COMMENTS ON THE CRA PAPER ENTITLED "AN ECONOMIC ANALYSIS OF THE USE OF SELECTIVE DISTRIBUTION BY LUXURY GOODS SUPPLIERS"

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A. Introduction

1. In this paper, we bring together the views of lawyers and economists in an effort to formulate a practical approach to a real problem.

2. Competition rules help keep consumers safe from corporate greed. This is how European Competition Commissioner Neelie Kroes describes the role of competition policy in preserving consumer purchasing power in the current financial crisis.[1]

3. With that in mind, the assertions made by the CRA paper[2] are remarkable. The CRA paper, part of an exercise conducted on behalf of the LVMH Group, purports to discuss the "economic foundations of competition policy towards vertical restraints on distribution, as applied to the selective distribution of luxury goods".[3] The paper is not a market study; it is a discussion based on selected literature and an interpretation of economic theory. Nevertheless, the paper asserts that regulators should assume that unspecified and largely speculative consumer benefits from "brand image" outweigh the well-recognised consumer welfare flowing from effective market competition. Basically, the proposition is that regulators should trust that supplier-imposed vertical restraints always and inevitably serve the consumer interest. In order to make their point, the CRA authors find themselves arguing that resale price maintenance by a monopolist can be presumed beneficial to consumers.[4] The reality, however, is

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1 See the opening remarks by Commissioner Neelie Kroes at the conference "Competition Policy, Growth and Consumer Purchasing Power", 13 October 2008, SPEECH/08/521.

2 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.

3 CRA paper, p 201, para 1.

4 We should recall that the focus of the Commission's enforcement policy against dominant companies is on protecting consumers, eg against higher prices and reduced consumer choice.

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—to the unambiguous detriment of consumers.

4. This response looks at the CRA paper's arguments regarding vertical restraints and finds that its conclusions should not be attributed to mainstream economics. In contrast to the CRA paper, this comment also looks at what is happening in the real world. It questions the blanket justification for vertical restraints in general and online restrictions in particular. A detailed analysis follows, but at the outset four general points warrant special emphasis:

5. First, the CRA paper ignores that the inconvenient truth is that market integration is one of the principal goals of EU competition policy. The single market is based on the premise that the fewer the barriers between markets, the more efficiently those markets will work, generating economies of scale that benefit all. The EU competition rules are here to ensure that companies do not recreate private barriers between Member States where legislative barriers have been abolished.

6. Vertical restraints have the potential to segment markets, allowing suppliers to charge differentiated prices. Vertical restraints also have the potential to foreclose market access to potential competitors. Consumers are left with a situation of dampened competition which reduces consumer choice and holds back innovation and development. Moreover, the cumulative effect of suppliers applying similar restrictions is not confined to luxury products, but affects the whole of the consumer goods sector. In the case of non-luxury products, suppliers also tightly control distribution and restrict the commercial freedom of authorised retailers by mere reference to "brand image".

7. Secondly, the CRA paper also ignores the fundamental EU principle of proportionality. In the case of vertical restraints, the proportionality principle demands that the least anti-competitive restraint be chosen to obtain certain verifiable (burden of proof) positive effects.[5] For example, the Vertical Restraints Regulation clearly states that it should not exempt agreements containing restrictions which are not indispensable to the attainment of the positive effects.[6] Indeed, as detailed below, there are less restrictive business tools available to suppliers to ensure a certain level of retail services, while at the same time allowing consumers to exercise the widest possible choice.

[5] See, eg Commission Notice, Guidelines on Vertical Restraints [2000] OJ C291/1, paras 136 and 196.

[6] Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices [1999] OJ L336/21.

8. Thirdly, the CRA paper is at odds with the European Commission's proactive policy of empowering and protecting consumers. The CRA authors argue that, since there is no "consistent" and "systematic" evidence of consumer harm from vertical restraints,[7] regulators should adopt a laissez-faire approach. The caveats of "systematic" and "consistent" place the bar too high (see the fourth point below) even if the general assertions were true. Also, they fail to recognise two fundamental tenets of EU policy: consumer welfare is at the heart of competition law enforcement, and the Commission does not trust companies to invariably operate in the consumer's interests.

9. "The core of our understanding of the world is that markets do NOT work best when left alone . . . this is what our enforcement record and independent evidence shows, and it is the only practical approach to take."[8]

10. This quote concisely summarises the general approach within the Commission. An example outside competition law enforcement is the Commission's recent proposal for a Consumer Protection Directive. The Directive actively prevents traders from using certain terms which are per se unfair towards consumers ("blacklisted" terms) or presumed to be unfair ("grey listed"). Moreover, the Directive implements the principle of favouring the consumer, ie stating explicitly that where there are doubts about the meaning of a term, the interpretation most favourable to the consumer prevails.[9]

11. This is also a growing approach outside the EU. In the US, the financial crisis has led to the conclusion that "in the real world—as opposed to the worlds of political and economic theory—markets are not perfect; that imperfect markets do not always correct themselves; and that business people do not always behave rationally".[10] The Special Report on Regulatory Reform, issued on 29 January 2009 by the Congressional Oversight Panel, is an expression of this.[11] Taking financial regulation as an example, the Report finds that well-conceived regulation has the potential not only to safeguard markets against excess and abuse, but also to strengthen markets as foundations of innovation and growth. The Report states: "History has consistently shown that markets cannot be counted upon to regulate themselves or to function efficiently in the absence of regulation . . . Excesses and abuse are all too common in a system without regulation."

[7] CRA paper, p 209, para 2.

[8] Kroes, *supra* n 1.

[9] Proposal for a Directive of the European Parliament and the Council on consumer rights, COM(2008) 614 final. See, in particular, Arts 34–36 and Annexes II and III.

[10] See remarks by J Thomas Rosch, Commissioner, Federal Trade Commission, on 29 January 2009 at the New York Bar Association Annual Dinner. The Commissioner suggested that the Chicago School of Economic Theory is on life support and described how Alan Greenspan and Henry Paulson have renounced by words and deeds their faith in the market.

[11] Available at http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf (accessed on 23 March 2009).

12. Fourthly, the CRA argument is contrary to the logic of Article 81 EC Treaty. This Treaty provision (which cannot be derogated from by secondary EU legislation) contains a clear prohibition of any agreement (including vertical agreements) which restricts competition unless it can be shown that any restrictions are indispensable to the attainment of clearly defined pro-competitive efficiencies and that consumers demonstrably receive a fair share of the resulting benefits. Viewed from that standpoint, it is the granting of any exemption, such as the Vertical Restraints Regulation, that represents the regulatory intervention: the Vertical Restraints Regulation qualifies the functioning of Article 81 by way of simplified presumptions exempting certain types of vertical agreement from the Article 81 analysis. However, any such exemption must correctly reflect the principles of Article 81(3). The CRA authors nevertheless argue that regulators should intervene even further by extending the Vertical Restraints Regulation to cover blatantly anti-competitive restrictions for which consumer benefits cannot be presumed. In doing so they ignore the logic of Article 81 EC Treaty: those defending anti-competitive restrictions bear the burden of showing that efficiencies flow from those restrictions and are passed on to consumers; in the case of alleged non-price efficiencies, this means showing in detail and with evidence how and why the claimed efficiencies constitute an objective economic benefit and carefully assessing whether these efficiencies create real value for consumers to counter the demonstrable harm caused for example by retail price maintenance. [12]

13. EU competition policy is designed to protect the consumer by making sure companies compete effectively and fairly.[13] Well-functioning markets provide consumer benefits in terms of better products at better prices.[14] The internet is a tool optimally geared towards achieving these objectives. It adds an unprecedented level of transparency, convenience and accessibility to the shopping experience and can contribute substantially to making the Single Market a reality. In the words of Commissioner Kroes, the internet gives more power to the individual than any technological change in history and this power must not be taken away from European consumers by companies who fear change and distrust competition.[15] The current debate about how to ensure safe, efficient and accessible online commerce for all European consumers is too important to be hijacked or distorted by the peculiar claims of a narrow luxury goods sector.

[12] See Communication from the Commission—Notice—Guidelines on the application of Article 81(3) of the Treaty [2004] OJ C101/97, paras 86, 102–04.

[13] Kroes, *supra* n 1.

[14] Speech by Commissioner Kroes at the General Assembly of BEUC, 16 November 2006, SPEECH/06/691.

[15] Closing remarks by Commissioner Kroes at the Online Commerce Roundtable, 17 September 2008, SPEECH/08/437.

B. Background

14. The CRA paper purports to give an extensive review of the economic foundations of vertical restraints (VR), particularly of the justifications for selective distribution agreements (SDA[16]) and resale price maintenance (RPM). The paper was prepared for the LVMH Group as an annex to its White Paper on legal and economic perspectives on internet-related vertical restraints in the selective distribution of luxury goods.[17] In support of LVMH's request that luxury brand manufacturers be allowed unconstrained dealings with selected distributors, the CRA paper focuses on luxury goods and on vertical restraints in the form of (partial[18]) prohibition of internet distribution by selected retailers. It provides distinct policy recommendations for the ongoing review of the Vertical Restraints Regulation.[19]

15. The underlying objective of the CRA paper is to justify the use of VR (and, in particular, SDA prohibiting internet sales) as a necessary tool for ensuring the provision of supposedly high-quality services by bricks-and-mortar retailers in markets in which demand does not depend solely on price, but also on other factors such as pre- and aftersales service, brand image and a convenient shopping atmosphere.

16. This response will show that the CRA paper, although written in economic jargon, extensively footnoted and richly referenced, fails to convince in important areas. In the following sections it will be argued that various key conclusions of the paper are either plainly wrong or at least dubious, and should not be attributed to mainstream economics. It will be shown that policymakers are well-advised to adopt a cautionary approach to SDA and internet restrictions.

17. Section C summarises the arguments brought fourth by the CRA paper and the conclusions it draws. Section D contains a detailed critique of the CRA paper showing that CRA's main conclusions do not flow from its string of assumptions; that CRA omits or obfuscates important welfare concerns connected with VR; and that if one relaxes the CRA paper's assumptions allowing for more realism, those conclusions appear even more dubious. Section E summarises our findings.

