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ROUNDTABLE ON VERTICAL RESTRAINTS FOR ON-LINE SALES

-- Note by Paolo Buccirossi --

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VERTICAL RESTRAINTS FOR ON-LINE SALES

-- Note by Paolo Buccirossi [*] --

1. Introduction

1. The increased transparency and cost efficiency brought about by the electronic commerce (hereinafter e-commerce) is often seen as a positive evolution of trade towards increased competition. The Internet is generally considered as a catalyst for consumers purchasing ability. Consumers can easily access a huge amount of information, can compare prices, have a wider choice of products, virtually reach any seller around the world, and their purchasing choice is aided by intermediaries often providing pre- and post- sales information and services. Search costs are dampened on the consumer side, besides operating costs for firms are often lowered thanks to the shift from paper-based transactions to electronic transactions. By and large, e-commerce is believed to have pro-competitive effects, and it enjoys a special protection in the European Union (EU) as it is consistent with the political goal of the Internal Market. E-commerce has transformed also marketing and distribution systems. Many producers capitalized on this new distribution channel that is often linked to cost-saving and an enlarged consumer base.

2. Relatively few industries have not been affected by this novel distribution prospect. Leaving those minority aside, today's trade is characterized by three predominant situations: 1) products that are available only on the Internet -e.g. some software, games or magazines can be bought only on-line, (pure on-line sales); 2) products that are available in the same format from physical and on-line distributors (mixed sales/same format); and 3) products that are available in different formats in the two distribution systems - e.g. home video and streaming, (mixed sales/different formats). Such categorization shows that it is common to see traditional distribution networks working in parallel with direct e-tailing networks, as defined in Kirsch and Weesner (2005). This paper explores the conflicts that may arise between these two competing distribution networks and discusses whether vertical restraints (VRs) imposed on e-commerce may work in the interest of consumers or may be aimed at depriving them of the benefits that an increased competition can bring about.

3. The paper is organized as follows. Section 2 gives a succinct overview of the economics of vertical restraints and explains how this literature has shaped the interpretation of competition law. Section 3 describes the main features of e-commerce that can affect retail competition. Section 4 discusses the most frequent restraints that are imposed on e-tailers. It builds on the two previous sections to understand whether the general approach developed in the economic and antitrust literature is applicable also to these vertical restraints and to what extent the peculiarities of e-commerce can further illuminate the competitive assessment of these practices. Section 5 summarizes the main decisions made by some national competition authorities and courts in Europe and in the US. Section 6 provides some conclusive remarks.

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2. An overview on the economics of vertical restraints

4. Vertical agreements are an essential element of a market economy. Firms at different levels of the supply chain deal with each other. Frequently this exchange occurs through spot transactions regulated by linear prices. However, in many instances, vertical relationships are disciplined by long-term contracts with complex pricing clauses and several obligations imposed on the contracting parties. This type of arrangement is common when the vertical relationship is between a manufacturer and its distributors.

5. In the vast majority of cases these restraints are an inherent part of the commercial relationship and aim at making it viable. However, in some instances they have as their object or effect to restrict or distort competition. The economic and antitrust literature has identified several economic justifications and anticompetitive motives behind vertical restraints and the conditions in which they can materialize. Although not all issues have been satisfactorily addressed and the debate is still on-going, a consensus was reached on the major competitive implications of vertical restraints. This allowed competition authorities to issue guidelines or other policy documents explaining how competition law should be interpreted and enforced in relation to these practices. In what follows, we will summarize this literature with the purpose of understanding whether the findings of the economic research on the subject can be extended to e-commerce. We will mainly focus on the relationship between manufacturers and distributors, the latter comprising retailers and/or intermediaries.

2.1 Two types of competition

6. A vertical agreement between a manufacturer and a distributor can affect competition in two distinct markets: the upstream market where the manufacturer competes with similar firms and the downstream market where retailers compete against other retailers. The former type of competition is called *inter-brand competition* as it occurs among various suppliers whose products are mainly identified through the use of specific brands. Downstream competition may also occur among retailers who sell the products of the same manufacturer; this form of competition is called *intra-brand competition*. It is generally believed that a reduction of intra-brand competition is unlikely to harm consumers if there is a strong inter-brand competition. For instance, the *EC Guidelines on Vertical Restraints*[1] (henceforth "*EC Guidelines*") state that "if inter-brand competition is fierce, it is unlikely that a reduction of intra-brand competition will have negative effects for consumers" (par. 102). The reason why inter-brand competition is deemed to have a stronger impact than intra-brand competition on consumer welfare hinges on two considerations. First, consumers derive most of their welfare from the characteristics of the products they consume and inter-brand competition guarantees that manufacturers will strive to innovate their products and to choose the features that meet consumers' preferences. Second, manufactures will also compete by offering consumers the lowest possible price; since consumers pay the retail price, they seem to have no reasons to limit price competition among their own retailers, unless this is the only way to induce retailers to provide ancillary services or to invest in promotional activities that benefit consumers more than a limited price reduction.

2.2 Various types of vertical restraints

7. To perform a competitive assessment of a vertical agreement we need to understand which are the efficiency purposes that it may pursue and which the anticompetitive effects that it may engender. Moreover we have to understand which type of restraints and in what market conditions are more likely to yield the former efficiencies and when and how the anticompetitive effects may occur. It is therefore useful to categorize the obligations that a vertical agreement can impose on the parties. These may concern:

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1 Commission notice - Guidelines on Vertical Restraints [2010] O.J. C 130.

- The scope of the transactions allowed to each retailer, in terms of territory or customers they are allowed to serve;
- The qualitative features of the retail services (e.g. size of the store; opening hours; parking facilities);
- The provision of complementary services (e.g. pre-sale or post-sale assistance; financial services);
- The undertaking of promotional activities (e.g. on-site advertising);
- The range of volume offered;
- The volume of products to be procured;
- The price charged to end consumers.

8. A general classification of vertical restraints distinguishes between: 1) price restraints and 2) non-price restraints. The former include all those agreements whereby the retailer agrees to charge a price that is: a) not higher than the price indicated by the manufacturer (**maximum Resale Price Maintenance**-RPM); b) equal to the indicated price (**fixed RPM**) or c) not lower than the indicate price (**minimum RPM**).

9. The major vertical restraints included in the non-price category are:

- **Exclusive distribution**: whereby each distributor is allocated a specific territory or a specific group of customers to which it can actively sell its products.
- **Selective distribution**: an agreement that restricts the number of authorised distributors based on selection qualitative criteria linked to the nature of the products and the complementary services that need to be provided to the buyers.
- **Single branding**: an agreement that imposes on the buyer an obligation to procure a product of a given category from a single supplier; the same situation may arise with a “quantity forcing” obligation whereby the buyer is forced or induced to buy (or stock) a predetermined minimum volume of product so that it will *de facto* limit its purchases from one supplier.
- **Exclusive supply**: an agreement whereby the supplier has an obligation to sell the relevant products to a single buyer; as in the previous case, the same effect can be obtained through some form of quantity forcing;
- **Tying and bundling**: whereby a manufacturer conditions the purchase of one product (the tying product) to the purchase of a second product (the tied product); when the two products are sold in fixed proportions this practice is normally called bundling.

10. Although this classification may help conceptualize the possible economic effects of these practices, it does not allow to form a conclusive opinion, as simple formal rules to discriminate pro-competitive and anti-competitive restraints based on this classification have not been found. It is now recognized that the proper application of antitrust rules in this matter has to be based on an effect-based approach. Therefore, it appears more appropriate to spell out the possible economic justifications and the theories of competitive harm that in general can apply and then try to identify observable factual elements that would allow the enforcer and the parties to find out whether the specific restraint in the specific market conditions in which it operates will likely do more harm than good to consumers or the opposite. In order to substantiate this approach, in what follows we describe the possible efficiency justifications and anticompetitive motives that may concern vertical restraints and provide a brief narrative of how they work.[2]

2 For a survey of the economic literature on vertical restraints see Rey and Vergé (2008).

2.3 Efficiency motives

2.3.1 Specific investments and the hold-up problem

11. In some instances, two parties, such as a supplier and a retailer, can profitably deal with each other only if one of them makes investments that would have little or no value outside that specific commercial relationship. Once this specific investment has been made, the investing party finds itself in a weak bargaining position: it is hold up by the commercial partner, as it will lose the value of the investment if it does not accept the trading conditions the latter requests. This is the main reason why parties sign long-term contracts which define many aspects of their relationship before each party undertakes the required investments (Williamson 1985). Two qualifications are necessary. First, a large fraction of transactions that occur at the wholesale level requires some specific investments[3]. Second, on the one hand reputation mechanisms or social norms may guarantee that all parties behave non opportunistically so that in some cases contractual restraints are not indispensable. On the other hand, when the value of the specific investment is significant and an ex-ante contract is insufficient to discipline all the conceivable relevant situations, the only efficient solution might be a vertical integration.

2.3.2 Vertical externalities and vertical coordination problems

12. When a manufacturer and a retailer make independent and uncoordinated strategic decisions each of them considers only the consequences of these decisions on its own profits. Yet, whenever the decision of one of the two parties affects the volume of the product sold, it entails effects also on the profits of the other trading party. This effect is called a "vertical externality", as the firm making the decision does not take it into account. For instance, if a retailer offers a discount, end consumers buy extra units on which the manufacturer earns a margin. However, the retailer will not consider this effect and may decide not to lower the price if this does not increase its own profits, even if it would increase the profits jointly earned by the manufacturer and the retailer.

13. The best known vertical coordination problem is the so called "*double marginalization*"[4]. It occurs when both the manufacturer and the retailer enjoy some degree of market power and both make uncoordinated pricing decision. As a consequence the manufacturer adds a margin on production costs to set the wholesale price and the retailer adds a margin on the wholesale price to set the retail price. Hence, the price end consumers pay contains a double-margin and is set at a level that is higher than the level that would be set by a vertically integrated firm. If the manufacturer and the retailer decide to coordinate their pricing decision and charge a retail price that maximize their joint profits, they would lower the price, increasing their profits and benefiting consumers as well.

14. This coordination problem may affect all the strategic decisions that firms (especially retailers) have to make. They may all be conceived as demand-enhancing investments that create benefits also for the firm that operates at a different level of the supply chain and that, therefore, may be undertaken at a suboptimal level if the vertical effect remains an "externality". For instance, it may concern advertising, ancillary sale services (Marvel and McCafferty 1984), inventories (Krishnan and Winter 2007), the range of products offered, and so on.

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3 The sheer familiarity with the trading party and its operational routines entails a value that is lost when the commercial partner changes.

4 This pricing coordination problem for complementary products was discussed by Cournot (1838); for a formal treatment see Rey and Vergé (2008).

2.3.3 Horizontal externalities and free-riding

15. A similar problem occurs when investments made by a distributor affect the sales made by other distributors. For instance, a franchisee that makes investments that improve the attractiveness of the brand (e.g. McDonald's), benefit other franchisees as well, as consumers may decide to patronize other outlets of the same chain. Since this external horizontal effect is not taken into account by the franchisee, its investment may be too low and some form of coordination among distributors might be needed to bring it at an optimal level.

16. In some cases the horizontal external effect occurs through opportunistic behaviour of competing distributors. For instance, in industries characterized by significant non-price intra-brand competition, for a producer may be vital to increase demand through retail services (e.g. pre-sale assistance services, showrooms). However, retailers are aware that they will not fully internalize the value produced by their effort exerted to offer pre-sale services, if consumers then buy from retailers who do not undertake the same investments and can pass on the cost-savings to consumers in the form of a lower price. This type of free-riding depresses the level of pre-sale services offered by retailers, possibly harming both suppliers and consumers. Again some coordination may be required to solve the free-riding problem and induce all players to make efficient decisions.

17. By the same token, a producer may be willing to protect its investments (for instance, in the form of IP rights, patents, trademark or reputation) limiting the scope of action of its distributors, e.g. introducing exclusive dealing clause in the distribution contracts. Vertical restraints in both cases are a viable option to avoid underinvestment.

