Selective Distribution and Restrictions of Online Commerce: *An Economic Perspective*

Dr Cristina Caffarra

CRA Charles River Associates

IEJE-FEB Competition Day on Vertical Restraints and Distribution Agreements

30 September 2009

Overview

- *Restrictions of branded sales through (internet-only) outlets*
  - *Legitimate efficiency rationale…*
  - *…or "attempts by entrenched manufacturers to increase profits through market segmentation, depriving consumers of benefits of the internet"?*
- Insights from economic analysis on selective distribution networks
- Is the internet fundamentally different as a distribution technology?
- Could the same efficiency goals be achieved by other means?
- Positioning in the Guidelines confirms real policy goal remains not so much efficiency, but market integration
- Guidelines do not make clear enough statement of presumption in favour of VRs, and that burden should not be on parties to demonstrate efficiencies but rather on complainants/agencies to prove anticompetitive effects

Insights from economic analysis into selective distribution

- Why would brand owner want to restrict *intrabrand* competition?
  - *Costly* to manufacturer to leave margin to the retailer: upstream firm should want its retailers to compete and make no margin (so can extract all profits)
  - Manufacturer can only have interest in ensuring a margin for the retailer if this creates **incentives for <u>sales-enhancing</u> activities that manufacturer cannot control *directly***
- Long recognised efficiency rationale: reward retailers' effort and protect in-store investment from free-riders
- Extensive empirical economic research shows VRs reduce intra-brand competition *but* also increase sales – positive effect
- Economic literature has identified some anti-competitive effects of VRs, e.g. foreclosure stories, raising rivals' costs and possibly collusion – *no economist in this debate says otherwise!*
- However they apply under fairly specialised circumstances

Contrasting view

– Free riding story overstated…
– Consumers do not attach much value to visiting outlets (including "luxury")…
– Unlikely anyone would get product demo in the store and then buy online…
– Selective distribution is a key "threat" to realising benefits of the internet

But *image, shopping experience, sampling and matching* are key requirements for some goods

– Incentive problem: avoid deterioration of product image and shopping experience (which consumers *value*), and long-term consequences of "bad matching" (loss of customer)
– Need to control shop quality, ensure retailer carries full range, staff provides feedback advice.. .**monetary incentive needed**
– Because amount and quality of some sales effort is hard to monitor and cannot be measured directly, **incentives tend to condition on *results* of the effort: retailer gets extra margin for extra sale made**

- **Is the internet so different this logic does not apply?**

What is so different about internet as retailing technology?

- Low search cost, low cost for basic transaction, unlimited shelf space
- But difficult for brand owners to control systematically “image” and “sales environment” projected by internet outlets. Also, poor opportunities for product matching and personalised advice
- Different e.g. for domestic appliances or consumer equipment
  - Subjective assessments of aesthetic value less important than objective info about characteristics performance – retailing for these already shifted largely to the internet
- What about re-orders? Matching less important, internet convenience here matters…
- But using both technologies **can pose same problem as discount stores** to upmarket brick-and-mortar outlets
- Economic analysis *not* fundamentally different because different sales technology is involved.

Restrictions observed in practice *directly* motivated by free riding concerns, and policy problems with alternative solutions…

- e.g. selective distribution agreements for luxury products typically include three restrictions on internet retailing, clearly aimed at addressing perceived free riding issues
  - (a) Only retailer with authorised bricks-and-mortar presence can be active as an internet retailer (*no pure internet retailing*).
  - (b) *No discounting*: same price for internet sales as in bricks-and-mortar store.
  - (c) *Quantitative restrictions* on internet sales with a maximum share of internet sales in total sales for a retailer
    - Otherwise retailer could qualify as authorised internet retailer by having a single retail outlet that satisfied all requirements set by the manufacturer, and then set a low price for *both* brick-and-mortar and internet shop. Retailer would meet the relevant contractual conditions, but make most business on the internet.
- While exact proportion can be debated, quantitative limitation is exactly what economic analysis suggests as natural response to free riding issues when other options are unavailable

Alternative efficient solutions to the contracting problem?