16 In SDA, the manufacturer, or supplier, operates a restricted system of distribution covering approved retailers, or distributors. Retailers are appointed on the basis of certain criteria and they agree not to supply unauthorised dealers outside the network. SDA are contracts that restrict the action space of supplier and retailer, and therewith their commercial freedom, while also limiting consumers' access to the products.

17 CGSH and CRA paper.

18 CRA paper, p 218, para 2: "[W]e 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".

19 The Vertical Restraints Regulation expires on 31 May 2010 and the European Commission is currently reviewing it with a view to replacing it.

C. Summary of CRA's Claims and Relevance for EU Legislation

18. The thread of the argument presented in the CRA paper is as follows:[20] first, what are the reasons for suppliers to engage in vertical restraints? Secondly, can it be determined with certainty that the VR decision by a supplier is welfare-depreciating for consumers? If not, is it welfare-superior, and thus prudent for policymakers, to engage in laissez-faire (and possibly commit "Type II" errors) or to regulate (and possibly commit "Type I" errors)?[21]

19. In answer to these questions, the CRA paper argues that the most likely reason for a supplier to engage in VR is his desire to enhance the service dimension accompanying his goods, and therewith his objective to increase demand.[22] Suppliers' decisions to invest in VR, so CRA maintains, are similar to other demand-enhancing business practices, such as advertising, sponsoring and customer fidelity points. CRA purports that this contention is uncontested amongst mainstream economics.

20. In a nutshell, the CRA paper brings forth four core arguments:

1. In the case of a monopoly,[23] there is no economic basis for regulatory intervention in a firm's use of RPM and SDA. A monopolist applies vertical restraints with the exclusive aim of aligning retailers' incentives with his own.[24] In order to successfully enact the monopolist's preferred price–service mix, VR are the only way of tackling market failure and to incentivise retailers to provide the efficient level of service efforts and brand image cultivation.[25] In support, the CRA paper claims:

[20] The following paragraphs summarise the content of the CRA paper without prejudice to the accuracy of the assertions contained. A detailed critique of the content of the central CRA claims is to follow in section D of this paper.

[21] Type I errors are "false positives". In other words, the policy over-regulates, ie accidentally prohibits a welfare-enhancing measure. Type II errors are "false negatives". They result when the policymaker under-regulates and an activity that is not prohibited turns out to be harmful to consumer-welfare.

[22] Service is the residual non-price dimension in consumers' demand functions. Service includes pre- and aftersale customer service, image-enhancing practices, the presentation of the good, a pleasant shopping experience, staff enthusiasm or influence, a well-organised inventory, short cashier lines, in-store promotion, local advertising and so forth.

[23] CRA paper, pp 203–11.

[24] Following standard economic practice, for the ease of reading the supplier will be referred to as he throughout this paper, while the retailer carries the personal pronoun she.

[25] In a world uniquely defined by price, so the argument goes, the monopolist is not interested in imposing any restrictions on his distribution system and on the number of retailers (eg by prohibiting online distribution). Perfect competition at the retailer level forces down their rents and ensures that the monopolist price equals consumer price. Any agreement that limits sales channels would thus go against the interest of the monopolist supplier. If at all, profit-maximising behaviour by the monopoly supplier would call for the introduction of a price ceiling rather than minimum prices, if competition among retailers was not sufficiently high. That way, the monopolist could ensure that the quantity sold is optimal (see CRA paper, note 8).

   a. that VR in the form of RPM and SDA have pro-competitive effects. The CRA paper argues that two market imperfections justify VR as the optimal strategy that helps the supplier enact his optimal price–service mix. These market failures are free-riding[26] and biased retailer incentives due to customer heterogeneity.[27] It concludes that, since VR are an effective tool for overcoming these market failures, they are generally welfare-enhancing;[28]
   b. that economic theory offers no basis for the position that a monopolist's preferred mix of service and price established by such VR is consistently and systematically welfare-depreciating. To the contrary, the CRA paper suggests that, since the monopolist will always try to maximise his sales, it must hold that the marginal consumer appreciates the monopolist's decision on the price–service mix; and
   c. that, importantly, these results carry over to non-monopolist settings.
2. Moving on from the expositional case of a supplier monopoly to the case of upstream competition, the CRA paper claims that there is some, albeit limited, basis for regulatory intervention in a firm's use of VR in a competitive industry.[29] However, according to the CRA authors, most of the competition concerns in connection with inter-brand competition are with respect to RPM and not to SDA.[30] In addition, anti-competitive effects of VR apply to intermediate levels of concentration only. VR in a situation of perfect downstream competition do not yield social welfare

[26] The argument is that the internet retailer free-rides on the service investments made by the bricks-and-mortar retailers. Consumers window-shop in the bricks-and-mortar outlets, but purchase online. Since the internet retailer has not incurred comparable investment costs, she is able to outprice the other retailers and attract more consumers. This behaviour creates an externality on all bricks-and-mortar retailers, who consequently are no longer willing to invest in services. As a result, the price–service mix in the entire industry is sub-optimal from the supplier's point of view. In the extreme case, the industry will collapse (CRA paper, at p 209, para 1).

[27] Assuming heterogeneous customers, the supplier would like retailers to adapt a sales strategy that focuses exclusively on attracting new customers (passive buyers). Since retailers have a natural inclination to attract customers away from other retailers, they develop a bias towards price competition instead of investing in services to win over impulse shoppers. When consumers cannot accurately be separated, retailers are prone to implement sub-optimal (from the supplier's perspective) service investments. VR in the form of RPM or SDA can help the supplier to avoid price competition at the retailer level and thus to institute the right level of retailer investment.

[28] In other words, monopolists must adopt VR so as to enhance the non-price service dimension of demand. The CRA paper brings forth a similar argument on the under-supply of inventories in the absence of a VR policy by the monopolist (CRA paper, p 210, para 3).

[29] CRA paper, pp 211–14.

[30] When the assumption of a monopolist is relaxed, VR can have anti-competitive effects in the form of collusion between competing suppliers: in a Rey–Stiglitz-type signalling game (CRA paper, p 212, para 1–p 213, para 1), suppliers quasi-vertically integrate and can thus credibly commit to maintain higher retail prices. In a set-up described inter alia by Jullien and Rey, suppliers can use VR to detect break-outs from an existing cartel (*ibid*, p 213, para 2). However, Rey–Stiglitz-type dynamics can be expected to be quite unique, whereas Jullien–Rey-type dynamics only apply to RPM, not to SDA, as a tool for enacting vertical restraints.

losses. If suppliers and/or retailers increase prices too drastically, consumers can always boycott a product by shifting to competing brands.

3. The CRA paper concludes that protection of intra-brand competition by policymakers is not universally efficient. To the contrary, restrictions on intra-brand competition may well be privately and socially efficient, as they can enhance the demand for the product in question and the non-price product (service) dimension that some consumers value, as well as inter-brand competition.
4. The CRA paper asserts that economic analysis suggests a laissez-faire approach to VR, rather than a prohibition. Regulatory vigilance (and intervention) is only pertinent in isolated cases, such as horizontal collusion under certain RPM policies. According to the CRA paper, the burden of proving any anti-competitive effects should reside with the regulator or the consumer. Absent horizontal collusion, the regulator should treat VR, and prohibition of internet distribution in particular, as suppliers' business strategies aimed at implementing their optimal policy choices. Just as advertising and other image-increasing strategies are not regulated by competition authorities, a hands-off approach to VR, the CRA paper argues, is equally reasonable.

21. It is important to emphasise that these core arguments brought forth in the CRA paper implicitly or explicitly reject the current approach to vertical restraints taken by DG Competition, as laid out in the prohibition of Article 81(1) EC Treaty; the Vertical Restraints Regulation, which provides a "safe harbour" from Article 81(1) for certain types of vertical agreements; the Commission's Vertical Guidelines[31]; and current EC jurisprudence. Specifically, the CRA paper contradicts

- the general logic behind Article 81 EC Treaty that the supplier bears the burden of demonstrating that consumers will benefit from the efficiency said to justify a restriction on competition;
- the general logic behind the Vertical Restraints Regulation that requires a sufficient level of inter-brand competition for its safe harbour to apply[32];

[31] Commission Notice, *supra* n 5. These guidelines are also under review together with the Vertical Restraints Regulation.

[32] Art 81(1) EC Treaty prohibits restrictions on both inter-brand and intra-brand competition (see para 17 of Commission Guidelines, *supra* n 12). However, the Vertical Restraints Regulation is particularly aware of the risks with insufficient inter-brand competition. Its "safe harbour" will therefore not apply to vertical agreements where the supplier has a market share exceeding 30%. In such cases where the supplier holds a certain degree of market power, the protection of inter-brand and intra-brand competition is important to ensure efficiencies and consumer benefits. In addition, where a number of leading suppliers who may individually have market shares below the 30% threshold apply SDA with similar (and strict) conditions, there are inherent anti-competitive risks, eg denied access to general price discounters, little if any consumer choice,

- the Commission's precautionary approach favouring Type I errors (false positives) over Type II errors (false negatives)[33];
- the logic behind the hard-core restrictions in Article 4(a) of the Vertical Restraints Regulations on the ban of RPM, and of Article 4(b) and (c) on territorial and customer restrictions;
- the content of paragraphs 53 and 184 of the Vertical Guidelines on the objection against territorial exclusivity in SDAs[34];
- the content of paragraph 136 of the Vertical Guidelines on free-riding as a necessary explanation to obtain exemption from a VR prohibition; and
- the content of paragraphs 51 and 53 of the Vertical Guidelines on restricting the use of internet by retailers.

22. The CRA paper draws conclusions that are inconsistent with the very core of the Commission's general stance on VR. This warrants a closer look at the theoretical foundations and findings of the CRA paper.

