

Summing up national welfare effects

61. *National welfare effects of changes in parallel import policies will probably not differ much from the global effects* ***unless*** *either a particular country would especially benefit from the increased competition parallel imports might bring, or bans on parallel imports are critical to sustaining price discrimination. If price discrimination does in fact depend on parallel import bans, a country will tend to gain more from repealing the bans the more it: is small in relation to the world market; tends to pay*

41 Such concerns may lie behind an observation contained in NERA (1999, Executive Summary, page 9), i.e. that: "…it will not necessarily be true that reciprocal or multilateral extensions [of international exhaustion] are better for the EU economy as a whole than is unilateral extension."

42 As earlier noted, price discrimination supported by bans on parallel imports is more likely to lead to increases in output (and welfare) the more diverse the pertinent international market conditions.

relatively high prices for IPR services; is a net importer of IPR services; and has a distribution system whose efficiency could be considerably improved by being exposed to competition from parallel imports.[43]

62. *To the extent that price discrimination is at the heart of the parallel import phenomenon, and assuming equal weight is given to consumer and producer interests, each nation may prefer a world where they alone practice international exhaustion irrespective of whether this is globally efficient. If this is true and if bans on parallel imports are in fact globally desirable, then a multi-national approach to setting parallel import policies may be needed. It would be more likely to bear fruit if the negotiations are extended beyond parallel import policies. A broader scope to negotiations could facilitate making policy concessions in other areas to nations that believe they are harmed by bans on parallel imports.*

IV. Empirical Work

63. Given the inconclusive predictions from economic theory concerning either global or national welfare effects of bans on parallel imports, it is very important to consider pertinent empirical work. There do not appear to be a large number of such studies and they tend to focus on specific kinds of IPRs and countries/regions. We describe first some studies that have not yet been considered by the Joint Group, before re-capping work contained in Australia (2000), NERA (1999) and Swedish Competition Authority (1999).

United States

64. In 1985 the U.S. Department of Commerce conducted an important survey of parallel imports into the U.S. Referring to that work, Maskus and Chen (2000, 24) state:

> Survey evidence reported rapidly rising parallel import volumes in 37 product categories, with most being high-end goods bearing recognised trademarks, such as Mercedes-Benz sedans, Opium perfume, and Nikon cameras….As Tarr (1985) and Hilke (1988) point out, this surge in parallel imports corresponded to a strong rise in the real effective value of the dollar. Dollar-denominated U.S. real prices within authorised distibution outlets did not fall in this period (indeed, many rose), suggesting strongly that foreign manufacturers were pricing to market in dollar terms. (24)

65. Tarr (1985) presented an analysis of the causes of increased parallel imports of trademarked goods into the U.S. in the mid 1980s, in which he focused on:

> …two plausible competing hypotheses for what explains gray market imports: (1) gray market imports are here because foreign manufacturers are employing monopolistic price discrimination; the U.S. price has increased relative to the foreign price as the value of the U.S. dollar has increased. And (2) gray market imports are present in the U.S. because costs are incurred in the authorised distribution chain that gray market importers avoid, the free-rider problem. Gray market importers are able to sell in the U.S. only because they do not incur the expenses that the authorised distributors incur in developing goodwill for the product. (2-3)

66. Tarr later made some interesting remarks about the kind of data needed to distinguish between these two hypotheses:

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[43] For analyses of how repealing bans on parallel imports might affect a smaller market, higher price paying, net importer of IPR services, see Australia (2000, 62-69) and Ergas (2001, 5-13).

> The ideal data for the purpose of distinguishing between the price discrimination and efficiency hypotheses are product-specific price-cost margins by country over time. If the U.S. mark-up were increasing relative to mark-ups abroad, this would reflect increased price discrimination and would be expected to induce increased gray market imports. Unfortunately those data are unavailable.
>
> It would also be extremely helpful to have economic profit data by product of the companies who are experiencing gray market imports. If these companies are not earning positive economic profits on the products being imported through the gray market, then the monopolistic price discrimination hypothesis would be rejected. Conversely, if positive economic profits are being earned then a pure free-rider explanation would be rejected. Again, unfortunately these data are unavailable. (28)

67. Tarr instead had to be satisfied with a cruder test focused on what happened to gray market imports as the U.S. dollar appreciated. Tarr noted that, assuming marketing support costs in the U.S. stayed relatively constant as the U.S. dollar appreciated, one could confidently predict an increase in both price discrimination, if such is indeed occurring, and in parallel imports which are rendered more profitable by the increased price discrimination.[44] Consequently, if there is no rise in parallel imports as the U.S. dollar appreciates, one can rule out the price discrimination theory, and instead give more credence to the free-riding hypothesis. Unfortunately, an appreciation of the U.S. dollar means that marketing support costs in the U.S. rise (denominated in a third currency) rather than remain constant. This means that although unchanged parallel imports into a country whose currency is appreciating would tend to rule out the price discrimination hypothesis, a rise in parallel imports does not rule out either hypothesis.

68. As it turned out, Tarr found that gray market imports did rise significantly with the appreciation of the U.S. dollar, so the price discrimination hypothesis cannot be ruled out. That, coupled with his observation that differential marketing costs probably did not explain relatively higher prices in the U.S. and some anecdotal evidence that price discrimination was instead the explanation, led Tarr to conclude that:

> …in most cases price discrimination is the dominant explanation of gray market imports. While there may be free-riding occurring in these cases as well, it appears to be less significant. There may well be cases, however, such as fragrances, where cost differences may be the dominant explanation of the price differences and where gray markets imports are driven primarily by free-riding. (48)

69. Based on the "introduction and summary" of the paper, we deduce that "most cases" probably refer to automobiles, cameras, outboard motors, ski equipment and champagne.[45]

70. Hilke (1988) also examined the 1985 U.S. Commerce Department survey, supplemented with various news articles, some U.S. Federal Trade Commission staff investigations of alleged consumer deception in various grey markets, and some additional government data. Out of that he culled six characteristics of parallel imports. These were (omitting references):

> 9. The volume of gray market imports into the United States has increased and decreased with the relative value of the dollar….

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[44] Increased price discrimination means that, denominated in a third currency, the price would rise in the U.S. relative to the rest of the world.

[45] See Tarr (1985, 3).

10. The brands involved in gray markets are usually premium brands among the most highly differentiated in their category in the United States….

11. U.S. wholesale prices for products with significant gray market activity were commonly substantially higher than comparable foreign wholesale prices when the dollar was appreciating….

12. Manufacturers have engaged in varying degrees of private efforts to curtail gray market imports….

13. Imported gray market products are usually physically close substitutes for the authorised imported products….

14. Systematic nondisclosure of material facts has not been found by the FTC staff in any of its investigations of gray market goods initiated in the 1980s. Although authorised importers have provided anecdotal evidence of consumer injury, allegedly resulting from various practices associated with the sale of gray market goods, there was insufficient evidence of a systematic problem to warrant bringing a complaint….(83-86)

71. Hilke also made a number of interesting empirical observations basically reinforcing what Tarr had found. The first was that if free riding was the main underlying driver it is somewhat difficult to understand the correlation between growth of parallel imports and appreciation of the U.S. dollar. This point was qualified by noting that since transportation and trade costs could eat up a lot of the gains of free-riding, one could find the positive correlation noted. Hilke remarked, however, that: "There is insufficient data to refute this possibility completely, but it seems unlikely that so many diverse industries would be so similarly situated." (89)

72. Also on the free-riding issue, Hilke commented that many of the complaints received by the U.S. Commerce Department concerned free-riding on licensed distributors' warranty services. One might expect that such free-riding would promote the unbundling of warranty work. Hilke believed that was in fact happening at the time his paper was written. On the other hand, Hilke also believed that many, but certainly not all, of the products subject to parallel importation were well known to consumers so required little marketing support, hence presented limited opportunities for free-riding.

