COMPETITION LAW & POLICY DEBATE

10

Volume 3 | Issue 2 | May 2017

CLAEYS & CASTEELS
PUBLISHING

The Commission's e-commerce sector inquiry – Time to change presumptions on vertical restraints?

Lars Wiethaus
Vice President
Charles River Associates, Brussels and Munich

Simon Chisholm
Vice President
Charles River Associates, London

1. Introduction

In May 2017, the European Commission published the final report on its e-commerce sector inquiry. The sector inquiry aims to, among other things, '*provide insights into the motivation of companies to employ vertical restraints in relation to e-commerce*'.[1] The findings ought, therefore, to give us a better understanding of whether vertical restraints tend to be employed for anti- or pro-competitive purposes. This article discusses the findings with regard to e-commerce in goods from an economic perspective and points to where the findings support possible pro- and anti-competitive interpretations.

In particular, we map out the different economic arguments and policy perspectives, and suggest a framework to assess the findings of the sector inquiry. For the sake of specificity we focus on retail price maintenance ("RPM"), for which the legal and economic context of the pro- and anti-competitive motivations has perhaps been most contentious across jurisdictions. In addition, pricing restrictions or recommendations are noted as being by far the most widespread restraints with over two-fifth of retailers reporting being subject to such restrictions.[2]

We suggest distinguishing three broad motivations to employ RPM. First, RPM may facilitate collusion or exclusion. Second, there are potential anti-competitive effects that do not rely on collusion or exclusion, nor would they necessarily be associated with (countervailing) pro-competitive effects. The reduction of intra-brand competition (i.e. competition between retailers selling products of the same supplier), and resulting higher prices, may be a sufficient motivation to employ RPM. Third, RPM may result in a reduction of *price* based intra-brand competition but with the motivation or effect of enhancing *non-price* based intra-brand competition; the latter effect increases demand for the product (that is to say increases inter-brand competition). We focus on the second (anti-competitive) and third (pro-competitive) motivations to comment on the findings of the sector inquiry.

In that regard one of the most striking findings of the sector inquiry is the suppliers' focus on competition through non-price parameters in contrast to the retailers' focus on price competition. Other findings we shall address in more detail concern suppliers' support of value-added services at the retail level, free-riding as one specific example causing incentive distortions between suppliers and retailers, issues of incomplete contracting particularly with regard to dual pricing between the online and offline sales channel, and the motivations behind retail price recommendations (or RPM) in particular. We

1 *Final Report on the E-commerce Sector Inquiry*, European Commission Staff Working Document, May 2017 ('*Final Report*'), paragraph 56.

2 See *Final Report*, Figure B.35.

address these findings in light of the economic arguments outlined and suggest that the findings of the sector inquiry appear to be consistent with a number of pro-competitive motivations to employ vertical restraints.

The plan of the paper is as follows. Section 2 briefly maps out the broader set of pro- and anti-competitive effects, with the main purpose to distinguish those applicable to the above sketched subset of circumstances. These will be discussed in more detail. Section 3 then takes a look at how the findings relate to the economics and what can be inferred about companies' motivations to employ vertical restrains. Section 4 summarises and draws some conclusions.

2. Economic context

We set out the economic context, focusing mainly on minimum RPM, albeit with reference to other restraints if and where insightful. RPM is probably the most generic and common vertical restraint to sustain high retail profit margins. For instance, whilst selective distribution systems, dual wholesale pricing vis à vis offline and online retailers and online-market place restrictions may all serve to sustain (high enough) retail margins (e.g. for brick and mortar stores), the same objective could be achieved through RPM. Whilst selective distribution systems and online-market place restrictions may be aimed at sustaining a high quality brand image, RPM can serve a similar purpose in that higher retail prices, first, may flag quality to consumers and, second, strengthen those retail outlets which do provide a high quality experience (essentially, by removing price based competition). Needless to say this simplification falls significantly short of addressing all possible motivations for vertical restraints with regard to e-commerce in goods. For example, suppliers may be concerned with their brand image well beyond what is signalled through pricing. That said, we feel that a focus on RPM strikes the best compromise between being comprehensive and sufficiently specific.

Below we discuss motivations for RPM in three broad categories. Within the first category RPM is a facilitating device of rather explicit forms of collusive or exclusionary conduct. We shall be brief here as these motivations do not appear to be closely related to the findings of the inquiry.

A second set of economic contributions explains why suppliers (and retailers) may have an incentive to employ RPM solely to reduce intra-brand competition. Consequently, sales volumes would shrink. The third category explains that RPM, whilst reducing price based intra-brand competition, may stimulate retail competition on other dimensions such as pre-sales and value added services. Consequently, sales volumes would increase.

2.1 Facilitation of collusion or exclusion

RPM can lead to instances where competitive harm is likely to arise, particularly where the restraints support collusion or exclude competitors (or competing distribution channels) from the market.

Vertical restraints can facilitate collusion both upstream and downstream. Upstream collusion can occur as restrictions on downstream prices can give suppliers greater transparency over rivals' wholesale prices, which might otherwise be difficult to observe (due to non-public negotiations), allowing deviations from a collusive outcome to be detected more readily.[3] Downstream firms can also collude by using a common upstream supplier as an enforcer of a 'sham' agreement to restrict prices across products or to share information.[4] Downstream collusion is harmful to consumers and total welfare due to higher prices and restricted output. It is likely to be harmful overall in the upstream case as well where retailers are prevented from responding to changes to their costs and demand.[5]

In addition to these collusive theories of harm, downstream competition can be dampened through use of vertical restraints where a retailer with buyer power forces upstream firms to extend RPM to the whole sector. This can dampen downstream competition and be exclusionary as

3 *Resale Price Maintenance and Collusion*, Jullien, B. and P. Rey, Rand Journal of Economics, 2007, 38(4), 983-1001, and *Why Should Manufacturers Want Fair Trade*, Tesler, L. Journal of Law and Economics, 3, 856-105.

