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AN ECONOMIC ANALYSIS OF THE USE OF SELECTIVE DISTRIBUTION BY LUXURY GOODS SUPPLIERS

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A. Introduction

This article discusses the economic foundations of competition policy towards vertical restraints on distribution and applies this analysis to the selective distribution restraint in the sale of luxury goods.[1] It also addresses some policy questions raised by the European Commission in the context of its ongoing revision of the Vertical Restraints Guidelines (Guidelines)[2]: whether the distinction between active and passive sales makes sense in an internet context, and whether luxury goods suppliers should be subject to regulatory restrictions when setting the criteria for retailers to join their selective distribution networks.[3]

We find that in policy terms a rule of reason approach should be applied to selective distribution cases. Selective distribution can play the role of enhancing retailer incentives to invest in promoting a product or in investing in enhancements to the product image. Moreover, within the context of a rule of reason, we suggest, the only potential concerns about restricted distribution relate to: (i) instances where the vertical restraints imposed by the suppliers are found to facilitate collusion (among suppliers or among retailers, including the situation where the vertical restraint is imposed as a result of pressure from a group of retailers); or (ii) instances where vertical restraints play a strategic, competition-dampening effect, such as those described by Bonanno and Vickers and Rey and Stiglitz and explained in this article. We find that selective distribution is unlikely to facilitate supplier collusion, leaving the competition-dampening effect or retailer-pressure/retailer-cartel as the main anti-competitive theories of

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1 Selective distribution refers to the practice by which a supplier restricts the channels through which its products are distributed.

2 Commission Notice: Guidelines on Vertical Restraints (2000/C 291/01), OJEC, 13 October 2000.

3 Throughout the article we use the term "supplier" to indicate a company operating at the upstream level from the retailers. In many cases the supplier will also be the manufacturer of the product, but in a number of instances in the luxury goods industry the supplier and trademark owner is not the manufacturer of the product.

selective distribution. In a case in which the incentive for selective distribution must be identified, the burden of proof, as in any vertical restraints case, should rest on the side of the regulator. That is, the appropriate burden rests not on the respondent to justify the use of selective distribution, but rather on the side of government intervention to demonstrate that the use of selective distribution is damaging to consumers or total welfare. Moreover, we find that a distinction between active and passive sales, as in the current guidelines, is meaningless in an internet context, and that a supplier's restrictions on "pure-play" retailers and more generally on internet sales by luxury goods suppliers can be a legitimate business practice.

The article begins in the next section by discussing the economics of selective distribution, drawing largely on two sources: Rey and Vergé's recent survey of the economics of vertical restraints in the Handbook of Antitrust Economics[4]; and Mathewson and Winter's review of the law and economics of resale price maintenance (RPM).[5] In Section C the analysis is applied to the selective distribution of luxury goods. Section D concludes with a discussion of a number of specific policy questions raised by the Commission in the context of the ongoing policy debate on vertical restraints.

B. The Economics of Selective Distribution

1. Introduction

Suppliers of products, in designing distribution systems for their products, rarely just set a wholesale price and let any retailers or distributors carry their products without contractual restrictions. Instead, suppliers often place restrictions on which retailers may carry their products, the prices at which the products may be resold, the territories within which or customers to whom the products may be resold, and so on. Vertical restraints on distributors are constrained and in some cases prohibited by competition law in the EU. This is in contrast to the US, where the law has evolved to a relatively liberal policy towards vertical restraints.

This section offers an economic analysis of competition policy towards selective distribution, the practice by which a supplier restricts the channels through which its products are distributed (eg in prohibiting the distribution of its products through low quality retail outlets).[6]

[4] P Rey and T Vergé, "Economics of Vertical Restraints" in P Buccirossi (ed), *Handbook of Antitrust Economics* (Cambridge MA, MIT Press, 2008).

[5] F Mathewson and RA Winter, "The Law and Economics of Resale Price Maintenance" (1998) 13 *Review of Industrial Organization* 57. RPM is in some ways (but not all) similar to selective distribution.

[6] Note that the economics of RPM in the form of vertically imposed price floors is similar. In fact, while RPM has often been used in the past to prevent distribution through discount outlets,

2. Competition Policy towards Restraints on Distribution: the Economic Foundations

(a) The Case of a Monopolist

Substantial confusion can arise in the analysis of competition policy towards vertical restraints as to whether strong inter-brand competition should only be sufficient or should also be necessary for a restraint to be appropriately permitted by competition authorities. European competition policy is particularly suspicious of the practices of dominant firms. Substantial clarity about the role of inter-brand competition is therefore added by first analysing the use of restraints by a firm that is completely dominant—without even the threat of competition in its market. In this case of complete dominance, can one justify a restrictive policy towards restraints on distribution or is a laissez-faire policy appropriate? The case of a pure monopolist is obviously extreme, but it is an essential analytical benchmark if one is to understand whether strong inter-brand competition is necessary to justify a laissez-faire approach to the use of vertical restraints.

In the simplest of markets, with the simplest of products, demand would be determined only by price. The demand function, $d(p)$, which describes the quantity demanded, would have a single argument, the price. In this kind of market, a monopolist would have no incentive whatsoever to restrict the retailers. Prohibiting or restricting "pure-play" internet retailers, for example, can only raise price at the retail level and, in this simple world, the increased price would harm the monopolist. Suppose, for example, that a monopolist has a cost of €5 per unit, and sets a wholesale price of €8 per unit. The monopolist would like as low a retail price as possible, because demand is downward-sloping, and the monopolist would like to collect its wholesale mark-up of €3 on as many units as possible. If the retail price in the absence of restricted distribution is, say, €12, then a monopolist that imposes restraints causing the retail price to rise to, say, €20 would be harming itself because at the higher price fewer units are demanded and the supplier therefore earns its mark-up of €3 on fewer units. A monopolist, in short, cannot benefit from selective distribution (eg prohibiting online distribution) in a world in which demand depended only on price. The "cost" of facing a higher retail price (and therefore lower quantity demanded) is

selective distribution imposes this restriction directly. In terms of economic motivation as well as effects the two practices are quite similar in that both involve trade-offs between low prices and greater non-price dimensions of product distribution such as service, convenience and a pleasant shopping experience. But there is an important difference: selective distribution does not eliminate intra-brand price competition since outlets within the distribution channels allowed by the supplier continue to compete on prices, whereas RPM eliminates intra-brand price competition completely.

not offset by any benefits as the wholesale price charged by the monopolist would not increase.

It cannot be emphasised 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.[7,8] This is stated explicitly in the brief submitted to the US Supreme Court in *Leegin* by 23 well-known antitrust economists, including eight former chief economists of the DOJ and the FTC.[9] While *Leegin* is a resale price maintenance case, the identical logic applies to selective distribution and other vertical restraints.[10]

The critical piece of evidence in a vertical restraints case is the simple fact that the supplier is adopting the restraint. As a matter of logic, assuming that firm managers are rational, retail demand in the case of a monopolist must depend on more than price since only then can a monopolist benefit from the

7 Non-economists have sometimes argued that RPM is a means by which a monopolist keeps its price high—and may have the (wrong) intuition that selective distribution is also explained as a profitable means of preventing low prices. This is incorrect as a supplier has absolutely no incentive to sell less and leave a higher mark-up to independent retailers.

8 Note that in the standard double marginalisation problem RPM is indeed a solution for the supplier, but it takes the form of a *price ceiling*, not a *price floor*. A price floor would be totally ineffective, since the retailer could continue to add its retail margin and harm the supplier's profit through lower quantities.