73. Hilke pointed to "[w]holesale price differences between countries (even after adjusting for cost differences including transportation and promotions) [being] apparently common in several industries when the dollar was rising." (90), and deduced:

> Neither the free-rider nor the consumer deception theories predict these wholesale price and profit differences.
>
> Within the severe limits of the available data, it appears that some form of geographic price discrimination, probably related to adjustment lags, took place in several gray market goods. (90)

74. The argument is normally made that foreign manufacturers should oppose free-riding. Therefore, if free-riding is indeed a problem, one would expect such manufacturers to try to curtail parallel imports. Hilke noted however that manufacturers in some markets had failed to take some obvious actions that would have reduced parallel imports. He deduced from this that manufacturers might be benefiting from the parallel imports as a means of disciplining distributors, including discouraging collusion among them. It should also be noted, however, that the manufacturers themselves could be the free-riders, i.e. be engaging in some post-contractual cheating.

75. As with Tarr (1985), Hilke noted that complaints to the FTC indicated, "…that consumer deception has not been widespread and systematic enough to justify government intervention on this basis." (91)

76. Hilke's general conclusion included:

> Although a theoretical case can be made that gray market imports are motivated by free-riding on the promotional and service efforts of authorised importers, the available empirical evidence is inconsistent with the strong form of this hypothesis that links all gray market activity to free-riding. The hypothesis that gray market imports are connected with lags in exchange rate adjustments is generally more consistent with the evidence in more industries. More definitive conclusions than these are not possible because of the limitations of the data. (91)

77. Maskus (2000) reviewed empirical work by Tarr (1985) and Hilke (1988) as well as developments in Australia and findings presented in NERA (1999). Those are surveyed in some detail below. He also repeated the view that weak adjustment to exchange rate changes supported the hypothesis that parallel imports are linked to price discrimination, and added that:

> …the recent collapse of numerous Asian currencies expanded incentives for parallel imports into the United States, Japan, and Europe. Indeed, press reports suggest that parallel imports into the United States of construction equipment, computers, cars and branded consumer goods rose quickly in 1998 and 1999. (1279-1280)

78. Maskus considered international price differences in pharmaceuticals, focusing particularly on Omeprazole, the active ingredient in medicines marketed under different brand names in various markets. Prices were higher in markets where patent protection was strongest, price regulation non-existent and parallel imports blocked. He concluded that: "…were parallel imports generally allowed in patented drugs, it is likely that considerable volumes of such trade would emerge." (1282)

79. Maskus' overall conclusion from the empirical work he surveyed was that the findings remained "…sufficiently inconclusive to make confident claims about policy." (1283)

80. The Maskus and Chen (2000) paper contained an extensive amount of regression work focused on explaining U.S. export prices in 1993, "…in 26 highly disaggregated products…that may be thought subject to parallel trade."(26) Two of the explanatory variables were U.S. (i.e. "home") tariff rates and a measure of competition prevailing in foreign distribution markets. At low levels, the regressions indicate that increases in U.S. tariff rates are associated with increases in U.S. export prices but starting at higher tariff levels the relationship is reversed, i.e. increased tariffs are associated with decreases in U.S. export prices. A simple negative relationship was found between Herfindahl concentration indexes in foreign distribution markets (a rough measure of competition) and U.S. export prices. These findings accorded with what Maskus and Chen predicted based on a model taking account of the need for vertical price control in situations where both IPR holders and distributors have market power. Maskus and Chen emphasised that:

> Indeed, except for the theory in this paper, there seems to be no other reason why the foreign wholesale price set by the manufacturer should depend on the home tariff rate. (26)

81. One might question this on the ground that U.S. manufacturers desiring to discourage free-riding on marketing support in the U.S., would be expected to take the home tariff rate into account in setting their export prices. Other things equal, however, this would indicate a monotonically negative relationship between the home tariff rate and export prices. Maskus and Chen (2000) instead found an "n" shaped relationship.

Denmark

82. Denmark (2001, 6) referred to the Danish Ministry of Trade and Industry having made "…a preliminary identification of the volume and nature of parallel imports to Denmark in 1997." Based on interviews with experts in the industries covered, the Ministry estimated the percentage of total imports accounted for by imports, namely:[46]

Medical/pharmaceutical products	11%
Perfumes, cosmetics, etc.	3 – 5%
Radio, TV etc.	3 – 5%
Spare parts for motor vehicles	1 – 3%
Clothing	3 – 5%
Photographic equipment, optics, clocks	3 – 5%
Various processed goods	3 – 5%
Gramophone records, CD's etc.	10 – 15%

83. The report estimated the major part of the parallel imports came from outside the EEA. The exception to that was pharmaceuticals where the source countries appear to be Spain and Portugal.

France

84. France (2001) referred to empirical work by both NERA (1999), discussed below, and the Economist Intelligence Unit (EIU) (2000). The EIU report was commissioned by the U.K. Department of Trade and Industry and the Swedish Ministry for Foreign Affairs. It basically compared average *retail* prices based on a survey of branded consumer goods in France, Germany, Sweden, the U.K. and the U.S. Selected goods from eight product categories were covered: computer games and toys; cosmetics and fragrances; clothing and footwear (non-sporting); sports and leisure; electrical goods; household goods and furniture; and accessories. Noticeably absent were photographic equipment (except for digital cameras), motor vehicles and parts, and pharmaceuticals. France (2001, para. 34) summarised the findings as follows:

> The EIU study reveals that, of a total of 98 products studied, among four chosen European Union members - Sweden, United Kingdom, France and Germany – and the United States, only 14 products were cheaper in the United States. In addition, it appears that prices within the European Union vary enormously across member states, despite the application of Community-wide exhaustion. Thus, France, which has never practised international exhaustion, has the lowest prices of the four chosen European Union members for 57 of the 133 products studied, while the United Kingdom, Sweden and Germany, which have had international exhaustion in the past, are the lowest priced countries for respectively, 9, 18 and 49 of the 133 products studied.[47]

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46 Table 3 of the Annex to Denmark (2001).

47 Author's unofficial translation. The price comparisons were probably made using after tax retail prices. This is implied in paragraph 35, i.e. the one following the paragraph cited.

Australia

85. Australia has made several amendments to its copyright laws in order to eliminate some bans on the parallel imports of copyrighted goods. To begin with, amendments in 1991 were made to liberalise parallel imports in books in instances where certain availability criteria were not met. According to Australia (2001, para. 12): "There is general agreement that the 1991 reforms have improved the availability of books but the impact on price is less clear."

86. In 1999, the Australian Competition and Consumer Commission (ACCC) was asked to report on the potential consumer benefits of simply removing the bans on parallel imports of books and computer software. The ACCC concluded that Australians had paid more over the past decade for books and computer software than overseas consumers, and that bans on parallel imports contributed to those relatively high prices by permitting copyright holders to price discriminate to the detriment of Australians.[48]

87. In mid-1998 Australia allowed parallel imports of sound recordings. The ACCC found this resulted in several changes.[49] First, some copyright owners may have resorted to both legal (i.e. producing enhanced CD's containing video as well as sound content) and possibly illegal, anti-competitive means to continue to restrict parallel imports. Second, dropping the bans on parallel imports enabled non-specialist distributors to become significant suppliers of low priced Top 40 CDs. Third, price drops on CDs have occurred but these have not been as significant as expected, perhaps because of the depreciation of the Australian dollar relative to the currencies of countries likely to be sources of parallel imports.[50] Finally:

> The available information indicates that advertising and promotional spending is continuing and the indent services provided by producers has improved. Very little has been heard about damage to artists' incomes from parallel imports. It appears that the incidence of piracy is low and the industry's own figures show that in Australia the incidence of piracy in 1999 decreased from the levels reported in 1998.[51]

88. A Committee reviewing Australia's IPR laws – see Australia (2000) – commissioned a report by the Australian Institute of Criminology (AIC) "…to undertake research and prepare an independent report on the extent and effects of counterfeiting and piracy in the Australian market particularly in relation to CDs…."[52] The report found little evidence of increased piracy since mid-1998, but conceded that it might be too early to realistically assess prosecution statistics.[53] In any case, any changes that do occur may be

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48 See Australia (2001, para. 13).