2.3.4 The use of dispersed and heterogeneous information

18. Suppliers and distributors might have heterogeneous information. On the one hand, distributors are better informed about local competitive conditions and about the specific preferences of local consumers. On the other hand, suppliers sell a sensibly lower number of products than the retailers and these products individually are likely to have a significant impact on their profits. Hence, they have a deeper knowledge than the retailers on specific products. Since both sets of information may be necessary to design and execute an optimal marketing strategy, a supplier may want to have some degree of control on the retail price, or at least the possibility to coordinate it with its distributors, because it may know better which price is more appropriate to maximize profits, given consumers' preferences and the price of competing products.

19. In this context even from the supplier's perspective a retail price may be inadequate because it is "too low", especially when the price is used to signal the quality of the product. Moreover, for some suppliers a retail price that is too low may prevent it from remaining in the market, either because distributors prefer selling competing products or even non-competing products that guarantee them higher margins, or because the manufacturer's margin is then forced below the level that makes production viable in the long run. Through a vertical agreement a manufacturer and its retailers may pool all the relevant information and make more efficient retail pricing decisions. To the extent that these decisions are still constrained by the competition stemming from other suppliers, the risk that consumers are eventually harmed is likely to be low.

2.4 Anticompetitive effects

20. Vertical agreements may affect competition both in the upstream market (i.e. inter-brand competition between manufacturers) and in the downstream market (i.e. intra-brand competition between retailers of the same manufacturer). Three distinct theories of competitive harm have been elaborated in the economic literature: VRs may a) foreclose the market; b) facilitate collusion; or c) soften competition.

2.4.1 Market foreclosure

21. The most feared motive by competition agencies is undoubtedly the foreclosure effect caused by VRs, especially in highly concentrated markets. Entry can be prevented at all levels of the supply chain, likewise exit can be driven at any of the vertical stages. Some VRs that mimic vertical integration, such us exclusive dealing (both single branding and exclusive supply), may discourage potential entrants as they anticipate that they will have limited access to distributors, and therefore it would be difficult for them to reach consumers.[5] In the same way, such restraints may be adopted in order to push competitors out of the market by squeezing their distribution possibilities, costs for competitors become too high for them to profitably remain in the market.[6]

2.4.2 Collusion

22. It is generally argued that some VRs may have the effect of facilitating collusion either in the upstream or in the downstream market. In the upstream market collusion may be hindered by the fact that suppliers do not observe wholesale prices, and, if retailing costs vary over time, manufacturers cannot correctly infer wholesale prices from retail prices. RPM agreements, as they make retail price less dependent on retail costs, improve price transparency, foster the ability of manufacturers to detect deviations and, thus, facilitate collusion (Telser 1960; Mathewson and Winter 1998; Jullien and Rey 2007). In downstream markets similar price arrangements, even if do not impose the retail price, may provide focal points to retailers and therefore increase their ability to coordinate on higher more profitable prices. Non-price restraints, such as exclusive distribution agreements, may similarly help distributors in sustaining a collusive equilibrium as they limit the scope for deviations from the collusive path.

2.4.3 Softening competition

23. While collusion indicates a dynamic phenomenon in which welfare reducing selling conditions are sustained through the threat of market punishments, competition may be softened also in static games by practices that lower firms' incentive to compete aggressively.[7]

24. Vertical restraints may have a direct and straightforward effect of softening intra-brand competition. A manufacturer imposing price restraints (e.g. RPM) tends to reduce the fierceness of competition among retailers; similarly, allocating exclusive territory rights to its distributors, the manufacturer, in a way, induce monopoly power for each retailer in the given territory.

25. These practices can also soften inter-brand competition. Rey and Stiglitz (1995) prove that through an exclusive distribution system a manufacturer may commit to price less aggressively and this, in turn, gives incentives to rival manufacturers to set higher prices.[8]

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5 A formal analysis of how exclusive contracts may foreclose the market has been proposed by Comanor and Frech (1985) and then developed by Mathewson and Winter (1998).

6 The "raising rivals' costs" theory was firstly and informally introduced by Krattenmaker and Salop (1986)

7 To clarify a collusive outcome refers to a market equilibrium in which sellers coordinate their behavior (in an infinitely repeated game) by adopting history-dependent strategies, whereas the "softening competition" outcome refers to a modification of the equilibrium of a one-shot game and does not require that firms monitor each other and punish deviations from the coordinated conduct. Some authors (e.g. Baker (1995)) refer to the latter effect as "dampening competition". This distinction can also be found in the 2010 *EC Guidelines*, where the Commission mentions as possible anticompetitive effects both collusive coordination and softening competition (see paragraph 100 ii) or iii).

2.5 Ambiguous effects on welfare

26. Some contributions in the economic literature show that some vertical restraints, such as exclusive dealing and tying, can be adopted by the suppliers to price discriminate (Burstein 1960; Chen and Ross 2005). However, the welfare effects of price discrimination are not clear cut and depend on the specific characteristics of the market, the heterogeneity of consumers, their demand elasticity and the degree of market power that can be exerted on each market segment (Armstrong, 2008).

2.6 How can we distinguish efficient (pro-competitive) VRs from anti-competitive VRs?

27. From the previous discussion it emerges a fundamental theme for the competitive analysis of vertical restraints: competition is a multifaceted phenomenon with many dimensions that, in some case, may conflict with each other. While in an ideal world we would like to have the highest level of innovation and the most qualified sale services coupled with marginal cost-pricing, this is simply not possible and in many instances the application of competition law requires to compare the likely anti-competitive effects of a practice on a market or on a specific dimension of competition with the likely pro-competitive effects of the same practice on another market or on another dimension.

28. Given this situation we need some operational tools to distinguish benign and malicious practices. The prevalent approach in several jurisdictions, as in the US, is that the assessment of vertical agreements is subject to a rule of reason which requires to balance, on a case by case basis, the effects on consumer welfare of the agreement.

29. In the EU, through the various regulations and guidelines the European Commission has built a series of relative presumptions (both of legality and of illegality). The general presumption is that, absent a significant market power either upstream or downstream, VRs are likely to be pro-competitive as they serve efficiency purposes. As market power is difficult to measure, it is proxied by the market share of the parties. This presumption explains the general rule which has been developed in the BER of the European Commission according to which if each of the parties has a market share below 30% a VR is, generally, supposed to satisfy the conditions set in Article 101(3) TFEU and therefore to be legal.

30. This general presumption admits some exceptions. Some practices are qualified as hard-core restrictions. For them the general presumption is reversed: even if none of the parties seem to enjoy market power, the agreement is presumed to fall within the scope of Article 101(1) TFEU and to fail to meet the conditions of Article 101(3) TFEU. In these circumstances the VR is presumed to be illegal, but the parties have the possibility to plea for a legal exemption in individual cases.

31. When the general presumption does not apply because one or both the parties have a significant market power (e.g. a market share above 30%) each practice must be assessed on its own merits balancing the evidence in favour or against its legality.

32. This approach is sensible. It provides as much legal certainty as possible without depriving the system of sufficient flexibility so as to adapt to specific circumstances. Of course the complexity of analysis remains when an individual assessment is required and when these rules must be applied to a new environment such as the Internet.

33. The assessment in individual cases must be carried out by confronting the possible economic justifications and the theories of harm that are applicable and by assessing to what extent the available evidence supports each of them. The best way to follow this approach is to formulate a group of competing

[8] This idea was initially explored formally by Bonanno and Vickers (1988) in a model in which producers for strategic reasons decide to delegate their marketing strategies to independent retailers. Further analyses are those provided by Lin (1990) and Shaffer (1991a; 1991b).

"stories" which describe the channels through which the VR would produce its pro-competitive or anti-competitive effects. These narratives would highlight some important elements that make each of them more or less plausible and that will have to be checked against the actual facts of the case, including the opinion of the market players.

34. Some elements that are likely to play an important role are: a) the market position of the parties and their competitors, b) the nature of the contract products and the relevance of the complementary services; c) the existence of factors naturally leading to concentration (economies of scale, network externalities); d) the presence of entry barriers. This list is not exhaustive and other factors will certainly enter the pictures in specific cases.

35. One element that is often neglected, but that in fact can provide an important guidance in the assessment of a vertical restraint, concerns the reason why the parties decided to ask for or to accept the specific restraints imposed by the agreement. Answering this question does not solve the legal problem because an anti-competitive intent is not required to find a violation of competition law. Yet an understanding of why the parties made recourse to a specific arrangement may shed some lights also on it likely effects.

36. In this respect, a striking characteristic of vertical agreements is that it is quite obvious that the parties have a convergent interest when they sign a contract that makes their transaction more efficient, but it is less clear why one of them may be willing to enter an agreement whose only or main purpose is to allow the other party to gain and exert market power. In principle, both suppliers and retailers take advantage of a competitive related market. Manufacturers generally benefit from a competitive retail market, because this brings retail prices down, spurring demand for their products at the wholesale level. Retailers benefit from upstream competition, as this brings down wholesale prices and make them earning larger margins.

37. Hence in a vertical relationship normally the parties have an incentive to limit each other's market power. However, this incentive is not sufficient to guarantee that a vertical agreement will never be anti-competitive. Several reasons to explain why this might happen have been proposed in the literature. First, one of the two parties may have such a strong bargaining position that the threat of terminating the commercial relationship is credible and sufficiently severe to force the other party to accept the anti-competitive arrangement. Second, the party that obtains or increases its market power through the VR may share some of the extra-profits obtained in this way with the other party. This compensation may occur through lump-sum payments or various types of discount (see Aghion and Bolton 1987). Third, when the anti-competitive effects stem from a number of vertical agreements concluded with different commercial partners, the latter can be played one against the others (as in a Prisoners' Dilemma game) as each of them, unilaterally, cannot avoid the anticompetitive effect (Rasmusen, Ramseyer, and Wiley 1991; Segal and Whinston 2000).

38. Rarely the analysis of a specific vertical restraint includes a fact-based assessment of whether one of these explanations applies to the specific situation under examination. Yet, we believe that this would be an important step to distinguish pro-competitive and anti-competitive circumstances. Indeed, the empirical literature has shown, quite consistently, that in most cases manufacturers and consumers have aligned interests and that when manufacturers voluntarily restrict the distributors' commercial freedom they do so to pursue these common interests. Lafontaine and Slade (2008) after a thorough survey of the available empirical literature on vertical restraints, conclude that "it appears that when manufacturers choose to impose such restraints, not only do they make themselves better off but they also typically allow consumers to benefit from higher quality products and better service provision. In contrast, when restraints and contract limitations are imposed on manufacturers via government intervention, often in response to dealer pressure due to perceptions of uneven bargaining power between manufacturers and dealers, the effect is typically to reduce consumer well-being as prices increase and service levels fall" (p. 409).

3. How e-commerce affects competition

39. This Section explores the main features of e-commerce that may have an impact on competition with the aim of understanding in what respect these features may influence the assessment of vertical restraints. It has been argued that on-line sales affect retail competition by: a) lowering search costs; b) altering distribution costs; c) enlarging the geographic scope of transactions; and d) introducing new forms of information asymmetry or way to overcome the same asymmetry.[9] These features are discussed in the following subsections.

3.1 Search costs

40. It is generally believed that consumers incur near-zero costs when surfing the web in order to gather information for their purchasing decision. The web has generated an enormous amount of information, and some websites grasped the opportunity to offer an additional service to consumers, overwhelmed by the information overload. Nowadays, there are many reliable 'buyer agents'[10] presenting easily readable aggregated information, such as price quotes from different on-line retailers for the same good or service, which support consumers in comparing prices and finding the most appropriate solution for their purchase. The increasing use of these websites, also called shopbots, is demonstrated to reduce search costs. Brown and Goolsbee (2002) provide empirical evidence in the insurance sector, showing how increased use of the Internet reduces average price of term life insurance by as much as 5 per cent. On the contrary, an increased Internet usage, in sectors not covered in shopbots, will not lead to lower prices for consumers.