9 *Leegin Creative Leather Products, Inc v PSKS, Inc*, 127 S Ct 2705 (2007) (No 06-480). According to the brief of Amici Curiae Economists in support of Petitioner in *Leegin* ("Economic Brief"):

> "Generally, a manufacturer wants retail margins to be low; having sold the product to the retailer, it wants the retailing function to be performed as efficiently as possible, with competing retailers, in turn, passing on to consumers the lowest price consistent with retailers' providing desired services and continuing in business. In real-world markets, however, the incentives facing retailers may be out of alignment with those of manufacturers, to the detriment of the manufacturers' ability to compete effectively with the products of competing manufacturers" (Economic Brief, 5).

10 In principle, the Commission could bring a case against RPM based on the following theory, even in the case of a pure monopolist in a world in which demand depended only on price: if contracts between a monopolist and all retailers are not publicly observed, then the monopolist and any particular retailer have the incentive to strike a contract with a low variable price so as to extract a larger market share for that retailer at the expense of other retailers. (The other retailers cannot observe the contract and therefore cannot make their own contracts conditional upon the contract struck with the particular retailer.) The monopolist cannot commit against this type of behaviour, with the result that low variable prices are struck and prices below the profit-maximising monopoly level follow: O Hart and J Tirole, "Vertical Integration and Market Foreclosure" [1990] *Brookings Papers on Economic Activity: Microeconomics* 205; D O'Brien and G Shaffer, "Vertical Control with Bilateral Contracts" (1992) 23 *RAND Journal of Economics* 299. O'Brien and Shaffer point out that the monopolist can ensure monopoly profits by adopting RPM, setting both retail and wholesale prices equal to the monopoly price. The monopolist becomes the residual claimant on all retail sales and can no longer extract transfers from other retailers when making an offer to one of the downstream firms. In any such application, however, the burden of proof should rest on the Commission, and we are unaware of any persuasive application to this point of the theory to a specific case or any persuasive application of the theory in general. In any case, this theory cannot explain restrictive distribution, eg restricting or prohibiting online distribution, which is our focus in this article. We therefore set aside this "commitment theory" of the monopolist's use of vertical restraints.

restraints. Demand must depend on factors other than price—factors such as (i) sales effort by the retailer; (ii) sales staff enthusiasm or influence; (iii) a well-organised inventory and short cashier lines, allowing for less time input by a shopper; (iv) a comfortable shopping environment, allowing for less time and less stress on the part of the consumer; (v) information provided at the point of sale; and (vi) retail service provided after the sale of the good. Anything that a retailer provides affects demand, and we know that the actions provided by a retailer contribute to demand simply from the evidence that suppliers are willing to use them rather than simply sell everything online or in boxes at discount stores.

It is important to recognise that whatever service is being enhanced by vertical restraints cannot be specified in a contract and enforced perfectly. "Enthusiasm" and "conveying a high-class image" are examples. This is the reasonable underlying assumption used in the economic models we discuss. This implies that it is simply not possible for suppliers to directly reward retailers for demand-enhancing activities that increase the demand for the product in order to prevent free-riding by retailers who do not incur such costs. This is also discussed in the Economic Brief.[11]

Suppose, then, that demand depends on non-price variables—for simplicity, a single variable other than price. We can write the demand function as $d(p,a)$, where a is the amount of the other variable, which we shall call "service" for simplicity but which can represent any of the dimensions of retailer effort (or others) referred to above. Recognising the impact of retailer actions on demand, we now have at least the potential for a profitable use of a vertical restraint such as selective distribution: if the use of the restraint enhances the additional dimension a, then this positive, indirect effect of the restraint may more than offset the direct negative effect that a restraint has on demand through the increase in price. For a pure monopolist, adding to retailer service as suggested by this framework is not only a possible rationale for vertical restraints—at the general level it is the only rationale.

This framework raises three key questions:

1. (the first positive economic question): Why does an unrestrained market (in which the supplier simply sets a wholesale price and lets all retailers buy without restrictions) not automatically provide the right mix of price and service (p and a)?

[11] "[M]anufacturers can contract with retailers for specific services. However, the nature of marketing and selling is such that it may be difficult to specify completely all of the services that the retailer must perform and the level at which it must perform them. It is also possible that the retailer, rather than the manufacturer, knows which retailer-level services will be most effective in maximising the competitiveness of the product, or that the most effective services will be discovered only through experience with the market and will be more apparent to the retailer than to the manufacturer" (Economic Brief, 9).

2. (the second positive economic question): How specifically can a restraint such as selective distribution (or resale price maintenance) change the mix of p and a provided at the retail level in a direction advantageous to the upstream monopolist?
3. (the normative question): Is there a basis for assuming with confidence that the monopolist's adoption of the vertical restraint to change the mix of p and a is against consumers' interests or the collective interest of all participants in the market? Or is there evidence on which one can confidently rely to determine when the supplier's change in the mix of p and a is against consumers' interests?

We address these questions in turn. With respect to the first positive question, two general classes of theories have been prominent in the economic literature: (i) theories based on free-riding arguments; and (ii) theories based on heterogeneity among consumers. The uses of selective distribution and RPM have been much more widespread than can be accounted for simply by free-riding theories alone. In practice, both rationales are likely to play a role for suppliers of luxury goods.

The free-riding argument for vertical restraints was originally developed by Telser (1960).[12] His argument, extended to the context of image-sensitive luxury goods, is the following. Consider the case of an internet retailer of a luxury good, for which image is a critical and expensive component of the product. All of the non-internet, upscale retailers have undertaken investment in expensive image and product-image-conveying aspects of their business. An important part of the investment in product image is at the retail level, and the costs of investment at this distribution level are paid for by suppliers voluntarily through high mark-ups, ie through high shares of revenue accruing to the retailers. An individual internet retailer can benefit from the investment by all the other retailers in the strong, upmarket images (which are conveyed to the product) without any investment itself. Its own contribution is small and it has an incentive to skip the investment in image formation, price low, and thus free-ride on the image investment by other retailers (ie on the investment by the supplier in having the product carried by the other, upscale retailers). This low-price internet retailer will therefore capture a large part of the sales that would have otherwise been realised by the upscale retailers. This, in turn, reduces the profitability of these upscale retailers, which may no longer be willing to make the important image-enhancing investments, given that they cannot reap the full benefit of those investments. In the extreme case, where all consumers buy at the lowest possible price, investment in consumer services will be stopped by all types

[12] L Telser, "Why Should Suppliers Want Fair Trade?" (1960) 3 *Journal of Law and Economics* 86.

of retailers.[13] Whether we are considering investment by a particular retailer or the choice "by the market" of which retail outlets will thrive, the logic is the same: the unrestricted market will choose points on the spectrum between low-price and high-image investment that are lower than the supplier would prefer. In order to prevent such free-riding, and the concomitant damage to images investments and ultimately the sales of its product, the supplier may impose RPM (thus preventing an outlet from attracting customers through low price instead of high image). Or, in today's world, where low-price channels such as the internet are so easily identified and RPM is in practice treated as a per se violation of Article 81, the supplier will simply impose restrictions that may prevent the online channels from carrying its product (or limit the volume they can sell). The Telser free-riding theory of vertical restraints extends well beyond the provision of retailer "special services" to which he originally applied the theory. Firms plausibly use a mix of distribution channels to match their need for creation of image, of provision to the customer of a place to sample the product, and so on. Importantly, perfume sampling at a store, then buying on the internet, is a perfect application or set-up for Telser's special-services free-rider story.[14]

A second class of theories is based simply on heterogeneity of consumers, allowing, in particular, for a difference in the types of consumers who are willing to search or shop among retailers and those whose choice is more focused on which product to buy, rather than from which retailer to buy.[15] The key intuition behind this theory is that a retailer chooses its mix of competitive instruments to

13 A very similar example is used by the DOJ and the FTC to describe this problem in their Amicus Curiae Brief supporting the Petitioner:

> "A retailer offering no services but a lower price can sell to consumers who have been educated by retailers that do provide the services desired by the manufacturer and the consumer. The problem is exacerbated by catalog retailing and the advent of the Internet, as consumers may visit traditional, brick-and-mortar retailers to examine a product and select its features but then purchase the product at a discounted price from a catalog or online retailer, whose very lack of 'bricks and mortar' affords point-of-sale services impossible and whose lack of expenses for bricks and mortar gives them a competitive advantage over traditional retailers who provide the services that some manufacturers desire" (Brief for the US (DOJ and FTC) to the Supreme Court in *Leegin*, *supra* n 9, 13).