- Economic analysis suggests in principle alternative solutions…
- e.g. Differential wholesale pricing for brick-and-mortar stores and pure internet retailers
  - Internet retailers could pay a *higher wholesale price*, as bricks-and-mortar retailers could get a per-unit discount on wholesale price to guarantee them additional margin – to be interpreted as a compensation for cost of sales effort
- …but likely misunderstood as price discrimination
- Resale price maintenance – not an option…
- Vertical integration by brand owner – not an option either…

Draft Guidelines on online sales (1)

- Discussion of internet sales couched in terms of territorial restrictions (Art. 4(b), ¶¶50-56)
- Key focus the (expanded) active/vs passive sales distinction: e.g. ¶51: OK for a supplier (even one with a share >30%) to restrict distributors from “actively” selling outside its territory, though cannot restrict “passive” sales
- ¶52: Internet sales almost always regarded as “passive”
- Examples of internet restrictions which would automatically rule out qualifying for BE:
  - “requiring a distributor to **limit the proportion of overall sales** made over the Internet”.
  - “requiring a distributor to **pay a higher price** for products intended to be resold by the distributor online than for products intended to be resold off-line”…

CRA Charles River Associates

Draft Guidelines on online sales (2)

- However brand owners have not lost out completely in the political wrangling over the language of the new Guidelines…
  - ¶54: *Notwithstanding what has been said before, under the BE the supplier may require quality standards for the use of the Internet site to resell his goods, just as the supplier may require quality standards for a shop or for advertising in general. The latter may be relevant in particular for selective distribution, where under the BE the supplier may require its distributors to have a brick and mortar shop or showroom before engaging in online distribution.*
- ¶52 also qualifies the statement that restrictions on proportion of total sales made online are "forbidden":
  - *(fn): This does not exclude the supplier requiring, without limiting the online sales of the distributor, that the buyer sells at least a certain absolute amount (in value or volume) of the products off-line to ensure an efficient operation of its brick-and-mortar shop.*

Real goal *market integration,* efficiency trade-off unclear

- We should focus on telling a coherent story where restrictions that suppliers could facilitate collusion, or lead to foreclosure
- However main motivation of opposition to internet restrictions seems to be that they restrict consumers arbitrage across regions – which would lead to more uniform prices
- But eliminating price discrimination does not have systematic *level* effect on prices, nor systematic pro-competitive effects
  - Arbitrage that eliminates price discrimination would lower prices for some consumers but raise them for others. *Average prices may go up or down* depending on the exact form of demand – welfare effects ambiguous
  - Forcing markets towards uniform margin may also be inefficient, as it may lead to under-provision of services where they are most highly valued, and over-provision elsewhere

CRA Charles River Associates

Policy implications of economic analysis

- Economic analysis strongly suggests presumption in favour of VRs like selective distribution, *irrespective of sales technology* and even by a dominant player
  - A new sales technology does not imply we should set aside established analysis, notwithstanding rhetoric about “new economy” or “21st Century economy”, and beliefs about the inherent goodness of the internet
- Should carefully consider potential anti-competitive effects – i.e. foreclosure, raising rivals’ costs or promoting collusion – though these are the exception
- Burden should *not* be on parties to vertical agreement to explain exactly how it is efficient, and whether there any so-called “less restrictive” alternatives
- In these sense, Guidelines miss an opportunity for setting out a clearer reference framework

Policy conclusions (2)

- Another very good reason for being "hands off" has to do with dynamic efficiency…
- As internet distribution channel still relatively new, important for brand owners to be allowed to experiment with the format to determine relative strength of potential efficiencies, and different solutions to potential free-riding problem
  - Actual impact of using the internet as a sales channel still untested for many players. Brand owners need to experiment with internet distribution to learn how severe the free-riding problem for bricks-and-mortar services may be, and whether there is real deterioration of brand image
- Different products may well have different optimal retailing structures, and experimentation should not be interfered with

Cristina Caffarra

ccaffarra@crai.com

99 Bishopsgate

London EC2M 3XD

+44 (0)20 7664 3700

81 Avenue Louise

B-1050 Brussels

+32 (0)2 627 1400

Charles River Associates