Summary of Discussion Points

Presented by the Business and Industry Advisory Committee (BIAC) to the OECD Competition Committee

Roundtable on Vertical Restraints for On-line Sales

February 27, 2013

I. Introduction

1. The Business and Industry Advisory Committee (“BIAC”) to the OECD welcomes the opportunity to submit these comments to the OECD Competition Committee for its roundtable on Vertical Restraints for On-line Sales at the meeting of the OECD Competition Committee on 27 February 2013. This is a timely discussion in light of increased scrutiny afforded by competition authorities to the online arena in recent times1 and the ever-increasing importance of electronic commerce.

2. The internet and, more recently, mobile technologies have quickly resulted in substantial changes to the sale and distribution of goods. This has been reflected in firms’ business models, in consumer behaviour and in the overall economy.

3. The last decade has seen the emergence of significant new online-only (and, over the last few years, ‘multi-channel’) economic players as well as the addition of the online and mobile channels to the distribution strategies of many traditional bricks-and-mortar businesses. Innovation and technological advancements such as mobile platforms, electronic and mobile payments2 and high-speed broadband mean that the online sales environment continues to develop rapidly.

4. It is difficult to quantify precisely the importance to the economy of online sales as few countries account for those separately3, and therefore may underestimate the size of the sector.4 Nevertheless, the available statistical analyses demonstrate that online sales are of considerable economic significance in a number of countries. By way of example, in the UK, it is estimated that online sales in 2011 amounted to €59.4 billion or 12% of UK retail trade up from 8.6% of UK retail trade in 2008. For Europe as a whole, the total online market was estimated to be €200.52 billion in 2011, (representing an increase from €117.84 billion in 2008).

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1 See, for example, the Ebooks case (European Commission) and Online Hotels Booking case (OFT).
2 As discussed at the Roundtable on Competition Issue in Payment Systems on October 24, 2012.
It is anticipated that these figures will continue to increase in the coming years.\(^5\) Total online sales in the United States were estimated to be $202 billion in 2011, and are forecasted to reach $327 billion by 2016.\(^6\)\(^7\)

5. However, it is interesting to note that some disparities may occur between EU countries regarding the relative importance of online sales to their economies. According to a Eurostat survey, while e-commerce accounted for 26% of company turnover in Ireland in 2008, only 1% of company turnover in Bulgaria and Cyprus was generated from e-commerce.\(^8\) EU consumers may also encounter difficulties in cross-border shopping online. In 2010, these difficulties were highlighted by Commissioner Almunia, who estimated that 7 out of 10 cross-border transactions attempted online in the EU ultimately failed.\(^9\) Nevertheless, it is important to also recognise that consumer experiences in this regard continue to improve.

II. Electronic commerce and competition in general

6. Any competition law assessment necessarily requires a detailed consideration of a variety of complex legal, factual and economic factors. The complexity of this assessment is increased in respect of electronic commerce due to the ever-changing nature of the environment leading one commentator to describe the task as being "as difficult as taking a neat photo of a cruising rocket."\(^{10}\) Nevertheless, it is possible to discern some general pro-competitive effects and anti-competitive threats that can be attributed to the development of electronic commerce.

7. Online sales have resulted in a number of clear pro-competitive effects as they fulfill one of the fundamental aims of competition policy – improvement in economic and consumer welfare. One of the primary effects of online sales has been increased competition on price (and other variables) between online retailers, and between online and bricks and mortar retailers. This has resulted in a direct benefit for consumers. Furthermore, consumers have been empowered to make more informed choices about their purchases. Search engines and price comparison websites have enabled customers to obtain information about products and services and compare prices, thereby reducing search costs. Consumers have also been afforded the opportunity to purchase a wider range of products unencumbered by constraints of geographical location, or their ability to visit bricks-and-mortar shops.

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6 Forrester Research Online Retail Forecast 2011-2016 (U.S.).
9 Speech by Commissioner Almunia “Competition in Digital Media and the Internet”, SPEECH/10/365, (London: July 7, 2010), noting that “Although most barriers to e-commerce are regulatory, competition policy does have a role to play in promoting the internal market” and the need for simple, secure and efficient payment services.
8. For businesses, the advent of electronic commerce has resulted in a divergence from the traditional distribution networks of bricks-and-mortar shops. A wealth of online business models (including online-only retailers, “click-and-mortar” retailers and third party platforms) has been established enabling suppliers to distribute their products to a broader range of consumers.