41. However, a growing number of empirical studies show that it might not always be true that price information services available on the Internet make search costs vanish. For instance, Brynjolfsson, Dick, and Smith (2010) develop a random coefficient model, in their study on price comparison websites, that show how the search cost of accessing the whole set of offers generated by a shopbots is non-trivial. Indeed, the maximum cost of searching a book in one of the major price comparison websites is estimated to be \$6.45, while the benefit deriving from the possibility to access the whole set of aggregated information is estimated to be \$6.55 for the median consumer. Similarly, with a different methodology, Hong and Shum (2006) apply a non-sequential search model to data on on-line bookstores prices, generating search cost estimates between \$1.30 and \$ 2.90.

42. A relevant body of literature is devoted to the study of Internet auctions. Bajari and Hortaçsu (2003) quantify the implicit cost of entering an eBay auction to be \$3.20 in a dataset of eBay coin auctions. Hann and Terwiesch (2003), instead, analyse offers submitted by consumers on reverse auction websites, also called Name-Your-Own-Price systems, whereby the seller seeks to match the buyer price through repeated offers. The frictional costs, defined as the disutility arising from taking part to the on-line transaction, in this particular type of e-commerce is measured to range between €3.54 and €6.08, according to the financial value of the product being auctioned. Moreover, the research also presents a further interesting result; frictional costs are negatively correlated to the experience of consumers, in terms of transactions previously conducted on the same website. A similar conclusion is reached by Johnson, Bellman, and Lohse (2009). They show how learning plays a crucial role in e-commerce. Through a cognitive psychology model they demonstrate that as the consumer becomes more experienced about (or accustomed to) a website, the time spent on that website declines.

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9 For a rich survey of the literature on this subject see Lieber and Syverson (2012).

10 Intelligent software agents designed to retrieve information on the Internet according to the user search input.

43. The fact that search cost are not eliminated by search engines and shopbots is also proven by the permanence of a significant price dispersion among the offers of various retailers (Baye, Morgan, and Scholten 2006). One explanation for this finding is that firms' endogeneise lower search costs so that while search engines try to create a frictionless environment, retailers counteract by adopting price-obfuscation tactics. Ellison and Ellison (2009) describe some of these tactics such as making product descriptions complicated or creating multiple versions of products or adopting 'bait-and-switch' methods, i.e. offering low quality products to obtain better visibility on shopbots and then try to convince consumers to pay extra for the better quality product they really want. Different explanations of the persistence of price dispersion are: i) the relevance of non-price attributes, like delivery time, shipping costs and availability, or the brand reputation of the e-tailer (Brynjolfsson and Smith, 2003) ii) the presence of switching-costs due to the familiarity with a retailer's site and purchasing interface (Varian 1999); iii) the adoption of price discrimination policies allowed by new personalisation technologies which enable e-tailers to exploit information about individual consumers in order to tailor both products and prices to individual requirements (Shapiro and Varian 1998); iv) consumers' limited rationality (Baye and Morgan 2004).

44. Although all these studies prove that a totally frictionless environment is not possible, they do not put into question that the new technology allows consumers to shop around at a cost that is sensibly lower than the cost they would incur if they had to visit physical stores or compare prices through other means. Notwithstanding the tactics adopted by suppliers and retailers, the reduction of search costs can have an impact on prices, market shares and profitability.

3.2 Distribution costs

45. The Internet has caused many shake-ups in terms of distribution costs. In a way, it reshuffled the elements of a business cost structure. The net effect is mostly positive, thus there is general consensus to link the diffusion of e-commerce to the drop in distribution costs.

46. First of all, it should be noted how the Internet has changed the relationship between producers and consumers. Some markets have been hit by an abrupt process of disintermediation, which resulted in the reduction or the complete dismantling of one or more stages of the supply chain. The most striking example in the past few years has been the travel industry, where the role of travel agencies has been dramatically reduced, since Internet reservations have become available.

47. From another viewpoint, the Internet led to increased intermediation, for instance in the motor vehicle sector. In the US auto sales, physical middlemen are mandated by law. That is, all car sales must go through a physical retailer. Taking stock of this, on-line technologies have developed systems to help consumers in defining the car that best match their preferences, then, through the referral service, advice consumers on the most appropriate dealer where to purchase the desired car.

48. The Internet revolutionised also how orders are handled. Faster communication along the supply chain permits downstream firms to quickly turn demand into orders to their suppliers, significantly reducing their need for inventory stock. Indeed Retail inventory-to-sale data show a declining trend from 1992 to 2012, reaching a peak in April 1995 with an inventory-to-sale ratio of 1.74, and a drastic fall in October 2011 with a 1.32 ratio[11].

49. Numerous firms adapted their business models to make the most out of the opportunities brought about by the World Wide Web. Businesses tend to be more consumer-focused rather than product-focused, so that they can directly respond to consumer demand. As a result, the pull marketing strategy is now extremely widespread, especially in markets with high demand uncertainty. Other cost-saving practices have been developed thanks to the faster communication between the different stages of the supply chain.

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11 http://www.census.gov/mtis/. Retrieved on 24\1\13

For instance, under a 'drop-shipping' system wholesalers will directly handle the shipping to final consumers, hence the order, originated by the retailer, will be entirely fulfilled by the wholesaler, skipping the extra step of transporting the good from the wholesaler to the retailer. This system significantly reduces distribution costs and speeds up the whole process.

50. As often argued, one of the main advantages of the abovementioned practices is that they enable retailers to have a much wider product offering choice. Bricks-and-mortar retailers will only carry a product if it reaches a certain volume of sales, meaning that many low-volume varieties are not likely to be found in physical shops, whereas they are available on-line. Similarly, some very niche sectors that are no longer served by offline retailers are now able to survive thanks to the wide selection offered on the Internet. Brynjolfsson, Hu, and Smith (2003) argue that, since the introduction of the Internet, variety is the main factor driving consumer welfare gains. They estimated that the rise of on-line book retailers, increased consumer welfare by 7 to 10 times, and on average an on-line book retailer (e.g. Amazon.com) offers 57 times more book titles compared to a typical large independent bookstore.

51. It should not be neglected, however, that despite all the benefits produced by the Internet to distribution costs, there are a few drawbacks. For instance, delivery costs have now become a predominant heading in the company trade costs. That is, even pure on-line retailers, which are believed to have reduced distribution costs the most, typically face much higher delivery costs compared to off-line outlets.

3.3 Increased geographic scope for transactions

52. E-commerce is believed to reach anyone anywhere in the world, as long as it is possible to access a connected device, even in the most remote area of the planet. As the often-cited catch-phrase claims anything is 'just one click away', no geographical barriers seem to exist in electronic trade. This is not only due to the enhanced communication channel, but also to the drop in costs faced by businesses, which are now able to serve larger geographical markets.

53. In the early years of the Internet, some experts predicted that the web upheaval would have reduced the importance of cities for trade. Forman, Goldfarb, and Greenstein (2005) sought to give an empirical answer to this widespread belief. Their findings reveal high participation rate in the Internet in rural areas compared to the cities, especially in terms of business technologies. Consistent to that, Kolko (1999) finds that population living in more secluded cities tend to be more likely to connect to the Internet than citizens of metropolitan areas. The insight to draw from these findings is that the Internet helped individuals located in rural areas overcoming the problem of distance from physical retailers (Sinai and Waldfogel, 2004).

54. Nonetheless, there is a significant body of literature showing that Internet users (both consumers purchasing on-line, and firms making on-line transactions) do not truly exploit the potential of the virtually limitless reach of the Internet. Geographical distance still matters, and Hortaçsu, Martínez-Jerez, and Douglas (2009) show to which extent spatial factors still play such a central role and why. Analysing data from two major auction websites they demonstrate that most of the transactions occur when the buyer and seller are located in the same metropolitan area. The most likely justifications to such results can be found in cultural factors; indeed, in their results the highest coefficient for the same-city transaction data is attached to sport-related goods, or tickets. While the lowest coefficient corresponds to more rare and valuable goods. Another argument put forward by the authors is that local proximity of buyer and seller ensure easier contract enforceability.

55. Looking at data on taste-driven purely digital products (e.g. music, games, movies), Blum and Goldfarb (2006) find that US consumers have the tendency to visit websites from neighbouring countries, and a 1 per cent increase in distance causes a 3.25 percentage reduction of website visits. The latter finding, according to the authors, cannot be fully explained with trade costs, therefore the most logical

reason is that tastes are developed locally and nearby countries typically have similar tastes. They finally argue that as globalisation drives a convergence in consumer tastes, there will probably be a reduced distance effect on on-line trade.

56. Lieber and Syverson (2012), further, investigate the relationship between the place of consumers purchasing on-line and the location of pure-on-line sellers. A 10 per cent increase in the use of e-commerce by local consumers is followed by a 2 per cent growth in the number of pure on-line sellers in the local area.

3.4 Information asymmetry

57. On-line purchasing involves information asymmetries that do not exist when consumers physically visit a store and make the purchase after having inspected and tested the product. Information asymmetries are also driven by the fact that on-line retailers have generally less brand equity compared to traditional stores, chiefly because it takes time to build reputation, and e-tailers are all relatively new.

58. Such a gap between the buyer and seller knowledge might generate market inefficiencies, referred to as the problem of adverse selection. This situation is often pictured as the 'market for lemons',[12] where there are two types of sellers, high quality good sellers and sellers of lemons, and consumer, at the other end, seeking to detect the good quality seller. Under perfect information, inefficiencies would not arise. When information is asymmetric, instead, inefficiency costs appears leading to an increase in the proportion of lemons in the market, and to a reduction in the equilibrium price. Therefore, high quality sellers have the incentive to signal their high quality so as to help consumers distinguishing themselves from the bad quality sellers.

59. In the past few years pure on-line sellers have developed signalling devices in order to overcome the lemon problem. For instance, it is common to find on-line companies offering favourable shipping and return policies, to prove their commitment to the quality of their offerings. However, there is a further issue that would refrain a consumer from purchasing on-line rather than at the physical outlet, and that is the delay between the moment of purchase and the moment of consumption, which may be more or less costly depending on consumer preferences and also on the type of good purchased. Evidence shows, further, that consumers tend to be more security-concerned when making on-line transactions, the cost of information asymmetry is therefore larger.

60. Commonly, sellers try to mimic the purchasing experience that customers would get in the physical shop by providing detailed information about the good or service. Empirical studies support this idea. For instance, Garicano and Kaplan (2002), in their research on used car auction markets, find no evidence that the Internet increases adverse selection costs. The argument they put forward is that the auction website (namely, Autodaq) adopted measures aimed at reducing the information asymmetries caused by unobservable characteristics of the cars. The website displays detailed information about each car's features and conditions; in addition sellers are enabled to access a third-party inspection service. A similar mechanism was employed in the market for collectable baseball cards. Jin and Kato (2008) report that information asymmetries in this particular market where addressed thanks to a third-party certification system.

61. Other ways to overcome the uncertainty tied to e-commerce were developed throughout the years. The most effective one, to date, appears to be reputation building. In the on-line book market, for example, the major retailers seem to have a significant advantage compared to smaller, less known players. E-tailers that built a strong reputation for quality are less exposed to price competition, as risk-averse

12 The obvious reference here is to the classical paper by Akerlof (1970) and to the vast literature spurred by this contribution.

consumers are willing to pay a price premium as long as uncertainty on the product quality is close to zero, as attested by Smith and Brynjolfsson (2001).

62. The reputational system adopted by eBay has been extensively covered in the literature. The feedback mechanism developed by eBay enables sellers to build their reputation. Resnick et al. (2006) carried out a very effective field experiment to test the impact of feedback rating on the price of the winning bid in eBay auctions. The same seller, selling homogenous goods, used two different accounts, one with very good feedback rating, and the other through a new identity with no feedback history. As predicted, the seller received higher bids (roughly 8 per cent higher) on the experienced account compared to the new account. Other studies have shown the risks of the feedback mechanism. Cabral and Hortaçsu (2010), for instance, presented evidence of the ambiguous effects of feedback, one single negative feedback to an eBay seller generates a plunge in the sales rate of a much greater magnitude compared to the positive effect produced by a positive feedback.

63. The Internet, moreover, set the stage for new peculiar services, which have no off-line replication. On-line blogs, video tutorials, user forums offer an incredible deal of extremely detailed and technical information for the very product\service that the consumer is looking for.

