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Vertical Agreements and the Internet: An economic assessment

Why is it important to ask a competition economist, with which school of thought he is affiliated? The affiliation of an economist to a particular school of thought determines the outcome of his analysis. In the following, these differences in schools of thought concerning vertical agreements are discussed.

Vertical Agreements in the Chicago School

According to one of the many US schools of thought, namely the Chicago School, economic efficiency is the prime goal of competition policy. Since vertical agreements, as stated by the Chicago school, lead to lower prices *per se*, there is no necessity for competition authorities to intervene in vertical agreements. In the end, the principle of *'survival of the fittest'* is applied: the strongest market participant will keep going.

In concrete terms the Chicago School emphasizes that agreements concluded by companies in a vertical relationship are, by their nature, very different from horizontal agreements. Vertical agreements are primarily used to make the vertical combination more efficient. Every party in a vertical agreement can be considered a natural ally of the consumer. The reason is based on, according to Chicago School thinking, the differentiation in substitute products and complementary products.

Vertical agreements are concluded by companies that are providing complementary goods or services. Where goods and services are complements, price cuts by one company will tend to stimulate demand for all products. Thus, each firm has an interest in seeing price cuts from suppliers of complementary products.

A joint profit-maximizing agreement between complementary firms will then seek to internalize the price externalities and lead to price reduction. This is in the interest of the consumers. As a result, an agreement entered into by providers of complementary products will, according to Chicago School thinking, increase consumer welfare *per se*. No individual assessment is required to confirm this relationship.

Vertical Agreements in the European School

In contradiction to this US Chicago School thinking, the European approach is enshrined in Article 101 TFEU. If an agreement restricts competition under Article 101 (1) TFEU, the analyses need to proceed to Article 101 (3) TFEU to qualify for an (individual) exemption from the cartel prohibition. This means that when it comes to vertical restraints in EU competition law, a **balancing test** based on the circumstances of each individual case needs to be done. In principle, this is a European *rule of reason*. Legality *per se* as applied in Chicago School thinking is wrong.

Since vertical restraints have the potential either to increase or decrease welfare, depending on the circumstances of the case, individual assessments are mandatory. For the majority of the cases, systematic investigations into the effects of agreements that are concluded between firms at different levels of the production or distribution chain are burdensome. That is why the European Commission published vertical guidelines and introduced the 30%-market share cap: Agreements without hardcore restrictions below the 30% thresholds qualify for a group exemption. All other agreements need to be assessed individually. In the example below the turnover the German Bundeskartellamt discussed in this individual case was about €10 bn. An individual assessment is justified when these amounts are affected.

In the following, vertical restraints such as dual pricing systems and the prohibition to use third-party platforms are discussed.

Dual Pricing Systems

In dual pricing systems a producer charges a retailer different purchasing prices, depending on whether the retailer distributes the product in question over the internet or via a brick and mortar-shop.

Dual pricing systems may restrict competition if the producer demands a higher purchasing price (or gives lower rebates) for products sold over the internet. According to the balancing test applied in Article 101(3) TFEU, such a dual pricing system may increase consumer welfare, if consumers value for example offline-services more than cheaper online-prices. According to European rules this needs to be assessed case-by-case by means of empirical analyses.

The Competition Problem

If there is a dual pricing system, the retailer faces higher purchasing prices for products sold over the internet. Accordingly, he has higher variable costs which he passes on to end consumers. Since internet consumers have a considerably higher price elasticity, the quantities of the product sold decrease significantly. The economic incentive for the retailer to attain more customers through an online distribution diminishes.

Through this kind of purchasing price discrimination, the producer influences the distribution of product sales via the distribution channels "Internet" and "Brick and mortar-shops". The freedom of choice of the retailer is limited. Such a practice impedes the development of internet sales in the long term and leads to a higher price level.

In the Vertical Guidelines of the European Commission, such dual pricing systems are treated as hardcore restrictions of competition (see para. 52). Nevertheless, a substantive individual assessment under Article 101 (3) TFEU remains as option.

Case: Rebate System Bosch Siemens Household Equipment (BSH)

BSH had introduced a rebate system with appointed retailers, who sell BSH-equipment either through a brick and mortar-shop or by means of the internet (so-called hybrid-retailers). The 'performance rebates' were applied to the purchasing price. They were reduced depending on the amount of revenue the respective retailer generated with online sales.

This differentiated rebate system served the purpose of honoring the high-quality services provided in the physical shops. They were even provided for certain presentation- and consultation rebates. The rebates should have compensated the higher investments of retailers in their brick and mortar-shops. Because of the critical remarks of the German Bundeskartellamt, BSH changed its rebate policy.

The Bundeskartellamt has challenged two other dual pricing systems: GARDENA and Dornbracht.

EE&MC-Approach

A general Chicago-School approach is not going to work here for the aforementioned reasons. Instead it is necessary to analyse an exemption on a case-by-case basis in a European School-like manner.

The restriction of price competition disfavouring online sales which results from the rebate system could be outweighed by improvements in quality competition. This issue has to be addressed in an empirical way. Die burden of proof for an individual exemption lies with the company.

The higher costs of selling in a physical shop, owing to consulting services and image-building and -maintenance, can in principle be spread in a technologically neutral manner to all sales channels. This argument is justified according to European School thinking, as long as consumers value aspects such as shop assistance, image-building and image-maintenance more than cheaper prices. This is the case with a lot of products.