49 Ibid., paras. 15 – 23

50 At paragraph 21 of Australia (2001) we read:

> Nevertheless, the ACCC estimates that as a result of the reforms, average CD prices in Australia are as much as $A8 less than they might otherwise have been given the depreciation of the Australian dollar and general price inflation. In other words, the competitive impetus flowing from the reforms has helped to prevent prices *rising* as much as they might otherwise have done.

51 Ibid., para. 23, reference omitted

52 Australia (2000, 58)

53 See Australia (2000, 59). The AIC's report was criticised by the Australian Visual Software Distributors Association, "…as having a 'fundamental flaw' in that it is based almost solely on informaiton provided by bodies for which copyright enforcement has a low priority." Ibid., page 60.

significantly influenced by the increased penalties for piracy and the reverse of onus of proof which were also introduced in the mid-1998 amendments.

New Zealand

89. The previously mentioned Australian review Committee also commissioned a study of the effects of New Zealand's repeal in May 1998 of its bans on parallel imports of copyrighted goods. The New Zealand study was confined to the markets for books, music, compact discs and computer software, and compared an international price analysis to one done by the same research group prior to the amendments. Most of the study's Executive Summary follows:

> Opponents to the law change predicted a flood of cheap imports, and warned of trade sanctions. Neither has materialised, and the effect of introducing parallel importing, to date, appears muted. However, although tangible impacts on volumes and prices have been small, the possibility of parallel importing has exerted pressure on the market place.
>
> Isolating the direct effects of the legislation is difficult, as a number of other factors have impacted on the markets studied. The weak New Zealand dollar proved unfavourable to potential importers, and was an inhibitor to any significant volume of parallel imports. The growth of the internet continued through the period, and combined with general market liberalisation, contributed to an already increasingly competitive environment.
>
> Claims of an increase in pirated products entering the country are hard to substantiate. There is evidence that the manufacture of illegitimate copies of music CDs and software was on the rise anyway, with low cost replication aided by improved technology. Although penalties for importing pirated goods were raised, the onus remains on the commercial sector to lodge notices (formal notification of goods suspected to be at risk of piracy) with Customs. Even prior to parallel importing, Customs did not stop goods at the border without a notice in place. Moreover, counterfeiting within New Zealand may also be a concern.
>
> A number of improvements can be associated with parallel importing. New Zealand prices for books and CDs now rival the rest of the world, as do release dates for new title CDs. Delivery speed has improved, with customer orders able to be filled in a matter of days instead of weeks or months. Access to a full range of titles is possible, with availability enhanced by electronic links with suppliers around the world.
>
> Retailers' negotiating power with suppliers has strengthened, partly due to consolidation of buying power in some markets, but also to the threat of parallel importing maintaining competitive discounts. Minor efficiency gains on the part of some distributors have been reported.[54] (269)

90. There were some significant differences across the sectors examined. The threat of increased piracy for example seems to be more of an issue in software ("with reported increases in illegitimate copies being directly linked to parallel importing" – 296) and CDs than in books. It is also interesting that in the study's conclusions, the issue of possibly reduced incentives for local creative activity was mentioned in connection with books and music CDs, but not in relation to software.[55]

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54 NZIER (2000, 269)

55 See ibid., page 296.

91. It could be argued that two years is not long enough to come to definitive conclusions about the effects of repealing bans on the parallel importation of copyrighted goods. Nevertheless, the New Zealand experience casts doubt on the idea that parallel imports amount to free riding on local marketing support expenditures. The threat of parallel imports may even have encouraged authorised licensees in New Zealand to increase such expenditures to differentiate themselves from the parallel importers.

Sweden

92. In July 1998, the European Court of Justice ruled in the *Silhouette* case that EU Member States could not apply international exhaustion as concerns trademarked goods first marketed outside the EEA. In September of the same year, the Swedish Government asked its Competition Authority "…to analyse how the Swedish market and Swedish consumers and producers would be affected were Sweden to change its established legal practice [i.e. international exhaustion] and apply the principle of regional exhaustion [i.e. solely within the EEA] of *trademark* rights."[56] To assist in producing what we will refer to as the Swedish Report [i.e. Swedish Competition Authority (1999)], the Competition Authority commissioned two consultants' reports on the probable effects of applying the *Silhouette* ruling. The first report essentially consisted of market research into the effects of parallel imports on competition, prices, employment and consumers in Sweden. The second study canvassed the advantages and disadvantages of parallel imports as presented in economic research, and considered how consumers could circumvent bans on parallel imports by turning to private importing including via the Internet.

93. In the Swedish Report, parallel imports are defined as, "…the import for commercial retailing of products bearing a registered or established trademark when such trading is not done via the trademark owner's general agent in the area." (9) Assuming that the "general agent in the area" holds the trademark rights for the area and that the goods are imported without the general agent's permission, this definition accords with the one used in this paper.

94. The Swedish Report contains descriptive material and empirical estimates concerning parallel imports, but notes that good statistical data are unavailable outside of the motor vehicles and pharmaceutical sectors.[57] Outside of those two sectors, the volume and origins of parallel imports had to be estimated based on a large number of interviews.

95. Concerning the extent of parallel imports, the Swedish Report produced some interesting estimates best presented by replicating the table found in one of the consultant's reports:

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56 Swedish Competition Authority (1999, 8), emphasis added.

57 The Swedish Report's empirical estimates were based on "…some 25 personal interviews with representatives of trade associations or equivalent bodies as well as with individuals involved in parallel trading." (90)

Estimated size of parallel imports[58]

Sectors	Parallel imports, value to the end consumer (annual sales)	Parallel imports as proportion of sales in each respective trade	Proportion of parallel imports	
			% from	
	SEK million, approx	%, approx.	EEA state (approx.)	Non-EEA state (approx.)
Foodstuffs (mainly certain beverages, biscuits, confectionery)	< 100	0,0		100
Motorcar spare parts	3 000	20	67	33
Tyres	40	2		100
Motor-cycles	85	9		100
Clothing	4 000	10	10	90[59]

Estimated size of parallel imports (cont'd)

Sectors	Parallel imports, value to the end consumer (annual sales)	Parallel imports as proportion of sales in each respective trade	Proportion of parallel imports	
			% from	
	SEK million, approx	%, approx.	EEA state (approx.)	Non-EEA state (approx.)
Footwear	400	5		100
Pharmaceuticals	1 000	5	100	
Sports equipment		8		
(mainly golf)	50			100
Snow scooters	60	8		100
	Total approx. 8 700			

96. Based on these data, the Swedish Report estimates that just over 60% of Sweden's parallel imports originated from a country outside the EEA zone. Strict implementation of the *Silhouette* decision would therefore result, at least initially, in a decline of about SEK 5,300 million in parallel imports, or roughly 0.6% of total private consumption in 1997.[60]

58 Sub-Annex 4 of Annex 3 - Swedish Competition Authority (1999, 133).

59 The last port of call for much of this import volume before it enters Sweden, however, is another EEA country, where consignments from, say, the US or Asian countries are discharged for customs clearance before being distributed to other parts of Europe.