3.5 Conclusions on the impact of e-commerce on retail competition

64. Much of the conventional wisdom supports the view that the Internet acted as a catalyst for the erosion of geographical boundaries, paved the way for the emergence of a large number of start-ups taking advantage of the reduced trade costs of doing business on-line, and, besides, was crucial in the development of technologies that enhanced communication and information sharing. All these factors teamed up have a significant impact on retail competition on various dimensions.

65. First, traditional distribution systems now compete in a setting in which consumers have an increased ability to shop around and compare prices. This might induce some retailers to shift their marketing efforts toward those strategies that allow them to compete on prices rather than on other dimensions of their offer, such as the quality and the scope of their retail and ancillary services.

66. Second, e-tailers have a significant advantage on the range of products they can offer. Distribution and inventory costs prevent brick-and-mortar shops from presenting a comparable rich assortment of products.

67. Third, geographic markets are now less clearly confined to a local dimension. While this increases consumers' freedom of choice, and may contribute to the achievement of the political goal of integrating markets, it may also induce traditional distributors to pay less attention to the tastes and preferences of local shoppers.

68. All these factors are likely to benefit consumers. However, at least in some industries, manufacturers and distributors over the years have strived to set distribution systems that offer consumers services that enhance consumers' evaluation of the products they buy, increase their welfare and make all market players better off. The diffusion of on-line sales poses some threats to these systems and it is important to understand in what circumstances imposing some limits on on-line distribution may improve the welfare of firms and consumers as well.

69. Finally, it must be considered that e-commerce has created channel-specific competitive risks. Readily available information on any product and price transparency may facilitate collusion. Furthermore, the necessity to build a strong reputation and the existence of significantly high sunk costs related to the creation of a successful on-line retailer generate network effects, which in turns lead to high concentration and may favour the formation of dominant position and market power.

4. Most frequent VRs in e-commerce

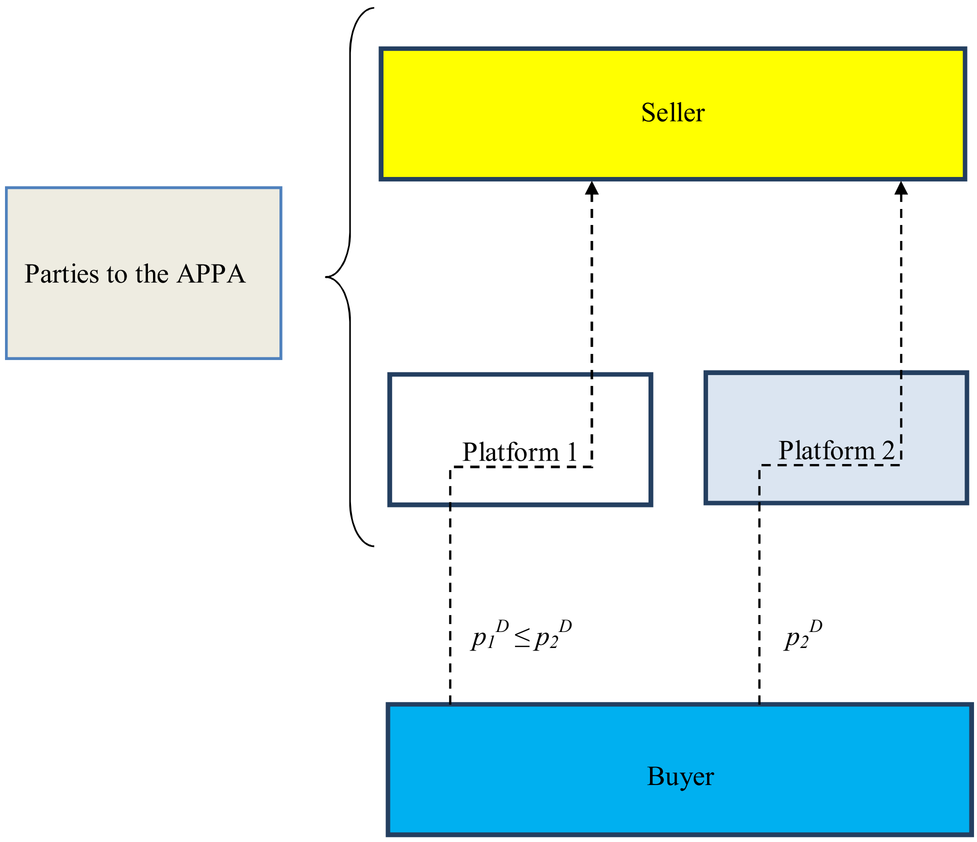
70. This section deals with the most frequent VRs that are imposed on on-line retailers and discusses to what extent the efficiency justifications and the anti-competitive concerns described in Section 2, could apply to these practices also in the light of the way e-commerce affects competition as reported in Section 3. For the sake of exposition the section distinguishes price and non-price restrains.

4.1 Vertical price restraints in e-commerce

4.1.1 Across-Platforms Parity Agreement

71. A pricing arrangement that appears to be becoming widespread, in particular in the on-line industry is embedded in contractual clauses between a seller and an electronic trade platform by which the seller undertakes to charge on that platform a price that is not higher than the price charged on other platforms, including the new entrants. These agreements have not been studied formally in the economic literature. Some initial reflections on their competitive effects are provided in a recent report prepared by Lear for the OFT (Lear, 2012). Following this analysis we can refer to these arrangements as Across-Platforms Parity Agreements (APPA). Figure 1 provides a schematic representation of an APPA concluded between a seller and the owner of Platform 1. Through the agreement these two parties stipulate that the price that Seller would charge to Buyer when the purchase occurs through Platform 1 (p_1^D) will not be higher than the price that Seller would charge to the same buyer for the same product is the truncation occurs through any competing platform such as Platform 2 (p_2^D).

Figure 1: An across-platforms parity agreement



72. This arrangement has been referred to as a type of Most Favoured Nation Clause (MFN) further qualified as Retail-MFN.[13] A MFN is a clause normally embedded in long-term contracts between two firms for the provision of intermediate goods or raw materials whereby the supplier undertakes to apply to the buyer the best price conditions among those applied to any other buyer. Although some similarity exists between MFNs and APPAs, the two have to be distinguished and it would be wrong to derive clear policy implications from the literature on MFNs.[14] The main difference between the two arrangements is that with a MFN clause the parties discipline the price of their own transaction, whereas with an APPA, the parties agree on a pricing obligation that does not concern their transaction but rather a transaction that one of them (the seller) will conclude with a party outside the agreement (the buyer). In this respect an APPA is similar to a RPM. However, an APPA differs from a RPM because the agreement does not fix a price or a limit to the price charged to the buyer, as the seller remains free to set whatever price it chooses, provided that the same item is not offered on other platforms at a more convenient price.

73. The main efficiency justification that would be applicable to APPAs hinges on the objective of the platform owner to protect the investment it undertook to develop the platform, especially if the success of the trading platform depends on a number of ancillary services that might reduce the asymmetry of information that afflicts on-line sales. Suppose that an on-line platform offers (for free) a number of pre-sale services and a rich assortment of products. If buyers use this high quality/high cost platform to search and then buy on a lower quality/lower cost platform, the high quality platform will not be able to obtain a return from its investments. Similarly, if the platform has invested over time in building a reputation for its services (e.g. how it selects the sellers present on it, how it grades their reliability, the quality of its reviews and so on), it may not want retailers to benefit in attracting buyers, but then have buyers make their purchases on the lower quality/lower cost platform.

74. This effect may be particularly important for trading platforms as they present the typical features of two-sided markets.[15] Indeed, platforms need to attract sellers and buyers at the same time; hence, losing some buyers may have a tremendous impact on the viability of the platform as it may make the platform less appealing for sellers, which in turn diminishes the value of the platform for buyers, and so on. Indeed, although the APPA imposes a constraint on the price charged by the seller to the buyer and hence the platform neither pays, nor receives the price to which the agreement refers to, there is a potential externality for the platform. The price paid by a buyer to a seller when he purchases a good or a service through the platform influences the willingness of buyers to make purchases through that platform and, therefore, the attractiveness of that platform. Hence, since the seller's pricing decisions entail adverse

13 See, for instance, the presentation made by Nelson Jung of the OFT at the workshop held by the US DoJ and the FTC in Washington on 10 September 2012 available at http://www.google.it/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=0CD8QFjAC&url=http%3A%2F%2Fwww.justice.gov%2Fatr%2Fpublic%2Fworkshops%2Fmfn%2Fpresentations%2F286773.pdf&ei=QvIPUaPCIcX5sgbjpoHwDQ&usg=AFQjCNHV3Ue0gg0c9LEQy782IcWxHxEX6A&bvm=bv.41867550,d.Yms&cad=rja.

14 For instance MFNs have been considered an effective way to solve the problem faced by a monopolist seller of durable goods, known as the Coase conjecture (see Butz, 1990), as a way to create price indexing mechanisms that mitigate problems arising from incomplete contracts (Goldberg and Erickson 1987) or as a device to signal some unobservable characteristics in the quality of the seller's product (Levy 2004). Moreover, it has been suggested that an MFN may be adopted with the aim of improving the seller bargaining position (Neilson and Winter 1993; Cooper and Fries 1991). These explanations do not seem applicable to APPAs. Indeed, they require that the price that is set in the contract containing the MFN clause acts as a commitment for prices set in subsequent transactions, whereas when the parties sign an APPA they do not set the price that is constrained by the agreement.

15 For a definition of two-sided markets and their economic implications see Rochet and Tirole (2003); Rochet and Tirole (2006); Armstrong (2006). A recent discussion of this economic literature is Rysman (2009).

(external) effects that are borne by the platform, the former will try to find some means to influence it and, therefore, may ask the sellers to agree to an APPA.

75. APPA may also have adverse effects on competition especially in the market were platforms compete. First, it may <u>foreclose entry</u>. Indeed, a new platform may decide to enter the market by charging a lower transaction fee to the sellers, so as to allow them to charge lower prices and attract buyers to the new platform. However, if the incumbent platform has signed an APPA with its sellers, covering also new entrants, these sellers cannot charge lower prices on the new platform. This reduces the ability of the new platform to attract buyers and sellers and, hence, may discourage it from entering.

76. Second, an APPA may <u>soften competition</u> among platforms, thus increasing the fees paid by the sellers and, as consequence, the prices charged by the sellers to the buyers. Indeed, as already argued, platforms compete also on the fees they ask to sellers. If a seller pays a lower usage fee on Platform 2, as its marginal cost decreases it will offer a lower price to buyers. However if it is prevented from price discriminating between Platforms 1 and 2 it will spread the price reduction across the two platforms. Hence, Platform 2 does not enjoy the entire advantages of its price reduction and Platform 1 benefits from the competitor's price move. As a consequence, both platforms have lower incentives to reduce the fee charged to the seller and, by the same token, a higher incentive to increase the same fee. Therefore, the market in which the two platforms compete would settle on a less competitive equilibrium.

77. Finally, APPA may <u>facilitate collusion</u> between platforms. If platforms set collusive fees to the sellers, the advantage of deviating by reducing the sellers' fee is strongly diminished by the parity agreements, because the fee reduction will be passed on also to the buyers that use other platforms. Moreover, an APPA improves the platforms' ability to monitor each other because, when a platform deviates, it is more likely that sellers will complaint against the higher fee that they have to pay on other platforms if they do not have the possibility to price discriminate across platforms.

4.1.2 Other price-restraints

78. Vertical agreements between suppliers and on-line distributors may contain other restraints on the distributor's pricing policy. When these restraints take the form of RPM, their competitive effects can be assessed as in the off-line environment.

79. Maximum or recommend resale prices are generally considered to raise weak competition concerns. In principle they could create focal points that might facilitate coordination among retailers. However, since they do not eliminate the retailers' ability to cut prices, nor seem to provide any new means to monitor each other pricing policy, these price restraints should not make collusion more stable. At the same time maximum RPM may be useful to alleviate a double-margin problem and recommended prices may be a useful tool for the supplier to convey its superior marketing information to its retailers. There is no clear evidence that agreements containing RPM clauses occur frequently in e-commerce.