4 See *Retail Price Maintenance: Explaining the Controversy, and Small Steps Towards a More Nuanced Policy*, Bennett, M., A. Fletcher, E. Giovannetti and D. Stallibrass in relation to *Argos Ltd. v. Office of Fair Trading* [2006] EWCA (CIV) 1318 [141], [2006] UKCLR 1135 (Eng).

5 The upstream case is less equivocal as there may be circumstances – for example, where retailers are only restricted from adapting to changes on the demand-side (and not the cost side) – where the impact of the vertical restraint may be ambiguous. See *Resale price maintenance and collusion,* Julien, B. and Rey, P. Rand Journal of Economics, 2007, 38(4), 983-1001.

it can prevent low-cost discount or online retailers from entering, thereby harming consumers and total welfare.[6]

> "Facilitating collusion is an obviously anti-competitive motivation to employ RPM."

These instances are, therefore, typically considered anti-competitive from a legal and economic perspective.[7] However, harm through collusion is predicated on certain assumptions, including uniformity of a given supplier's retail price, the prevalence of industry-wide (fixed) RPM,[8] external sustainability (i.e. no threats to the collusive outcome from outside those colluding such as entry), the ability to punish a firm that does not follow the collusive outcome, and repeated interaction between firms (that allows such punishment). Harm through exclusion requires market power at the supplier or retailer level. In many practically relevant cases these assumptions do not need to be satisfied in order to raise concerns about RPM or vertical restraints (see below). Furthermore, where the assumptions are satisfied – for example, the firms have coordinated to sustain a collusive outcome – the agreements may be captured by cartel provisions under Article 101 TFEU.[9] Finally, collusive and exclusionary theories of harm do not appear to relate well to the settings and motivations that are explored by the sector inquiry.[10] Consequently, we do not consider these particular cases further here.

2.2 Reduction of intra-brand competition as a sufficient motivation

Vertical agreements or contracting in static settings may be motivated without the need to assume collusion or exclusion, or particularly high degrees of market power, or repeated interactions and (coordinated) punishment strategies.[11] Seminal contributions, as outlined below, provide motivations based on a supplier's commitment problem towards retailers, and in the context of bilateral bargaining between suppliers and retailers.

First, with regard to the commitment problem, consider a supplier that has to negotiate non-linear delivery contracts with retailers sequentially[12] Where the supplier makes promises to the first retailer – for example, to restrict its supply or limit its distribution network – it may subsequently have an incentive to 'cheat' on these promises in negotiations with other retailers. Without the ability to credibly commit not to cheat, retailers anticipate that the supplier will subsequently increase supply or expand its retail network in negotiations with other retailers. This reduces the retailers' willingness to pay high fees, preventing the supplier from exercising its market power.[13] Vertical restraints can solve this problem and allow the supplier to fully capture the rents associated with its market power. Specifically, an industry-wide price floor (minimum RPM) can resolve this commitment problem by reducing the prospect of opportunistic behaviour by the supplier.[14]

6 *Slotting Allowances and Retail Price Maintenance: A Comparison of Facilitating Practices*, Shaffer, G., Rand Journal of Economics, 1991, 22(1), 120-135.
7 Such theories of harm can still be subject to possible submissions as the pro-competitive aspects of the policy under Article 101(3) but the prospects of both rebutting the theory of harm and successful efficiency defences may be limited.
8 The Block Exemption Regulation no longer applies where networks of vertical restraints cover more than half the market. Commission Regulation (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, OJ L 102 23.04.2010
9 Treaty on the Functioning of the European Union, Article 101
10 The findings of the sector inquiry do not give hints as for motivations to employ vertical restraints aimed at facilitating collusive agreements, although it does explore the scope for increased price transparency (pages 51 to 54) which may by and itself facilitate the monitoring of collusive agreements. As concerns exclusionary conduct, none of the sectors explored is highly concentrated (page 46).
11 For a summary of these results, as well as extensions to fragmented markets see *Anti-Competitive Effects of RPM Agreements in Fragmented Markets*, Shaffer, G. for the Office of Fair Trading, 2013.
12 A non-linear contract includes, next to a per-unit fee, fixed payments, for example, slotting allowances. A special case of a non-linear contract includes a zero per-unit fee and only a fixed payment, e.g. at the value of the whole supply for a given time period.
13 See *Vertical Integration and Market Foreclosure*, Hart, O. and J. Tirole, Brookings Papers: Microeconomics, 1990.
14 A bilateral price ceiling (maximum or fixed RPM) may also solve the problem by removing the scope for retailer margins. See *Vertical Control with Bilateral Contracts*, O'Brien, D.P. and G. Shaffer, Rand Journal of Economics, 1992, 23, 299-308.