D. A Detailed Critique of the CRA Paper

23. Section D.1 demonstrates in detail that, even if one accepts the rigid set of assumptions taken by the CRA economists, the purported conclusions drawn are wrong, or at least misleading: providing non-price services to customers are not the exclusive aim of VR (section D.1(a)); VR are unnecessary and overly distortionary tools for dealing with an externality (free-riding), whose incidence and actual harm for suppliers is empirically questionable (section D.1(b)); the heterogeneous consumer theory relied upon by the CRA authors is either a call for internet distribution or a reformulation of the alleged free-rider problem (section D.1(c)); and there are less restrictive and more efficient policies available to rational suppliers for achieving the goal of addressing a potential free-riding problem (section D.1(d)).

reduced inter-brand competition, which is not compensated for by smaller brands because of the leading brands' strong brand image, and reduced intra-brand competition because of strict conditions for admission (see paras 6, 21, 102 and 198 of the Vertical Restraints Guidelines).

33 See *supra* n 21.

34 Retailers within a selective distribution system cannot be prohibited from selling to consumers wherever situated. Even where selective and exclusive distribution is combined, the retailers must still be allowed to sell—both actively and passively—to consumers anywhere in the EU. See paras 52, 55, 162 and 184 of the Vertical Guidelines and Art 4(b) and (d) of the Vertical Restraints Regulation. See also Commission Decision of 21 December 2000 in Case COMP.F.1/35.918 *JCB* (paras 141–54), where, contrary to Art 81 EC Treaty, JCB restricted its selected distributors from selling outside their territories to other selected distributors and end-users. Confirmed by the CFI in Case T–167/01 *JCB Service v Commission* (paras 85–104); upheld on appeal by the European Court of Justice on 21 September 2006 in Case C–167/04P (paras 125–47).

24. Section D.2 shows that the CRA paper omits or obfuscates important welfare concerns in connection with RPM, SDA and an internet prohibition: as is well known in economic theory—but ignored in the CRA paper—VR can be effectively used to create market entry barriers against competing suppliers and retailers (section D.2(a)); the CRA paper downplays the anti-competitive effects that VR can have in markets of intermediate competition, such as the luxury and branded goods sectors (section D.2(b)); and the CRA authors offer little theoretical, let alone empirical, evidence for their contention that VR may benefit consumers (section D.2(c)).

25. Section D.3 relaxes the confining set of untenable assumptions that are driving the CRA paper's central—but ultimately questionable—claims to allow for a more realistic picture of supplier–retailer relationships: internet services are valuable to consumers (section D.3(a)); the relevant services can also be provided by suppliers (section D.3(b)); services are more industry-specific than brand-specific (section D.3(c)); and investments in better contracts, market knowledge and monitoring reduce the risk of the alleged free-riding problem (section D.3(d)).

1. Important Conclusions do not Flow from the Assumptions

26. At the outset, it is important to recall the pyramid of assumptions adopted in the CRA paper. The following assumptions drive, but (as will be shown below) do not substantiate, the results of the CRA paper:

- A1. Consumer demand functions in two dimensions: price and service.[35]
- A2. Consumers place a positive value on the service (image/sales effort/promotions/service/shopping experience) dimension, ie the provision of service can push the demand curve to the right. The supplier thus has an interest in seeing the right level of service provision, so as to attract more demand for his goods.[36]
- A3. Service only adds to sales if offered to consumers on a face-to-face basis by retailers. Internet services (FAQ sheets, price comparison, customising options, online after-sales services, etc) have no perceivable effect on consumers.[37]
- A4. Service is brand-specific and not industry-specific. Retailers can pinpoint service investments to a particular supplier's product; there are no service spill-overs to goods by rival suppliers.[38]

[35] In other words, consumers are driven by two distinct demand dimensions: "price" and "services". See *supra* n 22.
[36] See, eg CRA paper, p 204, para 2.
[37] *Ibid*, p 208, para 1, p 224, para 1.
[38] This is an implicit assumption (see *infra* section D.3(b)).

A5. Supplier–retailer contracts are incomplete; important aspects of the contract cannot be observed.[39] Due to the existence of "moral hazard" among retailers,[40] the supplier cannot tie service efforts directly to remuneration or mark-ups.[41]

A6. Retailers are either bricks-and-mortar companies with showrooms and fancy outlets or "pure-play" internet merchants; no mixed retailers ("click-and-mortar") exist.[42]

A7. All upscale retailers undertake investments, whereas internet merchants ("pure-play" retailers) invest nothing in the service dimension.[43]

A8. There are two kinds of consumers: (i) active buyers are price-sensitive and/or have low search costs; they shop around for the lowest available price; and (ii) passive, or impulse, buyers are less price-sensitive; they can be won over on the spot and enticed by retailers' service provision. Active and passive consumers are attracted by different mixes of price and services. From the point of view of the supplier, impulse shoppers are the more attractive customer type, because winning them over "pushes out" out the demand curve for his products.[44]

27. This section demonstrates that, even if one accepts this long string of assumptions adopted in the CRA paper, the purported conclusions drawn do not reflect—as is claimed by the CRA authors—uncontroversial standard economic wisdom. On the contrary, mainstream economics mandates reasons to doubt the findings of the CRA paper.

(a) Provision of Service is not the Exclusive Rationale for Implementing a VR

28. The cornerstone of CRA's argumentative chain is that monopolistic suppliers enact VR solely to improve the service provision for consumers. This

[39] In standard contract theory, contracts can also be incomplete if certain contractual provisions are "non-verifiable", ie unenforceable before a judge (because they cannot be observed by a neutral outside party). However, given that in the case at hand the supplier engages in self-enforcement by threatening to cancel the contract in case of an overt contravention, non-verifiability is not at the core of contractual incompleteness here. See, eg B Salanié, *The Economics of Contracts* (Cambridge, MA, MIT Press, 1997), ch 7.

[40] Moral hazard, or hidden action, is a frequent phenomenon in principal-agent relations. It describes an agent's propensity to deviate from joint-surplus maximising behaviour in the presence of asymmetric information. Since actions or proprietary information held by the agent (here, the retailer) are unobservable to the principal (the supplier), the former has an incentive to deviate from a previously concluded agreement or contract. For more details on moral hazard, see, eg OD Hart and B Holmström, "The Theory of Contracts" in TR Bewley (ed), *Advances in Economic Theory: Fifth World Congress* (Cambridge University Press, 1987), 39698.

[41] See CRA paper, p 204, para 1 and p 205, para 1.

[42] *Ibid*, p 206, para 1.

[43] *Ibid*.

[44] *Ibid*, p 207, para 1.

contention, albeit frequently repeated in the paper,[45] does not withstand economic scrutiny. Even accepting (for now) the quite rigid set of assumptions summarised in section D.1 above, the unqualified finding that a monopolist enacts VR with the sole aim of providing consumers with the valuable services they demand is false for at least two reasons.

29. First, this alleged conclusion only holds under a very important (and restrictive) additional assumption, namely that of a homogeneous market—ie the market is in a unified, unsegmented country or region with one prevailing single price and no internal trade barriers (eg tariffs, information barriers, exchange rates) or non-tariff barriers (eg sanitary measures, technical standards, legal standards). In the presence of such a homogeneous market, where the consumer demand curve is uniquely characterised by the price dimension, a monopolist supplier is not able to exploit the consumer by instituting VR.

30. However, in a segmented market (such as the EU), a monopolist does have a vital self-interest in implementing a VR, especially an SDA. Where the "law of one price" collapses due to natural barriers between the markets (eg informational, technical, political, social or cultural barriers), trade barriers or discriminatory business practices, the monopolist can segment the market and engage in price discrimination, thereby extracting consumer surplus. Market segmentation can be achieved by giving out exclusive dealerships, or by instituting regional (national) sub-markets. Coupled with a prohibition of internet sales that denies information to customers, the monopolist can thereby maintain a price discrimination strategy. Prohibiting internet sales effectively prevents arbitrage between the different sellers or markets, and allows the monopolist to cream off a disproportionate part of consumer surplus in the high-price/high-demand sub-markets.[46] It is hardly necessary to repeat that geographic segmentation goes against two paramount goals of the EU: market integration and consumer empowerment.

31. To be sure, internet retailing is capable of offsetting manufacturers' efforts to hermetically insulate country markets and to appropriate consumer rents in

[45] *Ibid*, p 204, para 2: "As a matter of logic, . . . retail demand in the case of a monopolist must therefore depend on more than price since only then can a monopolist benefit from restraints. Demand must depend on factors other than price"; p 205, para 2: "For a pure monopolist, adding to retailer service . . . is not only a possible rationale for vertical restraints—at the general level it is the only rationale; p 218, para 3, 1: "[T]he simple fact that the supplier is adopting the restraint shows that retail demand must depend on more than price".

[46] This strategy of market separation (sometimes also called "third-degree price discrimination") is a standard result in microeconomics. See, eg W Nicholson, *Microeconomic Theory—Basic Principles and Extensions* (Mason, OH, Thomson Southwestern, 2004), ch 13. For the application of this theory to vertical restraints, see P Krugman, "Pricing to the Market when the Exchange Rate Changes", NBER Working Paper No 1926, 1986; FM Scherer and D Ross, *Industrial Market Structure and Economic Performance* (Boston, MA, Houghton-Mifflin, 3rd edn, 1990), 560; and W Mueller, "The Sealy Restraints: Restrictions on Free Riding or Output?" (1989) 5 *Wisconsin Law Review* 1255.

those segmented markets. The advent of the internet heralded the "death of distance",[47] allowing consumers to purchase goods from geographically remote sources without having to physically cover wide distances.[48] This "death of distance" challenges price discrimination in segmented markets and facilitates consumer arbitrage. For the case of the EU, internet distribution brings consumers closer to the ideal of a single, homogeneous market with a single, or at least undistorted, price.

