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Vertical Restraints and Competition Policy—Internet Sales, a New Dimension to be Considered

Kornel Mahlstein

The Graduate Institute of International and Development Studies

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I. INTRODUCTION

The internet expands the size of the market and gives consumers access to more providers and more choice—that is the EC Commission's conclusion after having studied consumer experience and satisfaction with shopping online.[1] Nevertheless, in recent times there has been an increasing trend of suppliers imposing restrictions on their retailers, preventing them from effectively using the internet for sale and/or advertising, and thus hindering consumers from fully benefitting from this new retail channel.

These vertical restraints, imposed by suppliers on the online distribution channels, are the topic of this study. As a matter of definition, vertical restraints ("VR"s) are contracts between suppliers and retailers that restrict the range of actions the two parties can take. Generally, VRs comprise two groups, resale price maintenance ("RPM") and selective distribution agreements ("SDA"). Traditionally, with respect to competition policy, these two formats of VRs have received different treatment. RPM is prohibited in most countries; SDAs are generally looked at more favorably.

This short article makes the point that SDAs, and especially those that seek to

*Kornel Mahlstein; HEID Geneva, kornel.mahlstein@graduateinstitute.ch

[1]Commission Staff Working Document (2009), Report on cross-border e-commerce in the EU, SEC (2009) 283 final, 5.3.2009.

constrain internet sales, are dubious and potentially very detrimental to consumer welfare. As Lafontaine & Slade put it in their 2005 paper, "There is perhaps no aspect of competition policy that is as controversial or has been as inconsistent over time as the area of restraints between upstream firms and their downstream retailers."[2]

Some suppliers argue that restricting internet retailing constitutes a proper and therefore legitimate tool of overcoming free-riding. As this paper will show, solely prohibiting internet sales is an insufficient means to improve the free-rider problem. Furthermore, any attempt to restrict internet sales as a mean of mitigating the free-rider problem opens up an array of new problems. Considering the widespread use of VRs,[3] any policy development in the direction of allowing SDAs in the form of prohibiting internet sales would potentially have a negative impact on the prospects of internet sales, economic efficiencies, and on welfare in general. The possibility of distributing goods over the internet marks a paradigm shift in logistics, market penetration, and consumer information, which, we argue, is perceived by suppliers and traditional retailers as negative because of increased pressure on their profit margins.

This paper is structured as follows: Part II summarizes the current discussion on the motivation of VRs and why they may be appropriate in certain circumstances, Part III analyzes the inherent inefficiencies and problems related to their use, Part IV relates VRs to internet sales and analyzes their implications for consumer welfare, and Part V concludes.

[2]F. Lafontaine & M. Slade, M. 2008. *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, (2008), *in* HANDBOOK OF ANTITRUST ECONOMICS, *(P.* Buccirossi (ed.) (forthcoming) .

[3]L.G. Telser, *Why Should Manufacturers Want Fair Trade*?, J L ECON. 3: 86-105, (1960).

II. PRO VERTICAL RESTRAINTS

In recent times, internet sales have been increasingly perceived by brick-and-mortar shops and suppliers as a threat to their way of doing business. Online shops, it is argued, free-ride on upscale services without incurring any of the connected costs of providing pre-sales services that are appreciated by consumers. Saving on these costs, internet retailers enjoy a cost advantage over their brick-and-mortar counterparts, and, as a result, they are able to offer the product for much less and thereby capture a large part of the market, frustrating investment efforts by offline shops.[4] It is, however, important to realize that free-riding is not specific to internet retailers, but applies to all types of retailers. Simply forbidding internet sales is not sufficient to remedy the free-rider problem. For instance, how can an accredited Rolex-dealer in Paris be certain that his "service" investment does not benefit another Paris-based Rolex retailer?