80. A different restraint that is more often imposed in an on-line setting is the one that requires the e-tailer that operates also a brick-and-mortar outlet not to price discriminate between the two distribution channels. However, this condition is typically one of the restrictions set in a selective distribution system and will be discussed in the next subsection.

4.2 Vertical non-price restraints in e-commerce

4.2.1 Exclusive distribution

81. The protection of territories or costumer groups exclusively allocated to specific distributors may serve the purpose of inducing the latter to make investments in ancillary services that would be undertaken

at a suboptimal level otherwise. In the EU this pro-competitive effect is balanced against the risk of attributing market power to each distributor over the allocated territories or customers. Therefore exclusive distribution agreements are generally accepted if the restriction concerns only *active sales* and, therefore, it does not prevent distributors to make *passive sales* outside the allocated territories or customers.

82. One of the main features of e-commerce is that at least part of the transaction that occurs on-line (visiting the shop, acquiring information, inspecting the good, etc.) becomes immaterial and, therefore, the geographic dimension of the retailer's activity completely changes its meaning. The consequent enlargement of the geographic scope of the market seems to be one of the most important advantages of the Internet, as it largely increases the possibilities open to consumers. Yet, to the extent that an exclusive distribution system is needed to guarantee that distributors offer to buyers the services they value, e-commerce might jeopardize the well-functioning of this system. The new balance that has to be found requires on one side to allow suppliers and retailers to adapt the exclusivity constraints within the digital environment, and, on the other side, to preserve the liberty of consumers to shop wherever they want. Hence, the distinction between *active* and *passive* sales must be revised and made applicable to e-commerce. In the EU the followings are considered hardcore restrictions of passive on-line selling:

- market partitioning: agreements preventing costumers located in another territory from viewing a website or being rerouted to the website of the e-tailer which has been assigned that exclusive territory; or agreements requiring the retailer to terminate an Internet transaction once the credit details of the customer show that he\she is located outside the retailer's exclusive territory;

- sales quantity limit: agreements limiting the proportion of on-line sales against off-line sales;

- dual pricing: agreements containing higher wholesale prices for goods to be sold on-line compared to the price for the goods to be sold off-line.

83. In some cases, 'dual pricing' may have objective justifications. For instance, the manufacturer might have to bear considerably higher costs for products to be sold on-line with respect to costs for off-line sales, because off-line retailers offer also post-sale services, while the on-line sale does not, leading to a greater number of customer complaints and warranty claims.

84. Vertical agreements within an exclusive distribution system may also contain restrictions on the form of advertising that are permitted to the on-line retailer. Also in this case the criterion that may be adopted to distinguish legal and illegal restraints is to understand whether a form of advertising can be considered an active or a passive form of selling. In general, targeted advertising, which includes territory-based banners on third party websites or advertisements displayed to users in a particular territory, is generally considered a form of active selling. When instead, the advertisement is not targeted to specific customers or specific territories and the retailer undertakes an advertisement investment that would be financially attractive even if it would not reach customers in other distributors' exclusive territories, the retailer's initiative is considered a form of passive sale. Finally, manufacturers may restrict the use of trademarks and other IPRs in relation to on-line advertising. For instance, it can restrict the use of its trademark as a keyword for paid listings in search engines. However, a complete prohibition of the use of the trademark as a keyword may be equated to a prohibition of passive selling.

4.2.2 Selective distribution and general ban of on-line sales

85. The most common restriction imposed on retailers by the manufacturer is to limit the scope of their on-line offerings when distribution is organized through a selective distribution network. Such a distribution system is an effective means used by manufacturers to build a brand image, especially for luxury, experience and credence goods.

86. For luxury goods, the right brand image is an inherent characteristic of the product. Suppliers need that potential buyers associate the right image to their products and therefore must guarantee that the point of sale will provide a shopping experience that is consistent with the product brand and reputation. The investments that each outlet undertakes to promote its own brand, as well as the brand of the products that are sold there, will also benefit other outlets that offer the same products. Analogously, if a retailer does not meet the same quality standards, the negative impact on buyers' evaluation will spill over other retailers selling the same brand. To preserve the value of the brand, suppliers must be able to select only distributors with the right features and impose restraints that preserve the retailers' incentives to undertake investments in promotional activities and sale services. Moreover, the price charged for a luxury product is often an essential element of its brand image. Therefore, suppliers may want to avoid that their products are sold at a relatively low price that would endanger their exclusive, high-class image.

87. Experience goods are those products for which consumers can observe their quality and value only upon consumption. Health and beauty products are frequently cited as examples of experience goods, but they also include products such as food and books. When even the act of consuming a good does not provide sufficient information to assess its value, we have a credence good. In this case consumers have to rely on the opinion of experts. Typical examples of credence goods include professional services, automobile repairs and dietary supplements.

88. The sale of experience and credence goods requires that consumers must be in the position to acquire the information they need to make their decisions and therefore is largely improved by the offer of complementary services that allow buyers to experience the good or to obtain expert recommendation before purchasing. Again, a selective distribution system guarantees that the authorized distributors have the right incentives to provide these services.

89. In some cases, these potential efficiencies brought about by selective distribution have to be balanced against some competitive risks. The main concern stemming from a selective distribution system is that it may reduce intra-brand competition. This risk however, as already argued, is of minor importance if there exists sufficient inter-brand competition. This is why, when the vertical agreement has a limited ability to alter the upstream competition among different brands, there is a general presumption that its benefits overcome the competitive risks.

90. A different competitive problem concerns the risk that a selective distribution system may foreclose certain type(s) of distributors, especially in case of cumulative effects of parallel selective distribution networks in a market. This is probably the main issue that emerges in relation to e-commerce.

91. As discussed in Section 3, on-line sales present some characteristics that may conflict with the objectives of a selective distribution organization. Indeed, e-commerce tends to increase price competition and poses some problems of asymmetry of information that may exacerbate the difficulties that selective distribution is meant to overcome. Hence, for some products the Internet may be an inadequate marketplace and this, in principle, explains why a supplier may want to completely prevent on-line sales. As will be clarified in the next section, in the EU the attitude toward this restraint is strongly negative. An outright ban of on-line sales within a selective distribution system is considered a hard-core restriction which amounts to an infringement by object of Article 101(1) TFEU, unless it is justified by "objective reasons". This approach might be too strict. Indeed, one may wonder in what respects a decision to sell some products (e.g. toothpaste) only in one distribution channel (e.g. pharmacies) precluding their sales in other channels (e.g. supermarkets) is really different from the decision to prevent the sales of the same products over the Internet. Since a distribution system that excludes supermarkets is not in general presumed to unduly restrict competition, it is not clear why such a general presumption is valid when the excluded distribution channel is the electronic one.

92. Given this negative attitude toward an outright ban of on-line sales, selective distribution agreements typically imposes less stringent limitation on Internet retailing.

93. The most frequent restrictions for luxury goods are: (a) only a retailer with an authorised bricks-and-mortar presence can be active as an Internet retailer; (b) the price charged for Internet sales has to be the same as in the bricks-and-mortar store; (c) quantitative restrictions on Internet sales that establish a maximum share of Internet sales in total sales for a retailer. Such restraints directly tackle the free-riding issue as well as incentive problem, as when the same retailer jointly owns physical and virtual stores (i.e. restriction *a*) it will internalise both retail effort costs and on-line sales benefits. The uniform pricing clause (i.e. restriction *b*) is important to avoid forms of arbitrage and to guarantee that discounts would not negatively affect the brand image. The alignment of incentives only occurs, however, if the Internet sale limitation is implemented (i.e. restriction *c*). That is, it is fundamental to avoid 'cheating' retailers that do have a physical point of sale, so that they qualify for the selective distribution network, however mainly sell over the Internet so to minimise their retail effort. However, according to the *EC Guidelines* the supplier cannot force the distributor to limit the proportion of sales made on-line, but it is possible to require an absolute amount of sales to be made off-line.

94. For experience and credence goods, further restrictions may directly target the need for consumers to have access to information that would allow to assess the value of the product and to assure that they would purchase the product that fits to their needs. For instance, the on-line sales of health product may be restricted to those on-line outlets that provide the possibility for consumers to consult a dedicated medical staff before making the purchase.

95. As noted in Section 3, e-tailers have developed their own methods to overcome the asymmetry of information that affects on-line sales so as to allow consumers to try the product before buying or to get the opinion of other consumers or of experts (Weathers, Sharma, and Wood 2007). These methods work especially well for those products that have a specific electronic format. For instance, on the web consumers can browse books and listen to portions of songs before deciding to buy these items. For e-books, consumers can also receive a sample of the book on their e-book reader and then decide whether to buy the book. If these systems to provide potential customers with the information they need work properly, any restriction on on-line sales becomes less justified.

5. Case law

96. This section presents a summary of the most relevant cases related to VRs in the context of e-commerce to date, from a selection of jurisdictions. Given that most of the cases are relatively recent, it is easy to predict that the jurisprudence will be enriched in the future, although some authorities have taken measures aimed at creating more transparency and enforcement predictability which should, on the contrary, reduce the number of judgements related to this topic.

97. Cases have been grouped into two subsections. The first contains two examples of APPAs that is an instance of price restraints that may be prevalent in e-commerce. The second subsection includes various judgements and authority decisions related to selective distribution systems limiting or banning the use of the internet as a distribution channel. We will see that Courts as well as antitrust agencies around the world had varying approaches and, in some cases, even within the same jurisdiction one could find divergences in judgments. Another distinguishing element of this part of the case law is that it mainly covers high-end consumer goods. From the analysis of the cases it emerges that those who struggled the most, since the rise of the digital market place, are indeed producers of luxury, experience and credence goods.

5.1 Across-Platforms Parity Agreements

98. APPAs have been at the centre of two recent antitrust cases. The first one is about the sale of e-books and was partially closed with two settlement procedures. The second one concerns the market for on-line travel agent services and is still on-going. These cases are summarized in the following paragraphs.

- **E-book cases**[16]

  The *e-book* cases are probably among the most interesting cases in the antitrust field of vertical restraints concerning on-line sales. They received worldwide coverage because they involved very renowned parties. iBookstore, Apple's e-book on-line retailer, and five major international publishers (Hachette, France; HarperCollins Publishers., UK; Simon & Schuster, US; Macmillan, Germany; and Penguin Group, UK).

  The case encompasses parallel investigations by the European Commission and the Department of Justices of the United States.

  In March 2011 the European Commission carried out unannounced inspections in the premises of some major publishers in several Member States. This was followed by the opening of formal proceedings on e-books pricing practices, suspecting that the publishers with the help of Apple engaged in illegal agreements that would have the object or the effect of restricting competition in the EU.

  In the US, the Department of Justice (DOJ) charged five of the largest international publishers (Hachette Book Group, HarperCollins Publishers, Simon & Schuster, Macmillan and Penguin Group) and Apple for conspiring on e-book pricing. The alleged aim of such conspiracy was to limit intra-brand price competition among e-book retailers in order to raise prices. These practices were considered violations of Section 1 of the Sherman Act.

  Before the entry of Apple in the e-books market, publishers typically adopted wholesale contracts with their retailers. Pursuant these contracts, publishers charged a wholesale price for each e-book, and the retailers retained full discretion on the retailer price to set. In some cases, retailers would set a retail price below the wholesale price as a marketing strategy to stimulate sales of related products (e.g. Amazon promoting its e-book reader, Kindle). Publishers feared that such discounts would hinder their traditional business model. According to the allegations, they teamed up with Apple with the aim of limiting e-book retail price competition. According to the DOJ, Apple and the publishers agreed to alter the business model governing the relationship between publishers and retailers.

  As a matter of fact, short after Apple's entry, publishers sought to renegotiate their distribution agreements, now imposing agency agreements on all their retailers (e.g. Amazon and Barnes & Noble). In so doing, they were able to limit retailers' ability to reduce prices and offer discounts on their title offerings, to the advantage of Apple's iBookstore.