32. A second reason why a monopolist has a vital self-interest in instituting VR—even if the consumer demand curve is uniquely characterised by the price dimension—is to foreclose market access to potential rivals. As will be shown in more detail in section D.2(a) below, a dominant supplier has a strong interest in reducing market access to actual or potential competitors. He thus aims to increase their costs or otherwise impair their ability to compete. VR in the form of exclusive dealing agreements accompanied by a specific pricing scheme are a viable way of creating effective market-entry barriers for competitors.[49] It is somewhat surprising that this point is not referenced by the CRA authors, since two of them actually formalised the intuition behind the strategy of foreclosure.[50]

(b) VR are Inadequate Tools against Free-riding; a Prohibition of Internet Sales is Ineffective

33. The CRA authors claim that free-riding between retailers is a veritable concern for suppliers. At the outset, it should be noted that, apart from anecdotal evidence, the authors provide no evidence whatsoever on the scale and scope of the free-riding problem for suppliers. Free-riding may be of little real-life significance and a welcome figleaf for suppliers to hide their anti-competitive behavior behind. In the absence of serious empirical evidence on the incidence and the true dimension of free-riding, this issue should be treated as just one theoretical concern next to others.

34. Even if the theoretical free-riding bears any significance in the real economy, VR, be they in the form of SDA or RPM, are questionable tools against free-riding. And a prohibition of internet sales is a particularly ineffective measure against free-riding. Moreover, as is shown below in section D(1)(d),

[47] F Cairncross, *The Death of Distance: How the Communications Revolution will Change Our Lives* (Cambridge MA, Harvard Business School Press, 1997).

[48] Furthermore, as will be discussed in more detail below, internet retailing gives access to consumers in remote areas, and allows consumers to efficiently compare prices and services. Access and transparency are important tools to empower consumers vis-à-vis dominant manufacturers.

[49] Exclusive dealing agreements are those in which the distributor undertakes not to sell any products that compete with those of its supplier.

[50] G Mathewson and R Winter, "The Competitive Effects of Vertical Agreements: Comment" (1987) 77 *American Economic Review* 1057.

under the assumptions presented in the CRA paper, the free-riding problem has a proportionate and trivial solution, obviating any need for VR.

35. The CRA paper falsely asserts that a ban on internet sales can effectively tackle the free-riding problem. This conclusion is born from the paper's circular logic and its rigid set of assumptions: since, by the CRA paper's assumptions, none of the internet retailers offer "upscale" services but instead drive an aggressive "pure-play" price policy, and since all the other bricks-and-mortar retailers do invest in equal measure, an SDA 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. This is a somewhat nonsensical conclusion. In real life, suppliers do not know in advance which retailer will be a free-rider. Given that contracts are incomplete (CRA Assumption A5) and cannot be made contingent on unobservable actions, every retailer—not just online sellers—has an inherent interest in free-riding on the investment of all other retailers in the market and in engaging in minimal investment itself.

36. As a side remark, this simple insight—that every retailer (not just online distributors) has an innate interest in free-riding—casts doubt on the actual relevance of the free-riding problem in relation to internet sales.[51] Since the lynchpin of the CRA analysis is the presence of free-riding—which it uniquely attributes to online retailers—the CRA authors should have invested more effort into analysing the true nature and incidence of free-riding in the first place.

37. It is important to emphasise that restraining certain distribution practices (such as online selling) without at the same time eliminating intra-brand competition is a policy inept at preventing rational retailers from free-riding on other retailers' service-investment efforts.[52] Competition between retailers can be restricted through mandatory minimum prices (ie RPM)[53] or through special types of SDA. However, to prevent customers from enjoying pre-sales services in one outlet and purchasing in another, such an SDA must fulfil two criteria: (i) it must effectively segment markets and (ii) it must prevent consumer arbitrage. Thus, an SDA in the form of a ban on internet distribution alone cannot solve free-riding. To be effective, it must be coupled with territorial exclusivity for bricks-and-mortar retailers. It follows that the CRA paper must actually be read

[51] Every licensed Cartier dealer in, say, London can easily free-ride on the service investments of other Cartier distributors. Yet, apparently, Cartier licensees nevertheless seem to invest in services, brand image and shopping atmosphere.

[52] The CRA report concedes that selective distribution networks can only function if they eliminate intra-brand competition at the same time. See CRA paper, p 209, para 1:

> "[I]n cases where there is any free-riding on services . . . 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 . . . [R]estraining intra-brand competition enhances the profits that outlets earn".

[53] See CRA paper, note 6: "whereas RPM eliminates intra-brand price competition completely".

as an argument for territorial exclusivity within selective distribution systems. As will be shown below, such territorial exclusivity agreements entail significant welfare costs and social risks, their level of efficiency is highly dubious, and they are directly contrary to the Vertical Restraints Regulation[54] and its rationale for granting a calculatedly limited exemption for SDA from Article 81(1) EC Treaty.[55]

38. Moreover, it is wrong to believe (or argue) that VR—be they in form of an RPM or an SDA that removes intra-brand competition—necessarily achieve the optimal investment level by retailers. Investment in inventory, store-front, customer services or well-trained personnel imposes significant fixed and marginal costs on bricks-and-mortar retailers. In the face of VR (and therewith guaranteed higher mark-ups), any rational retailer has a keen interest in adopting a high-price/low-service strategy. The high-service route will only be taken if the costs connected to service investment are considerably and sustainably outweighed by marginal revenue generated by additional sales (ie winning over CRA's passive customers). Such an outcome can be achieved if the service dimension is very important to the vast majority of consumers and the retailer mark-ups are sufficiently high. Yet the supplier cannot raise retailer mark-ups infinitely.[56] The higher the final retail price, the more the supplier loses CRA's active (price-sensitive) customers. It may well be that the supplier's mark-up offers do not tip the cost–revenue balance of service investments for every retailer. Some retailers may thus engage in a high-price/low-service strategy.

39. Looking at SDA only, some additional specific concerns are noteworthy. An SDA, 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.[57] Apart from the fact that

[54] As explained *supra* n 34, retailers within a selective distribution system must be allowed to sell to consumers wherever they are situated within the EU. Through the selection criteria, the supplier can to a limited extent control how the products are sold by setting certain quality standards, but he cannot control to whom the products are sold, ie that the products are only sold to consumers situated in a certain territory. Moreover, retailers must always be allowed to sell to other appointed retailers within the same selective distribution system.

[55] On this, see *supra* nn 32 and 34.

[56] It is noted that the supplier's mark-up offers are connected with a considerable uncertainty. A retailer's service investment is a function of her costs and the mark-up proposed by the supplier. By definition, the supplier does not know the retailer's cost structure connected with her service investment. Thus, the supplier's mark-ups can be too high, leading to revenue losses for the supplier, or too low, resulting in under-investment by the retailer. This shows that offering mark-ups (fixing resale prices) is a very inefficient way of aligning retailers' incentives and inducing service investments.

[57] It goes without saying that such a market situation is quite uncommon, even without considering internet distribution. How can an accredited Cartier dealer in London be certain that his service investment does not benefit another London Cartier retailer?

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.

40. First, an SDA that eliminates intra-brand competition (ie granting exclusive dealerships in segmented markets, possibly coupled with a prohibition of internet sales) creates regional retailer monopolies. As is well known, monopolies create slack—or "dynamic inefficiencies", as economists call it. Monopolies have an innate tendency to result in lack of innovation, high labour costs and high production costs. As the only service provider in their market, exclusive retailers may thus under-serve their consumers.

41. Secondly, exclusive dealerships in segmented markets create the so-called "double marginalisation problem", in which both supplier and retailer act as monopolists. Double marginalisation is detrimental to consumer welfare because prices set by retailers are inefficiently high.[58] An interesting aspect to point out here is that if a supplier enacts an SDA with the objective of effectively overcoming the free-riding problem, then he must impose a maximum price (a price-ceiling) to prevent the double-marginalisation problem. A price-floor, ie a mandated minimum price, is ineffective. The CRA report acknowledges this fact.[59] Yet SDA featuring price-ceilings are a rare animal in supplier–retailer relationship. Thus, it must be assumed that an SDA accompanied by minimum prices has a different objective than that of overcoming free-riding.

42. A third concern about territorial exclusivity arrangements is that they open the door for price discrimination. As demonstrated in section D.1(a) above, at-market pricing allows sellers to appropriate consumer rents in high-demand markets.

43. Fourthly, as will be described in detail below, market segmentation also facilitates foreclosure of actual or potential competitors of suppliers and/or retailers, and is thus able to shut out lower-priced or technologically advanced products.

44. Fifthly, territorial exclusivity facilitates collusion between suppliers in competitive markets with differentiated products (more on this in section D.2(b)).

[58] J Spengler, "Vertical Integration and Antitrust Policy" (1950) 58 *Journal of Political Economy* 347; W Comanor, "Vertical Price Fixing, Market Restrictions and the New Antitrust Policy" (1985) 98 *Harvard Law Review* 983; J Tirole, *The Theory of Industrial Organization* (Cambridge, MA, MIT Press, 1988), ch 4.

[59] To fight double marginalisation, a price cap, not a minimum price, is pertinent (see CRA paper, note 8).

(c) The Heterogeneous Consumer Theory Presents Reasons for Internet Distribution, not against it

45. An alleged second class of theories for VR brought forth in the CRA paper is based on heterogeneity of consumers. To recap, the CRA argument is that suppliers are justified to focus retailers' attention on providing services to win over new (passive) customers, instead of driving a low-price strategy to poach other retailers' active customers. Suppliers thus use VR to align retailers' incentives to enact a price–service mix that focuses on generating new demand and denying benefits to active customers.[60]

46. This heterogeneous consumer approach is not, however, a theory supporting VR, selective distribution or prohibitions of internet distribution. If there are different types of consumers (CRA Assumption A8), and if these consumers can be discriminated between by means of market segmentation,[61] then the use of "differentiated distributors" is the optimal strategy for any supplier. Faced with heterogeneous customers, the profit-maximising supplier will attempt to address different consumer types separately and offer them different price/service packages.

