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Selective Distribution and Luxury Goods: The Challenge of the Internet?

Emily Clark, Mat Hughes, & Denis Waelbroeck[1]

I. INTRODUCTION

On July 28, 2009 the European Commission published for consultation its proposals for a revised vertical agreements block exemption regulation ("the Block Exemption")[2] to replace the current Block Exemption due to expire in May 2010;[3] as well as revised draft Guidelines on Vertical Restraints ("the Guidelines").[4] The Commission's accompanying press release states that "the Commission considers that the rules are working well overall and should not be fundamentally modified."[5]

One range of restrictions covered by the scope of the existing and draft Block Exemption relates to selective distribution which permits manufacturers to supply only authorized retailers who meet certain criteria. A key issue is the use of selective distribution by luxury goods producers and, in particular, whether the rationales which have traditionally been used to justify such arrangements can be applied to restrictions placed on a newer distribution channel, namely internet retailing.[6]

Diametrically opposing views have been expressed on this subject. The "pro-internet lobby,"[7] notably led by eBay, argues that selective distribution, and other forms of vertical restraints which may be used in conjunction with selective distribution, allow the supplier to foreclose online retailers, as well as partition markets to enable price discrimination and reduce competition among suppliers. The main alleged consequence

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[2] Draft Commission regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, 28 July 2009. Interested parties are invited to submit comments by September 28, 2009.

[3] Commission regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (2790/99/EC), OJ L336, 29 December 1999.

[4] Draft Commission Notice: Guidelines on Vertical Restraints, 28 July 2009. Subject to the outcome of the consultation process, this document will replace Commission Notice: Guidelines on Vertical Restraints (2000/C 291/01), OJ C291, 13 October 2000.

[5] "Antitrust: Commission launches public consultation on review of competition rules for distribution sector," IP/09/1197, Brussels, 28 July 2009.

[6] The Competition Commissioner, Neelie Kroes, has also launched a public consultation on online commerce and established a working group of business leaders and consumer groups to discuss "Opportunities in Online Goods and Services."

[7] This position is set out in the following papers: Stephen Kinsella, Hanne Melin, & Simon Schropp, *Comment on the CRA paper entitled "An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers,* 5(1) EUROPEAN COMPETITION JOURNAL, (2009); and Kinsella & Melin, *Who's Afraid of the Internet? Time to Put Consumer Interest at the Heart of Competition"*, GCP MAGAZINE (Mar-09). *See also* the 15 October 15, 2008 submission by eBay in response to the Commission's public consultation on "Opportunities in Online Goods and Services." Kinsella and Melin have assisted eBay on EU law matters.

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is to deprive consumers of the benefits of the internet and keep consumer prices high. In particular, Kinsella, Melin and Schropp (2009) argue that:

> Vertical restraints seem more likely to be enacted with the goals of geographically segmenting the market, raising barriers to entry for competitors, reducing competition between suppliers in the upstream market and maintaining high resale prices. In this sense, vertical restraints can be a tool for better exploitation of monopoly power and anti-competitive zeal—to the unambiguous disadvantage of consumers.[8]

The reply to these arguments is generally that selective distribution itself is unlikely to lead to market segmentation or foreclosure, or facilitate collusion among suppliers. In addition, it is argued that there are compelling efficiency arguments for selective distribution. Moreover, even an absolute monopolist facing no threat of entry would not adopt selective distribution unless it yields benefits which are valued by consumers and thereby stimulate demand. A monopolist would have no interest in increasing the overall costs of the supply chain in the absence of such offsetting benefits as this would reduce its sales and profits.[9]

This article seeks to add to this debate by considering:

- The application of the existing Block Exemption to selective distribution; the specific issues which have been raised by the Commission as part of its review; and how these issues have been addressed in the draft revised Block Exemption;
- The potential anticompetitive effects of selective distribution and consumer harm from selective distribution; and
- The potential pro-competitive and consumer benefits of selective distribution, and the appropriate balance to be struck between any likely adverse and positive effects as regards selective distribution.

[8] *Id*., Kinsella, Melin, & Shropp, ¶ 103.

[9] This argument may be found in Thomas Buettner, Adrea Coscelli, Thibaud Vergé, & Ralph A. Winter, *An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers*", 5(1) EUROPEAN COMPETITION J, (April 2009), referred to as the "CRA paper". To put the above point more technically, and to indicate its more general relevance, there is a fundamental difference in agreements between suppliers of substitutes (i.e. competitors) and suppliers of complements (whether this relates to a vertical supply chain, such as between suppliers and retailers or a manufacturer and a raw material supplier, or complementary products which are commonly purchased together, such as different inputs which are required to manufacture a product). This is because firms have an interest in agreements which increase their competitors' prices since this will boost their own sales and profits, whereas firms have an interest in agreements which lower the prices of complementary products and services as by definition this will increase their own sales and profits.

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II. THE APPLICATION OF THE BLOCK EXEMPTION TO SELECTIVE DISTRIBUTION AND RELATED ISSUES

A. An Overview of the Application of the Block Exemption to Selective Distribution

The existing Block Exemption permits suppliers to adopt selective criteria that their retailers must satisfy. It also permits suppliers to restrict sales to unauthorized distributors by members of a selective distribution system; albeit the new draft Block Exemption limits this to markets where such a system is operated[10] (see further below). Under the terms of the draft Block Exemption, this is subject to the following:

- The market share of each undertaking which is party to the agreement should not exceed 30 percent. This is a significant change from the existing Block Exemption where the market share threshold is applied only to the supplier for most agreements. In its accompanying press release, the Commission indicated that this proposal was intended to take account of the increase in large distributors' market-buying power over the past ten years;[11]
- The agreement should not contain a number of hardcore restrictions, two of which are specific to selective distribution; and
- A condition which is not covered by the Block Exemption that relates uniquely to selective distribution.[12]

It should be noted that if a vertical agreement contains a hardcore restriction then the Block Exemption is withdrawn altogether. As a result, the presumption of legality would no longer apply in relation to the agreement, a condition which effectively creates an additional sanction for hardcore restrictions.

B. General Hardcore Restrictions

As noted above, a number of hardcore restrictions are identified such that any vertical agreements containing these restrictions will fall outside the scope of the Block

[10] Article 4(b) of the existing Block Exemption, and Article 4(b) of the draft Block Exemption.

[11] "Antitrust: Commission launches public consultation on review of competition rules for distribution sector", IP/09/1197, 28 July 2009.