  Apple negotiated a different type of agency agreement with publishers. As in the other cases, publishers had direct control on retail prices on the iBookstore, and Apple would collect its 30% fee on the top of book revenues. Moreover, the publishers agreed what they called a Most Favoured Nation (MFN) clause with Apple, ensuring that no other retailer would sell an e-book title at a lower price than Apple. This clause is indeed an Across-Platforms Parity Agreement (APPA).

16 United States v. Apple Inc., et al., Civil Action n. 12-cv-2826 (DLC) (SDNY); Case COMP/C-2/39.847

Both the European Commission and the DOJ believed that such practices could infringe competition law, since they would have the object or the effect of softening of competition.

To date, Hachette, HarperCollins and Simon & Schuster reached settlements with the DOJ. The proposed settlements impose the publishers to terminate their contracts with Apple, and to enter a strict antitrust compliance program preventing them from conspiring again or sharing sensitive information with competitors for five year. The three publishers are not prohibited to make agency contracts, however these must not include any constraint on retailers' price setting ability or APPA. No settlement has been reached yet with Macmillan, Penguin and Apple.

Similarly, in the EU, the European Commission, through a decision issued in December 2012, accepted legally binding commitments proposed by Apple and four out of the five publishers involved – Simon & Schuster, Harper Collins, Hachette, and Macmillan – which entail the termination of existing price-restricting agency agreements. Akin to the DOJ commitments, publishers are prohibited from entering any agreements that include an APPA for five year. No commitments were proposed by Penguin.

- **On-line travel agents**

In 2010, the UK Competition Authority, the Office of Fair Trade (OFT) received a complaint from a small on-line travel agent, which was prevented from offering discounted price by some hotel chains. The OFT, therefore, started investigating into the hotel on-line booking sector. The main focus of sector investigation was to shed light on the relationship between hotels and on-line travel agents.

In 2012, the OFT issued a Statement of Objections against Booking.com, Expedia and Intercontinental Hotels Group (IHG). The major on-line booking companies allegedly entered into agreements with IHG aimed at limiting other agents' ability to discount hotel accommodations.

The companies involved in the proceeding so far are: Booking.com, world's leading on-line hotel reservations agency (and its American parent company Priceline.com active in the market of on-line travel sales); Expedia, a major travel-related booking service website; and Intercontinental Hotels Group (IHG), the world largest hotels company owning major hotel brands, such as Crown Plaza, Holiday Inn, and InterContinental.

The three companies are accused of infringing competition law for unlawful practices carried out between October 2007 and September 2010. The alleged agreements (that may fall within the definition of APPAs) are believed to be anticompetitive because they are aimed at limiting price competition among on-line travel agents. Moreover, according to the available information, the OFT fears that these agreements may increase barriers to entry and expansion for online travel agents that seek to gain market share by offering discounts to consumers.[17]

Although the case concerns some major companies in the market for on-line travel agent services, it is not yet clear whether the theory of harm that the OFT has envisaged would require that the parties enjoy a substantial market power. In the press release issued in July 2012,[18] the OFT states that it "limited the scope of its investigation to a small number of major companies, with a view to achieving a swift and effective outcome. However, the investigation is likely to have wider implications as the alleged practices are potentially widespread in the industry". This suggests that this practice may be considered unlawful even when adopted by smaller players.

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17 At the time of writing, the case is pending and the OFT estimates to close it by June 2014.

18 Available at http://www.oft.gov.uk/news-and-updates/press/2012/65-12#.URDklGerh8Y.

99. The e-book and on-line travel agents cases deal with a pricing arrangement that is relatively new and that has not been studied in depth in the economic literature. Moreover, as pointed out by the OFT, this practice is likely to affect many on-line sales whenever the Internet provides the opportunity to develop platforms that act as intermediaries.

100. According to the limited information available so far, it seems that competition authorities are mainly concerned with the risk that APPAs may limit the scope for price competition and allow both the platform owners and the sellers to coordinate their pricing decision. It is interesting to note that in the e-book case the sellers' policy appears to be a response to the perceived threat that the new electronic format was posing to the traditional format. Indeed, the practice did not have an impact on the on-line sale of traditional books, but only affected e-books. It is possible that a rapid diffusion of e-books, especially if sold at a significant discount, would put a pressure on the price charged for traditional books, and would also make traditional bookstores vulnerable, which in turn would have added some pressure on the ability of publishers to set wholesale prices for traditional books.

101. In the on-line travel agent case competition between the traditional and the new format does not seem to be an issue. Indeed, the off-line traditional services have been already largely superseded by on-line services and hotels do not obtain any apparent benefit from defending the old environment. In this case, it seems more plausible that the APPA is meant to pursue the interest of the platform owners either by facilitating price coordination across intermediaries, or by creating barriers to entry. Of course it might also be that the price arrangement serves efficiency purposes as it aims at protecting the specific investments made by the platforms.

102. Another issue that emerges from both cases is how to identify a genuine agency relationship in the on-line setting. According to the EC *Guidelines* on VRs, an agreement "will be qualified as an agency agreement if the agent does not bear any, or bears only insignificant, risks in relation to the contracts concluded and/or negotiated on behalf of the principal, in relation to market-specific investments for that field of activity, and in relation to other activities required by the principal to be undertaken on the same product market" (par. 15). In the two cases just discussed, it seems that the electronic platforms – that in principle could be qualified as agents of the sellers (publishers or hotels) – made substantial market-specific investments that would probably preclude a finding of a genuine agency relationship. Moreover, in the on-line travel agents case, there is evidence that the APPA was actually requested by the electronic platform and it seems unreasonable that an agent dictates an essential element of the principal's pricing policy.

103. APPAs are not specific to e-commerce. Similar arrangements could also be found in relation to other "platforms" such as shopping malls, or credit cards. Yet, the Internet, with the development of electronic marketplaces, is a context where these schemes may occur frequently. Our current understanding of the competitive implications of this practice is still limited and it is likely that new cases will arise. Hopefully, this will spur some new theoretical and empirical research on this subject.

5.2 Selective distribution and outright ban of Internet sales

104. Competition authorities and courts have already dealt with a significant number of vertical restraints imposed on on-line sales by suppliers who adopted a selective distribution system. These cases mostly concern products that can be qualified as luxury, experience or credence goods. A number of decisions or court judgements examine the distribution of perfumes or high-end cosmetics. It is no surprise that Paris took centre stage.

- **Yves Saint Laurent Perfumes**[19]

  In 2001 the European Commission approved Yves Saint Laurent Parfums (YSLP) selective distribution system as it satisfied the conditions set out in the Vertical Block Exemption Regulation (Regulation 2790/99 was in force at that time). Under the authorised system, Internet retailing was allowed, however on-line sales were only permitted to those retailers already operating a physical sales point.

  Selective distribution is commonly found in the luxury cosmetic products market, where YSLP competes, as it is believed to help preserving brand equity, which is of critical importance in this sector, as previously argued.

  From 1991 until 1997, YSLP's selective distribution benefitted from an individual exemption. The exemption, granted by the Commission[20], was then upheld by the *Court of First Instance* in the Leclerc case[21.] The Commission's decision was based on the fact that, although selective distribution systems affected competition, in the case of YSLP the tangible and intangible product features had to be taken into account. In the decision the Commission stated: "*It has always been recognized that certain products which are not ordinary products or services have properties such that they cannot be properly supplied to the public without the intervention of specialized distributors*".[22]

  The Commission argued that a system of selective distribution might be considered beneficial to consumers if:

  - The system is needed in order to preserve the quality of the products and ensure their proper use.
  - The system entails objective qualitative criteria related to the technical qualifications of the reseller.
  - Conditions are laid down uniformly and not applied in a discriminatory way.

  The Commission considered that the YSLP's system fulfilled those conditions, and could therefore benefit from an individual exemption.

  In 2010, when the new Block Exemption Regulation[23] entered into force, YSLP had already submitted its distribution system for the Commission approval. This time the Commission had to assess it from a new perspective. The new Regulation would not cover a ban on Internet sales, even within a selective distribution system. However, YSLP allowed retailers to generate on-line sales according to some selective criteria, i.e. retailers already operating a physical point of sale were allowed to distribute the contract products also on the web. Therefore the system was considered to be covered by the BER[24].

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19 Commission press release, 17th May 2001, 'Commission approves selective distribution system for Yves Saint Laurent perfume', IP/01/713.

20 16 December 1991, Commission Decision 92/33/EEC, IV/33.242 – Yves Saint Laurent Parfums, (Decision YSLP).

21 Case T-19/92 *Groupement d'achat Edouard Leclerc v Commission of the European Communities*. [1996] E.C.R. II-01851

22 Decision YSLP, Section II.

23 Commission Regulation (EC) No 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices [1999] O.J. L 336.

24 *EC Guidelines*, par. 51.

- **Pierre Fabre Dermo-Cosmétique** [25]

  In 2009, the European Court of Justice (ECJ) was called to give preliminary reference on whether a ban on Internet sales was to be considered a restriction to competition within the meaning of Article 101(1) TFEU, and whether it could be covered by the Block Exemption Regulation or benefit from individual exemption under Article 101(3) TFEU.

  Pierre Fabre Dermo-Cosmétique is a cosmetic and personal care products manufacturer. It markets its products through a selective distribution network. Distributors are selected on the basis of the quality of the physical point of sale and the requirement of a qualified pharmacist to assist the sales. The latter criterion was believed to indirectly limit the possibility for a distributor to sell products on-line.

  The *Conseil de la Concurrence* held that this agreement was anticompetitive under French and European competition law and did not fall within the scope of the Block Exemption nor could benefit from individual exemption. Therefore, it ordered to amend the distribution agreements so to enable retailers to sell products on-line. Pierre Fabre claimed that banning on-line sales was justified by health protection purposes (i.e. dermatological risk of using the products without appropriate pharmacist advice) and by the need to prevent counterfeits. However, in its decision[26] the *Conseil* rejected those justifications as immaterial because parapharmaceutical products were not medicines, and selecting specialist distributors was sufficient to guarantee product quality.

  Pierre Fabre appealed to the *Cour d'appel de Paris*, which in turn referred the underlying point of law to the ECJ for interpretation. The ECJ ruled that the restraint imposed by Pierre Fabre, being a *de facto* ban on the use of the Internet as a channel of sale, amounted to a restriction by object, within the meaning of Article 101(1) TFEU, not objectively justified. The block exemption, therefore, did not apply, while it was for the company to demonstrate that such restraints were individually exempted within the meaning of Article 101(3) TFEU.

  On the 31 January 2013 the *Cour d'appel de Paris* rejected the appeal[27]. In its judgement, the *Cour* confirmed that a *de facto* prohibition of on-line sales of cosmetics is to be regarded as an infringement "by object" of Article 101(1). It recognised that Pierre Fabre has a 20% market share and is exposed to a lively inter-brand competition where the quality of the products and innovation play a major role. However, it opined that preventing consumers from buying on the Internet would limit their ability to shop in more distant geographic areas and to compare prices and, therefore, would result in a reduction of intra-brand competition. The *Cour* also rejected the request for an individual exemption as it argued that Pierre Fabre had failed to meet the standard required to prove the existence of the claimed efficiency gains and that, moreover a complete ban of on-line could sales was not indispensable to achieve these efficiencies.

- **Bijourama v. Festina** [28]

  A pure on-line retailer specialised in the sales of watches, jewellery and silverware (Bijourama) tried unsuccessfully to enter the Festina France selective distribution system in the market for

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[25] Case C- 439/09, *Pierre Fabre Dermo-Cosmétique SAS v Président de l'Autorité de la concurrence and Ministre de l'Économie, de l'Industrie et de l'Emploi.*[2011] O.J. C 355/04.

[26] Conseil de la concurrence, 29 October 2008, Decision n° 08-D-25, regarding practices in the sector of distribution or personal care and cosmetic products sold upon pharmaceutical advice, *Pierre Fabre Dermo-Cosmétique.*

[27] Cour d'appel de Paris, 31 January 2013, RG n° 2008/23812, *Pierre Fabre Dermo-Cosmétique*.