60 See Swedish Competition Authority (1999, 30-31).

97. Following a look at the data, the Swedish Report considered various negative effects sometimes mentioned in connection with parallel imports. These are difficult to summarise, were somewhat anecdotal, and seem to be specific to certain products such as clothing, food, pharmaceuticals, tires and motor vehicles. The Report terminated its discussion of these effects by stating that:

> To ensure the long-term credibility of legally-imported parallel products on the market, the public authorities responsible must be strict in their regulatory duties, for instance by taking action against the parallel import of foodstuffs that lack the proper declaration of ingredients in Swedish or by calling attention to shortcomings in essential consumer information. (42)

98. The Swedish Report devoted a chapter to estimating what would happen in Sweden because of regional exhaustion replacing international exhaustion of trademarks. Only the parallel imports originating outside the EEA were presumed to be affected. It was estimated that of the roughly SEK 5,500 million in affected trade, SEK 2,500 million would shift to purchases over the Internet, and the rest would be transferred to traditional wholesale and retail channels.[61] One of the consultant's reports estimated the "macroeconomic effects" of *restricting* parallel imports from outside the EEA as follows (52-53):

Brand outlets	Increased sales of SEK 3 000 million
Parallel imports	Reduced sales of SEK 2 500 million
Consumers	Higher prices
The state	
- Loss in jobs	2 500
- Loss in VAT	SEK 500 million
- Loss in income tax	SEK 20 million
- Loss in company tax	SEK 75 million
- Loss in employer's contributions	SEK 150 million
Total loss in taxes, etc	SEK 750 million
- Increase in unemployment costs	SEK 350 million

99. The loss in jobs reflected above is based on assuming that increased Internet sales result in no increase in employment in Sweden and that parallel import and approved distribution channels generate about the same number of Swedish jobs per unit of sales. Both those assumptions may be false and, if so, have probably increased the estimated jobs lost. The Swedish Report does, however, point out that the negative employment effects will likely be less in the long run, and there could also be some downward pressure on wage levels.

100. Noticeably absent from the "macroeconomic effects" table is a reference to Swedish trademark holders. Perhaps there are few markets in which such entities might stand to benefit from a lower volume of parallel imports originating outside the EEA, but in those few, such as motor vehicle parts, significant gains in profits are possible.

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[61] No empirical justification was given for assuming that roughly half the sales will go through the Internet, and that there will be exactly offsetting price increases and volume decreases if parallel imports from outside the EEA are blocked.

101. The Swedish Report relies on one of the underlying consultants' reports for estimates of the effects parallel imports were having on prices in the various sectors. The consultant's estimates of the *direct* price effects were as follows:[62]

	Size of reductions, %	Impact on prices in trade sector, %	Impact on the general price level, %
Foodstuffs	..	0.0	0.0
Motorcar spare parts	20 - 25	4 – 5	0.06 - 0.08
Tyres	20	0.4	0.0
Motorcycles	10 - 15	0.9 - 1.4	0.0
Clothing	30 (1)	3	0.14
Footwear	30	1.5	0.01
Pharmaceuticals	10	0.5	0.01
Sports equipment (golf)	30	2.4	0.0
Snow scooters	10 - 20	0.8 - 1.6	0.0

1) Up to 50-70% for certain models

The consultant's report also referred to *indirect* effects on prices, i.e.:

> …primarily the impact on pricing attributable to the potential threat of parallel imports or to the kind of price adjustments that have to be made if the price gap is not to grow too large between, say, original stocks of the present year's models and parallel imported models from the previous year….Bearing in mind the price-sensitivity found in a number of the trade sectors in which parallel imports are widespread, it seems reasonable to assume that the indirect effect on prices of parallel trading could be on the same scale as the direct effect, i.e. around 0.2%. (119)

102. A section of the Swedish Report was devoted to various trends that, quite apart from the *Silhouette* ruling, might have reduced the volume of Swedish parallel imports. These include things like: increasing world-wide concentration in processing and distribution industries; trademark owners making less use of general agents (i.e. choosing to exploit their trademarks themselves and thereby being in a better position to control trade in their goods); and developments in national regulations and standards tending to raise parallel importers' costs. Another such factor is consumer sales over the Internet.

103. The Internet was portrayed as offering lower prices than parallel importers.[63] In addition, the Swedish Report believed that the Internet's weight in retail sales would grow since younger consumers presumably are more willing to engage in electronic commerce, and ways will probably be found to reduce problems associated with payment security over the Internet and high delivery costs. The Swedish Report speculated that:

> …a possible long-term effect of the ban on parallel imports could be either that Internet trade grows explosively or that exponential growth in this kind of trading occurs earlier, a development predicted by many. If this is a correct description of the dynamic process, a switch to regional exhaustion would paradoxically enough entail consumer gains in the longer term - above all in

62 Swedish Competition Authority (1999, 134)

63 Three examples were given, namely branded jeans, branded shoes and branded jackets. In all three, Internet prices (excluding VAT) were below parallel import prices and substantially lower than prices in "brand outlets"- see ibid., p. 59.

> the form of lower prices but also in the form of a wider range of available goods and a more efficient purchasing pattern as articles purchased over the Internet are often delivered to the customer's door. (60)

104. The overall assessment section of the Swedish Report summarised its findings, including reiterating that consumers, parallel importers, established retailers and state tax revenues would all be affected somewhat differently from a full application of the *Silhouette* ruling. Although noting the price pressure that parallel imports have exerted on established retail channels, the Swedish Report did not comment about likely impacts on existing levels of competition in Swedish distribution.

105. After acknowledging that a number of arguments have been advanced against parallel imports, the Swedish Report concludes with:

> The examination of such objections contained in the present report, however, does not suggest that they are sufficient to overturn the main findings of the investigation, namely that parallel imports do in fact lead to increased consumer benefits in Sweden. (65)

106. There were two areas where further work would have been particularly useful. One concerns the extent to which trademark owners were, prior to the *Silhouette* ruling, using alternative means of separating Sweden from other markets. The other was the degree to which regional exhaustion might have negative impacts on producer and distributor competition in Swedish markets.

107. During the Joint Group's May 30, 2002 discussion on parallel imports, Sweden noted that three things seem to have happened after Sweden banned parallel imports in trademark goods originating outside the EEA:

> First, parallel imports from third countries seem to have been more or less wiped out from the market. Second, e-commerce has not taken over this segment. In one of the consultants' studies, there was an assumption that e-commerce would replace parallel imports and increase substantially as a result of the changed exhaustion regime. This has so far not happened. Of course it may in the long run but we haven't seen a strong effect for the time being. Third, it seems that not only have parallel imports from third countries been reduced. The same is true of parallel imports from other EU member states. Parallel imports from other EU member states are, of course, legally permitted. The problem seems to be that neither traders nor suppliers wish to face the risks of lawsuits and having to prove that a specific product was legally put on the market in another EU member state. In short, this reinforces the conclusion that a change from global to regional exhaustion has reduced the parallel trade we would very much like to see as a part of the competitive element of the European internal market.[64]

European Union

108. In 1998, the European Commission's DGXV commissioned the National Economic Research Associates (NERA) to undertake a study of trademarked goods "…to analyse the effects of alternative exhaustion regimes on prices and trade volumes, product and market structures, consumers, and macro-economic indicators such as employment."[65] The NERA Study [i.e. NERA (1999)] was described as:

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64 OECD (2002, para. 79)

65 NERA (1999, 1) NERA was assisted by SJ Berwin and IFF Research.

> …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 [was] 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 [was] 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. (2)

109. As with the Swedish Report, the NERA Study's empirical work was based on market research rather than published statistics. Ten sectors were singled out as being sufficiently comprehensive and representative of sectors affected by parallel imports of trademarked goods. They were: confectionery; alcoholic drinks; soft drinks and mineral water; clothing; footwear and other leather goods; musical recordings; cosmetics and perfumes; domestic appliances; consumer electronics; and motor cars. Pharmaceuticals and agricultural products were explicitly excluded at the request of the Commission because of special features, notably the influence of governments on pricing and other issues, which made them less relevant to the objectives of this particular exercise.[66] Extensive interviews were conducted of trademark owners (including small and medium sized businesses - SMEs), importer/exporter associations (including parallel traders), consumer organisations and SME organisations. Answers to a written questionnaire plus responses sought from a number of other parties led to an analysis based on 193 responses.[67]

110. In the NERA Study, parallel trade and by implication parallel imports were defined and described as: "…trade in genuine trademark (or other intellectual property) protected goods that takes place without the consent of the trademark owner." The definition therefore accords with the one used in this paper.