[12] This condition relates to the Block Exemption not applying to a restriction which prevents a supplier's appointed dealers from buying products for resale from one or more specific competing suppliers (Article 5(c) of the Block Exemption). The Guidelines indicate that:

> The objective of the exclusion of this obligation is to avoid a situation whereby *a number of suppliers* using the same selective distribution outlets prevent one specific competitor or certain specific competitors from using these outlets to distribute their products (*foreclosure of a competing supplier which would be a form of collective boycott*). (¶ 61 of the Guidelines and ¶ 65 of the draft Guidelines.) [Emphasis added]

This is a puzzling condition. First, where a number of agreements lead to market foreclosure, there are provisions for the Block Exemption to be withdrawn. Why is the risk of possible foreclosure in relation to all such restrictions not addressed in this way? Second, it should also be noted that a collective boycott between a number of suppliers relating to one or more rival suppliers' access to common distributors would appear to be an agreement or concerted practice between these competitors which is outside the scope of the Block Exemption as it only applies to agreements between non-competitors.

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Exemption (as well as the de minimis Notice[13]). Two of these general hardcore restrictions have prompted considerable debate, namely those relating to the prohibition on minimum and fixed resale prices (commonly referred to as Resale Price Maintenance, "RPM")[14] and various restrictions focusing on single-market integration.

In the context of this article, it is appropriate to focus on the treatment of restrictions on trade. The Block Exemption distinguishes between exclusive and selective distribution. In the case of exclusive distribution, it treats any ban on "passive" sales as a hardcore restriction, but permits bans on "active" sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated to another buyer.[15] This distinction between passive and active sales is form-based and depends largely on whether the customer initiates the contact (which is defined as a passive sale) or the distributor initiates the contact (which is defined as an active sale, with active sales being linked to setting up premises in another territory and promotion in that territory). This leads to obvious issues of spill-over including when promotion to customers within that dealer's territory may attract customers in other territories; also, the internet, by its nature, does not respect geographic borders.

The revised draft Guidelines (in common with the existing Guidelines) clarify that, in general, the internet is not considered a form of active selling. The internet's wide geographic reach, resulting in potential effects outside a distributor's exclusive territory, is considered by the Commission to be simply a function of the technology, and the Commission regards a sale arising from a customer accessing a website and ordering on-line as a form of passive selling.[16] In this regard, the revised Guidelines include additional wording on what would constitute hardcore restrictions of passive selling in relation to the internet, namely:

- Requiring a (exclusive) distributor to prevent customers located in another (exclusive) territory from viewing its website or requiring the distributor to put on its website automatic re-routing of customers to the manufacturer's or other (exclusive) distributors' websites;
- Requiring a (exclusive) distributor to terminate consumers' transactions over the internet once their credit card data reveal an address that is not within the distributor's (exclusive) territory;

[13] Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (de minimis), OJ C368, 22.12.2001.

[14] Article 4(a) of the existing and draft Block Exemption. There has been some debate as to whether the treatment of RPM should be re-considered in the EU following the Leegin case in the United States in which the U.S. Supreme Court reversed the 96-year-old doctrine that vertical price restraints were illegal *per se* under Section 1 of the Sherman Act, ruling that they should instead be judged on the basis of a rule of reason approach (Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007)). In this regard, it is welcome that the draft revised Guidelines acknowledge that RPM may also lead to various efficiencies as well as potentially having adverse effects (*see* ¶¶ 220 and 221 of the draft Guidelines).

[15] *See* ¶ 50 of the existing Guidelines and ¶ 51 of the draft Guidelines.

[16] The Commission does, however, indicate that online advertisement specifically targeted at certain customers would be considered a form of active selling to these customers (*see* ¶ 53 of the draft Guidelines).

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- Requiring a distributor to limit the proportion of overall sales made over the internet (this does not exclude the supplier requiring, without limiting the online sales of the distributor, that the buyer sells at least a certain absolute amount (in value or volume) of the products off-line to ensure an efficient operation of its brick and mortar shop, nor does it preclude the supplier from making sure that the online activity of the distributor remains consistent with the supplier's distribution model (…). This absolute amount of required off-line sales can be the same for all buyers, or determined individually for each buyer on the basis of objective criteria, such as the buyer's size in the network or its geographic location); and
- Requiring a distributor to pay a higher price for products intended to be resold by the distributor online than for products intended to be resold off-line.[17]

In particular, the last two elements of the Commission's draft Guidelines seem controversial since they relate to internet sales *per se*, not whether the distributor is selling via the internet outside its defined territory. In particular, if a supplier wishes its distributors to focus on selling through shops, why should it be prohibited from imposing any limit whatsoever on its internet sales (e.g. suppose that a retailer makes 99.9 percent of its sales via the internet and only 0.1 percent through its off-line shops)? Similarly, if an off-line distributor (i.e. one which sells through shops) incurs additional retailing costs in making such sales compared with internet sales, why should a supplier not grant additional discounts for such sales rather than lower-cost internet sales? (The draft Guidelines add that "This does not exclude the supplier offering the buyer a fixed fee to support its off-line or online sales efforts",[18] but this misses the point that different sales channels may have different retailing costs per unit sold.)

This has prompted debate particularly as regards the impact of market partitioning (i.e. price discrimination[19]) and the ambiguous economic effects of measures which seek to prevent market partitioning. For example, suppose that a monopolist is able to command a high price in one country and a low price in another. As Motta observes, an obligation to charge the same prices in each country would have at best ambiguous effects from consumers' perspectives—if both markets continue to be supplied, then consumers in the previously high-priced country would benefit from lower prices but the consumers in the previously low-priced country would suffer from higher prices.[20] Worse still, Motta notes that the monopolist might respond by choosing to serve only the high-price country and not serve the lower-priced market at all—i.e. differences in market conditions between countries might become more pronounced.

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17 ¶ 52 of the draft Guidelines.

18 Footnote 30 of the draft Guidelines.

19 "Price discrimination" means charging different prices, which are not justified by cost differences, to different customers or for different products. The view expressed in the Guidelines is that market segmentation may allow price discrimination; although it does not elaborate on how exactly this would be detrimental to consumer welfare.

20 M. MOTTA, COMPETITION POLICY: THEORY AND PRACTICE, 23 (2004).

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This point also applies in competitive markets. Suppose that a supplier of an established luxury brand with a 10 percent market share in one country decides that it would like to extend that brand to another country, but this may require some discounting to persuade retailers in that country to stock a new brand. Measures which impede such discounting might therefore deter competitive entry, and also prevent market integration.

While there are a number of exceptions to the hardcore restrictions on territorial protection,[21] none of these provisions allow absolute territorial protection, despite there being possible pro-competitive rationales for such a restraint.