[28] Conseil de la concurrence, 24th July 2006, Decision n°06-D-24, *Festina France*. Upheld by Paris Court of Appeal in *Bijourama v. Festina*, 16 October 2007.

watches. Bijourama submitted a complaint to the *Conseil de la Concurrence*, alleging that Festina denied access to the selective distribution network on the grounds that Bijourama would exclusively generate on-line sales.

Festina's refusal to give its consent to Bijurama could not be justified by the requirements included in the selective agreements as there was no provision limiting on-line sales. Indeed, some of the existing retailers were granted the permission to do part of their sales on-line.

The *Conseil de la Concurrence* accepted Festina's commitments consisting in amending and completing the distribution agreements with provisions regarding on-line sales which, however, maintained a clause according to which Internet sales were permitted only to retailers with a physical point of sale. This contractual clause *de facto* prevents pure on-line retailers.

The French authority devotes one section of its decision[29] to review the relevant European law in force at that time[30], stressing the fact that a producer whose market share does not exceed 30% is allowed to set criteria on how to select its distributors, and these criteria may include vertical restraints (also limitation to on-line sales) as long as these are transparent and applied consistently throughout the system. According to the *Conseil de la Concurrence* the commitments proposed by Festina addressed the competition concerns given the limited market share Festina held (below 30%). Bijourama, nonetheless, was still excluded from Festina's distribution network.

The *Conseil de la Concurrence* confirmed this approach short after in a decision regarding several selective distribution systems of high-end cosmetics and personal hygiene products.[31]

- **PMC Distribution v. Pacific Création** [32]

  Pacific Creation produces and distributes perfumes, among which the perfume Lolita Lempicka, marketed in France through a selective distribution network. The other party, PMC Distribution runs a website (www.club-privè.fr) where it posts offerings at very attractive prices. The producer became aware that in September and October 2006 PMC Distribution organised discounted sales of Lolita Lempicka on their website, without being part of the authorised distribution network nor receiving Pacific Creation's consent.

  On the grounds of unfair competition and misleading advertising, the Court held that Pacific Creation was entitled to be repaid for the damages caused. The *Cour d'appel* upheld the judgement of the lower Court on the lawfulness of the selective distribution system. It opined that luxury perfumes and cosmetics form markets where a selective distribution system does not constitute an appreciable restriction on competition, since: 1) the nature of the product requires a selective distribution system, in order to preserve the quality and ensure the correct use of the product; 2) distributors are selected on the basis of objective qualitative criteria, uniformly applied to all potential distributors in a non-discriminatory way; 3) the criteria do not exceed what is necessary.

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29 Conseil de la concurrence, 24th July 2006, Decision n°06-D-24, *Festina France,* section B.

30 In particular, Commission Regulation (EC) No 2790/1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices [1999] O.J. L 336, and *EC Guidelines*.

31 Conseil de la concurrence, 8th March 2007, Decision n° 07-D-07¸ *Bioderma et al.*

32 Cour d'appel de Paris, 16 April 2008, RG n° 07/04360, *PMC Distribution v. Pacific Création*.

- **Makro v Beauté Prestige** [33]

  The *Liège Cour d'appel* was called to assess the legality of an Internet ban imposed by Makro on its selective distribution network in the market for luxury perfumes and cosmetics. The case was referred to the Belgian *Cour de cassation* that stated that restrictions on Internet sales are illegal unless there is an objective justification. In the specific case, according to the *Cour de cassation*, the restraints imposed by Makro were justified because of the nature of the products marketed, requiring personal expert guidance, that imposed methods of sale that could not be replicated over the Internet.

105. The case law on perfumes and high-end cosmetics supports the argument that, whenever a selective distribution system is justified for luxury or experience goods, suppliers may impose restrictions on Internet sales that have the objective to protect the demand enhancing investments made either by the manufacturer or by the retailers. One way to achieve this objective is to allow only those retailers that also run a brick-and-mortar outlet to operate on the Internet. The idea is that these retailers have an interest in preserving the value of the investments that they have made in the physical point of sale and that they would internalize, at least partially, the negative effects that inappropriate e-commerce practices would have on these investments. In order to have an effective alignment of interests, sales in the physical shop must be relevant and this justifies also the imposition of quantity limits on Internet sales.

106. These restrictions prevent the operation of a pure on-line distributor. However, a complete ban of on-line sales or the application of discriminatory conditions that would impede their development is still presumed to be illegal and the parties have the burden to prove that there exist "objective" justifications for such measures. This approach seems quite extreme. A general (but rebuttable) presumption that a ban of on-line sales has an anti-competitive object, irrespective, for instance, of the manufacturer's market position, seems too stretched. Of course, much depends on the standard of proof that it will be required to prove the existence of "objective" justifications and whether the manufacturer will be also asked to show that any alternative and less restrictive measure would have been inadequate to achieve the intended goal. The *Makro* judgement suggests that, some courts will be satisfied with simple qualitative arguments and will not ask for an in depth analysis of the feasibility and the competitive effects of alternative restraints. However, this attitude differs from that adopted by some competition authorities and other courts in Europe, especially in the *Pierre Fabre* case. This will also emerge from the discussion of some other cases that do not relate to the sale of cosmetics. In particular two decisions are worth reporting. The first one was made by the French competition authority and concerns the sale of Hi-Fi and home cinema products; the second one was adopted by the German competition authority and was about the distribution of contact lens.

- **Selective distribution of Hi-Fi and Home Cinema products** [34]

  Proceedings against some Hi-fi and home cinema equipment producers were opened in France in 2002 by the *Conseil de la Concurrence* after a referral of the Minister of Economy following an investigation led by the DGCCRF (Directorate-General for Competition, Consumer Affairs and Fraud Control) in the sector.

  The undertakings, allegedly imposing anticompetitive vertical restraints on their distributors, were the major player in the French market for Hi-fi and home cinema equipment, namely, Bose, Focal JM Lab, Triangle Industries, Bang & Olufsen France.

  The *Conseil* investigation confirmed the Commission's findings. Both Triangle and Focal JM Lab were imposing a ban on their distributors' possibility to sell on-line. Such a restriction was

33 Cour de cassation Belgique, 10 October 2002, N° C.01.0300.F, *Makro v Beauté Prestige International AO*.

34 Conseil de la concurrence, 5th October 2006, Decision n°06-D-28, *Bose et al.* ; Autorité de la concurrence, 12th December 2012, Decision n°12-D-23, *Bang et Olufsen.*

considered an unjustified limitation of trade, as it was neither proportionate to the objective nor equivalent to the limitations imposed on off-line retailers. Similarly, Bose's conditions on on-line sales were believed to be more restrictive than what was needed in order to preserve the brand image.

The Companies proposed commitments aimed at amending their selective distribution agreements allowing their approved distributors, in non-restrictive conditions, to sell their products on the Internet. In 2006, the *Conseil* accepted Bose and Triangle commitments. According to the *Conseil*, the new setup would have fostered intra-brand as well as inter-brand competition, for the benefit of consumers. That is, the drafted amendments to the selective distribution agreement would have led to a proper balance between the need to preserve the brand image, on the one hand, and the possibility for distributors to reach a greater number of consumers, on the other hand.

The proceeding against Bang & Olufsen has been dealt separately and finally concluded in December 2012 with the *Autorité de la concurrence* (which took the place of the *Conseil* in 2009) imposing a fine on the French subsidiary (Bang & Olufsen France) of the Danish parent company Bang & Olufsen A/S. The alleged anticompetitive practice, similar to that adopted by the other companies, was a *de facto* ban on sales over the Internet.

The French authority referred to the judgment of the European Court of Justice on a similar matter, in the *Pierre Fabre* ruling. The ECJ judgment clearly states that a general ban on the on-line sales in a selective distribution contract amounts to a restriction of competition by object, unless that clause is objectively justified.

According to the *Autorité*, Bang & Olufsen's unilateral actions were reckoned to limit the freedom of its distributors, hindering intra-brand competition at the expense of consumer welfare.

The Authority imposed a fine of €900,000 on Bang & Olufsen France and Bang & Olufsen A/S. It also required Bang & Olufsen France to amend, within three months, its existing selective distribution agreements, in order to make it clear that its approved distributors were authorised to sell on-line.

- **CIBA Vision** [35]

The *Bundeskartellamt* levied a fine of €11.5 million against CIBA Vision Vertriebs GmbH (CIBA), the German market leader of wholesale supply of contact lenses, for imposing price restraints and limiting Internet and wholesale sales of its products, infringing Article 81of the EC Treaty (now Article 101 TFEU).

Between 2005 and 2008, CIBA was found to take particular actions to monitor its on-line retailers' prices, called 'price management' measures. When the prices would be 10-15% lower than the Recommended Retail Price, CIBA personnel would contact the distributors to induce them to raise prices. Moreover, certain CIBA contact lenses were banned from on-line sales, and sales via eBay were also prevented.

Recommended Retail Price are not considered unlawful as such, however the *Bundeskartellamt* believed that the established procedures aimed at exerting pressure on retailers were clear indicators of a concerted conduct being in place between CIBA and its distributors.

Moreover, CIBA was also accused of having restricted the Internet trade limiting the product range, and imposing a ban on sales through eBay. This was considered an anticompetitive practice. In particular, limitations on Internet sales under the 1999 Block Exemption Regulation

[35] Bundeskartellamt press release, 25th September 2009, 'Bundeskartellamt imposes fine on CIBA Vision'.

were included in the black list of unlawful practices. Moreover, an individual exemption could not be applied because the *Bundeskartellamt* rejected the justifications presented by CIBA, which had stressed the necessity of a stationary optician at the moment of purchase to protect consumer health. The *Bundeskartellamt* contended that less restrictive options would have achieved the same objective, for instance, requiring at the moment of purchase proof of contact lens prescription.

Furthermore, the nature of CIBA products did not require a special regime for the launch of products, whereas, according to the *Bundeskartellamt*, a temporary ban on Internet sales would have been justified if investments were required on the optician's side, which was not the case.

107. These two decisions indicate that European competition authorities intend to interpret the requirement of "objective" justifications in a very strict way. In both cases much of the emphasis was on intra-brand competition with little consideration about the existing degree of inter-brand competition. Moreover, e-commerce was considered in its own terms a distribution channel that makes competition more intense irrespective of the nature of the product and the prevailing competitive strategies adopted by the manufacturers. Hence, a *de facto* prohibition of Internet sales is considered illegal unless there are no less restrictive options to pursue objectives that are not related to the marketing strategies of the supplier.

108. This attitude appears consistent with the European Court of Justice opinion in the *Pierre Fabre* case and the recent judgment of the *Cour d'appel de Paris*. The Court of Justice "in the light of the freedoms of movement, has not accepted arguments relating to the need to provide individual advice to the customer and to ensure his protection against the incorrect use of products, in the context of non-prescription medicines and contact lenses, to justify a ban on internet sales" (par. 44). It also added that "the aim of maintaining a prestigious image is not a legitimate aim for restricting competition and cannot therefore justify a finding that a contractual clause pursuing such an aim does not fall within Article 101(1) TFEU" (par. 46). Thus, it seems that the "objective" justifications to which the Court refers to are limited to those instances in which on-line sales are totally inadequate, given the nature of the product, because, for instance, they may be dangerous for consumers (e.g. prescription medicines). This would exclude marketing and economic purposes as "objective" justifications. The Court confirms the possibility that a vertical restraints banning Internet sales might benefit from an individual exemption when the conditions set in Article 101(3) TFEU are met. However, the French and German cases reported above reveal that proving that there are no less restrictive options to pursue efficiency goals when these concern the brand image or the provision of ancillary services will be very arduous.

109. A related issue is which "objective" justifications can be claimed to explain the adoption of different supply conditions to on-line and traditional retailers. This question was addressed by a Dutch court in a case concerning the distribution of electrical appliances.

- **Groen Trend v. Atag Etna** [36]

The Dutch District Court of *Zutphen* ruled that the Block Exemption Regulation covers the issuance of dissimilar supply conditions from a producer to on-line retailers compared to retailers using traditional channels of distribution, conditional to the existence of an added value differential between the two channels.