47. Offering products online is an easy way of effectively separating consumers. Remaining in the confines of CRA's axioms of analysis, which, as shown in section D.3(a), are overly simplistic and outdated, we can nevertheless see that utilising internet distribution actually helps suppliers to enact a self-selection of consumers: those consumers who are attracted by a different bundle of services select the internet; those to whom face-to-face service and shopping experience appeal will purchase in the local shopping mall or on the high street. According to CRA's assumption, impulse shoppers will not be attracted by (indeed, in all likelihood will not see) internet offers; their willingness to purchase needs to be "triggered" by means of face-to-face marketing. Impulse shoppers are by definition impatient. Thus, for them, searching and comparing on the internet is costly, as is waiting for the product to arrive. A price-insensitive impulse buyer wants the product now and not in a week.[62] In sum, offering different price–service packages and encouraging customers to self-select should therefore be a winning business strategy for the supplier, and most likely to maximise consumer welfare, but it takes effort—some just prefer to shut out the internet.[63]

60 The argument here is summarised *supra* n 27.

61 After all, if consumers fall into active and passive buyer categories, and passive consumers are driven by impulse and thus attracted by image, shopping environment and services, why should the two groups not be effectively addressed separately?

62 Adopting CRA's logic, an impulse shopper will buy online only if the difference in price between internet and offline suppliers is significant. If that is the case, however, the statement that the core value of the product for the customer is the service dimension becomes questionable.

63 Self-selection and self-revelation of customers is standard business practice in various industries, eg the insurance industry. Customers select their preferred combination of insurance fee and

48. Hence, it can be easily shown that if a rational supplier truly believed in consumer heterogeneity, he would be more likely to adopt a mixed offline and online strategy than to restrict himself to a single distribution channel. Only when and if the supplier cannot effectively segment his customer types at all is the supplier confronted with a problem: as characterised in the CRA paper, retailers may start poaching active consumers from each other, driving down their investment level in services.[64] But this is nothing but a reformulation of the standard free-riding problem. Therefore, the heterogeneous consumer theory is just a simple variant of the free-riding issue addressed above; it adds nothing new to a discussion about VR and the internet.

(d) More Efficient and Less Restrictive Alternatives to Vertical Restraints are Available to Address the Problem of Free-riding

49. VR are only one possible solution to the problem of free-riding. Other mechanisms yield more efficient outcomes at lower costs in terms of social welfare and supplier rents.

50. First, the CRA authors claim that the free-riding problem is triggered by "pure-price" internet retailers who refrain from investing in the service dimension and instead engage in aggressive pricing (CRA Assumption A5 that contracts are incomplete and CRA Assumption A6 that retailers are either bricks-and-mortar or "pure-play" internet retailers). What the CRA authors fail to say is that in this constellation the free-riding externality has a trivial solution, and the imposition of VR is simply unnecessary. Whenever suppliers can easily differentiate between different types of retailer, they can enact a multi-tiered wholesale pricing scheme.

51. In the case at issue, a supplier can simply charge online retailers higher wholesale prices and offer lower prices to bricks-and-mortar retailers, rewarding the latter for their investment in services. As a consequence, offline retailers would continue to be encouraged to make further investments in services and offer the services demanded by consumers.

52. Secondly, the CRA paper also argues that, since service provision by the retailers cannot be observed by the supplier (CRA Assumption A5 that contracts are incomplete), he offers sustainable retailer mark-ups as a tool for aligning retailer incentives with his own. Yet retailer mark-ups and eliminating intra-brand competition are not the most efficient way of bringing retailers to enact

franchise coverage and thereby determine their "type". See, eg P Bolton and M Dewatripont, *Contract Theory* (Cambridge, MA, MIT Press, 2005).

[64] It is noted that such a characterisation is most likely to overstate the case. Even if a supplier cannot perfectly segment consumer types, that does not mean there is no inherent value in trying. Suppliers will have to base their decisions on the probability of successfully segmenting different groups of consumers.

the right price/service mix. If incentive alignment is the true objective of a supplier (monopolist or not), there are better alternatives available, even in the presence of incomplete contracts. Contract theory, and principal-agent models in particular, offers a multitude of approaches to overcoming moral hazard and establishing incentive alignment in the presence of asymmetrical information.[65]

53. The simplest way to address free-riding and ensure that retailers' incentives are aligned with those of the supplier is for the latter to engage in so-called "incentive contracts" with retailers: the supplier and retailer agree to make the wholesale price at which retailers buy the product dependent on effective sales in the store or over the website (either through differentiated wholesale pricing or through supplier payments to support marketing effort). This would act like a transaction-specific subsidy and create incentives to invest in appropriate services and in the image of the brand. Another advantage would be that any lower prices offered by particular retailers would not come at the detriment of lower services: each retailer would determine what margin she required but retailers as a whole would still compete on two dimensions—price and service. As a result, both suppliers and consumers would benefit from this competition and, by default, over time, only those services which consumers actually desire would be provided. The decision as to which services are required would be made, as it should, by customers.

54. Other alternatives include specific payment schemes,[66] increased vertical cooperation (eg franchising), direct supplier investments (shop-in-shop concepts) and consumer segmentation through differentiated distributors. This range of options shows that retailers can be effectively incentivised to provide a jointly optimal level of service without incurring the long list of negative consequences thrown up by VR arrangements.

(e) Conclusion: Even if all Suggested Assumptions are Maintained, the Welfare-enhancing Effects of VR are Dubious; a Cautionary Approach to VR is Warranted

55. Using assumptions identical to those maintained in the CRA paper and using mainstream economic theory, this section has challenged the central hypotheses brought forth by CRA.

56. This section has demonstrated that, even if one is ready to accept the string of assumptions used in the CRA paper, the provision of services is not the

[65] For a general introduction, see Salanié, *supra* n 39.

[66] Payment schemes do not restrict retailer actions (like vertical restraints do), but provide monetary incentives to retailers. Examples are quantity discounts, profit-sharing, fixed fees, royalties and two-part non-linear tariffs. See V Verouden, "Vertical Agreements: Motivation and Impact" in W Collins (ed), *Issues in Competition Law and Policy* (American Bar Association, Antitrust Section, 2008), available at http://ec.europa.eu/dgs/competition/economist/verouden.pdf (accessed on 23 March 2009).

exclusive rationale for instituting VR. The contention that a monopolist is motivated to implement VR purely by his desire to provide his customers with a demanded level of service rings hollow, especially when applied in the context of the EU (it also assumes that consumers never know or cannot be trusted to select themselves the product/service combination they need). Geographic segmentation and the imposition of market entry barriers are more credible explanations for the incidence of SDA and prohibition of online sales.[67] A prohibition of internet sales may well signal the monopolist's attempt to segment the market and to appropriate consumer rents.[68]

57. This section has challenged theoretically the CRA paper's assertion that free-riding is a veritable concern to suppliers. Whether or not in the real world free-riding is a stumbling block for suppliers in incentivising their retailers to provide services is an empirical question, and one that is not addressed by the CRA paper. The CRA authors fail to underpin their assertion with any empirical evidence—indeed, they admit that there is limited empirical evidence that vertical restraints are concluded to fight free-riding.[69]

58. This section has explained that, even if free-riding truly was a major problem for suppliers, any policymaker should take into account the welfare aspects of the proposed remedy of VR. Those forms of VR that may help overcome the alleged externality problem of free-riding must eliminate intra-brand competition, ie must be designed in the form of RPM or SDA coupled with territorial exclusivity—but both of these strategies infringe the Vertical Restraints Regulation and come at significant social costs.[70] In industries where perfect competition between suppliers does not prevail and where both price and non-price dimensions attract consumers, VR may be employed by market-dominant suppliers to effectively segment the market, discriminate against groups of consumers and pocket parts of consumer rents[71]; to fend off competitors; and to facilitate horizontal collusion, or at least depress inter-brand

[67] These theoretical results carry over to demand in multiple dimensions and to non-monopolistic contexts.

[68] It is noted in passing that when demand truly depends on price *and* other factors, the optimal pricing strategy for a monopolist is not the imposition of a VR, but of a two-part tariff, ie selling the product at marginal costs and imposing a franchise fee (see P Rey and J Tirole, "The Logic of Vertical Restraints" (1986) 76 *American Economic Review* 921.

[69] Verouden, *supra* n 66, section V. W Comanor, F Scherer and R Steiner, "Vertical Antitrust Policy as a Problem of Inferences: The Response of the American Antitrust Institute" (2005) AAI Working Paper No 05-04.

[70] An important exception to the above results is the case of perfect competition in the supplier market. In a market characterised by intense competition, vertical restraints do not have welfare effects. If consumers are faced with too high retailer prices, they simply shift to competitors' products. Thus, VR cannot be utilised to engage in abusive pricing.

[71] For the present purposes, a "market-dominant supplier" is one who, by virtue of his brand, image or service, has some kind of market power, because those non-price differences are perceived as important by consumers.

competition. In addition, VR in the form of territorial exclusivity arrangements create local retailer monopolies—to the indisputable detriment of consumer welfare.

59. Moreover, a prohibition of internet distribution alone is utterly ineffective in addressing free-riding, and must be complemented with territorial exclusivity arrangements, which comes at significant risks to social welfare—eg under-provision of services by monopolist retailers, dynamic inefficiency, double marginalisation, at-market pricing and collusion. The immediate consequence for European consumers is higher prices, slower diffusion of new technologies and innovation, lower service levels, restricted access to goods available elsewhere in the EU and the exclusion of certain consumer groups. From a competition policy point of view, these consequences speak against a laissez-faire approach to SDA in general—and to internet prohibitions in particular.

60. Finally, this section has described that there are both trivial solutions to alleviate any significant incidence of the alleged free-riding problem and more efficient and less distorting mechanisms available to align retailers' incentives with those of the supplier. It is safe to assume that suppliers are well aware of the described alternatives. Hence, the imposition of VR casts serious doubt on the supplier's objective to overcome a free-riding issue. This, in turn, puts into question the CRA authors' claim that VR are imposed uniquely with the aim of achieving alignment between supplier and retailer. Regulators are therefore right to treat the free-rider justification for VR with scepticism.

