SELECTIVE DISTRIBUTION BY LUXURY GOODS SUPPLIERS: A RESPONSE TO KINSELLA *ET AL*

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A. Introduction

In the last issue of this journal, we outlined the economic principles underlying the use of selective distribution by luxury good suppliers, specifically the restraints placed by these suppliers on the extent to which downstream retailers can distribute their products over the internet.[1] Our article was based on a report prepared for the LVMH Group in the context of the European Commission's public consultation on on-line commerce in 2008. Kinsella, Melin and Schropp of Sidley Austin LLP, who are assisting eBay in EU competition matters related to selective distribution by luxury good suppliers, offered a lengthy comment on our article in the same issue of this journal.[2]

Finding little to disagree with in the statements and analysis that we offer in our article, Kinsella *et al* expand the set of statements we actually make to a set of arguments that they then incorrectly attribute to us. In this expanded set of arguments, they find much to disagree with. So would we.

We offered in our article a relatively straightforward analysis of the area of selective distribution by suppliers of luxury goods, concluding that economic principles supported a cautionary approach to regulatory intervention in the choice of selective distribution as part of a supplier's overall distribution strategy. Our concern with the lengthy and scattered comment by Kinsella *et al* is that the authors have, through various errors and misattributions in their comment, obfuscated the economic principles underlying an important area of competition

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1 T Buettner, A Coscelli, T Vergé and RA Winter, "An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers" (2009) 5 *European Competition Journal* 201.

2 S Kinsella, H Melin and S Schropp, "Comments on the CRA Paper Entitled 'An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers'" (2009) 5 *European Competition Journal* 227 (Kinsella *et al* comment).

policy. In this response, we briefly summarise the theme of our article and then delineate both the comments of Kinsella *et al* and our responses.

B. Selective Distribution by Luxury Goods Suppliers: Summary of our Theme

The first point of our contribution is that image is an important component of luxury products, in the sense that many consumers reveal a preference for products on which suppliers have invested substantially in image. Both the suppliers and the retail distributors of these products invest to enhance product image. Let us take perfume as a concrete example. Suppliers of perfume such as Dior or Chanel spend much more in creating the image of the product than they do on the chemicals in the physical product itself; chemicals account for only a small fraction of total costs for perfume suppliers. Investments in image take the form of fancy packaging, direct image advertising—and indirect investment through the suppliers' support of high mark-ups at upmarket retail outlets. Perfume suppliers invest resources on product image, rather than simply selling perfume in bulk as chemicals, because this investment enhances the demand for their product. A consumer values both the scent of a perfume and its image, and suppliers accordingly invest resources in both of these dimensions of the product. If the benefits from "brand image" were regarded by a regulator as merely "speculative" and without empirical foundation, as Kinsella *et al* claim,[3] the optimal regulatory response would be simple: regulate the price of perfume to be a few percentage points higher than the input cost of the product. Fancy bottles, image advertising, and distribution through expensive stores would disappear. The cost of perfume would drop to a few euros per litre, especially if the consumer provided her own container.[4] This type of regulation has not been implemented, not because of the difficulties of regulating prices in markets, but because it is recognised that for a product like perfume the image is an extremely important component of the product. Consumers demand perfume, and enjoy the product, because of both the scent and the image. A proposed regulation that would require perfume being sold for in bulk at low prices, with no image creation, would be regarded as absurd, in spite of the price savings to consumers. Product image has value, and public policy reflects this.

[3] Kinsella *et al* comment, para 3.

[4] Moreover, if (interbrand) competition were fierce enough between perfume suppliers, the market would regulate itself. Some suppliers would drop all fancy packaging and advertising, and have aggressive pricing strategies. Most consumers would then switch from expensive perfumes to these cheaper options, thereby increasing the demand—but also the profit—of these "competitive suppliers".