14 H Marvel and S McCafferty, "Resale Price Maintenance and Quality Certification" (1984) 15 *Rand Journal of Economics* 346 discuss the role played by quality certification of products by reputable retailers. The idea is very similar to that of the free-riding problem: since quality certification involves some incremental cost, this cost will only be incurred by the retailers if they know that they can be protected from intra-brand competition (the same argument as in the service provision free-riding problem). Such protection can be guaranteed through RPM (in the form of minimum imposed prices, though that would be illegal in many jurisdictions) or selective distribution. Their article applies directly to cases where the supplier is looking for certification from the retailers, which is not the case for suppliers already perceived as producing luxury goods that want to maintain their brand image through their retail network, but it might apply to new suppliers of luxury goods who want to be distributed by high-quality retailers only.

15 RA Winter, "Vertical Restraints and Price versus Non-price Competition" (1993) 108 *Quarterly Journal of Economics* 61. B Klein and KM Murphy, "Vertical Restraints as Contract Enforcement Mechanisms" (1988) 31 *Journal of Law and Economics* 265.

attract customers away from other retailers as well as attract customers to the product. The supplier would like the retailer to focus its sale strategy (mix of demand instruments) exclusively on attracting customers to its products since a customer attracted away from another retailer is not a net addition to the supplier's demand; instead, the retailer chooses the strategy to attract customers in both dimensions. This would not be a problem, in terms of designing an efficient distribution system, if the same mix of instruments (p and a) were optimal in both attracting customers away from other retailers and in attracting customers into the market. However, these two sets of customers are often of different types. A consumer who searches among retailers is often more concerned with low prices than with high service or other attributes. Consumers who search are often (i) less wealthy, with a lower cost of time, who are therefore less concerned with retailer actions that save time or provide a comfortable shopping environment (assuming comfort is a normal good, ie a good for which demand is increasing in income); and (ii) better informed about the product because they have taken the time to become informed at lower cost, or simply because becoming well informed at home allows them the chance of a purposeful shopping strategy to find the lower price. These consumers with low search costs (who are attracted by low prices) are to be contrasted with impulse shoppers, who are more likely to shop at the first store in which they stop. The impulse consumers are therefore more likely to be attracted by the image, shopping environment and services offered by upscale retailers. The retailer who attempts to attract customers away from other retailers, being focused excessively on low search cost consumers, is therefore biased towards price competition. In sum, there are plausible reasons why an unrestrained retail sector may, from the supplier's point of view, be biased towards price competition and away from providing various types of service. This bias may be manifest in individual retailers setting low prices and low service—or in a segment of the retail market (online retailers) offering low prices and limited service.

A number of recent articles have presented variants of these arguments. For instance, Spiegel and Yehezkel[16] considered an asymmetric situation assuming that a monopolist has the option to distribute its product through (exogeneously) differentiated retailers, ie through an upscale retailer (eg bricks-and-mortar with fancy showrooms) and/or through a no-frills discount retailer (eg a "pure-play" internet player). Note here that the level of services offered by each retailer is fixed and cannot be adapted.[17] These authors show that a monopolist would

[16] Y Spiegel and Y Yezekhel, "Price and Non-price Restraints when Retailers Are Vertically Differentiated" (2003) 21 *International Journal of Industrial Organization* 923.

[17] Although this assumption is always open to criticism, it is relatively realistic to imagine that upscale retailers are not likely to become no-frills discounters extremely quickly (especially when they do not sell only one type of goods but many different categories of products, which would be the case of upmarket department stores).

profitably use both channels only if it could somehow set customer restrictions to ensure that buyers with high willingness to pay are not diverted away from the upscale retailer. Otherwise, selective distribution—no distribution online—is optimal.

Let us turn to the second positive question above. How can selective distribution in particular change the mix of price and services to the monopolist's advantage? Selective distribution changes the mix towards higher prices and higher service through three mechanisms. First, by protecting the retail price margin from erosion through greater competition at the retail level, the distribution system increases the marginal benefit that each retailer obtains from attracting customers through service. If the retail margin is €10 per unit instead of €5, then the retailer has twice the incentive to attract more customers at the margin, and service in all of its dimensions will increase. Secondly, in cases where there is free-riding on services—by which we mean that a customer obtains pre-sales service (such as expert information, consultation or, say, sampling perfumes) at a high-priced outlet and then purchases the product at a low-priced outlet that provides no service—prohibiting low-priced, no-service outlets increases the incentive for other stores to provide the informational service since they retain all of the customers that they inform. Thirdly, restraining intra-brand competition enhances the profits that outlets earn. If an upstream supplier contracts with outlets for high service and must monitor (at some cost) the provision of this service with the strategy of terminating dealers who under-provide the service, the additional profits represent a "carrot" for the retailer that is lost with termination by the upstream supplier and therefore enhance the retailer's incentive to provide the service. This is a familiar argument in the economic theory of incentives, and is developed in the vertical restraints context by Klein and Murphy.[18]

Finally, we turn to the normative question above. Note that this question is not "Does the monopolist act in consumers' interest?" Some of the decisions that monopolists make are in consumers' interest, others are not. To support regulatory intervention, it is not enough to find that a monopolist may act against consumers' interest in changing the mix of p and a by retailers. That is, the question is not whether the supplier and consumers always, or sometimes, agree on trading off higher prices for greater service. To justify regulatory intervention, it is essential that evidence be available in which the intervention can, with very high probability, improve the market outcome. If consumers' willingness to trade off higher prices for greater provision of a were consistently much less than the supplier's willingness to make the same trade-off, for example, then a restrictive policy towards restraints would be called for.

[18] *Supra* n 15.

Is a monopolist systematically biased towards too much service and too high prices compared to the socially optimal mix? If so, then a regulatory prohibition of the vertical restraints would be justified. But this is not the case. Indeed, under the free-rider theory of restricted distribution,[19] if the free-riding problem is severe, then the adoption of restricted distribution or other vertical restraints is unambiguously welfare improving because the market would decrease in volume, perhaps even disappear, if vertical restraints were not available to remedy the free-riding problem.

The heterogeneous consumer theory of vertical restraints—the main alternative to the free-riding explanation of vertical restraints in the case of a monopolist—does not yield so easy an answer. As a matter of economic theory, the level of service (or quality) that a monopolist considers ideal depends on the preferences of marginal consumers, defined as those consumers willing to buy only at the monopoly price. If marginal consumers were willing to pay €1.05 more for an increase in service (or any other dimension such as image enhancement) that cost the monopolist only €1 per unit, for example, the monopolist would surely increase service by this amount. The socially optimal service, however, depends not on the marginal consumers but also on the average consumer purchasing the product. If consumers currently purchasing a product are on average willing to pay €1.05 for an increase in service expenditure of €1 per unit, then it is socially optimal to increase the service. Whether a monopolist's provision of service (or quality) is too low or too high thus depends on a comparison of marginal versus average consumer preferences for greater service versus lower prices.[20] In general, the willingness of marginal consumers to pay for higher quality may be less than or greater than the willingness-to-pay of average consumers. Thus, the supplier's shift in the mix of prices and service or other dimensions may or may not be in the right direction. Just as we cannot predict whether a supplier in general engages in too little or too much advertising, we cannot in general predict whether the supplier is biased towards too little or too much service. And just as we do not restrict in general a supplier's decision to advertise, nor should the decision of a supplier to adjust the mix of price competition and services through vertical restraints be prohibited in general. Unless there is persuasive evidence of the relative demand for service (or other non-price dimensions) by infra-marginal versus marginal consumers—and this evidence we believe is rare—there can be no presumption that a legal restriction against selective distribution will improve the market performance in the case of a monopolist supplier.