Groen Trend is an on-line retailer of large household electrical appliances, that buys directly or through third parties from producers in the Netherlands. *Schouten* markets its products (mainly home appliances) through retailers and it also supplies *Groen Trend*. *AEP* is a producer and

[36] District Court of Zutphen (Rechtbank Zutphen), 30th December 2005, Case 74100, KG ZA 05-309, *Groen Trend B.V. and Schouten Keukens B.V. / Atag Etna Pelgrim Home Products B.V*

importer of home appliances under the brand names *Atag*, *Etna* and *Pilgrim*. Both *Groen Trend* and *Schouten* had been *AEP* resellers for more than five years.

In 2005, *AEP* changed its policy and decided to charge higher price for products intended for on-line sales. Furthermore, consumers buying on-line were granted a shorter warranty (i.e. two years) compared to the warranty of products bought in physical outlets (i.e. five years).

The two above mentioned resellers sued the supplier for anticompetitive restrictions. The Court, however, held that such a different treatment had to be considered legitimate as it mirrored an 'added value' differential in the two channels of distribution.

110. A general requisite that a selective distribution system must satisfy is that supply conditions are not applied in a discriminatory way. However, this does not mean that these conditions must be the same for on-line and off-line retailers. Indeed, they may differ provided that the different treatment is objectively justified. There is a general consensus that this justification may stem from the different costs that a manufacturer incurs in dealing with the two distribution channels. The *Groen Trend* case is interesting because it also considers whether the two channels differ in the value they can generate for the manufacturer. Hence, to the extent that the traditional channel yields greater value, the supplier has a proper incentive to apply better conditions to traditional shops so as to encourage sales through this channel. While this approach might be interesting, its principle must be handled with care, as it is important to understand whether the greater value guaranteed by the off-line distributors is not the result of a market power that would be eroded by the development of e-commerce. In that case, it is apparent that the existing differences between the two distribution systems cannot be considered, for the application of competition law, an objective justification of a discriminatory policy.

111. The following two cases describe the approach of US courts in dealing with vertical restraints in e-commerce.

- **MD Products v. Callaway Golf Sales** [37]

MD products is a golf product retailer, owning two physical stores and selling products also through its website, other platforms or newspapers. For more than two years, MD products was able to sell Callaway Golf goods at discounted prices and through any distribution channel. In 2001, Callaway introduced a New Product Introduction Policy to address the problem it faced with retailers using discounted Callaway products to attract customers, then using a bait-and-switch tactic to direct customers towards a cheaper brand said to be comparable to Callaway. The new policy was aimed at retaining only retailers selling at full price, preserving the company's brand equity.

Consequently, Callaway stopped supplying MD products, and revoked its right to sell because it charged a retail price below the pre-determined one. The new policy also impeded MD products from advertising on Callaway's website, from selling Callaway's products on its own websites or on third-party website.

MD products filed an action before the U.S. District Court for W.D. North Carolina, asserting that Callaway policy amounts to a restraint on prices in breach of Section 1 if the Sherman Act as well as of the North Carolina Antitrust statute. MD products also alleged that Callaway was interfering with MD products business impeding it to enter into contract with third parties.

Both claims were dismissed by the Court that confirmed that Callaway's ban on some retailers on-line sales through their own website or on third party platforms did not pose any significant

[37] *MD Products, Inc. v. Callaway Golf Sales Co*., 459 F.Supp.2d 434 (2006).

constraint on competition and that a manufacturer that creates a selective distribution system is entitled to select, according to some criteria, those retailers which will be allowed to generate on-line sales.

- **Jacobs v. Tempur-Pedic** [38]

This case was raised by two consumers (Benny and Wanda Jacobs) who after purchasing Tempur-Peding foam mattress through one of its brink-and-mortar retailers, sought damages from the company, allegedly caused by its anticompetitive distribution agreements.

Tempur-Pedic North America, Inc. is a manufacturer of foam mattress, which are marketed through (brick-and-mortar only) authorized distributors and its own website. The Jacobs alleged that the company enforces a minimum resale price maintenance agreement with its authorized distributors, and at the same time reserved on-line sales for itself through its own website. The combination of the two practices was considered by the Jacobs as a horizontal price-fixing conspiracy, violating Section 1 of the Sherman Act.

The Court of Appeal for the 11th Circuit argued that the plaintiff had failed to prove actual or potential harm to competition in the relevant market. According to the Court, Jacobs had not properly defined the relevant product market and, above all, had not provided evidence of harm to competition cause by the detrimental exercise of power by Tempur-Pedic in the market.

In regards to the assessment of the alleged RPM, the Court argued that the plaintiff had the burden of proving the existence of an agreement in the meaning of Section 1 of the Sherman Act. It contended that the existence of similar prices for retailers and on Tempur-Pedic did not constitute sufficient evidence that such an agreement existed nor that prices were the result of a horizontal price fixing conspiracy.

Finally, the Court of Appeals for the 11th Circuit confirmed that the manufacturer was entitled to keep on-line distribution for itself, and that, in principle, such dual distribution system did not lead to an illegal horizontal relationship between independent retailers and the manufacturer acting as an e-tailer.

112. In the US the competition authorities and the courts have traditionally shown a more permissible attitude toward VRs in general. This approach is confirmed in the analysis of restraints that concern e-commerce. An outright ban on Internet sales is usually subject to a rule of reason approach which means that it is compatible with competition law unless there is convincing evidence that it will yield anti-competitive effects that are not offset by efficiency gains stemming from the solution of free-riding problems, or the protection of brand equity. This analysis is in line with the general principle that producers are normally free to unilaterally reserve distribution channels for themselves or for appointed distributors, established in the case law on catalogue sales.

5.3 Some conclusive remarks on the case law

113. The decisions made by competition authorities and courts summarized in the previous sections show that vertical restraints concerning on-line sales are assessed applying the criteria generally used in the analysis of vertical restraints as established in the jurisprudence and through soft law. Hence, the development of e-commerce did not require the elaboration of new concepts or *ad hoc* rules. This also means that the position that competition authorities have taken on these restraints reflect the traditional view on the right balance that has to be made between the freedom of the parties to choose the distribution systems that they think suit them and the need to protect some form of distribution or some form of competition that, according to the enforcer's view, is apt to increase consumer welfare. In this respect

[38] *Jacobs v. Tempur-Pedic Int'l, Inc.*, 626 F.3d 1327 (2010).

European competition authorities and courts seem more willing than the US authorities and courts to set more stringent limits on the choices available to suppliers and to scrutinize the details of vertical agreements. Although the two jurisdictions are converging over time, the area of what in the EU are referred to as “hardcore restraints” is still wider than in the US and the case law discussed above confirms that this is true also for the assessment of the organization of on-line sales.

114. Notwithstanding this comforting conclusion, the case law highlights also questions that are new or that deserve some further reflections.

115. First, the creation of electronic platforms that operate as intermediaries has induced firms that use these platforms to sell their products and the platform owners to conclude agreements that affect the sellers’ pricing policy. The use of APPAs in the on-line setting may be more widespread than one can conclude from the limited number of litigated cases. These types of arrangements have not been studied yet formally in the economic literature and no clear policy indications should be drawn from the analysis of apparently similar practices. Both the European authorities and the US DOJ seem inclined to take a negative stance against these pricing schemes. Yet, no firm conclusions can be derived by the decisions reached so far. Some light will be probably shed by the OFT investigation on the on-line travel agents and, hopefully, by more research on the subject.

116. Second, at least in the EU there seems to be a general presumption that e-commerce is a powerful means to increase competition and to enhance consumer and social welfare. This belief is supported by some economic literature and the recent growth of on-line sales shows that consumers and firms derive substantial benefits from them. However, there might be industries in which the Internet may improve one form of competition, namely price competition, and reduce the intensity of other forms of competition based on the (true or perceived) quality of the products and the provision of ancillary services. There is no reason to believe that the former competitive effects will always be more important than the latter, both for firms and for consumers. Moreover, preventing the use of the Internet is likely to affect only or mainly intra-brand competition and there is now a wide consensus that this is unlikely to hurt consumers if competition among brands is strong. Therefore, the position of the European Commission and the ECJ that a decision of a supplier to impede on-line sales of its products amounts to a hardcore restriction, which may escape the prohibition set in Article 101 only when there are (narrowly defined) objective justifications, might be too severe.

117. The viewpoint of the EU institutions might be interpreted by considering other objectives of the Treaty which are not strictly related to competition. It is revealing that the ECJ in the *Pierre Fabre* judgement mentions the freedoms of movement as an objective that explains its position with respect to a prohibition of Internet sales. In this respect, e-commerce is relevant more because it promotes the geographic integration of national markets than for its pro-competitive effect.

118. A different consideration regards the ability of e-commerce to expand the range of products available to consumers by providing new electronic formats, as in the e-book cases. When this happens, the Internet is not only spurring price competition, but it is also enlarging consumers’ choice and the opportunity for new businesses to grow. In these circumstances a more sceptical attitude about the efficiency purposes of restraints that limit the development of both the new distribution channel and the new format seems justified.

6. Conclusions

119. The Internet is not the first change in the distribution and retail sector, antitrust enforcement has been faced with many commercial upheavals over the years. Well before the advent of e-commerce, antitrust agencies reported market turmoil caused by innovations, such as the introduction of supermarkets chains, shopping malls, discount stores and the use of catalogues, among the others.

120. Yet, why did e-commerce draw much greater attention compared to the previous changes in distribution systems? The most straightforward reason is that the Internet is ubiquitous, whoever whenever, wherever has the possibility to access the digital world. Secondly, because the introduction of the Internet as a distribution channel affected the majority of products and services already marketed, and also led the emergence of new goods and services as well as the appearance of new consumer demand. Finally, because it is believed to have substantial pro-competitive effects which can enhance consumer and total welfare.

121. Therefore, there is a list of novelties brought about by the Internet, which should not be underestimated when designing an appropriate competition policy. On the one hand, the Internet created opportunities that strengthen competition: there is general consensus over the fact that the Internet allowed for increased consumer sovereignty, in terms of an enlarged geographical market, increased number of alternatives, easier purchasing choice thanks to intermediaries and an easier way to compare prices and shop around. On the other hand, e-commerce lends itself to practices favouring concentration. One might erroneously believe that the on-line sales lowered barriers to entry, however such a consideration would not account for the fact that entry costs in on-line retailing are mostly sunk and that not all websites are successful, hence other factors should be considered. For instance, in e-commerce very often the first mover enjoys a fairly relevant advantage compared to its rivals; in addition, concentration is easily induced by the 'virtual' network effect as it might lead to a single firm dominance.

122. Notwithstanding these novelties, what emerges from the analysis presented in this paper is that the approach that competition authorities and courts have developed over the years remains generally valid in this new economic and technological setting. The main economic elements that have to be taken into account in assessing the competitive effects of vertical restraints in e-commerce are those that have been identified in the economic and antitrust literature developed for the off-line world. In a nutshell, competition law enforcers need to consider the risk that some restraints imposed on the parties of a distribution system might reduce competition, either by facilitating some form of price coordination, or by limiting entry, and balance this risk with the pro-competitive effects that the same restraints generate when they are adopted to protect the investments that the supplier or the distributors make to improve the quality of their products or to offer demand enhancing ancillary services. In doing this appraisal, it is important to keep in mind that intra-brand competition is likely to have a second-order impact on consumer welfare when inter-brand competition is lively and manufacturers mainly compete on the qualitative features of their products or on other non-price dimensions. It is also important to remember that the risk of foreclosure is limited when none of the parties to a distribution agreement enjoys a dominant position and the agreement is not part of a network of similar vertical restraints covering a large portion of the market.

123. The challenge competition law faces is to adapt the established theoretical framework to the new environment. However, to succeed in this challenge there is no need to create new rules and it seems unwise to establish new general presumptions either in favour or against the role that the Internet plays in fostering competition. The Internet indeed might be a powerful means to increase price competition and, in some cases, a source of innovation on its own. But which of these effects will likely occur and which will be more appreciated by firms and consumers depends on the specific characteristics of each industry. The formation of new general presumptions obfuscates these differences and precludes the flexibility that it is needed to adapt the application of competition rules to the specific circumstances of each case.

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