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Vertical restraints on online sales

The sale of branded goods over the internet increases. Brand manufacturers try to impose vertical restraints on those online sales. The German Federal Cartel Office (FCO) is currently conducting two pilot procedures in this regard:

- One case deals about a selective distribution system, which includes restraints on online sales, i.e. a prohibition on the sale by third-party platforms such as eBay or Amazon. The brand manufacturer's argument is that these third-party platforms cannot guarantee an appropriate brand-friendly product presentation. Online sales should only be possible via websites which are authorized by the brand manufacturer.
- Another procedure clarifies e-commerce distribution rules with regard to possible restraints on online sales, i.e. to ban online sales on open third-party platforms.

The FCO examines in particular whether these selective distribution systems contain rules restricting or preventing competition in accordance with Article 101 (1) TFEU.

It is the duty of the companies to bring forward arguments related to a possible exemption of the cartel provision in accordance with Article 101 (3) TFEU. This CCR deals about a possible exemption for vertical restraints on online sales for branded products.

Exemption for vertical restraints for branded products?

The Court of Justice has clarified in its judgment on *Pierre Fabre Dermo-Cosmétique* (13.10.2011) that sales restraints on online sales for branded products are permitted in exceptional cases only.

Thus, the special characteristics of branded goods may justify vertical restraints on online sales. However, the restraints must be necessary to preserve and maintain the brand.

The Court confirmed that the exemption provision contained in Article 101 (3) TFEU is applicable on such a vertical agreement, if the requirements of that provision are fully met.

In order to facilitate the application of Article 101 (3), the EU Commission issued several guidelines. Companies are required to do a self-assessment of whether an agreement that restricts competition under Article 101 (1) might benefit from an exemption under Article 101 (3) or not.

Exemption under Article 101 (3) TFEU

Any assessment under Article 101 consists of two parts.

- The first step is to assess under Article 101 (1) whether an agreement has an anticompetitive object or actual (or potential) anti-competitive effects.

- The second step, which only becomes relevant when an agreement is found to be restrictive of competition under Article 101 (1) by a competition authority, is to determine the pro-competitive benefits produced by that agreement and to assess whether these pro-competitive effects outweigh any anti-competitive effects.
  This kind of balancing of anti-competitive and pro-competitive effects is conducted within the framework laid down by Article 101 (3).

The standards laid down in the Commission's guidelines have to be applied in light of the circumstances specific to each case. This excludes a mechanical application. Each case must be assessed on its own facts by applying the guidelines reasonably and flexibly.

The four conditions of Article 101(3) TFEU in order to qualify for an exemption are the following:

- efficiency gains;
- fair share for consumers;
- indispensability of the restrictions;
- no elimination of competition.

Those conditions are cumulative in the sense that all of them need to be fulfilled.

We will now review each of these conditions in detail for branded goods.

1. Efficiency gains

In the analysis of efficiency gains the type, the likelihood, the extent as well as the timing of the alleged efficiency gains are of great importance. In addition, a sufficient causal relationship between the vertical agreement and the efficiencies must be shown.

The Commission's guidelines discuss cost savings and qualitative efficiency gains, which produce benefits in the form of new or improved goods. Other effects such as the promotion of investment incentives for the removal of free-rider issues or hold-up problems are central in the analysis too.

Building up and maintaining a brand requires considerable capital investments. Consumers are willing - contrary to the economic logic to buy the cheapest products only - to pay higher prices for "branded" products. If the same product would be offered as "*no name*" product, many consumers still would prefer to buy the branded product despite a higher price (or even because of a higher price).

Price is an essential element in the positioning of a brand. Since consumers are willing to pay higher prices, the branded product has a higher value for consumers too. Brand manufacturers are trying to protect this high value brand image through restrictions on online sales.

It is necessary that

1) brand manufacturers continue to protect the brand value for the consumers and
2) that they keep on investing in order to maintain and expand the brand image, which is ultimately in consumers' interest too.