Theoretically, free-riding becomes an issue when the demand for a product has a price and a service dimension, and contracts are incomplete; i.e. the actual service effort taken by retailers, in form of sales effort and product presentation, is unobservable to suppliers. Providing these pre-sale services, it is further argued, is costly and if retailers are unable to recoup the full benefit of these investments, the level of investment in the service dimension will be suboptimal from the supplier's perspective. Or, as long as different retailers share the same market, they will be very hesitant to invest in the provision of consumer services. The strand of the literature favoring the use of VRs as an adequate tool to solve the alleged free-riding problem concludes that any VR that

[4]For more information on the free-riding argument see *Id*., 91, "Sales are diverted from the retailers who do provide the special service at the higher price to the retailers who do not provide the special services and offer to sell the product at the lower price."

eliminates, or significantly diminishes, intra-brand competition can help overcome the free-rider problem between retailers.[5] For instance, resale price maintenance (RPM), per se illegal in most countries, would force retailers to compete on the service dimension. SDAs in the form of exclusive territories represent another manner by which to deal with the same problem.

III. CONTRA VERTICAL RESTRAINTS

From a theoretical standpoint, free-riding is a simple principal-agent problem with asymmetric information (suppliers do not directly observe the service provision by retailers). Since providing customer service is costly, it tends to be underprovided compared to what would be optimal—which is detrimental to consumers, producers, and welfare in general. A closer look at the free-rider issue reveals, however, that the contention that VRs align consumer and producer interests does not withstand economic scrutiny. RPM and SDAs are non-sophisticated measures of dealing with the free-rider problem; they are suboptimal from an economic theory point of view. [6] Retailers may just enjoy high margins without providing any additional services. This uncertainty must be balanced against significant welfare costs. VRs can easily be enacted with the goals of geographically segmenting the market, raising barriers for potential competitors,[7] and reducing competition between suppliers in the upstream market[8] and facilitating

[5] *Id.*

[6] In the economic literature these two arguments have received only little attention, partly because they are so obvious.

[7] W. Comanor W. & P. Rey, *Vertical Restraints and the Market Power of Large Distributors*, REV. INDUS. ORG. 17: 135-153.(2000)

[8] P. Rey, P. & J. Stiglitz, *The role of exclusive territories in producers' competition*, RAND, (1995).

collusion.[9]

Great attention in the literature has been given to the possibility that SDAs in exclusive territories lead to competition-softening effects among suppliers. Rey and Stiglitz show that by delegating pricing decisions to an exclusive retailer in the downstream market, wholesale prices end up being higher compared to a situation in which the supplier competes directly. [10] The anticompetitive effect increases in market concentration. In other words, in oligopolistic and monopolistic markets, the competition-softening effect tends to be more important.

Further insight can be gained by identifying the type of market structure in which VRs may form an attractive tool to solve the so-called free-rider problem. In a competitive environment, a supplier would be foolish to force any VRs on retailers in order to increase sales. Consumer would enjoy the additional service but would be unwilling to pay the higher price, simply switching to another brand. Thus, competition would dissipate any rents from increased service efforts. We can conclude that free-riding is only an issue in markets in which suppliers enjoy some degree of monopoly power, possibly by cultivating a "brand image." Empirical evidence supports this view; a vast majority of VRs are found in markets in which suppliers have some pricing power.[11] The implications on the desirability of VRs are important; VRs are predominantly observed in markets in which they have a competition-softening effect. It could be argued that it is exactly this side effect which makes VRs particularly attractive to suppliers as a mean to

[9]G. Mathewson & R. Winter, *The Competitive Effects of Vertical Agreements: Comment*, AMER. ECON. REV, 77, 1057 (1987).

[10]Rey *supra* note 8. 431-451.and Vergé (2008).

[11]Telser, *supra* note 3.

realign the retailers' incentives with their own. It is common wisdom from contract theory that realigning incentives between the principal and the agent is costly for the principal.[12] The costs are incurred as higher mark-ups for the agent, in this case the retailer.

Nevertheless, VRs have, from the supplier's perspective, the pleasant side-effect of reducing competition among them. It is actually a way to get consumers to pay part of the costs related to the incentive alignment problem. Hence, VRs are attractive to suppliers for two reasons: they increase demand due to higher service provisions by retailers and they soften competition between suppliers.