C. Specific Hardcore Restrictions to Selective Distribution

It is unsurprising and correct that the definition and scope of hardcore restrictions should warrant close attention, particularly as regards a Block Exemption which has the stated objectives of permitting freedom to contract and a focus on anticompetitive harm.[22] However, notwithstanding that single market integration may not be generally beneficial to consumers and measures aimed at preventing price discrimination may have precisely the opposite effect, it is puzzling that more attention

[21] The hardcore restriction relating to resale is subject to a number of exceptions, namely: (i) a supplier can impose an active sales ban on a direct buyer in regard to resale into an exclusive territory or exclusive customer group of another buyer; (ii) members of a selective distribution system can be restricted from selling to unauthorized distributors; (iii) a buyer can be restricted from selling goods or services which are supplied for the purpose of incorporation (¶ 52 of the Guidelines). The draft revised Guidelines (¶ 55) and the revised Block Exemption limit the permitted restriction on sales to unauthorized distributors to those markets where selective distribution is applied (on this, see below under B.3). Moreover, for those agreements not covered by the Block Exemption, the Guidelines indicate that where a product is being introduced in a new geographic market, a fairly high degree of territorial protection may be allowed for two years. In particular, the draft revised Guidelines state that:

> Where substantial investments by the distributor to start up and/or develop the new market are necessary, restrictions of passive sales by other distributors into such a territory or to such a customer group therefore generally fall outside Article 81(1) during the first two years that this distributor is selling the contract goods or services in that territory or to that customer group."(¶ 56 of the draft Guidelines.)

[22] In the XXIXth Report on Competition Policy (1999) Professor Mario Monti identified a number of objectives to the Block Exemption:

> Its principal objective is to allow undertakings which have no significant market power to benefit from a safe haven within which they are no longer obliged to assess the validity of their agreements under the Community competition rules. In order to link the granting of exemption to the market power of the undertakings in question, the block exemption uses a market share threshold set at 30%. Above this threshold, the block exemption does not apply.
>
> By ensuring a wider coverage of such agreements in a single block exemption, the new rules will restore the freedom to contract for most companies, while allowing the Commission to concentrate more on important cases which raise serious competition issues and affect the interests of consumers.

The Commission's accompanying press release of 28 July 2009 emphasized similar objectives:

> At the time of its adoption in 1999, the Regulation aimed at considerably reducing the regulatory burden on companies, in particular companies without the ability to raise prices without a loss of profit (i.e. with no market power), like SMEs, and at introducing an effects-based approach to the assessment of vertical restraints. These objectives and concerns remain valid today.

The fact that "freedom to contract" is no longer specifically identified as an objective may simply be an omission on the Commission's part, or it may reflect recognition that a number of the proposed revisions to the Guidelines are intended to promote internet sales regardless of the preferences of suppliers (including suppliers with low market shares).

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has not been paid to the two hardcore restrictions specified in the Block Exemption and the de minimis Notice, which specifically apply only to selective distribution. The Commission has also identified an additional hardcore restriction in its draft revised Guidelines regarding differences between the selective distribution criteria adopted for shops and those for internet retailing, which warrants particular comment.

The two restrictions specific to selective distribution are substantially wider in scope than the general hardcore prohibition on restrictions of passive sales. They prohibit:

- The restriction of cross-supplies between distributors within a selective distribution system, including between distributors operating at different level of trade."[23] This provision will promote trade between distributors, so that if a distributor in one country faces higher prices than a distributor in another there will be scope for them to engage in arbitrage by purchasing from one another. Moreover, appointed wholesalers cannot be restricted as to the authorised retailers they can supply, further facilitating arbitrage.[24] For example, it would be a hardcore restriction for an appointed wholesaler in one EU country to be prevented from active selling to all authorised retailers throughout the EU;
- The restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level of trade, without prejudice to the possibility of prohibiting a member of the system from operating out of an unauthorised place of establishment."[25] This means that members of a selective distribution system cannot be restricted in the users (or agents acting on behalf of users) to whom they sell. Indeed, the revised Guidelines emphasise that "in a selective distribution system the dealers should be free to sell, both actively and passively, to all end users, also with the help of the Internet.

As noted above, the only other change to the Block Exemption is that the current Block Exemption generally permits restrictions on sales to all unauthorized distributors, whereas the revised text would limit restrictions to sales to unauthorized distributors in those markets where selective distribution is applied. This raises a practical issue: If a supplier considers that selective distribution is not appropriate for some reason in one EU market, it will then face the problem as to how it can prevent unauthorized distributors in that market from reselling to unauthorized distributors in other markets where it does adopt selective distribution—thereby undermining its system of selective distribution.

This may particularly disadvantage smaller suppliers who seldom sell their products across the whole of Europe and, in that way, create an inadmissible discrimination between them and bigger suppliers. This approach is also difficult to

[23] Article 4(d) of the existing and draft Block Exemption.

[24] *See* ¶ 55 of the existing Guidelines and ¶ 59 of the draft Guidelines.

[25] Article 4(c) of the existing and draft Block Exemption.

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reconcile with the definition of selective distribution, as contained in the ECJ case-law and in Article 1 of the Regulation. In our view, any restriction to sell to non-authorized distributors—wherever they may be situated—is a mere "ancillary restraint," which is inherent in the very concept of selective distribution.

In its revised draft of the Guidelines, the Commission writes that the obligation under the Block Exemption stating that, under selective distribution, distributors must be free to actively and passively sell to all users means the Commission would regard as a hardcore restriction any obligation imposed on appointed dealers which dissuades them from using the internet, specifically by imposing criteria for online sales which are not equivalent to the criteria imposed in relation to bricks and mortar outlets.[26]

This is clearly a form-based hardcore restriction, and one which introduces subjectivity as even small suppliers must ensure that the criteria applied to its authorized distributors are "equivalent" as regards both their on-line and off-line sales.

These hardcore restrictions are particularly striking as they impose unique obligations on those suppliers adopting selective distribution to permit active selling by their retailers across territories, and impose obligations as to authorized retailers' use of the internet. Such obligations seem intended to promote single-market integration, thereby raising the issues identified above. Since the desirability of single-market integration is raised by the pro-internet lobby, this issue is considered below in section C.

The Commission's recent proposals will undoubtedly provoke responses from the rival camps on this topic. For example, the pro-internet lobby may be expected to argue that online restrictions of any kind do not produce consumer benefits and should be subject to the same burden of proof as restrictions which fall outside the scope of the Block Exemption.[27]

On the other hand, those who highlight the potential pro-competitive justifications for selective distribution argue against more restrictive legal criteria. For example, the CRA paper suggests, in particular, that suppliers should be free to select (and review over time) the criteria for admission into their selective distribution networks. More generally, they argue for a laissez-faire regulatory approach to selective distribution by luxury goods suppliers because there are good reasons to believe that such restraints represent legitimate business practices designed to enhance the service dimension accompanying the goods, with the aim of increasing demand.