Second, a similar intuition can be expressed in a bilateral bargaining context over linear delivery contracts,[15] where multiple retailers source from multiple suppliers and there is upstream competition between suppliers and downstream competition between retailers. In such a setting, when a retailer has strong bargaining power it is able to negotiate a greater share of the combined surplus of the supplier and retailer. Anticipating this, the supplier focuses on increasing the total size of the available profits, which involves increasing retail prices, instead of pricing with the main aim of competing with its rival suppliers. As RPM increases retail prices across all retailers it lifts pressure from the supplier to concede lower wholesale prices.[16] This can be in the interest of the supplier, as long as the higher prices it sets do not lead to excessively high losses to its rivals (i.e. as long as inter-brand competition is not too strong). There are two harmful effects of RPM: reducing intra-brand competition and reducing the scope for retailers to negotiate a lower wholesale price.[17]

Based on the above contributions, broadly speaking, suppliers may have a unilateral incentive to instigate RPM in order to ensure a certain profit to the retailer, enabling the suppliers to sell at a higher wholesale price. Retailers benefit from reduced intra-brand competition and would therefore accept RPM.[18] In practice, retailers may actually negotiate their own wholesale terms by referring to their own margins attainable given their competitors' retail prices. Thus, retailers may well exert pressure on the supplier; but it is important to note that it would be in the supplier's own interest to reduce the incentive for retailers to bargain for lower wholesale prices even absent any sort of horizontal (or hub and spoke) collusion.

The extent to which a supplier would seek higher retail prices is limited by inter-brand competition with other suppliers: the stronger the inter-brand competition, the weaker the incentive to facilitate higher retail prices. This trade-off is gradual though, as Shaffer demonstrates by extending the above theories of harm towards more fragmented industries.[19] In other words, whilst the extent to which retail prices are raised through (supplier instigated) RPM depends on the relative strength of intra-brand and inter-brand competition, retail prices would always be lower without RPM. It is, therefore, also important to note that this literature provides an explanation for (supplier instigated) RPM absent any efficiencies such as the promotion of non-price based intra-brand competition (or inter-brand competition). Put differently, reduced intra-brand competition *can be a sufficient* motivation alone for RPM. In these situations the demand for the product would shrink and, as a result, RPM would be anti-competitive.

In this context it can seem as if suppliers have no incentive to instigate retail price floors because suppliers would benefit from retail prices being as low as possible (as this increases demand). This is typically true for *given* wholesale prices or margins. However, this logic may fail in the situations described above, in which a supplier's wholesale price or margin increases as the retailer's price or margin increases. In these situations minimum retail price maintenance may lead to higher retail prices and thus enable higher wholesale prices.[20] Given reducing intra-brand competition can be a sufficient motivation for a supplier, it cannot be assumed that where a supplier imposes a vertical restraint without explicit regard to reducing

15 A linear contract is restricted to per-unit fees without fixed payments.

16 Needless to say that this set-up requires retailers to have some degree of bargaining power, justifying a bargaining set-up to begin with. If, to the contrary, intra-brand competition between retailers was perfect, the supplier could simply set a profit maximising wholesale price or extract all profits through a fixed fee (subject to a possible commitment problem).

17 See *The Competition Effect of Industry-wide Vertical price-Fixing in Bilateral Oligopoly*, Dobson, P.W. and M. Waterson, International Journal of Industrial Organisation, 2007, 25(5), 935-962. Conversely, when retailers are in a weak bargaining position and there is limited intra-brand competition RPM can be beneficial to total welfare (although not consumers). In a similar set-up, with non-linear pricing (i.e. allowing for fixed payments between supplier and retailer), RPM agreements can eliminate *all* upstream and downstream competition; minimum RPM enables high retailer margins which can be redistributed through fixed payments between suppliers and retailers; see *Resale Price Maintenance and Interlocking Relationships*, Rey, P. and T. Verge, Journal of Industrial Economics, 2010, 58(4), 928-961.

18 This holds as long as retailers are homogeneous. More efficient retailers or those with different business models (such as online retailers) would not necessarily have an incentive to accept RPM.

19 *Anti-Competitive Effects of RPM Agreements in Fragmented Markets*, Shaffer, G. for the Office of Fair Trading, 2013.

20 This argument is robust with regard to the Chicago view purporting that the vertical relationship between supplier and retailer cannot alter competition upstream or downstream. For example, with perfect intra-brand competition, the supplier could capture the full monopoly profit without imposing a vertical restraint. However, intra-brand competition is not perfect in most practically relevant cases.

inter-brand competition, such a restraint would necessarily be pro-competitive.[21]

> "Suppliers may instigate RPM to offset buyer-power – to the detriment of consumers."

That said, there are a number of pro-competitive motivations which generally coincide with or even necessitate reduced intra-brand competition, which we explain next. On this basis, the extent to which RPM or other vertical restraints are motivated by suppliers seeking to reduce intra-brand competition is an area where there was significant scope for the sector inquiry to provide insights.

2.3 Promotion of non-price intra-brand competition or inter-brand competition

There are a range of pro-competitive arguments for suppliers to impose vertical restraints. When a supplier sells to a retailer, each cares about its own profit only. Yet, efforts by the supplier to increase demand will also likely have a positive effect on the retailer's profits. Similarly efforts by the retailer can impact the supplier's profits. Neither the supplier nor retailer are fully taking account of the impacts of their decisions on the other, which means that together they are not maximising their combined profit. These coordination problems reflect externalities that the supplier and retailer impose on each other. Similar externalities exist between retailers selling the same product. As we summarise below, vertical restraints can solve these coordination problems and potentially align the incentives of the supplier and retailer leading to higher product demand and profits than without the restraints in place. For the purpose of this paper we shall label demand enhancing vertical restraints pro-competitive.