9. Moreover, the online environment generally entails significantly lower barriers to entry than the traditional bricks-and-mortar retail environment. Online retailers can benefit from lower start-up and ongoing costs, while more sophisticated marketing techniques can help businesses to tailor product offerings and stock levels to consumer needs.

10. Nevertheless, the online sales environment may also present certain threats to competition. In the first instance, there are some concerns that increased pricing transparency (which is of benefit to consumers) may facilitate collusive conduct between competitors by enabling easier monitoring of each other’s activities. However, it is important that such concerns are not overstated, as greater transparency in the market as a whole is generally considered to result in a pro-competitive outcome.

11. A further concern is that dominant companies in the online sales environment may engage in abusive conduct, thereby foreclosing the market. This threat cannot be ruled out entirely, although the fluid nature of the online sales environment and the generally lower barriers to entry mean that foreclosure may be more difficult than in the bricks-and-mortar environment.

12. As noted above, competition authority assessments in the online environment will not be straightforward. Even basic concepts, such as definition of the relevant market can become quite complex, while establishing dominance and the degree of contestability in those relevant markets may also be difficult.

13. Despite these complications, competition authorities have been keen to highlight their commitment to application of competition principles to the online environment. In the European Union, successive Competition Commissioners have emphasised this point both in their public pronouncements and legislative activities. In 2010, Commissioner Almunia reiterated that “the principles of competition must be maintained in the digital economy with the same intensity

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11 Speech by Commissioner Almunia “Competition in Digital Media and the Internet”, SPEECH/10/365, (London: July 7, 2010).
12 See paragraph 9 above.
that they are imposed in the brick and mortar world." U.S. antitrust authorities have also emphasised the importance of the application of antitrust principles in the online sphere. In 1999, David A. Balto, Assistant Director, Office or Policy and Evaluation, Bureau of Competition, Federal Trade Commission, discussed the application of antitrust laws to electronic commerce. Balto stated, “The Federal Trade Commission has a vital role to play in electronic commerce markets. The Commission stands in the role of a referee, to protect the process of competition so that such competition occurs on the merits. We want to make sure that innovation in electronic commerce is not compromised by artificial barriers to entry erected by incumbent competitors or established by regulatory fiat. We are there to assure that private forces do not impede the development or growth of the market through exclusionary conduct, either collective or unilateral.”

14. Despite apparent agreement as to this general principle, competition authorities on either side of the Atlantic have taken differing approaches to the controversial issue of vertical restraints in online sales. While the European Commission in 2010 adopted guidelines dealing specifically with restrictions of online sales in distribution agreements, U.S. antitrust enforcement is content to rely on general antitrust principles and has decided not to adopt specific rules for such restrictions. This lack of consistency in treatment reflects the divergent approach of the authorities to vertical restraints generally but is of particular concern in relation to online sales policies since it creates significant additional complexity with resulting costs for businesses that are active themselves in the online environment, or engage with online distributors in the EU and the U.S. The specific features of online commerce demand a more internationally convergent competition law regime if this important sector is to develop freely so as to maximise benefits to consumers.

III. Vertical restraints in online sales

15. Suppliers enter into distribution agreements with external undertakings where this represents a more efficient option than vertical integration. However, such suppliers may wish to maintain some control over how and where their products are sold. Specifically, and particularly when e-commerce was in its infancy, some suppliers were concerned and may consider that the distribution of products online would result in less control over marketing and distribution, or (in certain cases) harm the image and goodwill of their brands. In order to alleviate such concerns, distribution agreements will include vertical restraints to regulate the conduct of either or both parties.

16 Speech by Commissioner Almunia “Competition in Digital Media and the Internet”, SPEECH/10/365, (London: July 7, 2010).
18 On which BIAC has commented elsewhere but which is not the subject of this paper.
16. It is generally accepted that vertical restraints are less harmful to competition than horizontal restraints and may provide substantial scope for efficiencies. This is because businesses are involved at different levels of the supply chain and will generally have an incentive to keep prices as low as possible to maximise product demand and so will only impose unilateral vertical restraints which they consider best-suited to achieve this objective.