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[26] ¶ 57 of the draft Guidelines. This paragraph adds the following clarification on the imposition of criteria on different distribution channels:

> This does not mean that the criteria imposed for online sales must be identical to those imposed for off-line sales, but rather that they should pursue the same objectives and achieve comparable results and that the difference between the criteria must be justified by the different nature of these two distribution modes.

[27] Kinsella and Melin, *supra* note 7, Note 7, pages 13-14.

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A useful framework to explore the opposing views on these issues and, more generally, selective distribution, is to consider first the potential anticompetitive effects before considering whether there are offsetting efficiency benefits.

III. THE POTENTIAL ANTI-COMPETITIVE EFFECTS OF SELECTIVE DISTRIBUTION AND CONSUMER HARM FROM SELECTIVE DISTRIBUTION

A. Market Power

A key feature of the Block Exemption is its recognition that anticompetitive effects and consumer harm are unlikely to arise unless the relevant parties to the agreement have market power (barring certain hardcore restrictions and certain conditions), with the Block Exemption adopting a market share threshold of 30 percent. Any concerns relating to the cumulative effects of networks of similar agreements are, moreover, addressed by the existence of various provisions for the Block Exemption to be withdrawn or disapplied.[28]

Similarly, Motta concludes that:

> A rule of reason for vertical restraints and vertical mergers does not mean that all vertical agreements should be examined by the anti-trust agencies. This would simply be impossible, as they would have to use their scarce resources to monitor thousands of vertical relationships. Vertical restraints and vertical mergers are anti-competitive only if they involve firms endowed with significant market power (we have seen in several cases that the potential harm created by a vertical restraint decreases with the presence of competitors). Accordingly, there is no need to monitor restraints and mergers which involve firms with little market power. An efficient policy towards vertical restraints would grant exemption to all the vertical restraints and mergers of firms which do not have large market power. From the operational point of view, it would seem a good proxy to exempt firms with market shares below, say, 20-30%."[29]

Perhaps unsurprisingly, the pro-internet lobby takes a different view. Kinsella, Melin, and Schropp argue that:

> The luxury goods and branded goods sectors are characterised at best by 'monopolistic competition.' *Every manufacturer has market power in its own market, due to unique non-price differences between competitors' products*. This non-price dimension can be "brand image," perceived quality guarantees, physical composition or service in general. *Due to this product heterogeneity, producers have a*

[28] The benefit of the Block Exemption may be withdrawn in any particular case where the agreements are not compatible with Article 81(3), particularly where access to the relevant market or competition therein is significantly impeded by the cumulative impact of parallel networks of similar agreements (Article 6 of the existing and draft Block Exemption). Member States' competition authorities may also withdraw the benefit of the Block Exemption under the same conditions where vertical agreements have adverse effects in distinct geographical markets within that Member State (Article 7 of the existing Block Exemption and Article 6 of the draft Block Exemption). Finally, the Commission may also by regulation declare that, where parallel vertical agreements cover more than 50 percent of a market, the Block Exemption does not apply to specific restraints (Article 8 of the existing Block Exemption and Article 7 of the draft Block Exemption).

[29] *Op cit*, Note 20 at pages 337-338.

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> *degree of control over their prices* but no business has total control over the market price, because consumers are still willing to switch from one brand to the other if end prices are too high. Luxury goods fit squarely into this category of differentiated products.[30] [Emphasis added]

In our opinion, this statement goes too far for three reasons:

- First, product differentiation is an economy-wide phenomenon in consumer goods markets (including both mass-market goods and those which are selectively distributed) as well as in producer goods markets where there can be both product and geographic dimensions to differentiation.[31]
- Secondly, Kinsella et al assert that a firm has market power if it has "a degree of control" over price, which presumably means that its prices exceed marginal cost. However, this is not a particularly helpful definition. All real world firms would have market power on this basis because prices are not typically set equal to marginal costs (i.e. the increase in total costs from selling one more unit of output), not least because such a pricing strategy would not allow the recovery of firms' fixed costs (which do not vary with output).
- Third, focusing on substantial market power in terms of an ability to act independently of customers, competitors, and consumers would seem more meaningful, not least because it would capture non-price competition and competitive dynamics. Observing that a luxury goods firm offers differentiated products reveals nothing about its competitive position. Similarly, observing that a successful luxury goods firm earns a relatively high gross margin may be unrevealing as to its competitive position. First, its gross margin may not reflect its overall profitability since this does not take into account the fixed costs it has incurred (for example, in marketing and product development). Second, its gross margin may also reflect a reward for the risks it has taken to achieve these sales and profits. For example, suppliers may need to invest considerably in new product development and promotion, and their market shares and profits may depend on their success or failure in this regard in developing new brands and products.

Market shares are obviously an imperfect measure of market power, but they are simple and workable and they are widely used in a number of other notices, block exemptions, and guidelines.[32] It is difficult to support any assertion that branded goods

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[30] Kinsella, Melin, & Shropp, *supra* note 7, ¶ 70. This statement is made in the context of arguing that the Rey-Stiglitz economic model predicting anticompetitive effects from exclusive distribution which are described further below are "thus fully applicable to the luxury goods sector."

[31] For example, to the extent that due to transport costs or convenience, customers prefer to deal with local suppliers rather than suppliers based in other areas.

[32] *See, for example*, the de minimis Notice, the Commission's Guidelines on the effect on trade concept, the Commission's Guidelines on Horizontal Co-operation Agreements (with market shares being applied as thresholds in the underlying Regulations relating to specialization agreements and research and development agreements), the

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suppliers with low market shares can, in any market, simply be assumed to have significant market power.

The pro-internet lobby could argue that the market share threshold should be lower if significant market power may arise at lower market shares, but obviously there is a balance to be struck between focusing on agreements most likely to lead to anticompetitive harm and providing both legal certainty and minimizing regulatory burden. The extensive provisions that already exist for the Block Exemption to be withdrawn in specific cases may, in themselves, indicate the market share threshold need not be lower.

However, two alternative—but closely related—arguments may be put forward, and for the purposes of this article it is appropriate to focus on these points in the context of selective distribution.

The first argument is best illustrated as an example. Suppose that the leading supplier of bicycles, with a market share of 40 percent and with a number of smaller rivals, wishes to distribute its bicycles only through those authorized retailers which meet its selective distribution criteria, rather than supplying a new distribution channel (for example, national chains of supermarkets, but it could also be via internet retailers). Let us further suppose that there are many consumers who would strongly prefer to buy bicycles from this new distribution channel. In such circumstances, the smaller suppliers would have strong incentives to supply the new distribution channel as this would enable them to substantially increase their sales and profits, particularly since the market leading bicycle supplier is not supplying that distribution channel.[33]

Smaller suppliers' incentives to supply this new distribution channel would be further strengthened if (hypothetically) their access to existing outlets was limited or if they could not compete effectively on price when selling through such outlets. Whether selective distribution might contribute to such outcomes is considered further below, but note that this could strengthen the incentives of small and new suppliers to supply new distribution channels.