111. The NERA Study distinguished between three different ways in which the current EEA wide exhaustion of trademark rights could be extended. One would be through unilateral international exhaustion meaning that once goods have been placed on the market anywhere in the world by a trademark owner or with his consent, trademark rights could not be used to block import of the goods into the EEA. Under this option, other countries' trademark laws would remain unchanged so they could still be used in some cases to block parallel exports from the EEA. The next option was reciprocal extension whereby international exhaustion would be adopted between the EEA and selected third countries. In this case, both parallel imports and exports between the EEA and the selected countries would be affected. Finally, there is the possibility of a multilateral agreement among all members of the World Trade Organisation which would have the same effects as reciprocal extension but would cover all rather than merely selected members of the WTO.

112. The NERA Study was careful to point out that:

> 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. (9 of Executive Summary)

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66 The Study nevertheless contains an interesting discussion of exhaustion in the pharmaceutical industry - see pp. 31-32.

67 Ibid., page 3

113. It also noted that the effects of reciprocal extensions to exhaustion could be different according to the countries covered and the sector involved.

114. The results of NERA's market research into the effects of international exhaustion (both the unilateral and reciprocal, i.e. with U.S. and Japan), are presented in the following two and a half page excerpt (emphases added).[68] "Prices" refer to producer prices.[69]

> ***Prices and trade volumes***
>
> Prices: in general prices were seen to be the same in the EU as in the USA or higher whereas in Japan the position was seen to be more mixed. *Parallel imports are seen to have beneficial effects on consumer prices.*
>
> Part of the reason for differences in prices between the EEA (in general) and other countries lies in consumer tax differences but other factors such as competitive and demand conditions and costs of production and sale also play a part.
>
> Price (retail and wholesale) differences are the main factors leading to parallel trade and both regimes of exhaustion would lead to an increase in parallel imports, e.g. from South-East Asia, the USA and perhaps Japan though the possible scale is a matter of considerable uncertainty. Trademark holding companies expecting an increase in parallel imports had widely differing views but expected the increase would be smaller in the reciprocal case.
>
> Currently, parallel imports may make up less than 5 per cent of the EEA market in the present regime, though a few organisations quoted much higher figures for their sectors.
>
> An increase in parallel exports under the reciprocal regime was foreseen by a minority.
>
> In the longer term, it appears likely that various kinds of action would be taken by the holders to attempt to reduce the flow of parallel imports.
>
> It should be borne in mind that these increases in parallel imports and exports are not net effects on the real trade balance, at least in terms of volume. For example, products of a non-EEA firm with a trademark registered in the EEA may be diverted into unofficial channels to reach Europe and be at the expense of official imports. Again, products of a US-based firm exported to the EEA and re-exported to Japan by unofficial channels will be recorded on both sides of the European trade account.
>
> ***Product availability***
>
> Consumer organisations believed that exhaustion leads to greater availability of products though importers/exporters thought the effect was on balance neutral. *Expected action by holders to extend or tighten up selective distribution systems prohibiting sales to unauthorised dealers would have some offsetting effect after initial increases in parallel imports took place*.

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68 NERA (1999, 73-75).

69 During the Joint Group's May 31, 2001 discussion, the NERA presenter was asked whether the price comparisons were made using wholesale/producer prices or whether retail prices were used. His response was: "We looked at producer pricing." OECD (2002, paras. 58-59)

Market structure

There were often widely differing views on whether an interest group was likely to be a gainer or loser from parallel trade. Parallel traders themselves, especially, and transport were seen as clear gainers from increased parallel trade. However, *the view of the impact on consumers is not clear cut. Consumers were seen at best as slight gainers with a number of adverse effects offsetting price and, perhaps, availability gains.* At the same time, manufacturers might be losers from increased parallel imports, but not necessarily strongly so. The position for retailers and official importers/exporters was broadly similar.

Action by manufacturers to tighten up on selective distribution would also eventually impact on structure.

Consumers

There was some perception, even amongst the consumer groups, that the benefits through lower prices and, perhaps, greater availability, would be accompanied by adverse effects on after sales services, guarantees and provision of product information. This helps to account for consumers not being seen as clear gainers from additional parallel imports. On the other hand, action by manufacturers to curb such services, while possible, is unlikely to be a first resort. (Rightholders did not envisage much price effect from increased parallel imports, though, for the most part, they found it difficult to judge what the effect on prices would be.)

At the same time there are signs that, in the longer run, manufacturers might be inclined to lower prices in high price markets, presumably including the EEA.

Regarding the ability of trademark owners to disown guarantees on parallel imports into the EEA when these goods have initially been sold outside the Area, it is conceivable that such action could be caught by EU competition provisions but this would require an extension of current jurisprudence, which seems unlikely to happen.

Businesses

As to effects on future product quality, cutting R&D and other expenditure [made] to improve product quality seems to be an unlikely response to increased parallel trade.

Holders found it difficult to judge what they would do about their prices and whether there would be any gain in retail sales. SME organisations, however, expect both retail and wholesale prices to be lower.

Relationship with third countries

There is general agreement that the impact of the unilateral regime would be greater than that of the reciprocal regime as specified. Most respondents said they would have given similar replies on the impact of a multilateral exhaustion regime based on WTO members.

Effect on border controls

The Community Regulation clearly empowers customs authorities to take action on counterfeit goods. In principle it is not clear that it would be more difficult. It is possible that counterfeiters would see wider exhaustion as an opportunity to try to sell more of their wares. However, parallel importers we have spoken to take great care to avoid becoming involved with such goods.

115. Qualitative and quantitative estimates of the effects of greater international exhaustion were also presented for each of the ten sectors examined. The quantitative assessments of the unilateral and reciprocal options were presented in two separate tables reproduced in Annex IV. The NERA Study, at pp. 123-124, summarised and qualified the above two tables as follows:

Any effort to quantify the impact of changes to the exhaustion regime, under either [the unilateral or reciprocal] 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.

116. The generally small macro effects do not arise because of any lack of importance attaching to trademark protection. The NERA Study was of the view that:

> 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. (112)

117. One somewhat curious result of the NERA Study's survey was that the effects on retailers and consumers were largely seen as neutral or small. Moreover:

> 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. (115)

118. It is sometimes argued that companies could respond to international exhaustion policies by increased reliance on contractually imposed exclusive territories. It is therefore interesting to note what the NERA Study found concerning the likely response by trademark owners to various extensions in the EU exhaustion policy:

> There was general agreement [among respondent's to the NERA survey] 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. (115-116)
>
> It would be interesting to know the extent to which these and similar responses explain the continued price differences and existence of parallel imports within the EU. In any event, advocates of abolishing parallel import prohibitions will wish to note the apparent unwillingness to cut "R & D or other forms of product improvement".

119. In comparing the unilateral to reciprocal (limited to U.S. and Japan) exhaustion options, the NERA study predicts that parallel imports will generally have a greater effect under the unilateral option. That makes sense since the unilateral option would admit parallel imports from a larger number of countries, considerably increasing the possibility of the kind of price differences needed to fuel parallel import activity.

120. There are only two categories that appear closely comparable in the Swedish and NERA Studies - clothing and footwear (including leather products for the EU). In the clothing sector the predicted effects are substantially greater for Sweden than for the EU in terms of market shares of parallel imports and of effects on prices. The same holds in footwear for price changes, but in terms of market shares, the prediction is that the EU would move to about where Sweden was prior to the *Silhouette* ruling. One would expect that Sweden would be more affected by a change in international exhaustion policy than

would the EU as a whole *if*, as is sometimes presumed, Sweden is indeed a relatively high price market within the EU.