17. Consequently, it is possible to discern a number of pro-competitive effects from the imposition of vertical restraints. In particular, vertical restraints can result in substantial efficiencies through the promotion of non-price competition and improved quality of services. This is of particular relevance where a company has limited or no market power and is seeking to differentiate itself through optimising manufacturing or distribution processes.

18. One of the primary arguments advanced in support of vertical restraints in online sales is that they are necessary to counteract the problem of free-riding. This line of reasoning suggests that restraints are necessary to prevent online sellers from free-riding on investments by bricks-and-mortar retailers in enhanced pre-sale services or promotional efforts. A restriction of online sales could therefore provide distributors with an incentive to keep up the provision of services that add to the value of the supplier’s brand.

19. It is necessary to recall in this context that whether customers actually benefit from such extra services or promotional efforts will depend on whether the extra promotion informs and influences (and therefore actually benefits) consumers. Already in 2009, research observed a “reverse free-riding” phenomenon whereby consumers conduct significant research into products online before carrying out their purchases in a bricks-and-mortar store, thus undermining in certain circumstances the justification for imposing such restrictions. It is also possible that the importance of so-called “reverse free-riding” has been exaggerated on the basis that consumer research online may gravitate towards manufacturer-generated (rather than retailer or distributor-generated) content.

20. One specific instance of the “free-rider” problem arises where a supplier enters a new territory. In those circumstances distributors will need to make “first time investments” to establish the brand on the market. It may be necessary to confer territorial protection on that distributor to prevent online retailers from free-riding on those investments. This ensures that incentives for suppliers to enter particular markets are preserved, which may ultimately be to the benefit of consumers.

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21 Guidelines on Vertical Restraints, para. 106.
22 Id.
24 Note that the discussion about free-riding is ongoing. For example research from the UK’s Ofcom’s UK Communications Market Report 2012 show that 57% of smartphone owners in the UK have used their smartphones when out shopping for (among other things) comparing prices between online and high street shops (25%), researching product features online (19%), and acquiring more product information by scanning bar codes (21%) - OFCOM International Communications Market Report 2012, 13 December 2012 http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr12/icmr/ICMR-2012.pdf (see page 209) and OFCOM Communications Market Report, July 2012, http://stakeholders.ofcom.org.uk/binaries/research/cmr/cmr12/CMR_UK_2012.pdf (see page 227).
21. It is also necessary to consider the extent to which vertical restraints in the online arena may result in anti-competitive effects, thus undermining the pro-competitive effects of online sales outlined above. However, it is submitted that the existence and extent of any such effects should be examined on a rule of reason basis.

22. By way of example, it is possible that a blanket restriction on online sales, if operated by suppliers with very substantial market power, could lead to the anti-competitive foreclosure of potential retailers from the relevant market. Such restrictions could result in fewer online retailers competing in the online sales channel, with a consequent reduction in inter-brand competition (i.e. reduced competition between a supplier and its competitors). This outcome could have a negative impact on consumer welfare due to higher wholesale prices, limitations on product choice or lowering the quality of or innovation in products.25

23. Further, the online arena means that the traditional distinctions between so-called suppliers and retailers can easily become blurred. One example is the airline sector, where airlines retail their own flights via their website while also distributing those flights via travel agents. In that instance, questions may arise whether vertical restraints imposed by those airlines could also result in the reduction of horizontal competition between the airline and the travel agent at the retail level.

24. A reduction in intra-brand competition (i.e. competition between distributors who are distributing the same products) may also ensue from vertical restraints but it is generally accepted that a reduction in intra-brand competition alone is only detrimental where there is significant market concentration.26

25. Negative competitive effects of such vertical restraints in the online market can be reinforced where several suppliers and buyers organise their trade in a similar way, leading to so-called cumulative effects.27 However, the high degree of innovation in online markets means that cumulative effects will be less likely to arise than in the context of more traditional industries.