In this example, the leading supplier may have had a degree of market power as to price-setting, but a failure to meet consumer demand by not supplying a distribution channel which is assumed to appeal to consumers provides an entry and expansion opportunity to its smaller rivals. A supplier with a 30 percent market share, by definition, still faces competition from rivals with a combined market share of 70

Commission's Guidelines on technology transfer agreements (with market shares being used as thresholds in the underlying Regulation), and the Commission's Horizontal and Non-Horizontal Merger Guidelines.

[33] This is, in fact, a brief case summary of what happened to Raleigh in the United Kingdom, whose market share had fallen from over 60 percent in the early 1970s to 40 percent in 1980, with supermarkets and other customers it did not supply imported bicycles (*see further* the 1981 UK Monopolies and Mergers Commission report on Bicycles, which reached an adverse finding in relation to Raleigh's selective distribution notwithstanding the collapse in Raleigh's market share).

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percent. In such circumstances, where a supplier has a market share of 30 percent or less, it would seem questionable to presume that regulatory intervention is required to ensure that an attractive new distribution channel is supplied, rather than presume that this outcome would occur through the normal interplay of competitive forces.

The CRA paper makes a related point"...by first analyzing the use of restraints by a firm that is completely dominant—with not even the threat of competition in its market." It goes on to observe that:

> It cannot be emphasized enough that high prices at the retail level, or limitations on the number or types of retailers, are a cost to a supplier—and would be incurred in reality only if there is some offsetting benefit.[34]

Kinsella, Melin, and Schropp object to this conclusion on two grounds. First, they argue that a monopolist has a vital self-interest in implementing vertical restraints, "especially" selective distribution, in order to price discriminate across the EU. Second, a monopolist has a vital self-interest in using vertical restraints to foreclose market access to rival suppliers.

Ignoring the substance of these objections for the moment, they fail to appreciate the simple point that even a monopolist has no incentives to adopt any specific retailing structure that increases supply chain costs since these will depress its prices and profits unless there are offsetting benefits. This Chicago School observation is wholly legitimate, and is not being advanced by CRA to deny that anticompetitive effects or discrimination cannot arise (but more on this later).

Two further conclusions could be reached following this line of argument. First, caution should be applied in prohibiting even absolute monopolists from entering into vertical restraints. A weighing of pro- and anti-competitive effects would be necessary. One could argue that the market share threshold should be higher, subject to the weighing of these effects.

Second, if there are any anticompetitive or discriminatory motives for adopting selective distribution in circumstances where it adds significant costs but little value to the supply chain (as alleged by the pro-internet lobby, but emphatically rejected by a wide range of suppliers who have chosen to adopt selective distribution), it is not a "free lunch" for the supplier to adopt selective distribution, but a costly one.

B. Theories of Harm

The pro-internet lobby argues that the provision of retailer services is not the exclusive rationale for implementing vertical restraints and highlights the following possible anticompetitive and discriminatory theories of harm:

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[34] *Supra* note 9, 204.

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- Market Segmentation: The use of vertical restraints (particularly exclusive dealerships and measures to institute regional (national) sub-markets) to segment markets and engage in price discrimination in order to exploit consumers in high-price/high-demand sub markets;
- Foreclosure: The risk that exclusive dealerships may raise barriers to entry for upstream suppliers by foreclosing their access to customers at a reasonable cost, if at all;
- Softening of Competition between Suppliers: Selective distribution may be adopted as a strategic device which allows a supplier to indicate a commitment to act less aggressively in price competition; and
- Cartel Enforcement: Retailers can exert pressure on their suppliers to impose vertical restraints that eliminate effective price competition.

1. Market Segmentation

The pro-internet lobby suggests that market segmentation (possibly achieved through exclusive dealerships) might be used as a means to engage in price discrimination, contrary both to consumers' interests and the EU goals of market integration and consumer empowerment. The internet, according to its proponents, challenges price discrimination in segmented markets by allowing consumers to compare prices across large geographic distances and divert demand to low price areas, thereby undermining price differentials.

As noted above, exclusive distribution agreements whereby a supplier agrees to sell its products only to one distributor for resale in a particular territory are considered in the draft Guidelines. On the question of the harm which may be caused by these agreements, the draft Guidelines state the following:

> The possible competition risks are mainly reduced intra-brand competition and market partitioning, which may in particular facilitate price discrimination. When most or all of the suppliers apply exclusive distribution this may facilitate collusion, both at the suppliers' and distributors' level. Lastly, exclusive distribution may lead to foreclosure of other distributors and therewith reduce competition at that level.[35]

As noted above, it is widely acknowledged that price discrimination generally has ambiguous effects on social welfare. In any event, the analysis of the pro-internet lobby is, however, fundamentally incomplete as to the risks of selective distribution leading to market segmentation for a number of reasons:

- First, selective distribution is by no means automatically applied with exclusive distribution. From casual observation, shopping centers typically contain a number of shops selling selectively distributed and luxury branded products.

[35] ¶ 147 of the draft Guidelines.

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- Second, as noted above, even if selective distribution is combined with exclusive distribution it would be a hardcore restriction for there to be any limit on:
  - authorized retailers or wholesalers selling to other authorized retailers in other territories, (for example, it would be a hardcore restriction for a wholesaler in one EU country to be prevented from active selling to all authorized retailers throughout the EU); and
  - active or passive sales to end users by members of a selective distribution system operating at the retail level of trade.

It would be an unappealing argument to mandate that suppliers without market power wishing to adopt selective distribution must supply internet retailers in order to further possible single market objectives.

2. Foreclosure

The pro-internet lobby suggests that vertical restraints also have the potential to foreclose market access to potential competitors. In particular, it highlights the risk that single branding (i.e. exclusive dealing obligations on the retailer) may raise barriers to entry for upstream suppliers by foreclosing their access to retailers and, thus, end-use customers (particularly where there are substantial economies of scale and scope in distribution).[36] This could prevent entry of potentially more efficient suppliers or possibly force the exit of existing suppliers, thereby reducing inter-brand competition among suppliers, which could result in social costs in the form of higher prices, less innovation, and less service.

However, it is difficult to understand why these competition concerns are relevant as regards selective distribution. First, as noted above, if the leading suppliers do not supply the internet and it is an attractive distribution channel, then this will create valuable entry and expansion opportunities for new and small rivals. How does this foreclose suppliers' market access?