First, vertical restraints can correct for vertical externalities with regard to the provision of retailer services. Retailers provide services that enhance demand of a supplier's product, for example, information and advice to consumers and after-sales support. These services are provided by the retailer but also benefit the supplier. Consequently, the retailer cannot capture the full return on its investment in these services. By not taking into account the benefits to the supplier from its investment, the retailer is likely to underinvest in retail services and instead rely too much on price as a competitive parameter.

This distortion arises because the supplier's focus is on attracting new consumers to its product (regardless through which retailer), whereas the retailer also seeks to attract consumers from other retailers.[22] This in turn hinges on consumers having differing preferences for services and price, whereby retailers compete more strongly for price sensitive consumers. For example, retailers may provide services that reduce the time it takes to purchase a product. Consumers search amongst retailers for their preferred combinations of price and service but shopping between retailers takes time. Those consumers that spend time searching between retailers are more likely to have more free time (or lower costs associated with that time) and so will have a relatively lower appreciation of service (which just reduces purchase time). Thus, the *marginal consumer for the retailer* is more interested in price than service, which means the retailer relies too much on competition on price and sets service levels too low. However, the *marginal consumer for the product* will more likely rely on service and is lost due to inferior service provision. Vertical restraints are a means through which the supplier can improve the levels of downstream service and thus increase demand

21 Winter (2013) suggests for policy purposes that a pro-competitive presumption should apply but this is driven by weighing off the costs of type I and type II errors and noting that RPM would on balance be more likely to be pro-competitive, rather than suggesting that RPM would necessarily be pro-competitive absent collusion or exclusion. See *Competition Policy and Vertical Restraints*, Winter, R., 2013, forthcoming in *Competition Law and Economics: Beyond Monopoly Regulation*.

22 Another vertical externality that can be removed through vertical restraints is double marginalisation. Where a supplier and retailer both have some degree of market power, each firm adds a mark-up to its costs. In setting its price the retailer takes account only of the costs and benefits to itself of doing so, ignoring the impact on the supplier. This leads to higher prices than would otherwise be the case. RPM (through a price ceiling) enables the supplier to ensure the combined costs and benefits are taken into account in setting prices. Price ceilings are usually not illegal and the motivations can be assumed pro-competitive.

for its product. RPM can protect retailer margins: as the wholesale price is lowered and RPM is imposed, the retailer benefits from increasing service levels on a unit by unit basis.[23]

Second, vertical restraints can correct for horizontal externalities in the supply of retail services. Investment by one retailer in services may also confer benefits on other (rival) retailers, which the retailer does not capture when maximising its own profit.[24] Consequently, market demand (as pursued by the supplier) is relatively more sensitive to service relative to price than individual retailer demand. Service is again under-provided by retailers relative to what would be optimal for the supplier.[25] Vertical restraints can address these externalities and allow the supplier to increase demand for the product.

> "Reduced intra-brand price competition can increase total demand for the product."

The rationale in these circumstances is driven by the extent to which the retailer can appropriate its investments. Some investments, for example car parking facilities, will be unlikely to benefit rival retailers. However, other services, for example where the retailer invests in a showroom, displays and pre-sale technical support, may be more difficult to ensure a return given the investment. A retailer without these investments is able to offer discounted prices and may free-ride on these investments. Consumers may obtain the service offered by the retailer that has investment in the showroom or expertise but pay the lower price at a retailer which has made no investment. This free riding problem may motivate suppliers to introduce vertical restraints.

Internalisation of the externalities outlined above will always be in the suppliers' interests. Importantly, while free-riding is the most well-known of these arguments, it is *not a necessary requirement for pro-competitive vertical restraints*. Each of these cases stems from the additional concern of the retailer on consumers that switch from rival retailers (i.e. intra-brand competition), rather than just those that are considering purchasing the product (i.e. entering the market). The former tend to value service less so the vertical restraint allows the supplier to restrict intra-brand competition and increases the service level investment by the retailer (and the overall demand for the product).

2.4 Brief preliminary conclusion

We considered above a range of motivations for RPM: to facilitate collusion or exclusion; to solve a vertical contracting problem solely as a means to reduce intra-brand competition; and as a means to align supplier and retailer incentives in balancing price and non-price competition. One of the main challenges is to distinguishing vertical restraints with regard to the second and the third type of motivations.

To the best of our knowledge there exist no models which allow for both (i) RPM to be profitable to suppliers on a standalone basis (that, is, without a secondary collusive or exclusionary effect, i.e. the second strand above) whilst (ii) allowing for both price and non-price means of competition (i.e. third strand). Such modelling would help to better understand and disentangle the conditions under which RPM, on balance, could be expected to be anti- or pro-competitive. Intuitively, it seems that regardless of whether a supplier is motivated to instigate RPM mainly in order to dampen intra-brand competition or to align retailers' incentives to engage in non-price competition, the latter will always be a consequence of the former. Therefore, indeed, alignment of incentives between supplier and retailer with the aim of inducing retailer sales efforts can, in principle, be a sufficient condition to have a positive stance at RPM.[26] However, for such a conclusion incentive distortions would need to be material to begin with whilst vertical contracting would need to be an effective tool to

23 See *Vertical Control and Price versus Non-Price Competition*, Winter, R.A., Quarterly Journal of Economics, 1993, 108(1), 61 - 78.

24 See *Resale Price Maintenance and Quality Certification*, Marvel, H.P. and S. McCafferty, Rand Journal of Economics, 1984, 15(3), 346-359.