One particular non-price dimension of retailer decisions that is enhanced by vertical restraints deserves special mention, because it is analytically distinct from

[19] We use the term "restricted distribution" to refer both to selective distribution and forms of exclusive distribution.

[20] AM Spence, "Monopoly, Quality and Regulation" (1975) 6 *Bell Journal of Economics* 417.

others. Inventories, or product storage, are fundamentally undersupplied when a monopolist relies on downstream competing retailers to make decisions on inventory. This is demonstrated by Krishnan and Winter,[21] and Marvel *et al.*[22] The explanation of the incentive distortions giving rise to the failure of unrestrained retailers to choose adequate inventories is somewhat complex, but can be summarised roughly as follows: price competition among unrestrained retailers will drive down retail margins enough that retailers' incentives to carry inventory (on which they can earn the retail margins should demand be strong) are severely compromised. The upstream supplier can protect incentives to carry adequate inventory by protecting retail margins through resale price maintenance, as these articles demonstrate. The theory would extend directly to the use of restricted distribution to protect retail margins, especially in environments where RPM is illegal. Krishnan and Winter provide evidence to support the theory that vertical restraints can be necessary to elicit adequate retail inventory levels: they report that when vertical restraints were prohibited for some firms by US antitrust decisions in the early 1970s, inventories collapsed and product distribution was severely compromised.

(b) Competing Suppliers Upstream

While the previous section has presented the key findings of the economic literature on the choice of vertical restraints (and selective distribution in particular) by a monopolist, in practice competition policy often deals with situations where there are a number of competing suppliers selling the products. The key question is to what extent the findings from the previous sections carry through to this setting and to what extent other concerns might emerge.

In the mid to late 1980s, a new strand of economic literature was developed analysing the role of vertical restraints when competition exists between suppliers selling through separate retail channels. This literature focused on the strategic use of vertical restraints by suppliers to affect the market outcome. The basic idea is that vertical restraints imposed by a supplier upon its retailers will affect the nature of (intra-brand) competition between these retailers in the downstream market. Since these retailers also compete with the other suppliers' retailers, this will ultimately affect the nature of the competition between suppliers.

[21] H Krishnan and RA Winter, "Vertical Control of Price and Inventory" (2007) 96 *American Economic Review* 1840.

[22] H Marvel, R Deneckere and J Peck, "Demand Uncertainty, Inventories, and Resale Price Maintenance" (1996) 111 *Quarterly Journal of Economics* 885; and "Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition" (1997) 87 *American Economic Review* 619.

In that setting, several authors (eg Bonanno and Vickers[23] and Rey and Stiglitz[24]) have shown that vertical restraints that eliminate intra-brand competition, such as territorial exclusivity clauses, can be used (through strategic interactions) to soften competition between suppliers. This ultimately leads to higher retail prices. The logic is that vertical restraints can provide an upstream supplier with the commitment to act less aggressively in price competition (eg by delegating pricing at the retail level to distributors with market power) and when rivals observe the commitment to a more passive behaviour they are induced to set higher prices. In short, the commitment to passivity via vertical restraints induces higher prices on the part of rivals, to the benefit of the manufacturer.

There are, however, three important caveats that apply to the policy implications of this "strategic theory of vertical restraints". First, the impact of such restraints clearly depends on the extent of inter-brand competition. The competition-dampening effect has no force in the case of very little inter-brand competition (ie close to a monopoly) and is highly unlikely to be a serious consideration when competition between suppliers is fierce. In theory, it is applicable only in the case of an intermediate degree of inter-brand rivalry.

Secondly, it is important to observe that the different types of vertical restraints affecting intra-brand competition between retailers may well have different effects in this setting. While exclusive distribution might act as a commitment device for a supplier to become less aggressive, RPM, for instance, could not perform this function. The intuition of the Rey and Stiglitz papers, to elaborate on our summary above, is the following. Suppose that competition between retailers (for a given product) is extremely fierce. Because of this fierce competition, in the absence of any restraint, a supplier's retailers will thus all set a retail price equal to the supplier's wholesale price plus their retail cost. Therefore, everything happens as if the two suppliers were directly competing in prices (ie the final prices are the same as in a model where the two suppliers can directly distribute their product and face the same retail cost as their retailers). Suppose, now, that a supplier imposes territorial exclusivity clauses to its retailers. Formally, the situation is the same as one where that supplier would use a single retailer (thus totally eliminating intra-brand competition). When setting its retail price, that retailer now takes into account the wholesale price at which it obtains the good from the supplier, but also the price set by the retailers carrying the competing brand. Because intra-brand competition has now been eliminated, it will set a higher retail price (it now takes a positive retail margin rather than simply setting a price equal to its wholesale price plus retail cost), which in turn affects the profits of the supplier producing the competing brand. As shown by

23 G Bonanno and J Vickers, "Vertical Separation" (1988) 36 *Journal of Industrial Economics* 257.

24 P Rey and J Stiglitz, "Vertical Restraints and Producers Competition" (1988) 32 *European Economic Review* 561; and "The Role of Exclusive Territories in Producer's Competition" (1995) 26 *Rand Journal of Economics* 431.

Rey and Stiglitz, under reasonable assumptions on the demand functions, eliminating intra-brand competition through the use of territorial exclusivity clauses softens the competition between suppliers and ultimately leads to higher retail prices in their model. Obviously, the effect on inter-brand competition will be limited if there are many suppliers (and many retailers).[25]

Thirdly, this strand of literature has focused on situations where suppliers distribute their products through distinct retail channels. This is clearly not the case for many consumer goods (such as perfumes and cosmetics), for which retailers carry competing brands.

Beyond the Rey–Stiglitz theory of vertical restraints, a second, more concrete and empirically more relevant, concern with vertical restraints has been discussed by Telser,[26] Mathewson and Winter,[27] and Jullien and Rey.[28] This is the concern that RPM can facilitate collusion. RPM leads to more uniform retail prices, thereby making price cuts easier to detect for the colluding suppliers. The intuition is that suppliers colluding on wholesale prices in the absence of RPM would find it difficult to distinguish between changes in retail prices caused by cheating on the collusive agreements and changes caused by changes in demand conditions or retail costs. This concern is explicitly stated in the Guidelines at paragraph 110: "when most or all of the competing suppliers limit the number of retailers, this may facilitate collusion, either at the distributor's level or at the supplier's level". This concern would be unlikely to apply to industries with multiple suppliers such as the cosmetics and perfumes sector.[29] More importantly,

[25] An example might be the approach used by car manufacturers in the past in the EU where exclusive dealers had different forms of territorial protection. This means the dealers could charge a mark-up over the wholesale price to reflect their market power, thereby softening inter-brand competition among the car manufacturers.

[26] *Supra* n 12.

[27] *Supra* n 5.

[28] B Jullien and P Rey, "Resale Price Maintenance and Collusion" (2007) 38 *RAND Journal of Economics* 983.