Second, single branding can, in theory, foreclose rival suppliers' access to retail outlets. However, there is nothing automatically linking selective distribution and single branding. Indeed, retailers selling luxury products typically sell a very wide range of brands, and there are typically a number of competing outlets in most shopping centers. Many suppliers actively want their products to be sold with a range of other related and similar products, since this adds to the appeal of their own products.

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[36] Foreclosure of new entrants at the upstream level is more likely if there are economies of scale at the retail level or a scarcity of good locations. For example, where there are economies of scale, a new supplier who is refused access to the established distribution system may then be faced with the less efficient alternative of setting up its own retail network. In other words, where there are economies of scale and scope in retailing, it will not be efficient for a manufacturer selling one product to set up a retailing operation which would need to sell a range of goods in order to match the existing economies of scale and scope.

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In reality, selective distribution will often facilitate market entry as a consumer entering a shop will have the choice among a multitude of products and may be tempted to buy a product different from the one he or she normally purchases.

3. "Softening" Competition among Suppliers

A further theory of harm relates to the scope for a vertical restraint to "soften" or mute price competition among suppliers. In particular, exclusive dealing may raise the costs of customers comparing competing suppliers' products, which effectively makes rival suppliers' products less close substitutes, potentially allowing higher prices to be set. A further potential theory of harm, developed by Rey and Stiglitz[37] in the context of exclusive dealing, is that, by eliminating retail intra-brand competition, each retailer will be able to charge higher retail prices and then use franchise fees (i.e. charging the retailer a fixed fee) to recover all of the retailers' profit.

Again, the focus of this issue is much more on single branding obligations where retailers sell only one manufacturer's products; but there is no automatic link between selective distribution and single branding and casual observation does not suggest that single branding is a pervasive feature of luxury goods markets.

4. Cartel Enforcement

As regards cartel enforcement, it could be argued that retailers can exert pressure on their suppliers to impose vertical restraints—such as resale price maintenance, exclusive territories, or potentially not supplying a new distribution channel (or new retail competitor)—that eliminate effective retail price competition contrary to suppliers' interests.[38]

This would seem a legitimate competition concern if it were to occur. However, it should be noted that any such "vertical" arrangements would be wholly "sham." Indeed, if there were to be any communication among existing retailers to the effect that suppliers should be pressured by retailers to impose "vertical" restraints that would reduce or eliminate retail competition, then competition authorities would have no

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[37] Patrick Rey & Joseph Stiglitz, *Vertical Restraints and Producers' Competition*, (32) EUROPEAN ECON. REV., 561-568 (1988) and *The Role of Exclusive Territories in Producers' Competition*" 26 RAND 431 (1995). The intuition behind this result is that exclusive territories reduce the gains to each individual supplier from price cutting because exclusivity gives the retailer a degree of market power so that it may pass on only part of a reduction in wholesale price to consumers. Furthermore, if one supplier's retailer cuts its retail price following a reduction in its wholesale price, then the other retailer may respond by cutting its own prices. Both effects therefore discourage price reductions by each supplier. The profitability of such a strategy from each supplier's perspective does depend on the supplier being able to levy franchise fees to extract retailer profits.

[38] The risk of collusion has been discussed most often in the context of collusion between suppliers rather than retailers, and it has been suggested that RPM might facilitate collusion between suppliers. In particular, RPM imposed by a group of suppliers may render their pricing decisions totally transparent, so that any fall in retail prices can be solely attributed to manufacturer price cuts rather than "noisy" retail price competition, and creates "focal points" for prices (with such focal points making it easier for manufacturers to reach agreements on prices). However, it is difficult to see how selective distribution contributes to collusion between suppliers in the same way.

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difficulty in characterizing this as a cartel among competing retailers which cannot benefit from the Block Exemption.

IV. THE POTENTIAL PRO-COMPETITIVE AND CONSUMER BENEFITS OF SELECTIVE DISTRIBUTION

Obviously, any anticompetitive effects need to be weighed against the benefits.

A. Why Would a Supplier Voluntarily Constrain Distribution of Its Product?

A helpful starting point for a discussion on the merits of selective distribution is to ask why a supplier might choose to constrain its distribution channels as opposed to adopting a "mass market" distribution model designed to reach as many consumers as possible. The existing competition regime assumes that benign effects outweigh adverse effects for agreements between firms with a market share below 30 percent.[39] Therefore, it may be instructive to consider the incentives facing a monopolist supplier to see whether pro-competitive arguments apply even in this extreme case.

As discussed above, the CRA paper envisages a scenario in which there is a single monopoly supplier who does not face any threat of entry and where demand for the good in question depends only on its price. In this case, it states that there would be no reason for the supplier to voluntarily constrain distribution of its product if the constraint yields no offsetting benefits. The effect would be to raise the retail price—but not the supplier's wholesale price—and reduce demand which would harm the supplier.[40] The paper stresses, therefore, that placing limitations on the numbers or types of retailers results in costs for the supplier which will only be incurred if there are offsetting benefits.

It is widely acknowledged that demand for certain goods and services depends not only on price but on a range of non-price factors collectively referred to as "service." These include sales effort by retailers, information provided at the point of sale, and investments in the shopping environment and inventories. For luxury goods, investment in such activities is likely to significantly enhance demand. For example, having consumers test the products and discuss their requirements with consultants facilitates a suitable match between the range of offered products and the consumer's specific needs. Moreover, brand image is a critical dimension and investments by retailers in sales assistance, exclusive showrooms, and a comfortable shopping experience are vital in enhancing the image of the product.[41] A customer lost because of a missed matching opportunity may be lost to a rival brand, which would not be in the interest of the supplier or, potentially, consumers if by switching brands they end up with a

[39] Subject to certain hardcore restrictions as discussed in section B.2-3.

[40] The wholesale price would stay the same and the supplier would earn its mark up over its costs on fewer units.

[41] The CRA paper states in this regard "if Chanel No 5 were sold in bulk over the internet, without any image investment, it would be an entirely different product than one sold in small bottle at up-market perfumeries, advertised in expensive magazines, and so on", Buettner, et al (2009). *Supra*, note 9, 220.

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suboptimal choice (e.g. a hair color which does not suit them or what they were seeking to achieve).

If the use of a restraint enhances the incentives of retailers to invest in "service" which, in turn, will stimulate demand, then this can offset the negative effects that a restraint has on demand through the increase in retailing costs and thus retail price (and thereby become attractive for a supplier to impose). In short, the supplier imposes the restraint on distribution in order to promote the provision of services which are valued by consumers, thereby leading to higher demand.