Our second point is that internet distribution, while now an essential part of the distribution system of virtually any retail product, potentially compromises the incentives for upmarket, bricks-and-mortar stores to invest in enhancing the brand image of a product or even to carry the product. This is because some consumers who are attracted to the product by the retail environment, the retail store prestige and product promotion at the store will subsequently purchase the product much more cheaply on the internet. If upmarket stores capture fewer of the consumers, they will, as a matter of simple economics, invest less in product promotion. And where the reduction in investment compromises product image, demand for the product will drop. To avois this, an upstream supplier of a product will often want to limit this distribution so as to encourage bricks-and-mortar outlets to promote or even to carry its products. Restricting distribution represents a cost to the supplier because, other things being equal, low retail margins and wide distribution (including over the internet) are good for sales—a basic economic point which Kinsella *et al* fail to acknowledge.[5] The supplier that bears the cost of restricted distribution does so in order to encourage more investment in image, or distribution through more upmarket stores. In short, selective distribution is simply a means by which a supplier changes the trade-off between price and image (or promotion or other retailer-supplied product attributes) in an unrestrained retail market.

For many products, as Kinsella *et al* point out, the internet is a complement to purchases at bricks-and-mortar stores, for example because consumers gather information about a product before shopping at a store.[6] If this positive effect dominates the negative effect of internet on retailer investment incentives, in terms of the overall impact on demand, a supplier will not restrict internet sales and a policy issue or legal case regarding selective distribution will not arise. The key piece of evidence in any selective distribution case involving internet restrictions, however, is that the supplier has chosen to adopt the strategy. In any real world case of restricted distribution, the positive effect of the internet on information provision is therefore not the dominant effect.

Consumer benefits, not firm profits, are at the heart of European competition law. Some economists might argue that the willingness of a product supplier to bear the cost of higher retail prices in exchange for greater investment in product image through selective distribution signals that the trade-off is necessarily in the consumers' interest as well. We do not. Kinsella *et al* attribute to us the proposition that "regulators should trust that supplier-imposed vertical

5 In other words, for a given wholesale price and product image, higher retail margins increase retail prices and reduce the demand for the supplier's product and hence the supplier's profit. This reduction in profit is a cost to the supplier.

6 Cf Kinsella *et al* comment, para 83. However, this pre-purchase information does not necessarily need to be provided by an internet retailer; it could also be (and indeed is) provided through specialised websites that compare and test products, or even by consumers themselves.

restraints always and inevitably serve the consumer interest" (paragraph 3). Yet we are perfectly clear in our article that economic theory does not predict that suppliers will always implement the ideal trade-off, from the consumers' perspective, between prices and image (or other product attributes provided at the retailer level). By incorrectly characterising our argument as markets-are-always-optimal, Kinsella *et al* set up their first straw man, one that is easily knocked down.

The third major point of our article is that the policy-relevant question is not "do unregulated markets always and inevitably serve the consumer interest". Taking this question as the basis for policy is known to economists as "the Nirvana fallacy".[7] The question that the design of optimal regulatory policy must ask instead is "can regulatory intervention systematically do better than the market?" In the context of selective distribution adopted by a luxury goods supplier, the question is whether the regulator can systematically improve markets by intervening, through legal restrictions on suppliers' distribution strategies that affect the price–image mix. Our welfare economics analysis shows that it would be extremely difficult with realistically available evidence to systematically improve upon the market outcome, ie—in the case of a supplier using selective distribution—to shift the mix of pricing and image investment at the retail level closer to the socially optimal level. One *could* simply adopt a value judgement that the benefits of investments in product image are speculative and without empirical foundation, as Kinsella *et al* do. The evidence, however, is that consumers demand strong product image—it is in response to this demand that suppliers use selective distribution to enhance investment in image at the retail level—and the mainstream economic view is that regulators should not substitute their own value judgements for revealed consumer preferences. Regulators do not systematically prohibit suppliers from strategies of greater direct investment in product image, combined with higher prices; nor should they when this choice is implemented through selective distribution.