[29] There have been several recent vertical Chapter I prohibition cases (vertical price fixing cases) in the UK, in particular on toys, football kits and cigarettes. See OFT Decision CA98/08/2003 on "Agreements between Hasbro UK Ltd, Argos Ltd and Littlewoods Ltd fixing the price of Hasbro toys and games" and OFT Decision CA98/06/2003 on "Price-fixing of Replica football Kit". The recent cigarettes case, which was partially settled, appears most relevant for the question of facilitation of upstream collusion via vertical agreements, as it involved the two major cigarette suppliers in the UK, Gallaher and Imperial Tobacco, as well as a range of major retailers (including Tesco, Asda and Sainsbury's). The settling parties admitted to (i) linking of the retail price of a supplier's brand to the retail price of competing brands of another supplier and (ii) indirect exchanges of proposed future retail prices between (a) suppliers via retailers and (b) retailers via suppliers. The activities in this case went far beyond bilateral vertical restraints between suppliers and retailers, but the case illustrates one potential channel through which vertical agreements might facilitate upstream collusion. Nevertheless, this case arose in the context of an effective upstream duopoly and had nothing to do with the use of selective distribution by the suppliers. See OFT press release 82/08 (11 July 2008), "OFT Reaches Early Resolution Agreements in Tobacco Case", available at http://www.oft.gov.uk/news/press/2008/82-08. There have also been a number of vertical cartel cases in France. A recent case involved vertical

these concerns have been expressed in the economic literature in relation to the use of RPM and not in relation to the use of other vertical restraints, such as selective distribution. Selective distribution does not facilitate collusion. Indeed, since internet prices are easily observable and observability of prices by rivals is a necessary condition for collusion, prohibiting distribution over the internet may even have the opposite effect of making collusion more difficult. Finally, it is also important to bear in mind that suppliers generally have no incentive to facilitate a retailers' cartel as this would lead to higher retail prices and lower sales for the suppliers.[30]

3. Policy Implications

As discussed above, in economics, taking the extreme case of a firm so dominant that its monopoly is not threatened, there is no general basis for regulatory intervention in the firm's use of vertical restraints, including the use of selective distribution. Economic theory implies that in this most extreme case the restraints of selective distribution serve only to elicit some non-price dimension of a product or service that is demanded by consumers. (Otherwise the monopolist would not tolerate the higher retail prices associated with a selective distribution restraint that eliminates the lowest-price distribution channel.) This dimension may be better retail service, a more pleasant or convenient shopping environment, retail information, and so on. While there is no general theory that the supplier's willingness to trade off a higher price for better service (or other dimension) is always in consumers' interest, the more important point is that there is also no basis for presuming that this trade-off is inefficient. In the absence of any evidence that the trade-off reduces market efficiency—and we must acknowledge that such evidence is in general difficult to uncover—economic theory supports a laissez-faire approach to selective distribution in the case of a monopolist. Competition policy does not restrict a supplier's choice between low prices and higher non-price dimensions such as service in its strategy of attracting demand; it does not regulate, for example, the expenditure

price fixing in the cosmetics and luxury perfumes market. The French Conseil fined 13 suppliers and three large retail chains a total of €45m for a series of independent vertical agreements to de facto enforce a form of RPM (recommended retail prices and maximum discounts allowed). Décision n° 06-D-04 bis* du 13 mars 2006 relative à des pratiques relevées dans le secteur de la parfumerie de luxe, available at http://www.conseil-concurrence.fr/pdf/avis/06d04.pdf. In Germany the Federal Cartel Office recently fined a number of perfume and cosmetics companies for collusion and price-fixing arising from information exchanges. The case also had nothing to do with the use of restricted distribution by these suppliers. See media coverage at http://www.iht.com/articles/ap/2008/07/10/business/EU-Germany-Fragrance-Fines.php (all URLs were accessed 8 December 2008).

30 "[T]he manufacturer—a key element in these agreements—receives no benefit from a dealer cartel, but on the contrary, suffers diminished sales. Therefore, manufacturers generally lack incentives to cooperate in furthering a dealer cartel" (Economic Brief, 15).

on advertising as a fraction of revenue. Where the choice of price and non-price instruments is simply implemented through vertical restraints, economic analysis shows that the policy should be similar. This policy conclusion contrasts sharply with the general suspicion in the Guidelines towards dominant firms.

The case where there is some competition is where one must be more vigilant for negative horizontal effects of these restraints. At various places in the Guidelines, however, the presence of "enough" competitors (in the absence of collusive effects) is taken as a sufficient condition for a more relaxed approach to vertical restraints (and this is the logic behind the block exemption). This is confirmed in recent papers written by economists working within DG Comp. For instance, Verouden[31] concludes his recent review by stating that "vertical restraints are unlikely to have detrimental effects when there is no market power on either level of the industry". We agree with this position. But we would emphasise that the presence of significant competition should not be regarded as necessary for a liberal policy towards these practices: as we have shown, the complete absence of inter-brand competition does not warrant a restrictive policy towards these business practices.

The Guidelines in many places point to the importance of intra-brand competition. Suppression of intra-brand competition is clearly seen simply in terms of a lessening of competition. There is little or no recognition of the economic point that (outside of inter-brand effects) if a supplier imposes a restraint on competition, some other dimension of value to consumers must be enhanced—otherwise the supplier (who also values competitive retail markets) would never restrict competition.[32] For example, the Guidelines state:

> "For most vertical restraints, competition concerns can only arise if there is insufficient inter-brand competition, ie if there is some degree of market power at the level of the supplier or the buyer or at both levels. If there is insufficient inter-brand competition, the protection of inter- and intra-brand competition becomes important" (paragraph 6).

As discussed above, economic analysis proves that protection of intra-brand competition is not universally efficient. If necessary to enhance non-price product dimensions that the consumers value, restrictions on this competition may well be both privately and socially efficient as they might enhance both the demand for the product and inter-brand competition.[33]

[31] V Verouden, "Vertical Agreements: Motivation and Impact" in WD Collins (ed), *Issues in Competition Law and Policy*, vol III (American Bar Association, 2008), 1813–40.

[32] Footnote 10 discusses the only potential exception (in terms of economic theory) of which we are aware. It explains why this is likely to be of little practical relevance in general and irrelevant when the vertical constraint in question is selective distribution.

[33] This is at least in part recognised in para 115 of the Guidelines even if there is an explicit reference to companies without market power, while the consideration applies more generally:

Secondly, we believe that as a matter of economic policy the burden of proof in a competition law case should rest on the side of the regulator. Markets do not always provide the ideal trade-off between price and non-price dimensions; there is no guarantee that firms in adopting vertical restraints make the right trade-off in accepting higher prices for greater provision of other dimensions at the retail level. However, placing the burden of proof on the side of a respondent who has adopted a selected distribution system is tantamount to a policy of intervention when there is the mere possibility that regulatory prohibition of the restraints will improve market efficiency. In some areas of antitrust it is appropriate to place the burden of proof on the respondent or defendant. We do not believe that the area of vertical restraints is one of them. In a recent paper, Cooper *et al* conclude (and we concur) that "absent a good natural experiment to evaluate a particular restraint's effect, an optimal policy places a heavy burden on plaintiffs to show that a restraint is anticompetitive".[34] The US law on vertical restraints has evolved to the point where it is consistent with this approach;[35] the Guidelines have not, and we would suggest that this problem be remedied in the forthcoming revision of the Guidelines. With respect to the allocation of the burden of proof, the difference between the Guidelines and the accepted view of industrial economists as well as US law on vertical restraints is striking.[36] Cooper *et al* elsewhere state, in their comparison of the US and EU approaches to

> "It is important to recognise that vertical restraints often have positive effects by, in particular, promoting non-price competition and improved quality of services. When a company has no market power, it can only try to increase its profits by optimising its manufacturing or distribution processes. In a number of situations vertical restraints may be helpful in this respect since the usual arm's length dealings between supplier and buyer, determining only price and quantity of a certain transaction, can lead to a sub-optimal level of investments and sales."

[34] See the abstract in J Cooper, L Froeb, D O'Brien and M Vita, "Vertical Antitrust Policy as a Problem of Inference" (2005) 23 *International Journal of Industrial Organization* 639.