B. Why Would the Optimal Mix of Price and Service Not Otherwise Be Achieved?

A key question is why the optimal mix of price and service which maximizes demand would not be achieved in an "unrestricted" market. Again, the possible reasons for suppliers legitimately wanting to restrict sales are widely acknowledged in the economics literature as well as in the Guidelines. As regards selective distribution, three main reasons are:

- Retailer "Free-Riding": If services are generally provided by retailers, then it will be profitable for some retailers (say discounters, "no-frills" retailers, or internet retailers) not to offer any services and to free-ride on the services and product-image-conveying investments offered by other retailers. Accordingly, consumers may visit one retailer to benefit from their advice, shopping environment, and/or product demonstrations (for example, sampling a perfume or cosmetic at a store) while purchasing the product from a discount or internet retailer where lower prices are offered. If business is repeatedly lost in this way, then the market will move towards a market in which low service (and low price) prevails even though the level of consumer demand would be enhanced if the services and image investments were made available.[42]
- Safeguarding Brand Image: The retail environment may effectively "advertise" the product and a poor retail environment may thus damage a product's brand image. In addition, retailers which fail to offer advice enabling consumers to match a product to their requirements risk compromising the brand's image as consumers will attribute any incorrect purchase decisions to brand failure. Failing to safeguard brand image deters the consumer from purchasing the brand at other outlets, which has an additional adverse effect on the sales of high quality retailers.
- Biased Retailers' Incentives: Incentives to attract customers may be biased towards competing on price rather than service, leading to a lower level of service than would be preferred by suppliers (the CRA paper refers to this as

[42] This theory was developed by L.G. Telser, *Why Should Manufacturers Want Fair Trade*?" (3) J. OF L. & ECON, 86 (1960).

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arising due to "customer heterogeneity"). This is based on the idea that the retailer will be interested in winning customers away from other retailers (known as "intra-brand competition"), as well as attracting new customers to the product (known as "inter-brand competition") whereas suppliers' focus is on winning new customers to their products. Retailers may have biased incentives to focus on competing on price because a customer who searches among retailers is often more concerned with price than with high services or other non-price attributes. In contrast, impulse shoppers are more likely to buy in the first shop they visit and therefore be more influenced by image, shopping environment, and/or services offered by up-market retailers. This theory provides plausible reasons why an unrestrained market may, from the supplier's perspective, be unduly biased towards price competition and away from investing in image and service levels.

C. Does Selective Distribution Address These Problems?

Selective distribution can be used to address these problems, bringing the mix of price and service into alignment with the supplier's interest. In particular, prohibiting distribution to low-priced, no-service outlets increases the incentives for other stores to offer the services in question, as they will retain all of the customers they attract by offering these services. In addition, selective distribution safeguards brand image for the benefit of suppliers and high quality retailers. By protecting the retail margin from erosion through such retail competition, the restraint also increases the marginal benefit that each retailer obtains from attracting customers through service.

The pro-internet lobby considers that selective distribution is unlikely to be an effective tool in addressing the problem of free-riding. It claims that *all* retailers (not just internet distributors) have an incentive to free-ride on the service-investment efforts of other retailers. This can only be addressed by eliminating intra-brand competition, which requires the imposition of territorial exclusivity within a selective distribution system where the markets in which exclusive retailers operate are effectively isolated from one another (to avoid investments by one retailer benefiting another). The pro-internet lobby considers such exclusivity arrangements to be both counter to the principle of market integration, as well as being in violation of the Block Exemption, on the basis of a range of potential anticompetitive effects.

It is interesting in this regard that exclusive dealerships (i.e. single branding) and territorial exclusivity are rarely found in the luxury goods sector. While luxury goods suppliers often seek to operate a restricted system of distribution covering approved retailers who are appointed on the basis of certain criteria (i.e. selective distribution), they rarely seek to appoint a single retailer in a given geographic area to sell all of their products, nor do they seek arrangements where a retailer will only distribute a single

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supplier's product.

Typically, luxury goods are distributed through a number of upscale retailers, each of which may also sell a range of other similar luxury goods (indeed there are likely to be conglomerate benefits from co-location of these goods). Consider, for example, the cosmetic sections of large department stores or specialist retailers. Luxury goods suppliers have an incentive to extend their distribution networks to as many retail outlets as possible, provided they undertake the investments required to enhance demand, and do not undermine incentives to invest by other retailers in the network. This does require, however, criteria to be set by suppliers and for these criteria to be reviewed periodically in relation to the performance of the retailers within the network.

The pro-internet lobby also questions the use of vertical restraints to align retailers' incentives to enact a price-service mix which focuses on generating new demand (i.e. from impulse shoppers) as opposed to competing on price alone in order to win more price-sensitive customers from other retailers (i.e. the heterogeneous customer problem). It argues that the answer to this problem is not selective distribution or prohibition of internet distribution, but rather market segmentation in order to offer different price/service packages to different customer types (i.e. price discrimination). It is suggested by this lobby that different distribution channels could be deployed in this regard—internet offers to price-sensitive "active" customers, and bricks and mortar outlets aimed at customers who value face-to-face service and the shopping experience.

However, this is based on the false premise that internet retailing is hermetically sealed from other distribution channels—i.e. that low service internet retailers cannot "free-ride" on the investment in service levels by bricks and mortar retailers or compromise overall brand image.

D. What Are the Implications for Consumer Welfare?

While the scope for selective distribution to bring retailers' incentives into alignment with those of the supplier is clear from the discussion above, the question remains whether this is good for all consumers.

Such measures will be beneficial for "marginal" consumers. In order to influence the level of sales, the services provided by the retailer must be directed towards the preferences of "marginal" consumers—i.e. consumers who are just at the point of indifference between the supplier's products and those of a rival. However, the preferences of other customers (known as "infra-marginal" customers") who would have purchased the product in any event will not influence the supplier's profit-maximizing decision as to service levels.

In some cases, the marginal customer may place a greater value on these services, but all consumers have to pay the resulting higher prices even though other customers'

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valuations may be lower, in which case the mix of prices and services will not be socially optimal (services will be over-supplied and prices will be too high). The effect may, however, work in the opposite direction—i.e. marginal customers may place a lesser value on these services than the infra-marginal customers in which case the services may be under-supplied. Competition among suppliers increases the number of marginal customers and is likely to reduce any divergence between the preferences of marginal and infra-marginal customers.

Despite this ambiguity it is difficult to presume that the trade-off made by a supplier between price and service is so systematically distorted that it can be improved via legal restrictions. Regulation does not extend to other demand-enhancing activities undertaken by suppliers (such as advertising, packaging, or overall product quality) which can also be subject to under- or over-supply. Economic theory therefore supports a laissez-faire approach to selective distribution in the case of a monopolist, as there are strong reasons to believe that this approach will optimally adjust the mix of price versus non-price product dimensions supplied by independent retailers (as opposed to being imposed for anticompetitive purposes).