25 This case can also be viewed as a special and particularly pronounced form of a vertical externality, whereby the horizontal externality induces or magnifies the vertical one.

26 See *Competition Policy and Vertical Restraints*, Winter, R., 2013, forthcoming in *Competition Law and Economics: Beyond Monopoly Regulation*.

restore incentives to such an extent that overall output would likely increase (compared to a counterfactual with a ban on the vertical restraint/ RPM).

3. The findings of the sector inquiry – any help?

Above we have delineated different motivations for firms to employ vertical restraints. These include vertical contracting aimed at increasing retail margins; that is decreasing price-based intra-brand competition. Under certain conditions the reduction of (price-based) intra-brand competition may be profitable by itself both for suppliers and retailers. In most if not all circumstances reduced (price-based) intra-brand competition enhances *non*-price intra-brand competition. If a supplier instigates RPM for this reason, then the increase in non-price competition in the form of higher sales efforts outweighs the effect of higher prices and thus increase demand for the product.

The results of the sector inquiry do not give many hints as for the possible motivations to employ vertical restraints to reduce intra-brand competition in itself. For instance, there seem to be no questions aimed at exploring the prevalence and/or severity of possible commitment problems or suppliers' intentions to employ restraints in order to improve their bargaining position vis à vis retailers.[27] This seems like a missed opportunity to better understand and document motivations that lack pro-competitive purposes.

However, the results address a number of issues in relation to possible pro-competitive motivations. As concluded above, economics tentatively supports a proposition that if (i) retailer incentives are strongly distorted towards neglecting non-price based sales efforts; and (ii) vertical restraints function to restore these incentives, these conditions may suffice to expect an overall pro-competitive effect on the market. Therefore, while observations concerning these two factors may directly hint at pro-competitive motivations, conversely, the lack of such observations would underpin the remaining likelihood of anti-competitive effects.

With that in mind we draw out some interesting results from the inquiry findings and relate them to the economic literature reviewed above, again focusing primarily on retail price maintenance.[28]

3.1 Incentive distortions between suppliers and retailers

One of the most striking results concern the assessment of the importance of competitive parameters by different players including manufactures, retailers, marketplaces and price comparison tools. In line with the economic literature discussed above, suppliers are most concerned about non-price competition. Almost all suppliers consider quality to be either the most or second-most important factor affecting competition with other suppliers followed by other non-price parameters such as brand, innovation and product novelty as well as pre- and/or after-sales services.[29] Price is only ranked fifth with around 20% of suppliers considering it highly important.

In contrast, price is the most important means of competition for retailers whether it is hybrid or pure online players. Consumer service is considered relatively unimportant by hybrid and especially by pure online players.[30] Needless to say caution is warranted when interpreting these high-level results without knowledge of the underlying distributions and end-user preferences. Yet, if anything, the results would seem to support a fundamental incentive distortion between suppliers and retailers, in line with the economic intuition that suppliers seek to increase marginal demand for their *products* more through non-price parameters (than price), including (pre- and/ or after-sales) service levels at the retail level, whereas retailers seek to increase marginal demand for their *outlets* more through price competition (than non-price). As discussed above in such a situation stronger price competition at

27 The only hint is given through responses of suppliers as to why they employ retail price recommendations (paras 569 to 572 of the *Final Report*), see below. Possibly more specific questions were asked, whereas answers are subsumed under "Other".

28 Needless to say that the list of findings is not exhaustive.

29 Specifically, over 70% of suppliers (the Commission use the term manufacturers) responding considered quality to be highly important while branding was considered highly important by over 60%, and innovation by around 40%. See Figure B.13, page 45 of the *Final Report* for an overview of these results.

30 Specifically, around 40% of hybrid (online and offline) and 50% of online-only retailers responding pointed to price as highly important, while quality was considered highly important for only around 25% of both categories of retailers. Range was considered highly important by 20% and 30% of hybrid and online-only retailers respectively. See *Idem*, Figures B.14 and B15, pages 46 to 47.

the expense of non-price competition may lower total demand for the supplier because, at the margin, stronger non-price competition would increase the *amount* of goods sold, whereas stronger price competition only determines *where* goods are sold.[31]

> "The main empirical challenge is to identify whether RPM increases or decreases total demand for a product.."

Interestingly, online marketplaces seem to strike a more balanced view on the importance of non-price and price competition, rating the range of available products, their image and user-friendliness most commonly as highly important, followed by pricing. All of these parameters are considered as highly important by more than 70% of marketplace respondents.[32] From this viewpoint, incentive distortions between suppliers and marketplaces appear less pronounced at least considering a simple binary distinction between price and non-price factors. In particular, consumers may select their preferred marketplaces based on search quality ("user-friendliness") and the likelihood of finding and being able to order a desired product ("range of available products"). As such marketplaces need to compete more strongly on non-price dimensions in order to attract marginal consumers to their site. In that regard suppliers' and marketplaces' incentives would actually appear more aligned than those between suppliers' and online retailers. Vertical restraints such as RPM or marketplace bans may therefore appear poorly motivated by missing lack of incentives of marketplaces to engage in non-price competition.[33]

3.2 Suppliers' support of value added services at the retail level.

Against the above background it is not surprising that the majority of suppliers (85%) consider value added services offered by retailers (in particular pre-sales services such as showroom presentation by dedicated staff, consumer support and call centres) to be important to increase demand for the brands/products. Moreover, almost every supplier underlines the importance of providing expert advice to consumers.[34] Out of these, again, the majority of suppliers employ measures which are consistent with the aim to promote value added services at the retail level. Such measures may fall into two categories.