[35] For instance, in the recent Supreme Court judgment in *Leegin*, Justice Antonin Scalia acknowledged the "free rider problem" when "customers shop at the place that has the big showroom" to learn about a product but then "buy it at a lower price from somebody else who has not incurred that expense". The free-rider explanation of RPM (and selective distribution) has clearly affected US law. Earlier, in *Monsanto Co v Spray-Rite Service Co*, 465 US 752, 760–61 (1984), the Court endorsed vertical restrictions that encourage retail service, supporting a supplier's right to terminate a discounting dealer to prevent free-riding: "independent action is not proscribed. [A supplier] has a right to deal, or refuse to deal, with whomever it likes as long as it does so independently".

[36] See, eg para 136 of the Guidelines: "[t]hese efficiencies have to be substantiated and must produce a net positive effect. Speculative claims on avoidance of free-riding or general statements on cost savings will not be accepted." See also para 163:

> "The market position of the supplier and his competitors is of major importance, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited. The stronger the 'position of the supplier', the more serious is the loss of intra-brand competition. Above the 30% market share threshold there may be a risk of a significant reduction of intra-brand competition. In order to be exemptable, the loss of intra-brand competition needs to be balanced with real efficiencies."

vertical policy, that even after the Guidelines were issued "Art 81 is still likely to subject a greater number of agreements to condemnation than would US antitrust law".[37]

Thirdly, within the Guidelines there is excessive focus on free-riding as not just a sufficient explanation for an efficient use of vertical restraints but also a necessary condition.[38] When combined with the allocation of the burden of proof to the respondent, this means essentially that a respondent must come up with a convincing free-riding argument (not just "speculative claims", as in paragraph 136 of the Guidelines) to justify its use of the restraints. This position has no basis in economics, as there is a much wider range of circumstances under which RPM or selective distribution will be used. A dominant firm faced with the burden of a clear proof of efficiencies based on free-riding arguments may be put in an impossible position. This would be the case, for instance, in the absence of "pure" free-riding issues but where consumers are heterogeneous. In this type of situation, although selective distribution might lead to high prices (and high services) that may harm consumers with low search costs, it may still be socially optimal.

Economic analysis, in short, supports a rule of reason policy under which the search for evidence of negative impacts of selective distribution focuses on horizontal inter-brand effects such as facilitation of collusion in those cases where this might be a plausible theory of harm. The burden in any legal case involving these restraints should be on the regulator, not on the firm that is simply using the restraints to adjust the mix of price versus non-price product dimensions supplied by independent retailers.[39]

[37] J Cooper, L Froeb, D O'Brien and M Vita, "A Comparative Study of United States and European Union Approaches to Vertical Policy" (2005) 13 *George Mason Law Review* 289, 299.

[38] The Guidelines also take a fairly narrow view of the free-riding problem. Paragraph 116 states:

> "For there to be a problem, there needs to be a real free-rider issue. Free-riding between buyers can only occur on pre-sales services and not on after-sales services. The product will usually need to be relatively new or technically complex as the customer may otherwise very well know what he or she wants, based on past purchases. And the product must be of a reasonably high value as it is otherwise not attractive for a customer to go to one shop for information and to another to buy. Lastly, it must not be practical for the supplier to impose on all buyers, by contract, effective service requirements concerning pre-sales services."

Economic analysis shows that the concept of free-riding should be broadened to include externalities. Free-riding is far too narrow a term. To generate incentive for vertical restraints in the case of luxury goods, it is enough that investment in "image" by one outlet at the retail level add to the demand for the product at other outlets—or at least not attract demand away from the other outlets.

[39] Other vertical restraints can play the role of excluding competition in a market. In calling for a more laissez-faire policy towards selective distribution, we are not suggesting that other vertical restraints cannot have anticompetitive effects even in the absence of exclusion. Design of the right economic policy towards vertical restraints in general would be the topic of a much broader article.

The development of discount stores in Europe and North America with the fall in consumer transportation costs in the post-war period presented a challenge to traditional outlets. In this period, RPM periodically played a role of foreclosing discount stores, under pressure from traditional outlets, across a variety of suppliers. (This was most evident in drug store markets in the US and grocery stores in Europe[40]). The hypothesis that a group of suppliers is being collectively pressurised to avoid distributing through the internet is one that could appear in a case involving selective distribution. In fact, this would seem to us to be the main plausible hypothesis under which a prohibition of selective distribution could be justified alongside potential concerns related to competition-dampening effects of vertical restraints à la Rey and Stiglitz.

On the other hand, we have explained in this section why a supplier might foreclose internet resellers entirely; the same arguments apply, *mutatis mutandis*, to partial limitations on internet resellers. The fact that observed contracts in the distribution of many luxury goods set minimal levels of service clearly supports our claim that the role of the restraints is to enhance services. Economic theory is clear on why services may be undersupplied (from a supplier's perspective) in the absence of vertical restraints—individual retailers are biased towards low prices and away from higher service in their choice of instruments to attract consumers because this blend of instruments is most effective at attracting consumers away from other retailers, whereas the supplier would like retailers to focus on attracting consumers away from other products. And economic theory offers no basis for the position that a supplier's choice of price versus service, whether implemented directly or through vertical restraints, is so systematically distorted that it can be improved upon via legal restrictions.

4. Conclusions

The key conclusions from the economic literature discussed in this section are as follows:

1. Selective distribution leads to high prices at the retail level or to limitations on the number or types of retailers, both of which represent a cost to a supplier—and a single supplier (operating independently of a cartel) would voluntarily incur this cost only if there is some offsetting benefit. That is, the simple fact that the supplier is adopting the restraint shows that retail demand must depend on more than price.
2. Economists believe there are two main reasons why—setting aside inter-brand competition entirely—an upstream supplier would use vertical restraints: to remedy free-riding distortions among retailers and to

[40] GF Mathewson and RA Winter, "Competition Policy and Vertical Exchange" (Royal Commission on Canada's Economic Prospects, 1984).

offset biases in retailer dimensions of competition induced by consumer heterogeneity. Protecting retailer incentives for investing in adequate inventories is a third reason.

3. Introducing more restrictive legal criteria for the use of selective distribution by suppliers can reduce consumer welfare by constraining legitimate business practices that contribute to consumer welfare.
4. For vertical restraints in general, but especially for non-price restraints such as selective distribution, an appropriate policy places a heavy burden on plaintiffs to show that a restraint is anticompetitive. Economic analysis supports a rule of reason policy under which the search for evidence of negative impacts of selective distribution focuses on negative effects on horizontal inter-brand competition. Chief among these potential negative effects in the case of resale price maintenance would be the facilitating-practice hypothesis, that RPM is facilitating collusion. As we have shown, the vertical restraint at focus in this article—selective distribution—cannot likely be used to facilitate an upstream cartel. This leaves policymakers with two theories of negative effects of selective distribution on welfare, on which intervention could be based. The first is the Rey–Stiglitz theory that the device is adopted as a strategic commitment to dampening competition in the market. We believe that evidence supporting this theory would be rare in practice (although we do not rule out the theoretical possibility). Such evidence might, for instance, take the form of a geographical cross-section of markets for the same product (eg across countries) in which the restraint is adopted for intermediate levels of concentration but not for near-monopoly levels or low levels of concentration: this is the key testable implication of the theory. The second theory is that selective distribution is the result of pressure exerted by a retailer cartel, against the manufacturer's (or manufacturers') interest and therefore not at the manufacturer's initiative. Evidence for the retailer cartel theory, where it is at work, should be easily found.

C. Application to the Supply of Luxury Goods Using Selective Distribution Networks

Why might some luxury good suppliers restrict the distribution of their products so as to exclude or restrict internet ("pure-play") retailers? Are such restrictions anticompetitive or socially detrimental in a way that justifies regulatory intervention? This section applies the economic principles developed in the previous section to address these questions. We begin the section by discussing the economic rationale behind the Commission's acceptance of the use of selective distribution networks for the distribution of luxury goods and then ask what (if anything) is specific about the use of the internet as a distribution channel.