121. Comparing Australia (2000), the Swedish Report and the NERA Study, the latter paid the most attention to the probable impact of international exhaustion on producer interests. This is not surprising given that the EU as a whole, and certainly some of its Members, may be net exporters of trademarked goods, whereas Australia and Sweden are presumably net importers of such goods. As part of estimating effects on producer profitability, the NERA Study several times referred to steps producers might take to continue to practice market segmentation even with parallel imports permitted. In specific, the Study noted that trademark holders might turn towards making greater use of selective distribution. That might well translate into reducing the number of distributors and relying more heavily on those having business formats involving heavy investments in market development and service provision. A smaller number of distributors would be easier to control using contractual restrictions. In addition, the kind of distributors chosen would probably have more reason to believe that any parallel exports they facilitated would be met with retaliation in the form of parallel imports into their own market.

International Chamber of Commerce Survey

122. At the May 30, 2001 Joint Group meeting, the OECD's Business and Industry Advisory Committee presented a room document essentially consisting of a position paper regarding international exhaustion. That paper was prepared by the International Chamber of Commerce's Commission on Intellectual and Industrial Property (ICC Commission) based on a survey it conducted in July 1999. The survey was sent to ICC Commission members "…and to ICC national committees in 70 countries, which in turn sent [it] to their national members."[70] A total of 87 replies were received broken down as follows:

> …64 from Europe; 11 from the USA; 9 from South America and 3 from Asia (India). Responses from the various sectors were as follows: Pharmaceuticals (15); Chemicals (7); Cosmetics (2); Engineering (7); Information, Computer Software and Entertainment (4); Telecommunications and Information Technology (6); Household Equipment and Electronics (4); Domestic Consumer Goods (2); Automobile and Transport (6); Retail (4); Legal and Intellectual Property Consultants (18), Pan-industry Organisations (2) and Miscellaneous (10).[71]

123. Survey respondents were asked to identify themselves by company name, sector and country. Only one question was posed, i.e.: "Please indicate below if your company supports, is against, or does not feel strongly about having a regime of international exhaustion for the different intellectual property rights indicated [separate answer spaces were provided for patents, trademarks and copyright], and the reasons for your position".[72] The ICC summarised the responses as follows:

> Globally, 67.8% took a position against international exhaustion of patents and trademarks, and 54% took a position against international exhaustion of copyrights. 20.7% responded in support of international exhaustion for patents, 23% for trademarks and 17.3% for copyrights. 11.5% did not respond or did not feel strongly either way regarding patents, 9.2% regarding trademarks and 28.7% regarding copyrights.[73]

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70 BIAC (2001, 10)

71 Ibid., page 10. Considering that the ICC has over seven thousand member companies and associations in over 130 countries, the reply rate seems quite low.

72 Ibid., page 11

73 Ibid., page 10

124. The ICC paper provided a regional breakdown of the answers received which revealed that:

15. Opposition to international exhaustion was, with one exception, greater in Europe and the U.S. than in South America and Asia – the exception was that 56.6% of the South American replies were against international exhaustion of copyright, while the same figure for Europe was 48.4%; and

16. Except for copyrights, the majority of the 12 responses received from South America and Asia supported international exhaustion.

125. It would be interesting to know whether the differences noted reflected generally different points of view as between IPR holders and licensees.

126. The responses were also broken down into thirteen different sectors. Since, however, the number of responses in six of those fell below five, it would be unwise to attach much significance to cross-sector differences.

127. In its summary of the ICC position regarding international exhaustion, BIAC stated:

> The majority of ICC members believe that, in the absence of a single global market, moving toward a system of international exhaustion would on balance be more harmful than beneficial to international trade and investment, and undermine the incentives provided by IPR to invest in innovation and brand reputation. Businesses have a legitimate interest – for reasons relating to commercial strategy, quality control, brand reputation and product safety etc - in controlling the distribution of their goods across different markets, and in ensuring that products tailored for one market are not sold in another. Moreover, consumer welfare may actually suffer under an international regime that permits parallel imports.
>
> A small minority of ICC members favour international exhaustion. Proponents of this view believe that international exhaustion will lead to greater competition and increased consumer welfare. They note that the Internet will have an equalising effect on markets and prices.
>
> The majority view holds that:
>
> Limiting companies' returns on products sold internationally would reduce their willingness to invest in commercially risky products. Companies which invest in innovation and brand reputation need to recover the costs of their investments. The expected cost recovery drives the risk-taking associated with the development of new products and technologies. Financial returns on internationally successful products also help fund the development of products that may benefit social welfare, but are individually less profitable.
>
> Economic studies have shown that charging different prices to different users is necessary in order to achieve an appropriate rate of return and to supply low-margin markets that would otherwise not be served. If faced with a system of international exhaustion, IP owners might withdraw from the low-priced markets, standardise international pricing so that the previously low-priced markets will face higher prices, or reduce investment and service in certain countries. The result of any of the above would be to deprive consumers in certain markets of options they would have had under a differential pricing system.

> Permitting parallel imports could result in the importation of goods that do not meet the standards of IP protection in the importing country, as the standards of IP protection vary across countries.[74]

The economic studies referred to in the second bullet point were not identified.

128. It is remarkable that a desire to prevent free-riding on marketing support was not explicitly highlighted as a reason for opposing international exhaustion. Instead the emphasis is on justifying the need for price discrimination, and pointing out that there are good reasons for products to be customised for various markets.

129. A short summary of the empirical work described above is provided in the next section, i.e. under the bullet point: "There is a need for further empirical work about the effects of parallel imports."

V. Summary Observations

130. As noted in the introduction, this paper is not intended to draw conclusions or make recommendations. We end instead with some summary observations.

- *The less vigorous is competition among IPR holders and among those distributing pertinent goods, and the more bans on parallel imports reduce such competition, the higher is the probability that bans on parallel imports reduce rather than increase economic welfare.*

131. Bans on parallel imports are likely to facilitate price discrimination, and simultaneously hinder free-riding. Price discrimination is more likely to improve welfare the greater the differences in market characteristics across the nations covered, and the more vigorous is competition at the IPR holder and authorised licensee levels. Free-riding can be presumed to harm welfare *if* competition is sufficiently strong in all markets, but its effects grow more and more ambiguous as competition weakens.

- *Decisions to adopt or retain bans on parallel imports could, in some circumstances, amount to governments facilitating exclusive territories. In other situations they instead play the role of enforcing exclusive territories that would have existed in any event.*

132. Few if any governments assist firms in segmenting domestic markets. Instead most head in the opposite direction by submitting exclusive territories to scrutiny under competition laws. There could, however, be good reasons for a different approach to domestic and international market segmentation. In particular it may cost private parties considerably more to enforce exclusive territories through reliance on contract and tort remedies when the parties are foreign rather than entirely domestic. So *if* such market segmentation is considered beneficial, there would be a stronger argument for government support on the international front than would be the case domestically. Nevertheless, it would seem wise to consider alternative, less competition inhibiting means of achieving pertinent public policy objectives when bans on parallel imports are debated. Such policy objectives could include, *inter alia*, a desire to increase investment in IPR creation, enhance consumer safety, restrain piracy and counterfeiting, and reduce consumer confusion.

- *The effects of international exhaustion policies could differ across countries.*

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[74] Ibid., pp. 2-3

133. Such differences have to do with things like: size of the internal market; whether the country is a major creator or instead largely a consumer of IPR services; competitive vigour in the distribution system; how competition among IPR holders and distributors might be affected by bans on parallel imports; and general market characteristics (such as those related to per capita income levels) that would tend to make the country either a higher or lower priced country if international price discrimination occurs. Nations accounting for small shares of the world market, having high per capita incomes, and being net importers of IPR services could have especially strong incentives to permit parallel imports, particularly if the competition they provide would improve distribution system efficiency.