61. All this casts doubt on the central claims brought forth in the CRA paper that there is a legitimate trade-off between low-price/low-service on the one hand and high-price/high-service on the other; that the only options are low-price/low-service or high-price/high-service, whereas the internet can offer low-price/high-service; that VR are a legitimate demand-enhancing business practice, just like advertising; that a prohibition of internet distribution is an effective tool for overcoming free-riding; and that VR effectively have a welfare-enhancing effect on consumers. In the face of the overwhelming theoretical and real[72] evidence of the harmfulness of VR to social welfare, the "normative question" posed by the CRA paper[73] is a non sequitur. Policymakers are well advised to adopt a cautious approach to VR.

[72] An independent study by Frontier Economics, commissioned by eBay, showed substantial price savings for consumers purchasing on eBay platforms compared to offline. Frontier's findings indicated that the average price saving available to eBay buyers in the UK, Germany and France across the 12 product categories included in the study was around 17%. Frontier estimated that total savings when using eBay's European platforms would amount to about €1.1 billion per year. NB: accounts only for goods presently allowed to be sold and would be far higher in the absence of existing internet restrictions.

[73] CRA paper, p 209, para 2–p 210, para 1.

2. The CRA Paper Omits Important Concerns in Connection with SDA and RPM

62. Applying its theories to the case of luxury goods (the CRA paper having been commissioned by LVMH), the CRA paper argues in favour of allowing an exclusion of internet sales as a criterion for appointing retailers of selective distribution systems.[74] The luxury sector is unusual in many ways, eg it is characterised by "monopolistic competition". As demonstrated in more detail below, the CRA authors' arguments do not even work in the context of luxury goods and thus their recommendations should not be considered as the basis for a general approach to VR in any sector.

63. This section shows that the CRA authors conveniently exclude, or at least obfuscate, important negative aspects in connection with VR and SDA. This section also highlights that the CRA authors fail to explain the nature and scope of any countervailing benefits to consumers that VR could entail.

(a) The Risk of Market Foreclosure

64. There is mounting empirical evidence that dominant suppliers and retailers can use SDA as an effective barrier to entry, ie to prevent market entry by competitors, both upstream and downstream.[75] This strategy of foreclosing market access to competitors leads to a reduction in the ability of rival suppliers or retailers to compete fairly in the market at issue. The CRA paper conceals this important argument against the use of SDA.

65. Foreclosure of rival suppliers occurs when a supplier with market power offers an exclusive dealing contract featuring a wholesale price and/or a fixed fee low enough to make it more profitable for the distributor to accept this contract instead of another supplier's. When there are substantial economies of scale and scope in distribution, signing exclusive dealings with a number of distributors raises the distribution costs of other suppliers and reduces the possibilities for new suppliers to reach the market. This is an effective barrier to entry for new suppliers. Less competition creates significant social costs in the form of higher prices, less innovation and less service provision.[76] The more competitive the downstream retailer market[77] and the smaller the market power of distributors,[78] the more likely are exclusive dealings and market foreclosure at the supplier level.

[74] *Ibid*, s C.
[75] See, eg Comanor *et al*, *supra* n 69; Verouden, *supra* n 66, s V, and references mentioned therein.
[76] S Salop and D Scheffman, "Rising Rivals' Costs" (1983) 73 *American Economic Review* 267; W Comanor and H Frech, "The Competitive Effects of Vertical Agreements" (1985) 75 *American Economic Review* 539.
[77] P Rey and T Vergé, "Economics of Vertical Restraints" in P Buccirossi (ed), *Handbook of Antitrust Economics* (Cambridge, MA, MIT Press, 2008).
[78] P Aghion and B Bolton, "Contracts as a Barrier to Entry" (1987) 77 *American Economic Review* 388.

66. Another area of concern in connection with VR is the issue of "dynamic entry". VR affect the competitive structure of an industry. Whereas most of the existing literature focuses on a given market structure (fixed numbers of suppliers and retailers), a recent paper by Reisingert and Schnitzert[79] focuses on market entry and exit of firms. [80] Applying dynamic modelling, this paper assesses the impact of VR on endogenous changes in the market structure, ie the number of retailers and suppliers as a function of the market structure. Reisingert and Schnitzert show that more intense competition in the downstream market improves social welfare in oligopolistic supplier markets. Whenever the supplier market is dominated by a small number of large firms (this is a feature of luxury goods and many other sectors, including the branded consumer goods sectors), the imposition of VR is detrimental to social welfare.[81]

(b) Vertical Restraints in Markets of Monopolistic Competition

67. VR can be used to reduce the level of competition between suppliers and/or retailers. The CRA paper obfuscates the relevance of two anti-competitive motives pursued by VR, namely that of softening competition and that of "cartel enforcement", ie the ability of cartel members to enforce their price-fixing agreement. The CRA paper's review of the theoretical literature does not present a balanced view of VR in the luxury goods industry; it is incomplete and downplays the true relevance of the practices of softening competition (Rey–Stiglitz-type strategic behaviour) and of cartel enforcement (the Jullien–Rey-type behaviour).

68. Rey and Stiglitz, in a seminal article,[82] describe how VR can be used strategically by suppliers as a means to commit themselves to reduce competition among them. The CRA paper downplays the relevance of these findings by bringing three "caveats"[83]—though "caveat" is a somewhat misleading term, since CRA's caveats apply exactly to the luxury goods sector.

79 M Reisinger and M Schnitzer "A Model of Vertical Oligopolistic Competition", Discussion Paper No 228 (Department of Economics, University of Munich, 2008), 1–46.

80 In other words, market entry and exit of firms is not assumed exogenously, but is a result of the model framework.

81 The authors show that more competition in the downstream market has two countervailing effects. On the one hand, suppliers can sell to more outlets, which has a positive effect on sales. On the other hand, competition on the retail market becomes fiercer, which puts downward pressure on the upstream prices. This tends to reduce the number of suppliers. The first effect dominates the second, whenever there are only a few firms active in the supplier market. Hence, an artificial restraint on downstream competition in oligopolistic markets is likely to harm social welfare, because too little competition among them will drive consumer prices up.

82 P Rey and J Stiglitz, "The Role of Exclusive Territories in Producers' Competition" (1995) 26 *Rand Journal of Economics* 438.

83 CRA paper, p 212, para 2–p 213, para 1.

69. As a first caveat, the CRA paper correctly notes that the Rey–Stiglitz results apply to markets with intermediate degrees of inter-brand rivalry.[84] However, this is not a caveat because the market for luxury goods, and indeed most branded products, exactly is such a market of intermediate competition. Hence, the findings of Rey and Stiglitz fully apply to the luxury goods sector.

70. The luxury goods and branded goods sectors are characterised at best by "monopolistic competition".[85] Every manufacturer has market power in its own market, due to unique non-price differences between competitors' products. This non-price dimension can be "brand image", perceived quality guarantees, physical composition or service in general. Due to this product heterogeneity, producers have a degree of control over their prices but no business has total control over the market price, because consumers are still willing to switch from one brand to the other if end prices are too high.[86] Luxury goods fit squarely into this category of differentiated products.[87] The Rey–Stiglitz results are thus fully applicable to the luxury goods sector.

71. As a second caveat,[88] the CRA paper notes that the Rey–Stiglitz findings of competition dampening are most pronounced in the case of territorial exclusivity. This is a correct observation. What the paper does not say, however, is that territorial exclusivity is exactly the measure that CRA defends as a remedy to free-riding and is the objective pursued by internet restrictions.[89] Hence, if the CRA authors really want to advocate territorial exclusivity, coupled with an online prohibition, then they must recognise that the Rey–Stiglitz findings of competition dampening will also be a necessary side-effect of such VR.

72. As a final caveat against the theory of competition softening, the CRA paper notes that this strand of theory is limited to exclusive dealing agreements and does not carry over for cases in which a retailer carries goods of rival suppliers.[90] This is a mis-characterisation of the Rey–Stiglitz findings, which explicitly state that the competition-dampening effect of territorial exclusivity agreements is reinforced by non-exclusive distribution.[91]

[84] *Ibid*, p 212, para 2.

[85] See also para 5 of the Vertical Restraints Guidelines, where it is noted that branding tends to increase product differentiation and reduce substitutability of the product, leading to a reduced elasticity of demand and an increased possibility to raise price.

[86] The concept of monopolistic competition dates back to AK Dixit and JE Stiglitz, "Monopolistic Competition and Optimum Product Diversity" (1977) 67 *American Economic Review* 279.

[87] Krugman, *supra* n 46.

[88] CRA paper, p 212, para 3.

[89] This was discussed at length in section D.1(b) *supra*.

[90] CRA paper, p 213, para 1.

[91] The economic logic is straightforward. Territorial exclusivity has two effects: a competition dampening effect on inter-brand competition, and the double marginalisation problem as a consequence of the retailer monopoly (see *supra* para 41). The double marginalisation problem

73. Jullien and Rey,[92] building on findings of Green and Porter[93] and Abreu *et al*,[94] have formalised the insight that RPM facilitates cartel enforcement (and hence formation), making it difficult for individual suppliers to cheat on any collusive agreement. Why the CRA authors maintain that this theory is "more concrete and empirically more relevant" (than the Rey–Stiglitz theory) is unclear.[95] What is clear, however, is that the CRA paper mis-characterises the relevance of this theory for the case at issue.