The competition-softening argument is not the only one that warrants a cautionary approach towards VRs in general. When markets are heterogeneous, a supplier does have a vital interest in implementing a VR, especially an SDA, in order to segment the market and to be able to price "at market." In the presence of natural barriers to trade between markets, or due to a prohibition of internet sales, the monopolist can sell the good at different prices to single retailers. This allows suppliers to effectively appropriate a larger part of the consumer surplus than would otherwise be possible.[13]

Another point worth mentioning in this context is the assumption of homogenous consumers. Even when assuming that the "service" provision is optimal from the supplier's perspective, i.e. retailers' incentives are perfectly aligned with those of the

[12]For a general introduction, see B. SALANIÉ, THE ECONOMICS OF CONTRACTS, (2nd ed., 1997).

[13]This strategy of market separation (sometimes also called "third-degree price discrimination") is a standard result in microeconomics (*see, e.g.*, W. NICHOLSON, MICROECONOMIC THEORY – BASIC PRINCIPLES AND EXTENSIONS, §13, (2004). For the application of this theory to vertical restraints, see P. Krugman, Pricing to the Market when the Exchange Rate Changes, NBER Working Paper No. 1926 (1986), F. M. SCHERER, F. M. & D. ROSS, D. INDUSTRIAL MARKET STRUCTURE AND ECONOMICS,560 (3RD ED.,1990) and Mathewson, *supra* note 9.

supplier, there is still no guarantee that the overall welfare effects of a VR are positive. It depends critically on the homogeneity assumption of consumers. Assuming differences in consumer preferences may put into question the societal gains stemming from increased service provisions. [14] The optimal "service" and price mix is trimmed to best suit the marginal consumer; i.e. the one who was not buying before but now buys due to better service offered by the retailer. It is obvious that higher service efforts by retailers have a cost which comes in the form of an increase in the wholesale price. Many inframarginal consumers (consumers who have been buying the product already before the change of the "service" and price mix) may value the service increase much less compared to the marginal consumer. In the absence of close substitutes they will continue to buy the product, but are worse off.

Overall, there are good reasons to believe that providing the right mix of "service" and price may not be the principal objective of a supplier. Furthermore, less restrictive measures than VRs, such as increased vertical cooperation or direct supplier investments (shop-in-shop concepts), are available to address the problems of free-riding. Furthermore, assuming that investments by the supplier in monitoring and market knowledge are possible, moral hazard behavior on the part of retailers is more easily detected, which again reduces the incidence of free-riding. After all, service provisions by retailers are observable to consumers, and there is no obvious reason why they are not observable to suppliers. Clearly, granting territorial exclusivity is costly to suppliers, but VRs, due to the competition-softening effect, may end up being more attractive than

[14] *See* V. Verouden, *Vertical Agreements: Motivation and Impact*, in ISSUES IN COMPETITION LAW AND POLICY, (W. Collins, ed., 2008); *available at* http://ec.europa.eu/dgs/competition/economist/verouden.pdf).

increased investment in market knowledge and the supervision of retailers.

IV. INTERNET RETAILING

The objective of this part is to underline the consequences of VRs (especially SDAs in the form of a prohibition of internet sales) on internet sales and welfare in general. This note underlines the possibility that the alleged free-rider problem in the context of internet sales is, in reality, a disguised effort by suppliers and retailers to fight the technological and fundamental market changes caused by the introduction of internet sales, which they perceive not to be in their interest. It will be demonstrated below that a laissez-faire approach towards VRs, especially SDAs in the form of a prohibition of internet sales, is problematic and cannot be reduced to a simple free-rider problem.

Distributing goods over the internet marks a paradigm shift in logistics, market penetration, and consumer information. It is important to realize that, even in the absent of free-riding, internet stores face lower costs and are more competitive vis-à-vis traditional brick-and-mortar store. From an economic point of view, they should, as a consequence, capture a bigger market share. A priori, one could be tempted to think that it should be in the supplier's interest to favor internet suppliers over traditional brick-and-mortar stores since it would allow them to sell their products for less.