Consumers do not usually behave as rational economic market participants fully informed about all prices in transparent markets. On the contrary, consumers are human: they buy impulsively and highly value a personal approach. Empirical sciences have developed tools to analyse and model such consumer behaviours. EE&MC holds solid experiences in applying these instruments required for individual exemptions.

Prohibiting the use of third-party online platforms

In ordinary distribution systems, platform prohibitions by manufacturers may restrict competition. The question is whether a manufacturer, who sells its products only to distributors fulfilling certain criteria (selective distribution), can contractually determine which type of platform is eligible for the distribution of the products and which one is not.

Are manufacturers allowed to prohibit distributors from using third-party online platforms, like Amazon or eBay, for selective distribution?

With respect to selective distribution systems, it is commonly recognized that, next to price, other competition parameters exist, such as product- and service-quality. They can improve consumer welfare in a similar manner. When buying brands for instance, consumers expect a certain shopping experience or intense advice. As opposed to that, consumers might associate online distribution through platforms like eBay with randomness and trash. This is why manufacturers can further their brand image by fixing criteria to be met by such an online platform.

Restraints on distribution within selective distributions are possible, if selling via online platforms do not correspond to the manufacturer's quality standards.

It is however the manufacturer's responsibility to credibly argue his case. For an individual exemption under Article 101(3) TFEU, empirical evidence that the restriction indeed increases consumer welfare is indispensable. A distribution restriction is, for example, considered arbitrary and disproportionate if the manufacturer prohibits the distribution via Amazon or eBay while at the same time offering its products in discounters.

The Competition Problem

Advantages of platform sales

For sellers, platform sales expand the range of consumers they can reach, as its platforms facilitate addressing consumers. Sellers can not only reach more but also different types of consumers. Particularly, those consumers who usually do their online shopping on familiar online platforms and market places for reasons of shopping comfort can be addressed more easily.

Furthermore, platforms can decrease entry costs for new sellers when they can avoid the fixed costs of constructing their own web shop and the corresponding advertisement but only have to face commission payments. Hence, competition between sellers on internet auction platforms and market places is intensified. On the consumers' side, these platforms decrease transaction costs by enabling the comparison of multiple product offers. The search cost of the customer is minimized. These effects are to be balanced against the advantages that a platform prohibition can bring along.

Advantages of the distribution restriction

Here, the key element is not to assume that a prohibition of marketing a product via an online platform will *per se* reduce consumer welfare by preventing the emergence of lower prices. In fact, the product price is only one element in the assessment of consumer welfare. Other important factors are brand image and the perceived value of the product.

Brand manufacturers that spend considerable resources on the building and the maintenance of their brand image can suffer if their products are offered for sale on online platforms. For example, it is important for a particular brand product to be exclusively presented within a certain product range. This is particularly crucial if the brand image is part of the product and if the consumer is willing to pay for the brand image attached to the product. The consumer's valuation of the brand is then a given that might vary depending on the single product. Therefore, an investigation needs to be done on a case by case basis.

Moreover, platform prohibitions also serve the prevention of free riding on the consultation services provided by sellers in their physical shops and on their online shops. In this way, a manufacturer can durably maintain his brand image, which is in the consumer's interest.

It is for exactly these reasons that EU competition law considers quality requirements within selective distribution systems for brand products to be pro-competitive. Manufacturers are allowed to protect the marketing of their products.

Case: Sennheiser Audio Products

The German competition authority currently investigates against producers of sports equipment, such as Adidas, in order to test the lawfulness of their platform prohibitions. In the case of Sennheiser Audio products, the Bundeskartellamt has already disapproved a platform prohibition.

Sennheiser's selective distribution system contained a clause prohibiting distributors to sell their products over third platforms, such as eBay or Amazon marketplace, if they did not meet specific criteria. The Bundeskartellamt held that a producer of standardized electronic products for end consumers cannot prevent an appointed seller to sell its products via online platforms if the platform is fully integrated into the electronic distribution of another appointed seller.

The Bundeskartellamt did not recognize an efficiency-enhancing effect of the platform prohibition at all. Also, the effects on product presentation and service quality were not convincing either. The competition authority therefore concluded that Sennheiser, who had authorized Amazon as a seller within its selective distribution system, could not prohibit the sales of other appointed sellers via Amazon.

EE&MC-Approach

The analysis of clauses contained in a selective distribution system requires, according to the European school, a detailed balancing of the anti- and pro-competitive effects of a platform prohibition pertaining to the individual case at hand.

Its effects on all competition parameters (i.e. price, quality, service, and product image) have to be assessed. In the framework of the individual assessment, the link between price and image has to be demonstrated empirically and modeled according to the legal guidelines.

One has to assess, whether there is an economic relationship between the third party platforms as a distribution channel, the resulting possibility of a price decrease and the quality criteria perceived by consumers such as consulting brand and image. The result of this modeling exercise is the calculation of consumer welfare for two scenarios: distribution with platform use and distribution without platform use.

The question whether manufacturers can prohibit the sales of appointed sellers via online-platforms such as Amazon or eBay within selective distribution systems thus requires an empirically sound and well founded answer. This is the European approach.

From a Chicago-School economist you can instead expect, without any complicated calculations at all, the direct answer that in vertical relations anything is possible: the market is going to regulate itself.