26. From the above, it is clear that vertical restraints may have pro-competitive or anti-competitive effects in practice, depending on the particular context. This is particularly so in the online context where, for example, free riding may represent a clear issue in one scenario and may not be a concern in another.

27. Adopting too strict an approach to vertical restraints may unduly undermine investment incentives in the online sector. It is therefore advisable that each vertical restraint is considered on a “rule of reason” basis, taking into account any resulting efficiency gains and anti-competitive effects.

26 See Guidelines on Vertical Restraints, 2010 paragraph 101 for the Commission’s concerns regarding restraints on intra-brand competition.
IV. EU approach to Vertical Restraints in Online Sales

28. Until the adoption of the 2010 VBER and Guidelines on Vertical Restraints, there was little guidance under EU law regarding the application of the rules on vertical restraints to the online distribution of goods. As online sales were in its infancy at that time, it is of little surprise that the previous version of the regulation and guidelines were vague on the topic of online distribution (and in fact, it seems that the paragraphs on online sales were only added by the European Commission in a penultimate draft). The 1999 Guidelines prohibited restrictions on “passive sales” which included blanket bans on online sales. The Guidelines did not elaborate on other issues affecting the online environment, such as free-riding.

29. When revising the 1999 Block Exemption Regulation and Guidelines in 2010, the European Commission responded to calls for further guidance on the instances where vertical restraints in online sales may be permissible. In comparison to the approach adopted by U.S. antitrust authorities, the guidelines are very specific indeed.

30. As a general proposition, the Guidelines confirm that a prohibition on internet sales is considered to be a ban on “passive sales” which represents a hardcore restriction.

31. From this starting point, the Guidelines provide additional rules on the extent to which online sales restrictions can be included in vertical agreements. Such rules include the following guidance:

- Suppliers **may not restrict the proportion** of overall sales made by the distributor over the internet (but may require the distributor to sell a certain absolute amount (in value or volume) of products offline).
- Suppliers **may not charge different wholesale prices** for products to be sold online or compared to offline (but may agree a fixed fee with the buyer to support the latter’s offline or online efforts).
- An exclusive distributor cannot be prevented from allowing customers located in another exclusive territory from viewing its website. Such customers should not be re-routed to the manufacturer’s or another distributor’s websites.
- As a pre-condition for joining a supplier’s selective distribution system:
  - Suppliers may require distributors to operate one or more bricks and mortar shops or show rooms;
  - Suppliers may impose quality standards on the use by distributors of an internet site to resell its goods (and may impose quality conditions on third party platforms).
- Guidance is provided on what constitutes “active” and “passive” sales in the online context e.g.:
  - provision of language options on national websites (passive)

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28 Dolmans and Leydens, e-Competitions, No. 45647 “Internet & Antitrust: An overview of EU and national case law”.
29 When announcing the new Guidelines and Regulation, Competition Commissioner Almunia said that the new rules were “internet friendly” and clearly limited “the possibility of suppliers to restrict online sales”. Speech 10/172, available http://europa.eu/rapid/press-release_SPEECH-10-172_en.htm?locale=en
o responses to unsolicited consumer requests (passive)
o online advertisement specifically addressed to certain customers (active).

32. These guidelines attempt to translate the EU rules applicable to traditional bricks and mortar distribution rather literally across to the online sales environment. In light of the generally pro-competitive impact of online sales and the consumer benefits they bring and of the drive by business to find innovative ways to develop this new environment, BIAC would urge a more nuanced approach to vertical restraints here. The very flexibility inherent in EU competition law, which was recognised to accept selective distribution policies initially in the bricks and mortar environment, could usefully be applied to ensure suppliers have the necessary renewed flexibility to best developing their online sales policies.

33. In fact the adoption of these EU guidelines has not been motivated solely by competition concerns but also the desire by the Commission to advance other policy aims, in particular single market objectives. As such, the EU guidelines should not be taken as a precedent for competition rules in other jurisdictions where these single market policy objectives do not apply.