The fourth point of our analysis is to acknowledge that vertical restraints in general can have anticompetitive uses, and are not always used by suppliers simply as a means of shifting incentives at the retail level as described above. Vertical territorial restraints can be adopted to dampen the intensity of price competition upstream. Resale price maintenance can be used to support an upstream cartel since it allows coordination on a stable, common and visible set of retail prices instead of more-easily-hidden wholesale prices. We cited case examples of both types of anticompetitive uses of vertical restraints. We expressed some doubt as to the applicability of these theories to selective distribution, the topic of our article. For example, we do not believe that restricting

7 The term was coined by H Demsetz in "Information and Efficiency: Another Viewpoint" (1969) 12 *Journal of Law and Economics* 1.

internet sales would facilitate an upstream cartel. Prohibiting internet sales would leave a potential cartel in the position of trying to coordinate prices at bricks-and-mortar stores; bricks-and-mortar store prices are less transparent and less easily monitored by cartel members than internet prices—not more so. But we acknowledged that in principle selective distribution agreements could somehow be used for anticompetitive purposes among upstream suppliers, and that this could be a basis for regulatory intervention. We did not call for per se legality of selective or restrictive distribution.

Our position is that selective distribution agreements should be interpreted prima facie as instruments used by suppliers to shift the mix of price competition and investment in image or other retailer services at the downstream retail level. Interestingly, Kinsella *et al* offer no theory or case examples as to how selective distribution can be used to lessen upstream competition. In a comment that criticises a simple, mainstream economic explanation of selective distribution as encouraging retail sector investment in image and other product dimensions, it would have been appropriate to offer at least one case example of an alternative hypothesis.

The fifth and final point in our article is that in any regulatory intervention in markets the burden of proof should lie on the regulator to show that such intervention is likely to raise consumer welfare. This simply means that a regulator should not intervene on the mere theory that such intervention *might* increase welfare. The regulator should rely either on evidence that the particular practice is generally adverse to consumers' interests (in which case the burden would switch to the firm adopting the practice to show that in the case at issue the practice is efficient), or evidence that in the particular case the practice harms consumers. Whatever the state of the current law, economics does not support intervention in markets on the basis that the intervention *might* increase welfare. This point, contrary to the claims of Kinsella *et al*,[8] is neither "remarkable" nor out of the economic mainstream.

With this summary of our main points, it is useful, prior to evaluating the comments of Kinsella *et al*, to delineate some of the things that we do *not* say. Our article is about selective distribution. Nowhere in our article do we argue that vertical territorial restraints should be per se legal in Europe as they effectively are in the US. Nor do we defend exclusive dealing as presumptively pro-competitive. Indeed, some of us have written papers discussing the possible anticompetitive consequences of these restraints. Finally, while our analysis of selective distribution has some similarity with potential roles for resale price maintenance, we do not address the full costs and benefits of resale price maintenance and in particular do not deny its potential role as a cartel-

8 Kinsella *et al* comment, paras 3–4.

facilitating practice. We have written elsewhere on the historical importance of this role of resale price maintenance.[9] The focus of our article is the economic foundations of policy towards selective distribution agreements to limit internet distribution.

C. The Comments of Kinsella et al

The counter-argument that Kinsella *et al* offer to our perspective on selective distribution is summarised distinctly by these authors on the first page of their comment. After incorrectly characterising our case in the following terms "Basically, the proposition is that regulators should trust that supplier-imposed vertical restraints always and inevitably serve the consumer interest" (paragraph 3)—their first "straw man", discussed above—the authors respond:

> "The reality, however, is that vertical restraints can easily be imposed to geographically segment markets, raise barriers to entry for competitors and reduce competition between suppliers upstream, resulting in higher prices and less choice—results to the unambiguous detriment of consumers" (paragraph 3).