- *A multi-national rather than nation by nation approach to determining policies towards parallel imports could prove beneficial if bans on parallel imports would be globally efficient.*

134. Even if a multi-national ban on parallel imports would be globally efficient, that would not guarantee that each nation would be better off under such a policy. Some nations could end up being higher price markets for most affected products. To the extent that is true, successful multilateral negotiations instituting bans on parallel imports might have to take place in a larger context so that nations losing by the policy are compensated by gains made in other policy domains.

- *There could be types of IPRs and particular sectors where international exhaustion regimes might have considerably stronger positive or negative effects than in other sectors.*[75]

135. This observation applies with special force to sectors where international price discrimination is determined more by government policies than by commercial considerations.

- *There is a need for further empirical work about the effects of parallel imports.*

136. Based on the work to date, one cannot be sure that parallel imports are generally driven more by free-riding than by international price discrimination, or *vice versa*, although some researchers have leaned towards the price discrimination hypothesis at least as concerns parallel imports into the U.S.

137. Two empirical studies, focused on Sweden and on the European Union, seem to indicate that repealing bans on parallel imports would lead to lower prices for consumers, but might at the same time adversely affect the profitability of various actors. These two studies also indicated that whatever the effects of bans on parallel imports, they could well be larger the smaller the country or region concerned.

138. Australian and New Zealand studies of the results of repealing bans on parallel imports generally show favourable effects, but on a somewhat smaller scale than proponents of international exhaustion may have expected. The favourable effects include a positive impact on competition among distributors. The same studies tend to cast doubt on some of the negative effects that opponents of international exhaustion had predicted.

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75 For example, the conclusions of United Kingdom, House of Commons (1999, para. 90) include:

> In our opinion, in the areas of clothing and shoes, perfumes and toiletries, and motor vehicles, the potential consumer benefits of international exhaustion of trade marks outweigh the dis-benefits. In some sectors the consumer benefits may, however, be outweighed by the problems that international exhaustion would bring with it; particularly in the pharmaceutical and music industries. Whilst a seamless approach to international exhaustion would be preferable we do not see the justification for retaining EEA-wide exhaustion for trade mark rights for all sectors in order to protect one or two sectors.

139. The International Chamber of Commerce survey cited in BIAC (2001) provides reason to believe that most, but certainly not all businesses oppose parallel imports. The majority view does not seem to be grounded, however, in a strong concern about free-riding. Instead it appears to be linked more to a desire to preserve profitable price discrimination (believed to be positively correlated with investment in IPR creation) as well as to inhibit piracy and counterfeiting and at the same time reduce consumer confusion and enhance consumer safety.

140. To improve understanding concerning the potential effects of bans on parallel imports, data on producer prices and on margins earned by IPR holders, authorised licensees and parallel importers would be especially helpful, particularly if they were available over a number of years. That is admittedly a tall order. As a second best, it would be good to return to countries such as New Zealand, Australia and Sweden to see how changes in their international exhaustion policies continue to work out.

Annex I

Brief description of common IPRS

1. The WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) refers to seven categories of IPRs: patents, trademarks, trade secrets, copyrights, geographical indications, industrial design, and layout-designs (topographies) of integrated circuits. It is beyond this paper's scope to explain what is entailed in each of these and exactly what legal protection is typically offered. Enough of the context can be gleaned by a brief mention of patents, trademarks and copyrights.

2. Anderson et al. (1998, 408 & 411) have provided a good description of patents and trademarks:

> A patent is a statutory right, granted by each nation, which provides an innovator with exclusive rights to make, use, and sell the patented "process, machine, manufacture, or composition of matter" within the national territory of the country granting the patent.
>
> A trademark is a word, name, symbol, mark, or other identifier used by a firm or person to distinguish its goods or services from those of its competitors. It provides its owner with rights of exclusive use in relation to the products associated with the trademark.

3. Using the U.S. as an example, copyright protection is granted to certain statutory categories of original works requiring a modicum of intellectual activity to produce. The protection attaches only to the expression, not the idea expressed. According to Besen and Raskind (1991, 12), U.S. copyright provides five basic rights:

> ...1) the right to reproduce the protected work; 2) the right to prepare derivative works from the protected work; 3) the right to distribute copies; 4) the right to perform literary, musical, dramatic, choreographic works publicly, as well as pantomimes, motion pictures, and other audio-visual works; and 5) the right publicly to display literary, musical, dramatic, choreographic, pantomimes, and pictorial, graphic, and sculptural works, including the individual frame of a motion picture and other audio-visual works.

4. A succinct statement of the reasons governments grant IPRs can be found in Swedish Competition Authority (1999, 17):

> The foremost purpose of intellectual property rights is to protect...investments in research and development (e.g. patents, copyright and design registration) and investments in quality and product improvement (e.g. trademarks). If these intellectual property rights are not upheld, individual companies and entrepreneurs are not sufficiently motivated to develop new products as other players may erode the creator's yields on the original investment ('free-riding'). Trademarks also have another important function: they enable...consumers to identify genuine articles and distinguish these from copies or products much alike in appearance. This function is important as the latter category may lack the genuine product's qualities in part or altogether. By noting the trademark, the consumer can identify the genuine product and thereby avoid the costly process of shopping around.

5. Although countries have signed international conventions to improve the protection afforded to IPRs, the rights themselves remain, at most, national in scope. There can be considerable international

differences in exactly what they cover and how they are enforced. In any given country, such differences clearly exist as well across the spectrum of IPRs.

6. Again with considerable variation depending on the right and country considered, IPRs are generally subject to the application of competition law. This is especially likely to be true as regards the licence agreements IPR owners typically employ to extract revenue from their rights. In general one could say that competition agencies rarely directly challenge IPRs, even if they give rise to some market power. They also do not presume that IPRs give rise to dominant positions that are then subject to special review under many countries' competition laws. Competition agencies instead seek, as with other property rights, to prevent IPRs being used in an anti-competitive fashion.[76]

7. IPRs have also been affected by international trade rules, most notably the WTO TRIPs Agreement. As with competition law:

> ...the TRIPs Agreement generally respects intellectual property rights subject to the rules and practices set forth in previous international agreements and conventions relating to intellectual property, and sets forth the minimum standards of enforcement to be applied in domestic law. [OECD(1999c, 39)]

[76] Readers are referred to OECD (1998), and in particular its "Background Note" (pp. 21-44), by Willard Tom, for further discussion of the competition/IPR policy interface.

Annex II

Competition effects of international market segmentation

1. Bans on parallel imports and exclusive, usually nation-wide, territories for authorised licensees (each licensed by a different IPR holder) could together act as barriers to entry tending to reduce the number of companies distributing and/or manufacturing products embodying significant IPRs. To the extent parallel importers often use different distribution formats than those employed by authorised licensees, bans on parallel imports might also render distributors more homogeneous. A smaller number of more homogeneous licensees in each national market would tend to increase the probability of anti-competitive co-ordination among them. The risk of such co-ordination also depends on things like concentration levels, market transparency and barriers to entry, including the effect of bans on parallel imports. Together with the number of competitors and their level of homogeneity, such factors have an important effect on the expected profitability of cheating on anti-competitive arrangements among competitors. Where cheating is improbable, anti-competitive co-ordination is more likely to occur and to be stable.[77] Should stable anti-competitive co-ordination actually materialise, it will presumably result in higher prices and other welfare reducing effects. These negative effects would be considerably magnified if the co-ordinating businesses were handling a wide range of goods extending well beyond those affected by parallel imports.