First, the great majority of suppliers that consider value added services important employ policies to protect retail margins. In particular, three-quarters sell their products through selective distribution systems (or exclusive territory restrictions), and 85% recommend prices to retailers or wholesalers.[35] Again, these findings would appear consistent with pro-competitive rationales. In this context it would also be interesting to see to what extent such measures are employed by suppliers who do *not* consider value-added services important. If measures such as retail price recommendations are more important for suppliers that rate value added services highly than for those that do not, one may infer that price recommendations are driven by pro-competitive motivations rather than anti-competitive ones.

31 Even if, at the margin, stronger non-price competition at the expense of softened price competition increases demand, the effect on consumer welfare is not clear. Clearly, consumer welfare increases for the marginal consumers who would not have bought the product otherwise. However, infra-marginal consumers (i.e. those who would have bought anyway) are more price sensitive, caring relatively less about non-price competition. Therefore, even if the rebalancing of non-price to price competition increases demand at the margin, the impact on consumer welfare cannot be predicted.

32 Specifically, range was considered as highly important by around 85% of marketplace respondents, and around 80% flagged marketplace image and user-friendliness as highly important. A range of other non-price parameters include availability of latest product models, consumer services (including complaints' handling), number of sellers, delivery services, consumer reviews, return policy and frequent buyer schemes are rated as highly important or important. See *Final Report*, Figure B-16, page 48.

33 Indeed, the reasons for marketplace restrictions mentioned by suppliers include (i) the protection of the image and positioning of the brand, (ii) combating the sale of counterfeit products, (iii) ensuring sufficient pre- and retail services, (iv) protection of existing distribution channels and brick and mortar shops/free-riding and (v) concerns about the market position of certain marketplaces. *Idem*, paragraphs 478 to 487.

34 See *Final Report,* paragraphs 280 (value added services) and 284 (expert advice).

35 *Idem,* paragraph 281. In contrast to RPM, retail price recommendations are legal. The extent to which firms employ recommendations, however, may hint to the extent to which firms would employ RPM if it was legal.

Second, suppliers may directly require or incentivise certain forms of retail services. These may include training, the provision of product information, a certain shop design (offline), high resolution photos or videos (online), etc. Half of the suppliers indicated that they provide incentives to retailers to enhance the quality of customer services.[36] These incentives may include material support (such as in-store materials, manuals, catalogues, marketing material, sample products), non-material support (in the form of trainings) and financial support (such as rebates, bonuses and cost-sharing agreements).

As an intermediate conclusion, incentive distortions between suppliers and retailers appear ubiquitous. This follows from economic modelling under a set of weak and plausible assumptions and is confirmed by the results of the sector inquiry. Suppliers take steps to address this incentive misalignment through supporting provision of services by retailers. Thus far we have addressed this issue broadly as it may apply to pure offline and/or pure online markets. Next we turn to *one* specific and particularly clear-cut *example* of this problem, free-riding, which can aggravate distortions particularly due to competition between offline and online retailers.

3.3 Free-riding

Free-riding issues as described above have become increasingly prominent as internet penetration and expanded online product sales mean that competition between online retailers and those with physical outlets has increased with physical outlets generally investing in retail service not provided by online retailers. [37]

According to the results of the sector inquiry 45% of suppliers consider free-riding, whereby consumers benefit from services offered by brick and mortar shops to make their choice but then purchase online, is common (35%) or very common (10%). An additional 27% consider this happens occasionally.[38]

Interestingly, free-riding appears about equally common the other way around, whereby consumers may inform themselves online and then purchase offline.[39] Crucially though, even though free-riding may go both ways, it is reported to be a bigger issue with regard to offline services as these are more costly. This holds especially for brick and mortar shops, which are often required to be at good locations, as well as requirements for specific facilities and training of staff. Moreover, efforts and investments by offline retailers are considered to be more incremental than those by online retailers (measured by their impact on the marginal costs of selling); therefore free-riding on offline efforts would be more distortive than free-riding on online efforts.[40]

The relevance of free-riding is further underlined through the various measures employed in order to mitigate them. These measures include compensations,[41] direct provision of material and training, recommended retail prices and/or online-offline price equivalence, overall equivalence between online and offline (ensuring a 'level playing field'), vertical integration of suppliers into retail, selective distribution systems and/or exclusion of pure online players, requirements to sell certain amounts offline and the opening of showrooms.[42]

It follows from the above that suppliers employ different measures to induce additional sales efforts of retailers. Among them are measures aimed at increasing retail margins (retail price recommendations and selective distribution systems). These measures are contentious from an antitrust perspective.[43] However, suppliers face limitations to efficiently induce value-added retail services through alternative measures alone. This conclusion follows due incomplete contracting, which we address in turn.

36 *Idem*, paragraph 292.

37 Despite the much broader set of possible incentive distortions concurrent case law seems to focus on free-riding as the only means to potentially justify vertical restraints under Article 101(3) TFEU. See for example the *Bundeskartellamt's* decisions in the *Asics* case (Decision of 26 August 2015 (Case B2-98/11).

38 See *Final Report*, paragraph 313.

39 Around two-fifths (42%) of the respondent suppliers consider free-riding by offline retailers on services by online retailers is common (32%) or very common (10%), whereby another 20% consider this practice occasional. *Idem*, paragraph 314.

40 *Idem*, paragraphs 318 to 319.