1. Image as a Component of the Products

The image of a luxury product is an essential component of the product. Expensive perfumes provide a perfect example. A perfume with a strong (and expensive) image that is purchased by a consumer is enjoyed by her—and perceived by her friends as an input into her own image—more than if it were sold as a chemical compound without any image whatsoever. The product is defined not simply by its chemical composition but by its image.

Suppliers choose to invest in image because this is what consumers demand. Chanel and Dior, for instance, have the option not to invest in image; but without investments in image, the demand for their products at any price would be much lower.

2. Retail Distribution Channels as Investment in Product Image

Luxury goods in general tend to be distributed by their suppliers through upmarket retailers. Whether the distribution systems are vertically integrated or not, greater expenditure is undertaken at the retail level on aspects such as sales assistance, an exclusive showroom, comfort for the shopper and a strong retail brand name. Some of this expenditure is designed to make the shopping experience more pleasant for the consumer. However, the main effect is to enhance the image of the product: if Chanel No 5 were sold in bulk over the internet, without any image investment, it would be an entirely different product than the one sold in small bottles at upmarket perfumeries, advertised in expensive magazines, and so on.

The use of an upscale distribution channel is expensive for suppliers, in that the supplier needs to tolerate a retailer margin that allows the retailer to recover its investment cost. The benefit for the supplier is that the retailers' contribution to product image adds a component to the final product, as perceived by both the purchaser and those who interact with the purchaser. The choice of upmarket retailers as distribution channels is hence a costly investment in product image by the supplier.

3. The Need for Vertical Restraints on Distribution

Accepting that image is a valuable and expensive component of a product, and that one important investment into the overall product image takes place at the retail point-of-sale, the question is, why will the retail market not provide the supplier's desired investment in image? Why might an unfettered market, simply purchasing the supplier's product at a wholesale price and reselling to consumers, fail to provide the mix of low price and strong image?

In the case of luxury goods, the two prominent reasons for the failure of the unrestrained market—for the price system itself—to provide the right incentives are free-riding among retailers and consumer heterogeneity. Both are discussed in Section B.2. For luxury products, restricting distribution is a means of enhancing investments in product image at the retail level that is a response to incentive incompatibilities in the retail distribution sector. Without such restraints, the investment in image by retailers will be fundamentally under-supplied from the supplier's point of view.

4. Normative Analysis

From an economist's perspective, the axiom of "consumer sovereignty" takes consumer welfare as the values that are revealed by their choices. Consumers are evidently willing to pay high prices for goods with a strong luxury image. To the extent that a supplier uses a selective distribution restraint to enhance the retail sector's input into the image of a product, the supplier is adding to a valuable dimension.

As explained at the start of Section B, nothing in the development of this perspective relies on competition among suppliers. Even in the case of a pure monopolist of luxury goods, a restriction on downstream competition or distribution channels is a means of investing in product image. If image were not important to consumers, the monopolist would be the first to enlist low-cost internet retailers.

The optimal competition policy towards distribution strategies of luxury good suppliers then follows directly from the normative analysis in the first section of this article: there is no basis for the position that manufacturers' choices of the mix of price and non-price dimensions, such as image at the retail level (whether implemented via restrictive distribution or not), systematically reduce consumers' welfare. Economic theory therefore suggests that legal prohibitions against selective distribution are no more justified than attempts by a regulator to micro-manage suppliers' advertising expenditures. Indeed, where potential retailer free-riding distortions explain the design of restrictive distribution systems, these distribution systems are welfare enhancing so legal constraints on the choice of such systems will reduce welfare. Because the burden of proof must lie on the regulator, and there is no basis for assuming that intervention will improve welfare, a laissez-faire policy towards the design of distribution systems is called for.

5. What is Specific about Internet Distribution as an Additional Sales Channel?

The Guidelines indicate that the Commission accepts the use of selective distribution networks for supplies of luxury goods. However, the internet as a distribution channel is generally considered by the Guidelines as a form of "passive sales" and as such receives special treatment. The key questions are then: what is special about the internet as a distribution channel? And should suppliers be allowed to restrict internet sales through quantitative restrictions on retailers who are part of the selective network or through sheer exclusion from the network of "pure-play" internet retailers?

A number of recent papers in the economic literature study the use of the internet as an additional sales channel and the approach suppliers have taken to dealing with channel conflict between online and offline retailers. For example, Gertner and Stillman[41] explore the relationship between the development of online stores and vertical integration. Their evidence suggests that vertically integrated chains developed online sales more quickly than non-integrated chains. One explanation they propose is that non-integrated chains find it difficult to provide the right incentives for retailers to develop online stores that match the standard that the chain would like to maintain. Suppliers selling through non-exclusive retailers and department stores also find it more difficult to address channel conflict issues. Gertner and Stillman conclude that "it is not surprising that executives in the apparel industry regard channel conflict between vendors and department stores as a major issue" (p 430). This is consistent with our theme that free-riding issues (and more generally channel conflict issues) play a critical role in suppliers' choices among distribution models.

Carlton and Chevalier[42] suggest that suppliers prevent or limit internet distribution by discount sites and that suppliers' websites tend to have higher prices. They explain that

> "[M]anufacturers of branded goods have placed a variety of restrictions on their brick and mortar retailers in an effort to control free-riding on the sales and promotional efforts of retailers. The emergence of the Internet as a new distribution channel requires suppliers to develop restrictions on Internet retailers to control free-riding" (p 441).

Chevalier[43] reiterates her conclusions in a submission to the FTC in a workshop discussing "Possible Anticompetitive Efforts to Restrict Competition on the Internet". Borenstein and Saloner[44] also report anecdotal evidence of some

41 R Gertner and R Stillman, "Vertical Integration and Internet Strategies in the Apparel Industry" (2001) 49 *Journal of Industrial Economics* 417.

42 D Carlton and J Chevalier, "Free-riding and Sales Strategies for the Internet" (2001) 49 *Journal of Industrial Economics* 441.

43 J Chevalier, "Free Rider Issues and Internet Retailing" (2002), available at http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/chevalier.pdf (all URLs were accessed on 8 December 2008). More recent academic articles in the marketing literature have discussed similar concerns. See, eg S Van Baal and C Bach, "Free-riding and Customer Retention across Retailers' Channels" (2005) 19 *Journal of Interactive Marketing* 75; J Shin, "How Does Free-riding on Customer Service Affect Competition?" (2007) 26 *Marketing Science* 488.

> "clothing manufacturers . . . [who] refused to sell their products over the Internet, or to allow retailers to do so, so as to prevent the free rider problem between 'showroom' retailers, who allow consumers to check out the product in person, and purely Internet retailers, who can operate with much lower overhead" (p 8).

These papers document that in the US legal environment, where firms are relatively free to design their distribution systems, many suppliers choose to restrict the distribution of their products through the internet. The papers argue that the motivation for restrictive distribution is to avoid free-riding and other types of incentive distortions.[45]

D. Conclusions

The use of selective distribution to solve the channel conflict between bricks-and-mortar and online retailers (by luxury good producers and others) is at the heart of an ongoing high-profile policy debate in the context of the revision of the Guidelines. Competition Commissioner Kroes has also recently launched a public consultation on online commerce for which she has established an advisory group consisting of high profile business leaders and consumer associations.[46] We conclude this article by addressing some key questions raised in the Commission's Issues Paper to the group.[47]

1. The Distinction between Active and Passive Sales Loses Merit in an Internet Context

We find that there is a clear efficiency rationale for suppliers to restrict active sales by retailers operating in different territories wishing to free-ride on the effort of retailers operating in the territory. The rationale applies with equal force to passive sales. In short, economic analysis suggests that suppliers should be free to restrict passive sales as well.