2. We have so far been considering competition among licensees, but there are several reasons why bans on parallel imports and other means of segmenting international markets might also affect competition among IPR holders. First, to the extent such bans and segmentation increase the market power and profit margins of national licensees, IPR holders could have lower incentives to cheat on any anti-competitive arrangements they may be engaged in, thus increasing the incidence and stability of such arrangements.[78] Second, the incentives to cheat would be further reduced to the extent that reductions in *intra*-brand competition increase IPR holders' confidence that changes in final market prices can be attributed to other IPR holders, i.e. to cheating, rather than to the ebb and flow of competition among their licensees. Third, international market segmentation, even if it does not reduce intra-brand competition, could increase the market power enjoyed by an individual IPR holder or a group of such companies.

3. An IPR holder enjoying supra-competitive profits might wish to deter new entry by acquiring a reputation for dropping its prices whenever such entry occurs. The cost of acquiring such a reputation is clearly higher when prices must be dropped over the entire world market rather than being confined to one or more national markets where new entry is occurring. Closely related to this point, international market segmentation permits a customised approach to retaliation intended to punish cheating. That could lower the cost and increase the effectiveness of the retaliation, which in turn means it is less likely to be needed in the first place.

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77 For a discussion of the general determinants of the probability of anti-competitive co-ordination, see OECD (1999d, 21-31).

78 This is another manifestation of double marginalisation. National licensees with market power do not fully pass on to their customers any secret discounts they may receive from cheating IPR holders. This consequently reduces the extra profits that a cheating IPR holder may expect to make. For more detail on how exclusive territories could both increase distributor or national licensee market power and assist anti-competitive co-ordination by suppliers, see Rey and Stiglitz (1995).

Annex III

Further Detail on the Welfare Effects of Price Discrimination

4. The point about price discrimination having ambiguous static welfare effects may seem to conflict with the well known proposition that Ramsey pricing, i.e. a specific type of *regulated* price discrimination, is the most efficient way to recover an exact amount of fixed costs and profits.[79] With unregulated price discrimination, however, there is no guarantee that profits will be held to the same level that would prevail with uniform pricing. Profits could well be greater with discriminatory prices and that could reduce welfare or at least erode some of the welfare gain that price discrimination might otherwise make possible.[80]

5. Bans on parallel imports may result in profit increasing price discrimination, chiefly because they may permit an IPR holder to exercise market power in one or more markets. This could happen either because such bans grant IPR holders unilateral power to raise prices in various markets, or because, as noted when discussing free-riding, market segmentation increases the incentives and abilities of IPR holders to engage in anti-competitive collusion.

6. Suppose, however, that IPR holders face such a high degree of competition that they are unable to earn supra-competitive profits on their world-wide businesses. Suppose further that demand conditions vary across national markets, and no firm can cover its total costs (including a normal return on investment) by restricting sales to a subset of national markets with the lowest price elasticities of demand. All firms will therefore have to sell in all national markets, and in the absence of international market segmentation, they will be unable to price discriminate. Now consider what will happen if nations adopt bans on parallel imports giving sellers the power to segment markets and engage in price discrimination. The result could be that competitive pressures force all IPR holders to raise prices in markets where demand is less price elastic and simultaneously lower prices where demand is more price elastic.[81] As in the pre-ban situation, competitive pressures could ensure that none of the firms will be making supra-competitive profits. If that is indeed the case, static welfare *could* be increased by price discrimination for exactly the same reason that Ramsey pricing has that effect.

7. The observation that unregulated price discrimination could be welfare enhancing *provided* markets are sufficiently competitive may seem to be of little practical value. According to conventional wisdom, price discrimination will not be found in competitive markets, i.e. market power is a necessary

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79 Ramsey prices bear an inverse relationship to consumers' price elasticities of demand, and are fixed at the minimum level necessary to recover all the regulated firm's costs, including its fixed costs and a regulated return on capital. Ramsey prices generate greater welfare than could be achieved by a set of uniform prices *set to recover the same fixed costs and generate the same level of profits.*

80 In addition, net changes in welfare losses associated with price discrimination could be negatively affected because firms could waste resources trying to obtain, retain or augment the market power that would increase the profitability of price discrimination. There is also the possibility that price discrimination might itself increase market power and therefore tend to insulate a firm from having to minimise its costs, i.e. would breed x-inefficiency.

81 Despite the fact that no firm enjoys market power, consumers in countries paying prices exceeding each seller's *overall* average costs will not escape their predicament through one or more incumbent sellers or new entrants cutting price in their markets. This is because such a seller would be forced to simultaneously raise prices in other markets, and no such strategy can be devised that would allow the seller to cover all its long term costs.

condition for price discrimination.[82] But that conventional wisdom may need some qualification. Market power may not be a necessary condition for price discrimination *if* there are important economies of scale and significant IPRs are one possible source of such economies.[83] To make this argument one must implicitly assume that such economies of scale either stop short of virtually guaranteeing market power or, alternatively, the product faces competition from goods manufactured using substantially different technology.

8. Price discrimination under sufficiently competitive conditions could increase static welfare but only if the discrimination is voluntary, i.e. commercially motivated. To illustrate this point as well as the basic proposition that market power may not be necessary for price discrimination, consider a set of competing patented products sold in Countries A, B and C. Assume that: 1) none of the competing sellers enjoys market power in the sense of being able to earn supra-competitive profits; 2) no seller can break even unless it sells in all three countries (i.e. there are substantial economies of scale); and 3) international arbitrage rules out price discrimination. The result will be that each firm practices uniform pricing across the three countries and none earns any profits. Now assume that Country A's government decides to regulate the price of the product so that it falls below average costs (calculated over all markets) but remains above marginal cost,[84] and simultaneously takes steps to prevent international arbitrage. All producers will find they must accept the lower price in Country A and balance its effect by raising prices in the other two countries. Any producer either exiting Country A or failing to raise prices in B and C would find it cannot break even. The pressure of competition forces the firms to price discriminate. It should be noted, however, that in this situation where the price discrimination is rooted in government regulation, the international price pattern could diverge from Ramsey pricing, i.e. Country A could be a relatively low price elasticity country. Consequently, this government instigated price discrimination might raise national welfare but simultaneously lower global welfare.

82 See for example Carlton and Perloff (1989, 437) and Varian (1989, 599).

83 For further insights into why market power may not be necessary for price discrimination, see Frank (1983) and Levine (2000).

84 Alternatively, Country A could decide to withdraw patent protection for the good causing its price in "A" to fall to something close to its marginal costs of production and marketing.

Annex IV

Selected tables from NERA (1999, 125-126)

Note: "PI" refers to "parallel imports"

Quantitative Assessment I: *Unilateral* Change of Exhaustion Regime[85]

Sector	PI penetration	Decrease in retail prices	Increased EU production	Increased EU employment[86]	Potential impact on profits in EU
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%)

85 NERA (1999, 125-126)

86 Qualified as: "[I]ndicative and subject to significant uncertainty...."

Quantitative Assessment I: *Unilateral* Change of Exhaustion Regime (cont'd)

Sector	PI penetration	Decrease in retail prices [in sector][87]	Increased EU production	Increased EU employment[88]	Potential impact on profits in EU
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

87 The parenthesised addition was confirmed with NERA. The price changes apply to the category rather than simply being a comparison of prices between parallel imports and the same goods sold through authorised channels.

88 Qualified as: [I]ndicative and subject to significant uncertainty…."

Quantitative Assessment II: *Reciprocal* Change of Exhaustion Regime

Sector	PI penetration	Decrease in retail prices in sector	Increase in EU production	Increase in EU employment[89]	[Potential][90] Impact on profits in EU
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%)

89 Qualified as: [I]ndicative and subject to a range of uncertainty…."

90 This addition was confirmed with NERA.

Quantitative Assessment II: *Reciprocal* Change of Exhaustion Regime (cont'd)

Sector	PI penetration	Decrease in retail prices in sector	Increase in EU production	Increase in EU employment[91]	Impact on profits in EU
Soft drinks	Negligible	Negligible	Negligible s	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

[91] Qualified as: [I]ndicative and subject to a range of uncertainty…."

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