34. National competition authorities: Prior to the adoption of the revised guidelines in 2010, national competition authorities in the EU had not adopted a uniform approach when considering the permissibility of restraints on internet sales falling short of outright bans. By way of example, the German national competition authority rejected an argument that restrictions imposed on online sales of contact lenses were necessary to protect consumer health (on the basis that less restrictive methods could have been used to achieve this aim). On the other hand, the Netherlands national competition authority found that issuing different sets of supply conditions to online retailers compared to traditional retailers was permissible due to the difference in added value between the two distribution systems. This resulted in uncertainty for business.

35. The speed of the development of online sales in the past decade has meant that the specific rules set out in the 1999 Guidelines were swiftly overtaken by market developments, resulting in confusion among national competition authorities and industry regarding the extent to which vertical restraints could restrict online sales. Ambiguity regarding the application of concepts of “active” and “passive” sales to this new environment resulted in further uncertainty for businesses.

36. The Commission may have considered that the elaboration of the meaning of “passive sales” in the 2010 Guidelines will resolve some of this uncertainty for businesses. Uncertainty still remains but it is important to note that while the Guidelines are not binding on national competition authorities, they are likely to be of considerable assistance in ensuring the consistency of decisions going forward.

37. Financial importance of online sales: The European Commission has consistently emphasised the importance of online sales to the EU economy, and has singled out the digital

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economy in its Europe 2010 growth strategy as one of the pillars of the EU’s economic recovery. Commissioner Almunia has specifically noted the “political mandate to ensure that this sector grows to its full potential” and that “[i]t is clear to me that competition policy must be a key part of this strategy as a way to ensure market access and opportunities to all efficient players capable of delivering new value.”31 It is therefore possible that the specific limitation in the 2010 guidelines on the scope of vertical restraints are informed by wider policy considerations of developing further the online economy rather than competition concerns alone.

38. **Internal market:** Successive competition Commissioners have also emphasised the importance of the promotion of online sales for the completion of the internal market.32

39. Completion of the internal market remains an important aspect of EU competition policy and it is clear that the online environment will represent an important aspect of achieving this aim. Nevertheless, it is also important that over-regulation of the online environment does not dis-incentivise investment, thereby endangering the single market imperative. This is particularly the case as there are persuasive arguments in favour of considering vertical restraints in online sales on a rule of reason basis, taking into account the specific circumstances of each case rather than prescribing strict rules.

40. Although it is perhaps too early to assess the full impact of the 2010 Vertical Guidelines in the online sector, the further development in this area since 2010 (in particular the impact of mobile devices and smart payment systems) is presenting new opportunities as well as challenges for business. Therefore, it remains to be seen whether these updated specific rules regarding vertical restraints will strike an appropriate balance between the promotion of online sales and the protection of legitimate business interests and investment incentives. However, as discussed above,33 BIAC is concerned that the certainty of the guidelines comes at too great

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31 Speech by Commissioner Almunia “Competition in Digital Media and the Internet”, SPEECH/10/365, (London: July 7, 2010).

32 In a 2010 speech Commissioner Almunia has confirmed specifically that the revised Vertical Guidelines were underpinned by internal market considerations: “Although most barriers to e-commerce are regulatory or have to do with, competition policy does have a role to play in promoting the internal market. With our recently adopted rules on distribution agreements, we have taken some steps towards safeguarding consumers’ rights to shop online across the EU. Companies are not allowed to establish artificial barriers that partition the internal market to the detriment of consumers and I believe that evidence of such market segmentation should be met by enforcement.

The influence of the internal market aims can be seen clearly in several instances in the revised Guidelines. By way of example, the prevention of restrictions based on location of the consumer clearly references the Commission’s finding in its Communication on e-commerce that many online shops are not prepared to sell to consumers from every EU country. Speech by Commissioner Almunia “Competition in Digital Media and the Internet”, SPEECH/10/365, (London: July 7, 2010).

After the adoption of the Guidelines, the then Director General for Competition at the European Commission, Alexander Italianer stated that (Interview in The Antitrust Source, April 2011) “the promotion of online sales is extremely important for the internal market in Europe because it broadens the market, improves the choices for customers and generally speaking, enhances competition. But that doesn’t mean that we should treat online sales differently from offline sales...We have tried to strike a balance between strongly promoting online sales on the one hand and on the other hand, requirements that are indispensably linked to the branding and sales of certain products”.