41 As mentioned above, 36% of suppliers provide compensation to offline retailers for their offline shops and services. The same proportion of suppliers offer compensation to online retailers. The average amount of offline versus online compensation is not mentioned. *Idem*, paragraph 323.

42 *Idem*, paragraphs 323 to 331.

43 Especially, if retail price recommendations turn into explicit or implicit forms of minimum retail price maintenance.

3.4 Incomplete contracting

As reported above, from the perspective of suppliers, retailers are too focused on price competition, which reduces their incentives to engage in non-price (service) competition; in turn this may reduce overall demand for the supplier's product. Incentives could be aligned by measures that ensure sufficiently high retail margins: RPM, selective distribution, or dual-pricing with regard to online and offline sales. These measures are largely illegal. In theory, suppliers could support retail efforts directly through financial compensation or other direct measures, contingent on retailers' efforts. Indeed, as reported above, suppliers employ multiple such strategies.

However, whilst higher retail margins can essentially fully align suppliers' and retailers' incentives, alternative measures will not. In particular, retailers will probably not turn down direct (lump-sum) compensations for brick and mortar outlets, facilities, training, etc., but such compensations do not affect retailers' incentives to attract the marginal consumer (i.e. to go 'the extra mile' for each and every unit). The results seem to confirm these issues in different contexts.

First, there seems to be a general perception among suppliers that they have to monitor the level and/or quality of sales efforts.[44] Not surprisingly, monitoring efforts and hence costs increase the more suppliers participate financially. Monitoring takes the form of random checks, regular visits, inspections and carrying out shop satisfaction surveys as well as mystery shopping.[45]

Second, the limitations to contracting and monitoring also emerge in the context of dual (wholesale) pricing for offline and online channels. As these are perceived to be hardcore passive sales restrictions according to the Vertical Guidelines, they seem to be largely avoided.[46] However, the Commission has used the Final Report to clarify the legal position on dual pricing, as this was one of the issues most commented on in responses to the consultation on the inquiry. The *Final Report* considers that charging different wholesale prices to different retailers is permissible and a normal part of the competitive process while dual pricing for sales made online and offline to the *same* retailer is a hardcore restriction.[47, 48]

Legally, the supplier is allowed to provide the retailer with a fixed fee to support offline and/or online sales efforts. However, the results of the sector inquiry indicates that the granting of a fixed compensation for higher costs of offline channels faces practical difficulties as it requires knowledge about the costs of services performed by the retail staff (for a certain brand), suggesting that suppliers cannot simply revert to less anti-competitive means to the same end: The retailer would have to compute these costs for each sale to each brand, thus creating significant inefficiencies in retailing.[49] These considerations underpin the imperfections in writing and monitoring contracts aimed at supporting sales efforts through direct financial support. Indeed, many respondents to the consultation sought more flexibility for performance-related price reductions, discounts or bonuses allowing for differences between the online and offline channel.[50]

3.5 Retail price recommendations/ maintenance

In terms of specific types of conduct (minimum) retail price recommendations or maintenance appear the most generic way of reducing price-based intra-brand competition.[51] According to the

44 This is confirmed by a share of 66% of suppliers. *Idem*, paragraph 281.

45 *Idem*, paragraph 300, whereby the most important tools would be visits and monitoring shopping.

46 Only 2.5% of retailers reported that they pay a different price depending on whether the product would be sold online and offline. *Idem*, paragraph 595.

47 *Idem*, paragraphs 595 to 597.

48 The *Final Report* also makes a point of noting that the Commission is open to consider efficiency justifications under Article 101(3) TFEU in relation to dual pricing arrangements, for example, where sales via one channel leads to substantially higher costs for the supplier than sales through the other channel and where dual pricing is indispensable to address free-riding with regard to retailers that sell both online and offline (i.e. these retailers can be subject to free-riding by other retailers reducing their incentives to invest in their 'bricks and mortar' sales proposition). See *Final Report*, paragraphs 600 to 601.

49 These results were noted in the *Preliminary Report on the E-commerce Sector Inquiry*, European Commission Staff Working Document, September 2016 ('*Preliminary Report*')., paragraph 547 but were not included in the *Final Report*.

50 Further detail on suppliers concerns were provided in the *Preliminary Report*. Supplier apparently expressed an interest to '*incentivise retailers to sell more and do not grant them an* 'ex ante' *fixed benefit (with an up-front reduced wholesale price). Suppliers would rather link such benefit to the actual level of services or other investments that will have played a role in the level and quality of the generated sales*.' This statement seems slightly conflicting in that lower wholesale prices (at least at given retail prices) only benefit retailers precisely if and when they sell more. See *Preliminary Report*, paragraph 548. These specific results were not included in the *Final Report*.

51 The Block Exemption Regulation permits suppliers to set non-bind-

results, 38% of retailers reported that suppliers recommend retail prices while four out of five suppliers report using price recommendations.[52] Furthermore, nearly 30% of suppliers indicated that they systematically track the online retail prices of their products sold via independent distributors. Retailers indicated they comply with the recommended prices, either to obtain a higher margin or through the explicit threat or fear of retaliation or punishment from the supplier.[53]

The reasons for providing recommended prices indicated by responding suppliers can be reconciled with demand enhancing motivations and reasons that, in isolation, would likely be demand reducing. In terms of potentially demand enhancing motivations brand and product positioning are mentioned, as well as the support of brick and mortar channels by preventing online prices to fall below a certain level; more generally suppliers seem to care about ensuring a certain profit margin for retailers and addressing structural differences between the online and offline channels.[54] These motivations seem consistent with an intention to promote non-price competition at the retail level, as discussed above.