74. While it is true that it is RPM more than SDA that facilitates cartel enforcement among suppliers,[96] the paper omits that SDA may very well be used to enforce cartels between retailers. In certain circumstances, retailers can exert pressure on their supplier(s) to impose VR that eliminates effective price competition between distributors, such as preventing internet sales.[97] To its credit, the CRA paper acknowledges this point:

> "The hypothesis that a group of suppliers is being collectively pressured 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 . . ."[98]

75. Yet despite that admission, the CRA authors even go so far as to argue that the internet facilitates anti-competitive tendencies by making enforcement of collusion easier and cartel break-outs more transparent. A prohibition of distribution over the internet, the argument continues, "may even have the opposite effect of making collusion more difficult".[99] This argument is without merit. In order to enforce cartels, suppliers must be able to observe other suppliers' wholesale prices that retailers are asked to pay. Those prices are not published over the internet (or elsewhere); they are highly confidential information between supplier and retailer. On the other hand, retail prices may be available online; yet knowledge of end prices is inconsequential for the enforcement of collusive agreements, except in the case of RPM

harms suppliers. However, where a retailer carries competing brands she cannot raise the price of one good at her discretion because her customers will switch to competing products. This reduces the incidence of double marginalisation, to the satisfaction of the colluding supplier. See also Rey and Stiglitz, *supra* n 82.

92 B Jullien and P Rey, "Resale Price Maintenance and Collusion" (2007) 38 *Rand Journal of Economics* 983.

93 E Green. and R Porter, "Non-Cooperative Collusion under Imperfect Price Information" (1984) 52 *Econometrica* 87.

94 D Abreu, D Pearce and E Stacchetti, "Optimal Cartel Equilibria with

95 CRA paper, p 213, para 2.

96 *Ibid.*

97 See Verouden, *supra* n 66.

98 See CRA paper, p 218, para 1. See also Verouden, *supra* n 66.

99 CRA paper, p 213, para 2 (emphasis in original).

agreements.[100] Also, retailer prices can be readily obtained by suppliers through companies providing marketing intelligence, such as Nielsen. However, we have to applaud the ingenuity of an argument that it is necessary to prohibit online sales so as to promote competition.

(c) Harm to Consumers

76. The CRA authors actively avoid the question whether VR, in general, and the prohibition of internet distribution, in particular, are at all beneficial to consumers.[101] Instead, the paper concludes that, just because VR exist, the outcome must be desirable for consumers (at least the marginal consumer[102]), because the monopolist supplier would not otherwise enact them.[103] This contention is not only highly speculative and perfectly circular, it is also wrong.

77. It is speculative because the only outcome of VR that is beyond dispute is higher consumer prices. The CRA report cites no empirical literature that would prove that customers benefit from higher service provision that would not be offered in the absence of VR. The contention is wrong, or at least myopic, as there are a number of reasons why suppliers may want to enact VR, SDA and a prohibition on internet distribution for selfish reasons and to the detriment of consumer welfare (this was discussed at length above). Finally, it relies entirely upon an assumption that the hostility of suppliers to the internet in particular is both "rational" and bound to serve the interests of consumers. We could devote an entire supplementary article to unpicking that assumption.

78. Thus, the CRA paper pits the highly speculative assumption of consumer benefit from services that they do not choose against real consumer benefits conveyed by internet distribution, such as lower (or at least more transparent) retail prices, extended market access, low information costs and convenience.

(d) Conclusion: Important Negative Aspects with VR and SDA are Left Out; Countervailing Consumer Benefits are not Substantiated

79. Sometimes what is not said matters as much as what is said. The CRA paper fogs the mirrors when not mentioning the relevance of VR-induced

[100] However, under RPM, it is far easier for suppliers to observe the pricing behaviour of other competitors, even without access to the internet.

[101] See, eg CRA paper, p 209, para 2: "Note that this question is not 'does the monopolist act in consumers' interest?'"; "That is, the question is not whether the supplier or consumers always, or sometimes agree on trading off higher prices for greater service".

[102] *Ibid*, p 210, para 2.

[103] See, eg *ibid*, p 204, para 1:

> "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 therefore depend on more than price since only then can a monopolist benefit from the restraints."

collusive concerns in markets of intermediate competition. Both competition-dampening effects and cartel enforcement can result from exactly those SDA that allegedly help suppliers overcome the hypothesised free-riding issue. Strategic behaviour of this kind can be expected to be most prominent in markets of intermediate competition—exactly those markets that prevail in the luxury goods and, more generally, branded goods sectors.

80. Finally, the CRA authors are remarkably coy about any consumer benefits that result from any VR, such as the prohibition of internet retailing. All those factors make a laissez-faire approach by policymakers very dubious—and risky in terms of ensuring consumer welfare.

3. The Set of Assumptions Maintained in the Paper is Excessively Rigid—More Realism is Obtained by Relaxing Them

81. Economic theory often must abstract from reality in order to cut down on complexity and achieve expositional clarity. However, the set of assumptions maintained in the CRA report overshoots the mark. This section relaxes the various assumptions employed by CRA to allow for a more realistic view on vertical restraints. The findings in this section raise even more doubt about the central conclusions of the CRA paper.

(a) Internet Services are Valuable to Consumers and Less Costly for Every Market Participant

82. A particularly unreasonable assumption advanced by the CRA authors is that part of CRA Assumption A3 which stipulates that service only adds to sales if offered by bricks-and-mortar retailers on a face-to-face basis.[104] It is beyond controversy that web presence and online services are appreciated by twenty-first-century consumers. Also, internet services are not costless to provide—though, if properly utilized, they can be more efficient.

83. Consumers appreciate the vast variety of internet services. Today, consumers often inform themselves on the internet prior to shopping (and purchasing) in bricks-and-mortar outlets.[105] FAQ sheets, price comparison,

[104] See, eg *ibid*, p 224, para 2:

> "Internet-only shops would free-ride on the investment made by bricks-and-mortar retailers to increase demand for their products . . . 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 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."

[105] This would represent "online free-riding". In n 48, the CRA paper brushes aside this empirically proven issue (eg S van Baal and C Dach, "Free Riding and Customer Retention across Retailers' Channels" (2005) 19(2) *Journal of Interactive Marketing* 75) by stating: "In fact [online free-riding] is likely to be materially less relevant and easier for the suppliers to monitor and reward."

consumer reports and customising options are just some examples of internet services offered and used over the internet. From a consumer's point of view, the internet permits a leisurely comparison of goods without sales pressure, coupled with around-the-clock pre- and aftersales services.

84. Not only do internet services enhance consumer satisfaction and reduce purchasing costs, the internet is also a good way of reaching out to otherwise under-served, or even untapped, consumer groups or types. Note that in reality there are not just two consumer types (active buyers and passive, or impulse, shoppers; CRA Assumption A8), but a multitude of them. In the twenty-first century, important customer groups can be reached uniquely by means of the internet.[106] An equally important advantage of online retailing is that the internet enables consumers to find special or niche products. If a certain product, size, colour or type is unavailable locally, the consumer may well find the desired product on the internet. Hence, suppliers invested in "pushing out" the demand curve for their products should have a keen interest in offering internet services.

85. Creating and maintaining online content comes at a cost. The creation of a state-of-the-art web presence can cost hundreds of thousands of euros. Moreover, operating a user-friendly and attractive website is a financial and intellectual challenge.[107] Thus, contending that the provision of internet services is by definition inferior to "upscale services" by bricks-and-mortar retailers is an uninformed argument. Further, if properly utilised, internet retailing can be more efficient and online services can create efficiency gains for retailers, since economies of scale and scope can be achieved more easily.

86. Shutting out internet distribution with the claimed objective of preventing free-riding on services is an argument that does not withstand scrutiny. Online retailers provide services that are important to consumers, yet their investments can be more efficient than those of offline retailers. Also, in sectors where the service dimension is important to consumers, online services can enhance consumer welfare by allowing consumers to exercise real choice at their convenience. The internet empowers consumers and is a crucial stepping stone

[106] Many professionals do not have the time or the appetite to go window-shopping in malls or pedestrian zones; some live in remote areas; and some work far away from their home markets. Common to all consumer types is that they rely heavily, if not exclusively, on online shopping.

[107] The main costs in connection with the provision of attractive online services lie in the challenge of creating a pleasant "shopping experience"—a requirement that is mentioned in the CRA paper only in connection with offline shopping: It takes time, effort and skill to target and address individual consumers, to keep users on the site, and to make them purchase products (ie creating a user-friendly website) and return frequently. It is arguably more difficult online to attract and keep a user on the site, because of the very characteristics of the internet: transparency, easy access and the fact that the competition is "just one click away". An online retailer competes globally, not just with retailers geographically close by. Also, online users tend to be impatient: if a website is slow, complicated or counter-intuitive, users readily move on to other sites.

towards a single European market. It puts the consumer in the centre—promoting consumer-driven competition—and it offers valuable services at lower costs, which in turn reduces scope for free-riding.

(b) How Retailer-specific are Services?

87. CRA Assumption A2 states that services can only be provided by (bricks-and-mortar) retailers. An implication of this assumption is that, in the presence of RPM or territorial exclusivity, and if "image" of a brand is a crucial demand factor of goods, a retailer is inclined to invest sufficiently, since the image conveyed depends uniquely on her own behaviour and all rewards will flow back to her alone.[108] This is a very restrictive, if not unrealistic, assumption.

88. In reality, brand image is to a large degree the result of the marketing strategy of the brand owner. Cognisant of this, the community of retailers has relatively low incentives to incur additional investment, since they will in any event profit from the supplier's image campaigns. They will only make further significant investments in the brand if contractually required—which suggests that policing is possible.

89. Moreover, if the service component of a product is an important factor in consumers demand, as is said to be the case in the luxury goods sector, economic theory would predict vertical integration and in-sourcing of services.[109] Suppliers may well provide these services themselves, or at least be inclined to co-invest in retailers' service efforts. Examples are supplier-sponsored retailer trainings, shop-in-shop concepts, deploying promotion teams and co-sponsoring local advertisement campaigns. Direct supplier services can drive down retailers' service investments and their appetite to engage in free-riding (however big that appetite is in the first place).

(c) How Product-specific are Services? The Case of "Supplier Free-riding"

90. CRA Assumption A4 holds that services are brand or product specific. But what if efforts to improve the distribution channel on the part of the supplier also benefit rival suppliers? What if retailers' investments in services also benefit competing suppliers?