Kinsella *et al* note that vertical territorial restraints can be used by a monopolist to separate markets and increase profits through price discrimination: "Market segmentation can be achieved by giving out exclusive dealerships, or by instituting regional (national) sub-markets" (paragraph 30). Different prices across different areas within the European Union runs counter to the market integration objective of European Competition policy. We agree. We disagree with other claims by Kinsella *et al* about territorial exclusivity, such as their assertion that territorial exclusivity is "to the indisputable detriment of consumer welfare" (paragraph 58), a statement which also conflicts with the recognition in the European Commission's Guidelines on Vertical Restraints that "[e]xclusive distribution may lead to efficiencies, especially where investments by the distributors are required to protect or build up the brand image".[10]

Kinsella *et al*'s discussion of vertical territorial restraints, however, is unrelated to our article. Nowhere in our article do we discuss vertical territorial restraints as an efficient vertical restraint, an argument that Kinsella *et al* attack. Our paper focuses on selective distribution agreements to limit internet distribution, which are a different contractual arrangement in both form and effect. A supplier's decision to limit the volume of sales over the internet within its selective

9 GF Mathewson and RA Winter, *Competition Policy and Vertical Exchange* (University of Toronto Press, 1985), 29–34.

10 Commission Notice "Guidelines on Vertical Restraints" (2000) Official Journal of the European Communities, C291/01, 13 October 2000, para 174 (henceforth "Vertical Guidelines").

distribution system would not somehow lead to the establishment of exclusive national dealerships.[11]

In equating selective distribution agreements (which we discuss in the context of limitations on internet distribution) to vertical territorial restrictions and exclusivity arrangements (which are not the focus of our paper), Kinsella *et al* set up a second straw man. Their use of this straw man is best illustrated with the following example, although the attempt to confound our analysis of internet-limiting agreements with other vertical restraints is made throughout the comment:

> "An SDA [selective distribution agreement], which eliminates intra-brand competition, can only address free-riding (should such problem exist) if markets can be rigorously segmented. This means that the markets in which exclusive retailers operate are effectively isolated from one another. Investment by one retailer, be it in local advertisement, promotion or in-store service, must not benefit other retailers [footnote deleted]. Apart from the fact that such an SDA—providing territorial exclusivity to the appointed retailers—goes against the very essence of the European ideal of the single market and violates the Vertical Restraints Regulation, such exclusivity arrangements create five distinct problems: dynamic inefficiency, double marginalisation, at-market pricing (ie discrimination), market foreclosure and collusion between suppliers" (paragraph 39).

This paragraph makes several errors. First, unlike territorial exclusivity, a selective distribution agreement *limiting* internet distribution (eg by excluding pure internet players from the distribution network) in fact does *not eliminate* intra-brand competition. Bricks-and-mortar outlets compete amongst themselves and may distribute on the internet as well to the extent allowed under the agreement. Second, selective distribution can mitigate the free-riding problem even though it has nothing to do with the "rigorous segmentation of markets" that would result from territorial exclusivity. Selective distribution does not of course completely eliminate free-riding, or more precisely eliminate positive externalities among retailers: in a distribution system where retailers contribute to the promotion, image and reputation of the products they offer, such positive externalities will always be present. We make no claims to the contrary. However, selective distribution is a means for the supplier to reduce (not eliminate) intra-brand competition for the purpose of enhancing retailers' incentive to invest in image (although not necessarily at the level that would be first-best for

[11] On a related note, allowing unrestricted internet distribution does not, contrary to Kinsella *et al*'s claim (para 31) "[bring] consumers closer to the ideal of a single, homogenous market with a single, or at least undistorted, price". Internet distribution in parallel with traditional distribution results in two sets of prices. Low internet prices are of course a benefit to both consumers and suppliers, a benefit that suppliers will balance against the potentially detrimental impact on retailers' incentives to invest in the product promotion and image.

the supplier). Without the ability to limit internet sales, the incentive for such investments would be severely curtailed.

Kinsella *et al*'s third straw man is to equate selective distribution that limits internet sales to a ban on internet sales. They attribute to us an assertion "that a ban on internet sales can effectively tackle the free-rider problem", on the argument that a selective distribution agreement "that prohibits internet distribution must by default result in a foreclosure of free-riding, since it shuts out—by definition—all non-investing free riders". Kinsella *et al* then refer to this conclusion as "somewhat nonsensical" (paragraph 35).