However, suppliers also quote motivations which, in isolation, would point precisely to demand reducing effects. In that regard several suppliers refer to retailers' strong bargaining power and requests for guaranteed profit margins or compensations for lower profit margins.[55] This evidence is consistent with the prediction of the bargaining models outlined above: "*Guaranteed profit margins and occasional compensation of losses or decreased profit margins may put increasing pressure on suppliers to ensure a minimum retail price level throughout their distribution network and thereby minimise the risk of compensation to retailers.*"[56]

Unfortunately, the results do not reveal the frequency of the different types of motivations; nor do they reveal whether demand reducing motivations prevail in isolation or conjunction with possibly demand enhancing effects.

4. Conclusion

This paper reviewed a number of the findings of the e-commerce sector inquiry and assessed whether the underlying motivations appear in line with pro- or anti-competitive motivations.

> "All in all, if anything, the findings would not appear to support a (de-facto) non-rebuttable presumption of illegality of vertical restraints including RPM."

We focus on a simple economic framework: Pro-competitive motivations are aimed at aligning suppliers' and retailers' incentives with the effect of expanding the sales of the supplier's products across all retailers and channels. This may occur in relation to reduced price based intra-brand competition; that is the restraint may lead to higher retail prices but enable stronger and/or additional competition on non-price dimensions. In contrast, anti-competitive motivations are not aimed at output expansion. Suppliers may have an incentive to ensure higher retail margins, provided that their own wholesale margin increases in the retailer's margin (as for instance in bilateral bargaining situations). Driven by such motivations alone, sales would decrease. Pro- and anti-competitive motivations are not mutually exclusive though. Even if a supplier would instigate RPM with the main purpose of enforcing higher margins, higher retail margins may still enhance non-price based intra-brand competition and eventually expand sales. Whether pro- or anti-

---

ing recommended retail prices. However, where the supplier attempts to enforce the recommended prices in any way, this is likely to be considered illegal and treated as equivalent to a hardcore restriction. See, for example, the *Bundeskartellamt's* decisions in the recent furniture RPM case (Decisions of 3 August 2016 (Case B1-164/13); 4 November 2016 (Case B1-167/13); 30 November 2016 (Case B1-87/14); and 15 December 2016 (Case B1-47/15).

52 *Final Report*, paragraphs 557 and 559.

53 *Idem*, paragraphs 584 to 586. The proportion of retailers highlighting each of these very different motivations for compliance are not provided.

54 *Idem*, paragraphs 562 and 567.

55 *Idem*, paragraphs 570 to 571.

56 *Idem*, paragraph 572.

competitive effects dominate is driven by the question of whether output expands or shrinks, respectively, as a result of the restraint.

[Shout-out box: All in all, if anything, the findings would not appear to support a (*de-facto*) non-rebuttable presumption of illegality of vertical restraints including RPM.]

Naturally, the published results do not provide for sufficient detail and granularity to derive definite conclusions on whether pro- or anti-competitive purposes dominate. However, in our view the results lend considerable support to pro-competitive motivations. First, the results support substantial incentive distortions between suppliers and retailers: suppliers care a lot about non-price based competition whereas retailers mainly compete on prices. Second, consistent with this, the sector inquiry provides ample indications of suppliers engaging to support non-price based competition – whether it be by means of direct retailer support, financial contributions and/or recommended retail prices. With regard to retail price recommendations in particular, the inquiry quotes both pro-competitive motivations as well as those driven by suppliers' desire to relieve pressure in their negotiations with retailers. All in all, if anything, the findings would not appear to support a (*de-facto*) non-rebuttable presumption of illegality of vertical restraints including RPM. Rather, the overall picture drawn by the results supports a policy ensuring that a presumption of illegality is truly rebuttable.

It would be useful where more granular results from the inquiry do exists that these are made available.[57] On the basis of the published results, no conclusions can be drawn about the relative importance of different motivations. In addition, the report reveals only few positive insights as for potentially anti-competitive motivations. Mostly these have to be thought of as residuals contingent on a lack of pro-competitive motivations, although it is not always clear of those respondents that employ a certain restraint what proportion did not note a pro-competitive motivation; nor is it clear what the full set of underlying motivations are. More detail on the latter would confirm that certain aspects were included in the research but positively dismissed by the respondents. More generally, the publication of the detailed anonymised survey results by the Commission alongside the Final Report would be insightful. Finally, one would wish to see more contingencies in the results. For instance, contingent on a supplier aiming to promote non-price based competition, *or not*, what is the propensity to employ certain vertical restraints? Put differently, if firms do employ certain vertical restraints, are these firms likely to care substantially about stimulating sales efforts (indicating vertical restraints are introduced with pro-competitive motivations, and vice versa)?

The e-commerce sector inquiry followed previous work undertaken by Member States[58] and so hopefully continued research on the prevalence and motivations for vertical restraints will provide more detail and insights that may enable competition authorities to more comfortably reconsider hardened presumptive positions on the competitive impacts of certain restraints.

-

All opinions expressed are solely those of the authors and should not be attributed to CRA or any of its clients. We are grateful to Ralph Winter for helpful comments on aspects of the article but any shortcomings are the sole responsibility of the authors.

57 See for instance on retail price recommendation (paras 562 to 572) or motivations for retailer compliance (para. 584 to 586).

58 See *Vertical Restraints: new evidence from a business survey*, UK Competition and Markets Authority, March 2016