The protection of the brand value and the investments related to brand building is the counterweight to a restriction of competition.

The willingness of brand manufacturers to further invest, leads to increased brand competition which is in the benefit of consumers too. Such a competition contributes to improving the production and distribution of goods as well as to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefits.

2. Fair share for consumers

In the case of branded products, consumer benefit from the investments of the manufacturers in the development and, in particular, maintenance of a brand. Manufacturers satisfy with their branded products the wishes (and sometimes desires) of consumers. As a result, consumers benefit

from an improved quality of the goods/services in question. From the perspective of the consumers, brand image is an essential element of the product or service itself.

In a first analysis it is necessary to examine which factors are for consumers relevant in their buying decisions. Studies e.g. on drugstore goods suggest that beside price other factors are important as well. The importance of price as a decisive element in a buying decision is about 30-40 percent. The remaining percentages are distributed among factors influencing a buying decision too like brand, services, quality, product range, product presentation etc..

If analysis reveals that the factor "brand" is of importance for a particular product, it can be simulated how consumer benefit will change when the factor "brand" diminish e.g. because of cheap sales through third open platforms. The advantage of such analyses is that the economic effects can be quantified and verified.

In a final step, the pro-competitive elements of a vertical distribution agreement are balanced with the quantified restrictions of competition.

Our experience is that qualitative arguments alone are not successful to meet the concerns of antitrust authorities. The point is that efficiency gains and their pass-on to the consumers need to be quantified.

3. Indispensability of the restriction

Vertical restraints on online sales must constitute an indispensable measure for the brand owner. The question is how online sales limit the incentives for brand owners to invest in building up and maintaining a brand.

It can be shown analytically how a return on advertising spend (ROAS) evolves in relation to online sales. In particular, if one finds a significant negative relationship between the two, this would provide evidence that online sales are detrimental to investment. More specifically, one can define ROAS as follows:

$$ROAS = \frac{Advertising\ revenue - Advertising\ spending}{Advertising\ spending}$$

The second step then consists of regressing ROAS on a set of exogenous explanatory variables including online sales volume. This can be written as follows:

$$ROAS_t = \beta_0 + \beta_1 Online_t + \beta_i X_{i,t} + \varepsilon_t$$

where $ROAS_t$ refers to ROAS at time t, $Online_t$ corresponds to online sales volume at time t, $X_{i,t}$ is a vector of exogenous variables affecting ROAS (e.g. total assets, degree of competition, etc.), and ε_t is the error term of the regression. All β´s refer to coefficients which need to be estimated.

If one finds that $\beta_1 < 0$, this would prove that online sales lead to a lower advertising profit for the brand owner. This would support the argument that online sales restriction is necessary, at least to a certain extent, in order to protect brand related investments made by the brand manufacturer.

4. No elimination of competition

The market for many branded products is highly competitive. There rarely might be a case where any product truly has no competing substitute. Interbrand competition is mainly driven by the need to differentiate from these competitors in the very first place.

Thus, in the presence of competitive pressure, selective distribution agreements on online sales might rather unlikely amount to substantial restrictions on trade.

In assessing the level of interbrand competition, one could derive cross-price elasticities between the brands of the same product. This can be done by way of an *Almost Ideal Demand System* (AIDS). This method requires knowledge about firms´ market shares and prices.

EE&MC Approach

The companies have the burden of proof for an exemption under Article 101 (3) TFEU. Competition authorities have only to determine a restriction of competition under Article 101 (1) TFEU. The "art" to achieve an exemption under Article 101 (3) is that consumer benefits are quantified in concrete terms. The next step is to illustrate that these consumer benefits are passed on to the consumers as well. Furthermore, the proof must be provided that all four conditions of Article 101 (3) are met. Without "hard numbers" exemptions are hardly possible. EE&MC is specialized in economic appraisals for exemptions under Article 101 (3). In particular, the quantification of consumer benefits by market simulation models is an outstanding field of expertise of EE&MC.