An additional important difference between the traditional bricks-and-mortar case and internet sales is related to the magnitude of search costs. Prior to the development of the internet, when an exclusive distribution system had been put in place, with active sales prohibited but passive sales not prevented, search costs were very high for consumers. Consumers are in fact unlikely to drive long

[44] S Borenstein and G Saloner, "Economics and Electronic Commerce" (2001) 15 *Journal of Economic Perspectives* 3.

[45] The second potential explanation for this practice—the hypothesis that restrictive distribution is an attempt by suppliers to strategically dampen competition by committing to a less aggressive organisational form—relies on a highly concentrated industry upstream (see the Rey and Stiglitz articles, *supra* n 22). If restrictive distribution is observed across industries for different levels of concentration, then it becomes implausible that rampant suppression of inter-brand competition is the predominant motivation for this practice.

distances to compare the prices in different geographical markets. In this setting, passive sales were unlikely to be a very important issue for retailers, and territorial clauses solved the free-riding issues even if passive sales could not be prevented. The internet has totally changed the situation. The internet almost completely eliminates any search costs for consumers: consumers can check prices on many websites within minutes (through price comparison sites, for instance), and they do not need to restrict attention to their own geographical area. Since shopping costs are often not much higher for international sales, the internet reduces effective distances between outlets. Setting up a website to provide products can be viewed as essentially a means of generating active sales.

Once it is correctly accepted that there are good reasons for a supplier to set up an exclusive distribution system, and that such a choice does not harm consumers, then we believe that this supplier should also be allowed to prevent sales from "pure-play" internet sellers, wherever these internet sellers may be based and independently of whether these sales would be classified as "active" or "passive".

2. Suppliers should be Free to Select (and Review over Time) the Criteria for the Admission into their Selective Distribution Networks (eg Restrictions on "Pure Play" Internet Retailers)

The rationale for this is discussed above in Section B.2. Internet-only shops would free-ride on the investment made by bricks-and-mortar retailers to increase demand for the products. This would lead to underinvestment in activities that consumers value and are happy to pay for. It is important that suppliers are able to decide whether retailers are making a sufficient investment in bricks-and-mortar shops and in sales assistance more generally before accepting them into their network. A simple formal requirement for the existence of a bricks-and-mortar shop might attract retailers aiming to minimise investments in their bricks-and-mortar network and focusing almost exclusively on internet sales. This would generate similar negative externalities to those generated by "pure-play" internet sellers.[48] Suppliers need to be able to decide

[46] See http://ec.europa.eu/comm/competition/consultations/online_commerce.html.

[47] See http://ec.europa.eu/comm/competition/consultations/online_issues_paper_annex.pdf. We focus on the issues relating to "non-copyrighted goods and services".

[48] Strictly speaking, one could also argue that free-riding could occur in the opposite direction as well, as internet sites could provide product reviews and product information more generally that could then be used by consumers purchasing the products in bricks-and-mortar shops. In fact, this is likely to be materially less relevant and easier for the suppliers to monitor and reward (eg a supplier could pay a fixed fee to internet sites hosting valuable product reviews and product information). Moreover, sales services costs at a bricks-and-mortar shop (essentially costs of sales personnel) increase with the average number of consumers visiting the shops, while sales services costs for internet sites (product presentation, reviews etc) tend to be fixed. This is discussed by Carlton and Chevalier, *supra* n 42, 443.

whether retailers make a sufficient contribution to the investment in the product image to belong to the sales network. The supplier has every incentive to welcome into its network as many retail outlets as possible, provided they contribute to product demand by making the required investments and so long as they do not undermine incentives to invest by retail outlets already in the network. The supplier must therefore be able to exclude any retailers who generate negative externalities. This includes being able to exclude retailers who invest "too much" in internet sales and "too little" in their bricks-and-mortar network as they overly focus on winning sales away from other retailers as opposed to increasing the demand for the product. This means that the suppliers should be able to freely set (and review over time) the criteria used to select dealers without having to fear regulatory intervention.

This is consistent with the rationale (and the empirical findings) of Carlton and Chevalier.[49] In fact, they conclude their article where they analysed distribution of fragrances, DVD players and refrigerators as follows:

> "Our research indicates that channel conflict is and should be a serious concern for manufacturers. Where exclusivity is used in offline brick-and-mortar retailing to control free-riding, some comparable restraint is needed to control Internet websites. The two most common restraints are pricing (with no discounts allowed) and, less frequently, the restriction of available supply to only certain Internet websites (such as only a supplier's or a selected retailer's website)" (p 460).

Importantly, these authors find that suppliers of fragrances in the US market imposed restrictions on internet websites as an efficient way to control channel conflict. They go on to note that

> "[it] appears to us, from examining both the trade press and trends in litigation, that there is growing recognition that uncontrolled Internet sales through unauthorised websites are not always in a manufacturer's best interest where free-riding can occur and sales service is important. Accordingly, in the future, we expect to see manufacturers paying more attention to channel conflict and further restricting Internet pricing and availability for products where sales service is important" (p 461).

As discussed earlier, their interpretation is that it is welfare-enhancing to allow suppliers to introduce these restrictions. Comanor and Scherer in their economic brief to the US Supreme Court in the *Leegin* case suggest that "the efficiency defenses of RPM and other similar restraints arise preponderantly from circumstances where the manufacturer is the moving party" (p 7).[50]

49 *Supra* n 42.
50 Brief for W Comanor and F Scherer as Amici Curiae supporting neither party in the US Supreme Court in *Leegin*, *supra* n 9.

3. Antitrust Authorities Need Not Worry that Selective Distribution Systems and Consequent Limitations on Internet Sales Are Used for Products the Nature of Which Does Not Require Selective Distribution

For luxury goods suppliers choosing a selective distribution system instead of adopting a "mass market" distribution model generate significant costs. The number of retail outlets is more limited, thereby, *ceteris paribus*, reducing sales and asking retailers to invest in their stores (or investing directly through the employment of additional sales assistants) has a significant cost for these suppliers as the mark-up offered to retailers has to increase to ensure the retailers' commercial viability. These suppliers believe that employing this expensive distribution method increases the demand for their products and is ultimately more profitable than adopting a less selective (and cheaper) distribution method. If the characteristics of the products were different, these suppliers would move to a cheaper distribution system. The suppliers' incentives to choose a particular distribution system is therefore closely aligned with whether the nature of—and demand for—the product is such that it requires selective distribution.

For instance, airlines have traditionally used travel agents to provide sales assistance to consumers. Over the last few years, market circumstances have changed such that it is now in the airlines' best interest to choose a distribution system that is much more focused on internet distribution. Realising this, airlines have moved to this distribution system, selling directly to consumers using their websites or via online agents. Should market circumstances and consumer demand evolve such that luxury products no longer require selective distribution, suppliers of these products can be expected to change their distribution systems accordingly.

4. Antitrust Authorities Need Not Worry that Selective Distribution Systems Hinder the Development of New Methods of Distribution

Suppliers have no interest in hindering new methods of distribution that are suitable to distribute their product. A selective distribution system is a very expensive way for the suppliers to sell to consumers as it is based on expensive point of sale investment by the retailer and/or the supplier. The suppliers choose this system because demand for the product is significantly enhanced by this investment in sales activities (for instance, more consumers buy make-up or skincare products if they can test the product and discuss their needs with beauty consultants etc). If demand could be similarly enhanced through a cheaper method of distribution, the suppliers would have strong incentives to adopt it.

The fact that some luxury goods producers have decided against using internet "pure-players" to distribute their goods does not seem to have hindered the development of internet distribution. For instance, almost all the best-selling perfumes and cosmetic products can currently be purchased on the internet via the suppliers' own websites or the authorised distributors' sites.