The label "nonsensical" is a surprisingly aggressive reaction by Kinsella *et al* to an argument that is entirely of their own invention. Nowhere in our article do we call for a ban on internet sales. Nowhere do we claim that an internet ban would completely foreclose all free-riding, ie render retailer incentives perfectly aligned with a supplier's interest. As noted above, the internet is of course a vital part of the distribution network of virtually every product, and there is "free-riding" (more precisely positive externalities) in any distribution system where retailers contribute to the promotion, image and reputation of the products they carry. Kinsella *et al* fall into the straw man fallacy throughout their comment, but this is a particularly extreme example.

Kinsella *et al* introduce another theme: there are less restrictive alternatives to vertical restraints that can address free-riding. They suggest wholesale price discrimination by the supplier (paragraph 51) but ignore that to be effective this strategy must eliminate the internet's key benefit: lower prices.[12] They argue that free-riding could be overcome by incentive contracts which make the wholesale price dependent on effective sales (paragraph 53) but fail to explain how this would work in practice or the restraints it would imply.[13] Another alternative they suggest as an example of increased vertical cooperation is franchising (paragraph 54), ignoring the fact that franchising agreements can be more restrictive than selective distribution.[14] Assessing in the abstract whether these (or other) hypothetical alternatives are in fact more efficient means for a supplier to achieve a legitimate goal in practice is an extremely difficult exercise for a regulator. But there should be no presumption that a supplier would choose a policy

[12] Such a strategy would be implemented by setting low wholesale prices to the upmarket bricks-and-mortar stores (to reward them for their investments in brand image) and high wholesale prices to the internet retailers. To have the desired effect of stimulating investments in brand image by bricks-and-mortar stores, the price differential would have to be such that internet players could not effectively compete in prices with the bricks-and-mortar stores since the strategy would need to ensure that not too many customers were diverted from the latter to internet sales.

[13] In fact, for such contracts to be able to address free-riding they would have to limit the quantity that could be sold by each retailer through increasing wholesale prices or by making wholesale prices conditional on total sales. Both of these options in effect limit intra-brand competition substantially.

[14] Some franchising agreements may, for instance, impose exclusive dealing and offer territorial exclusivity arrangements to some, if not all, of the franchisees.

that is more restrictive than necessary. To the contrary, since retail competition is in the supplier's interest, not just the consumers' interest, the supplier benefits from choosing the least restrictive policy sufficient to solve whatever incentive problem is faced at the retail level.

In our article, we offered two basic explanations for selective distribution agreements to limit internet sales: the classic free-rider problem, based on the assumption that internet distributors do not on average contribute as much to brand image and promotion as an upmarket store offering the product in an environment of prestige, comfort, the ability to "touch-and-feel", and so on; and a second explanation based on simple consumer heterogeneity. In contrast to the free-ride problem, the heterogeneity argument does not rely on positive externalities between retailers but is applicable where consumers differ in the value they place on image. The argument is that retailers place some attention on attracting customers away from other retailers, where the supplier would prefer the retailers' focus be on attracting new customers to the product. Consumers attracted away from other retailers tend to respond less to product image than to low prices. Hence the retailers' bias, from the supplier's point of view, towards intensive price competition and away from competing on other retailer attributes.

Kinsella *et al* make an interesting observation in stating that the heterogeneity theory is really "just a simple variant" of the free-rider theory (paragraph 48). We refer the reader to their comment for the details of this interpretation, and simply note here that this observation is an important contribution not just to the economic foundations of vertical restraints but also to competition law. By pointing out that the concept of free-riding extends well beyond the narrow, conventional interpretation involving pre-sale information, Kinsella *et al* effectively argue for an expanded interpretation of the free-rider defense of vertical restraints under the Vertical Guidelines.[15] Limitations on internet distribution as a means of enhancing retailer incentives are then not only supported by economic theory, as we have shown, but, following the logic of Kinsella *et al*, are also consistent with European competition law. A cautionary approach to regulatory intervention in selective distribution cases is well founded in both economics and the law.

[15] In the Vertical Guidelines, the admissibility of vertical restraints relies on the credibility of a free-rider argument: "Speculative claims on avoidance of free-riding or general statements on cost savings will not be accepted" (Vertical Guidelines, para 136).