E. Alternatives to Selective Distribution

Finally, the pro-internet lobby claims that vertical restraints are not the only solution to the problem of free-riding and that other tools are available offering more efficient outcomes with lower social costs. In particular, it advocates a regime of differentiated wholesale prices where online retailers face higher wholesale charges and bricks-and-mortar retailers are offered lower wholesale charges thereby rewarding the latter for their investment in services (a form of "incentive contract"). The wholesale price could be made dependent on effective sales (in the store or over the website) in order to bring retailer incentives to invest in appropriate services and brand image into alignment the suppliers' interests. Another option would be for suppliers to make payments to support marketing efforts.

In order to implement any measure which links performance to reward via a contract, the pro-internet lobby notes that a service provision must be introduced as part of the contract between supplier and retailer. For example, retailers could be required to provide proof of services invested in and provided.[43] Suppliers would also need to undertake monitoring of the service efforts undertaken by retailers.

This raises interesting questions as to the difference between vertical restraints that provide formal obligations and those that provide financial inducements (for example, supplier payments or lower wholesale prices if investments are undertaken by retailers). While the latter may seem more appealing given that these, in theory, allow

[43] The authors give the following examples "training and further education of their workforce, awareness-raising campaigns conducted or customer-satisfaction surveys launched".

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for discretion on the subjected party, it is far from clear that they are workable or give rise to more efficient outcomes.

The suggestion by Kinsella et al that the free–rider problem has a "trivial solution"[44] in that suppliers can simply charge online retailers higher wholesale prices and offer lower prices to bricks-and-mortar retailers does not address how suppliers could prevent the arrangement from being undermined by arbitrage between the distributors. For example, a prohibition on passive or active sales by distributors seems likely to compromise those single-market objectives which Kinsella et al have emphasized at some length. It also assumes that suppliers can perfectly control the resale of their brands. Nor does this approach address the adverse effects on brand image from low-service quality internet sales.

Equally, although Kinsella et al suggest specific payment schemes as an alternative to vertical restraints, there is no explanation of how to address the supplier free-riding problem if the expenditures required are not product-specific and may therefore benefit competing suppliers.

Last, although Kinsella et al suggest that suppliers should improve their monitoring and market knowledge in order to allow them to devise contracts which make rewards directly contingent on investments in service, they insufficiently discuss the difficulties facing suppliers in seeking to align incentives through contractual instruments, including the costs of ongoing monitoring, and the fact that some of the elements of performance will be unobservable. It is notable, in this regard, that competition authorities tend to take a less favorable view of behavioral remedies to address competition issues because of the potential difficulties associated with policing the behavioral regime which is put in place.

V. CONCLUSIONS AND POLICY IMPLICATIONS

The Commission's consultation on its revised Block Exemption and revised Guidelines provides an opportunity to address whether policy should be amended to reflect the growing impact of internet retailing.

The pro-internet lobby recommends a cautionary approach by regulators on the basis of arguments that there may be anticompetitive motives for vertical restraints and selective distribution in particular, that a prohibition on internet retailing alone would be ineffective in addressing free-riding, and that there are less restrictive tools which obviate the need for vertical restraints.

However, the Block Exemption is already focused on those vertical agreements with the greatest potential anticompetitive effects and harm to consumers based on the market power of the relevant parties to the agreement. There does not seem to be any

[44] Kinsella et al., *supra* note 7, ¶50.

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sound policy basis for competition law generally favoring one retail distribution channel over another (supermarkets, department stores, specialist retailers, mail order, catalogue retailers, or the internet, etc.). Nevertheless, in its revisions the Commission appears to be adopting a very strict form-based approach of:

- requiring suppliers to ensure that the criteria for online sales are "equivalent" to the criteria imposed for sales from other distribution channels such as brick and mortar shops; and
- prohibiting any restriction on sales to non-authorized distributors outside those markets where selective distribution is adopted.

It is particularly striking that, in the context of the Block Exemption which is intended to be effects-based, that the Commission is seeking to extend the scope of hardcore restrictions.

Moreover, it seems uncontroversial that even highly dominant companies have and should have freedom regarding with whom they deal and their supply terms, and that their obligations to supply are bounded rather than limitless under EC competition law. For example, in its Guidance on the Commission's enforcement priorities in applying Article 82 of the EC, the Commission observes that:

> When setting its enforcement priorities, the Commission starts from the position that, generally speaking, *any undertaking, whether dominant or not, should have the right to choose its trading partners and to dispose freely of its property*. The Commission therefore considers that intervention on competition law grounds requires careful consideration where the application of Article 82 would lead to the imposition of an obligation to supply on the dominant undertaking. The existence of such an obligation - even for a fair remuneration - may undermine undertakings' incentives to invest and innovate and, thereby, possibly harm consumers.[45] [Emphasis added]

Imposing additional obligations on suppliers with small market shares—perhaps including precise criteria for selective distribution and how this may impact internet sales—would seem inappropriate. This is particularly the case as suppliers adopting selective distribution are already subject to two additional hardcore prohibitions that prohibit any restriction on passive or active sales and sales between authorized retailers and wholesalers.

This conclusion is strengthened by fact that the potential anticompetitive effects which are highlighted by the pro-internet lobby do not appear to be closely associated with selective distribution *per se*.

Turning to the issue of the consumer benefits from selective distribution, a key question is whether internet distributors can free-ride on the sales and promotional

[45] Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, issued on December 3, 2008, at ¶ 75.

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efforts of other retailers, thereby undermining incentives to undertake these investments and, if so, whether there is an economic rationale for placing restrictions on internet distribution. This is of particular concern to suppliers of luxury goods where investments in brand and point-of-sale service are vital in promoting demand and safeguarding brand image. In this regard, the relevant question is whether internet channels which cannot offer the service, shopping experience, and ambience of an upscale retailer should be restricted, just as a bricks-and-mortar retailer who can't offer these things would be restricted. The alternatives to selective distribution identified by the pro-internet lobby do not seem workable.

It is already acknowledged by the Commission's current policy and in its recent proposals on vertical restraints that there are strong efficiency reasons for vertical restraints. While the literature has identified some anticompetitive effects, it would appear that these are only likely to apply under fairly limited circumstances. A strong presumption that selective distribution by luxury goods suppliers is likely to be efficiency enhancing, therefore, would seem sensible unless anticompetitive effects can be demonstrated. In this possible latter scenario, the Block Exemption can be withdrawn.

The internet undoubtedly delivers a range of benefits to customers in many dimensions for a range of goods. However, it should be subject to the same treatment as a down-market bricks-and-mortar outlet would be if it cannot provide the demand-enhancing investments which are so important in the luxury goods industry. Accordingly, there should be no special considerations for internet retailing, and the Commission's recent proposals to extend the scope of the hardcore prohibitions as regards selective distribution should be re-visited.

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