An important step in the argument is to understand why suppliers do not favor the development of online stores. Actually, internet stores are more than just an additional sales channel; the emergence of internet sales changes the market structure in important ways. First, markets become much wider in scope; consumers are now able to purchase

an article independently of the geographical location of the seller, provided that shipping costs are not too high. This paradigm shift in market structure from the introduction of online retailing may be comparable to the effects described in traditional trade models when tariff barriers fall; there is a pro-competitive effect and prices fall and the product range increases.[15] Similarly here, consumers now have a much wider range of possible retailers to choose from. Internet stores enable consumers to obtain product information and prices in a very short period of time, at almost no cost. As a result, internet sales make consumers more price-sensitive, reducing suppliers' and retailers' ability to charge high prices. As a result, the perceived price elasticity by suppliers and retailers increases, which is detrimental to their profit-margins. Effectively, internet sales are a powerful tool to break up national markets and make them truly European in scope. It is important to point out the tremendous gains for consumers. Prices have fallen for two reasons: because competition increases due to the change in the market structure and, also, lower distributional costs. Combined, these changes lead to important economic efficiency gains.

More importantly, it is simply not true that online stores do not provide any service to consumers. It is often neglected to note that it is very difficult to design and operate online services that consumers appreciate, use, and come back to. Consumers have a very low acceptance threshold on the internet—for the same reason that the internet is beneficial: It's easy to move on and find something else/better. Just a click too many or incomprehensible purchasing instructions, and the consumer easily leaves the site. Therefore online services are not costless and require substantial intellectual

[15] P. Krugman, P. & E. Helpman, MARKET STRUCTURE AND FOREIGN TRADE (1985).

investment to make them work. The pre-sales service offered by internet stores may be as effective as the one provided by tradition stores, but they are able to offer it at a much lower price. This reduces the scope for the argument of internet-induced free-riding and puts internet retailers on equal footing with brick-and-mortar retailers.[16] It seems appropriate to do away with the arbitrary assumption that "service" can only be delivered offline. Internet services are valuable to consumers and less costly for every market participant. Consumers today often inform themselves through the internet before shopping (and purchasing) in brick-and-mortar outlets. FAQ-sheets, price comparisons, consumer reports, and customizing options are just some examples of internet services offered and used over the internet. Internet services not only enhance consumer satisfaction and reduce purchasing costs; they also allow for efficiency gains in distribution. Online retailers provide services that are important to consumers and thus welfare-enhancing.

One could even go as far as to claim that, in an important way, the internet mitigates the free-rider problem. Many pre-sales services (product information, product comparison, prices, etc.) can now be made available at much lower costs and easily verified by suppliers simply checking the corresponding internet stores' website.

V. CONCLUSION

This paper analyzes the possible motivations underlying the uses of VRs and their potential effects on welfare. It is quite obvious that VRs cannot be qualified across the board as consumer-welfare improving. Welfare implications of VRs for consumers are

[16]Gertner, R. H. and Stillman, R.S. 2001. "Vertical integration and internet strategies in the apparel industry" Journal of Industrial Economics, Vol. 49, No. 4: 417-440.

context-sensitive.[17] In general, VRs are unnecessary and overly distortionary tools for overcoming market failure and for aligning supplier and retailer incentives. Most VRs are observed in industries which are characterized by monopolistic or oligopolistic competition and *prima facie* tend to have competition-softening effects.

This article also argues that the alleged free-rider problem in connection with internet sales is potentially a disguised attempt by suppliers and retailers to impede the ongoing change in the market structure caused by technological evolution and the possibility of consumers purchasing goods over the internet. Online stores effectively widen the scope of the market and, due to lower fixed costs, enjoy a competitive advantage over traditional brick-and-mortar stores. Internet sales increase competition, reducing the ability of suppliers and traditional stores to enjoy high mark ups. Thus, these changes have created tremendous benefits for consumers.

From an economic point of view, given the cost advantage internet stores enjoy, it is natural to see them gaining market share at the expense of traditional shops. Any policy measure that would effectively impede the free operation of these markets would be welfare detrimental. For the above mentioned reasons, a critical approach towards VRs is more than warranted.

[17]W. Comanor, *Vertical Price Fixing, Market Restrictions and the New Antitrust Policy*, HARV. L. REV.98, 983,(1985)