91. Commercial or technical training to distributors or retailers' awareness campaigns implicitly benefit competing suppliers as long as they can make use of the same distribution channel (imagine a perfumery carrying many branded

[108] The logic here is that, in the absence of intra-brand competition, customers purchase the good at the store that offers the highest "image factor", because no other store will offer better prices. Those retailers with high "image" are thus rewarded for their investment and manage to "bind" all the clients they managed to attract.

[109] Verouden, *supra* n 66.

scents). These rivals have a keen interest in free-riding on other suppliers' efforts (or the mark-ups they offer to retailers). Without incurring the costs, they can lower wholesale prices to obtain extra market shares. As a consequence, all suppliers can be expected to make sub-optimal investments from the social welfare point of view.[110] Clearly, individual RPM or a prohibition of internet sales does not remedy such supplier free-riding. Only exclusive dealing contracts between supplier and retailers can effectively address the problem of upstream free-riding. Yet, as is mentioned at various instances in the CRA paper, such exclusive dealerships are rarely found in the luxury goods sector.[111] This casts doubt on how seriously such suppliers view free-riding.

(d) Investments in Market Knowledge, Contracting and Monitoring Vastly Reduce the Risk of Free-riding

92. CRA Assumption A5, stipulating incomplete contracts due to hidden action by retailers, is questionable, at least if upheld as categorically as in the CRA paper.

93. First, every contract in history since the Ten Commandments has been incomplete; complete contracts are a theoretical archetype. Thus, the fact that contracts are inherently incomplete does not mean that an investment in better contracts would not pay off for the supplier.

94. Secondly, although the assumption of non-observability is accurate in some instances,[112] a distribution contract between supplier and retailer featuring service investments is not of this kind. The suppliers claim that service provision matters to consumers; thus, services must be generally observable—at least by the consumers, who are expected to value and be happy to pay a premium for them. Why, then, should their delivery not be observable to suppliers if they try? Supplier investment in better market knowledge and in monitoring may pay off in the sense that they diminish the risk of free-riding and thus the need for vertical restraints.

95. By investing in a better contract, the supplier can institute more efficient ways of aligning retailers' incentives to his own. To be sure, simply offering mark-ups and guaranteed minimum prices or offering territorial exclusivity is neither a very creative nor necessarily a very effective way of incentivising retailers to invest optimally in the service dimension.[113] In section D.1(d), profit-

[110] See, eg H Marvel, "Exclusive Dealing" (1982) 25 *Journal of Law and Economics* 1.

[111] See CRA paper, p 213, paras 1–2 (eg "[Situations in which suppliers distribute their products through distinct retail channels] is clearly not the case for many consumer goods", p 213, para 1).

[112] Think of a health insurance contract. The insurer does not know *ex ante* the insurant's "type" due to hidden knowledge, whereas the insurant may know, but not disclose, whether he is a high- or low-risk patient.

[113] See *supra* n 56.

sharing contracts, intricate payment schemes and franchising arrangements were noted as contracting options. In an effort to make the service dimension part of the contract, suppliers could require retailers to provide proof of services invested in and rendered, such as training and further education of their workforce, awareness-raising campaigns conducted or customer-satisfaction surveys launched. This seems to work in franchise systems with controls such as "mystery shopper" visits. In the end, if suppliers cannot be sure the service is delivered, how can they insist on consumers paying for it, eg by imposing RPM?

96. Once the service dimension is part of the contract, suppliers are well advised to find out more about the service efforts undertaken by retailers. Monitoring activities render observable previously unobservable retailer behaviour, such as shirking on services, ie engaging in free-riding. The CRA paper—in a surprising deviation from its earlier assumption to the contrary—actually acknowledges that monitoring is an effective tool for overcoming moral hazard by retailers (and therewith the incompleteness of the contract).[114] However, the CRA authors clearly assume that the only sanction for non-provision of such services is termination of the supply contract, rather than devising a contract that links performance to reward.

97. Another way for suppliers to uncover moral hazard behavior by retailers is an investment in market knowledge. The absence of suppliers' end-market expertise is an implicit assumption maintained in the CRA paper—indeed, this is a very surprising assumption, given that luxury or branded goods suppliers claim to care so much about consumer experience.[115] More intimate market knowledge by suppliers will reduce alleged free-riding behaviour on the part of retailers, because suppliers will be able to deduce more easily their level of service investments from sales effected.

(e) Conclusion: More Reality Exposes VR as a Flawed Business Tool

98. This section has shown that relaxing the assumptions cherished in the CRA report to bring them into line with observable reality makes the incidence of free-riding less likely, and the use of VR a less credible business tool.

99. The image of the free-riding online retailer must be qualified because internet services are neither worthless to consumers nor costless to provide. If

[114] See CRA paper, p 209, para 1:

> "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*" (emphasis added).

[115] If suppliers had an intimate knowledge of the consumer market, ie understood the consumer demand curves of each particular market, they could infer from each distributor's sales figure and retail prices the true level of services that single retailers engaged in.

suppliers are motivated solely by overcoming free-riding, the choice of an exclusion of online services is a flawed business practice. Whenever internet distribution is prohibited, without reference to the objective merits of the retailer, the chances are that overcoming free-riding is not the real reason for action. This finding raises doubts as to the true motives behind suppliers who prohibit online retailing.

100. Depending on the importance of retailer services—be it offline or online services—in the perceived demand of consumers, an investment in better contracts, improved monitoring and better market knowledge can help suppliers make their retailer contracts directly contingent on investments in service. Such direct and targeted measures are indubitably preferred to indirect and welfare-diminishing contracting tools, such as minimum resale prices and overly restrictive selective distribution networks.

101. Moreover, in reality, suppliers can deliver services themselves, thus reducing the scope of the alleged retailer free-riding problem. And if services are industry specific rather than product specific, a ban on internet sales cannot address upstream free-riding between suppliers.

102. This section has demonstrated that there are serious doubts as to the true motives behind suppliers' hostility to online retailing. Witnessing VR would more readily suggest that suppliers are concerned by different, more selfish, motivations than to fight an empirically dubious concept such as free-riding.

E. Conclusion

103. Providing non-price services to customers is not the exclusive aim of vertical restraints—as the CRA authors mistakenly assert. Vertical restraints seem more likely to be enacted with the goals of geographically segmenting the market, raising barriers to entry for competitors, reducing competition between suppliers in the upstream market and maintaining high resale prices. In this sense, vertical restraints can be a tool for better exploitation of monopoly power and anti-competitive zeal—to the unambiguous disadvantage of consumers.

104. The CRA authors' assertion that the exclusive aim of vertical restraints is to align retailers' incentives with those of the supplier (in order to improve the service dimension for consumers) rests on a string of assumptions, one of which is that free-riding between retailers is a veritable concern for suppliers and another that suppliers pursue consumer interest. The true dimension of free-riding ultimately is an empirical question. However, the CRA authors provide no evidence on the scale and scope of this free-riding problem. And our response, on a theoretical basis, questions CRA's contention that free-riding is a significant concern for suppliers.

105. Even if the theoretical free-riding problem bears any significance in the real economy, our response shows that vertical restraints are questionable tools for addressing it. If vertical restraints are to effectively tackle the alleged free-rider problem,they must be enacted in the form of either retail price maintenance or a selective distribution agreement that disables intra-brand competition, ie territorial exclusivity within a selective distribution system. Both schemes are prohibited under EU competition rules; they come at the price of significant welfare costs; and they are sub-optimal measures, since there is no guarantee that they will really align retailers' incentives with those of the suppliers (and even less with those of consumers). A prohibition on internet distribution alone is utterly ineffective in addressing free-riding. For it to be effective, it must be coupled with territorial exclusivity arrangements, a combination that goes against the fundamental idea of the internet and the single market—not to mention its directly detrimental effects on consumer welfare in terms of, inter alia, higher prices, restricted access to goods and the exclusion of certain consumer groups.

106. This response also shows that the theoretical free-riding problem has a trivial solution and the retailer's incentives can easily be aligned with the supplier's, obviating any need for vertical restraints. The supplier can enact a multi-tiered wholesale pricing scheme that rewards retailers for investments in bricks-and-mortar services. It is, moreover, wrong to believe (or argue) that vertical restraints necessarily achieve the optimal investment level by retailers in non-price services. Investment in inventory, store-front, customer services or well-trained personnel imposes significant fixed and marginal costs on the retailer. In the face of retail price maintenance (and therewith guaranteed higher mark-ups), any rational retailer has a keen interest in adopting a high-price/low-service strategy, unless the retailer can be certain that her investments in services will pay off in the form of additional demand for her own stock alone. Instead of VR, there are other mechanisms which yield more efficient outcomes at lower costs in terms of social welfare and supplier rents. The simplest way of aligning retailer incentive is for the supplier to engage in so-called "incentive contracts", ie making the wholesale price dependent on effective sales in the store or on the website. Other alternatives include specific payment schemes, investing in better contracts and monitoring activities, increased vertical co-operation and direct supplier investments.

107. Vertical restraints are a complex phenomenon and the welfare implications of supplier–retailer contracts are highly context-sensitive. CRA does not provide a balanced view of this complex phenomenon. CRA's conclusions do not flow from initially made assumptions, leave out or obfuscate important concerns about vertical restraints, or are based on too confining assumptions.

108. As highlighted by this response, the actual incidence of free-riding, over and above theoretical speculation, is not discussed in the CRA paper. Free-riding may very well not be sufficiently widespread or serious to warrant restrictive selective distribution agreements, which can readily be abused for anti-competitive, collusive and welfare-depreciating purposes. But are we not talking about competition between types of services? DG Competition is therefore well advised to maintain its cautionary approach vis-à-vis vertical restraints. It is also well advised to use the review of the Vertical Restraints Regulation to ensure that real consumer benefits conveyed by internet distribution (such as extended market access, transparency and low information costs, lower retail price and convenience) are not held back by practices alleged to satisfy speculative and unproven consumer demand for certain services. In sum, we should look for a solution that leaves the consumer free to seek out and choose between services, rather than being forced to pay for them.

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Editors' Note

The June issue of *ECJ* is expected to contain a reply to this critique by the authors of the CRA paper.