33 See paragraph 33
a cost in terms of flexibility for business to innovate and choose their optimum distribution policy in the online environment.

V. U.S. approach to Vertical Restraints in Online Sales

41. The United States takes a different approach than the EU to its assessment of vertical restraints. Following the Supreme Court’s 2007 decision in *Leegin*, virtually all vertical restraints, including price restraints, are evaluated under a rule of reason approach, primarily based on §1 of the Sherman Act, which balances any pro-competitive and anticompetitive effects.

42. It is interesting to note that the Department of Justice did issue Vertical Restraints Guidelines in 1985. However, these Guidelines were not generally enforced in practice and were withdrawn in 1993. Anne K. Bingaman, Assistant Attorney General for the Department of Justice’s Antitrust Division, announced the withdrawal of the Guidelines thus: “*The Vertical Restraints Guidelines do not set forth the Division’s current analysis of vertical practices and are not consistent with judicial interpretations of the antitrust laws. They are misleading both to practitioners attempting to counsel clients as well as businesses attempting to conform with the law. For these reasons, it is appropriate to withdraw the Vertical Restraints Guidelines.*” After the withdrawal of the Vertical Restraint Guidelines, the Department of Justice has not enacted any specific policy in respect of vertical restraints.

43. The U.S. authorities have also made the conscious decision to refrain from legislating specifically in the online sector. As far back as 1999, the Federal Trade Commission’s David A. Balto stated, “Although the growth of this [online] market may be unprecedented, traditional antitrust principles still apply.” Therefore, the same rule of reason approach has been applied to internet sales and sales through traditional brick-and-mortar channels.

44. The adoption of the rule of reason approach has meant that companies have much broader flexibility to impose vertical restraints on distributors, including in respect of online sales and there is greater emphasis on freedom of contract.

45. Very little legal precedent exists in the United States on the specific issue of vertical restraints in online sales. It may be that plaintiffs have been deterred from bringing cases due to the fact that the rule of reason approach adopted by the U.S. authorities has made it more difficult to establish an antitrust infringement. In addition to the low probability of success under the rule of reason standard, U.S. plaintiffs face additional hurdles in the form of heightened pleading standards requiring a showing of plausible grounds to infer an agreement.

46. However, this does not mean that the U.S. authorities have been silent on the importance of e-commerce. As part of the process of examining possible barriers to e-

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commerce, the Federal Trade Commission has strongly encouraged policymakers to adopt rules that encourage e-commerce. For example, the Federal Trade Commission filed a staff comment before the Connecticut Board of Opticians, which was considering additional restrictions on out-of-state and Internet contact lens sellers, and in an FTC Staff Report, concluded that states could significantly enhance consumer welfare by allowing the direct shipment of wine to consumers.38

47. The U.S. approach represents a firm adherence to traditional (broad) U.S. antitrust principles and a rejection of the stringent application of specific rules in the online sector. There has been broad acceptance in the U.S. that this approach is “sufficiently flexible, and sufficiently informed by economic theory, to cope effectively with the distinctive-seeming antitrust problems that the new economy presents”. This point has also been emphasised by the U.S. Supreme Court, which has noted that “antitrust doctrine “evolv[es] with new circumstances and new wisdom.”39

VI. Conclusions

48. In conclusion, it can be said that the increase of online sales is presenting competition authorities with novel issues and novel problems. This does not, however, in BIAC’s view, require the adoption of novel legal approaches or specific rules. Competition law has always needed to be flexible to adapt to changes in the economic environment and market practices.

49. In a global online market, it is important for businesses that rules are consistent and applied in a consistent manner. Given the broad geographic context in which many online businesses function, inconsistency between the rules, such as currently exists between EU rules and rules elsewhere, can impose additional costs and create risks for market operators and make it more difficult for international online commerce to flourish.

50. The rule of reason approach applied under U.S. law is one which can adapt itself to a variety of circumstances, including the novel aspects of online markets. This approach enables a competition authority to consider each vertical restraint on its own merits and in the actual economic context, taking into account any resulting efficiency gains or anti-competitive effects. BIAC would commend this approach to all competition authorities considering vertical restraints, including price and non-price ones, in the context of online sales.