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Vertical restraints

The Economics Perspective

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Verticals ***Good*** *or Bad*?

- Firms in vertical relationships face coordination issues and exert externalities on each other
  - They are well documented in the economic literature and economic textbooks put a large emphasis on these

- The *business rationale* for vertical restrictions is often to address these issues
  - Vertical agreements primarily aim at improving vertical coordination and aligning incentives between complementary actors.
  - They often restore investment incentives by solving issues like *hold up* or *free riding.*
  - They lower prices and increase consumer welfare by reducing *double marginalization*.
  - They *facilitate entry* by helping firms to establish a brand image, signal product quality or ensure adequate use and costumer satisfaction.

Verticals *Good* or ***Bad***?

- **Softening competition**
  - Softening *intra-brand competition*: e.g. RPM, MFN, selective distribution system where fewer retailers compete.
  - Softening *inter-brand competition*: a manufacturer can commit to higher prices and rivals react by also keeping prices high (can be an indirect effect of softening intra-brand competition)
- **Foreclosure**
  - Locking-in a significant portion of retailers, or a few strategic ones.
  - Could reduce the profitability of entry.
  - Like for naked-exclusion or rebates: why would retailers enter into these agreements?
- **Collusion (upstream and downstream)**
  - Exclusivity facilitates market sharing
  - Price restrictions such as RPM and PRAs enable manufacturers to monitor each others' behaviour (and therefore to punish deviations).
  - Price restrictions may facilitate collusion among retailers by eliminating intra-brand price competition, providing a focal point for collusion, facilitating punishment of deviations.

Focus on theories of harm

- Their object is generally plausibly motivated by *procompetitive rationale*
  - This means that no vertical restraint can be an object restriction, let alone a cartel like hardcore restriction (*Cartes Bancaires, Asnef-Equifax*)
  - This is not only about 101.3, but also about 101.1
  - This Is what *Coty* says and this is why it is so general
- Vertical restraints' *object* is not to restrict competition, but they could have this effect
- However, *RPM* or *Selective distribution* are not theories of harm
  - Theories of harm are based on a certain number of assumptions
  - One of them is that there should be some market power
  - *Intra-brand* competition should also be an important driver of consumer welfare
- In many instances, it is very unclear that there is any *theory of harm* at all

Example: the French Bang & Olufsen case

- In 2002, the FCA started a case against the prohibition of online sales for the selective distribution of hi-fi
  - Against Bang & Olufsen France, Bose, Focal JM Lab et Triangle Industries
  - All but B&O settled in 2006 and the FCA waited for Pierre Fabre to impose a fine in 2012
  - The FCA concludes this is a restriction by object and imposes a fine of €900,000
- According to B&O, the restriction aims at preventing *freeriding* in order to maintain local shops providing high level of services and advice
  - The Court of Appeal quashes the argument as it did not seem indispensable to provide advice to sell headphones and accessories
  - As a consequence, the prohibition is too broad and the whole thing is a restriction by object
  - It does not even address the issue of cross-subsidization: can a network of shops survive based on the sale of the most expensive/complex items?

Example: the French Bang & Olufsen case

- Given that the arguments of B&O are plausible, you only want to intervene if the restriction is *capable* of generating harm

- Here, B&O has low market share, *inter-brand* competition is what matters and there can be no harm from the restraint

- This is explicitly acknowledged by the FCA and the Court of Appeal
  - French law imposes that fines are proportionate to the damage to the economy
  - The FCA assessed that the harm was "very limited" but imposed a fine of €900,000 based on gravity (even though Pierre Fabre came in 2011)
  - The Court of Appeal reduced the fine to €10,000

- It took 12 years to achieve this great result!
  - All B&O has to do is to set *objective criteria for selective distribution online* and nothing will change
  - Don't tell me the rules are clear and working

Evaluation of the Vertical Guidelines and VBER – food for thought

- The Vertical Guidelines have many complicated separate form based legal categories that justify different treatments: agency, selective distribution, exclusive distribution, etc.
  - Firms try to fit in more and more things into these categories.
- For instance, what conditions are necessary to have a preferential treatment of an agent under the vertical's safe harbour?
  - Is Amazon an agent selling books or a firm providing a service?
- Isn't it time to have more general principles for effects based analysis instead of form based categories for verticals?
  - This would be consistent with other areas of antitrust enforcement.
  - This would also be consistent with merger control as firms can always decide to vertically integrate and clearly there is no *form based approach* here.

De minims for vertical restraints?

- Vertical agreements are likely to harm consumers only if firms using them possess substantial market power (individually or collectively).
- Since firms with small market shares are unlikely to enjoy substantial market power, competition agencies should not use their scarce resources to monitor vertical agreements between them.
  - Unless of course such agreements cover overall a very large share of the market.
- Firms with little market power really need legal certainty that they can enter into vertical agreements as they see more convenient.
  - They are most likely to benefit from these agreements and without a real safe harbour they may not enter into them because of the potential legal costs.
- Rightly so, according to the VBER, Article 101.1 does not apply to vertical agreements in which the supplier does not hold more than 30% market share.
- However, what about the famous hard core restrictions that are excluded from this safe harbour?

The myth of the *internal market objective*

- Allegedly, the prohibition of some practices (the hard core) would be related to the non-economic *objective of the integration of the internal market*
  - This objective is *sui-generis* and therefore there is no economic grounds to discuss these rules.
  - How convenient?
- The internal market objective is in fact from the very beginning an economic one
  - It is to have a big internal market
  - The size of the internal US market give a home base to US companies to conquer the world
- This is about allowing European *firms to sell everywhere* in Europe
  - Restrictions are sometimes necessary for firms to enter neighbouring countries: then, who segments the internal market?
- Third, passive sales *do little to help consumers* in practice
  - If passive sales were massive, they would be active: no shop wakes up by chance with a queue
  - EU officials and MEP look under the lamppost: they focus very much on their own problems

RPM

The main theory of harm in RPM

- RPM might be a way to solve the classical *monopolist's opportunism* problem and thereby increase prices.
  - A monopolist normally has a *temptation to reduce the wholesale price set to a retailer* (in exchange for compensation) to allow it to expand its market share to the detriment of rival retailers.
  - Since all retailers anticipate that the monopolist could behave in such an *opportunistic* way, they will not be willing to accept to pay a high wholesale price in the first place.
  - Vertical agreements (e.g. RPM or territorial restrictions) may solve this *commitment problem* of the monopolist and allow it to restore its monopolist profits.
  - This can also be the case of MFNs. For example, in the EC's 2012 *Ebook*s case, where MFN clause (with Apple) worked as a joint commitment device for publishers not to lower price to Amazon.

- RPM can also reduce *inter-brand* competition.

- By the way, RPM is not the only way to solve the *opportunism problem*, for instance price ceilings also do the trick but they are not *hardcore.*

The same limits apply to enforcement against MFNs

- The Hotel Booking cases are at first about restoring i*ntra-brand* competition
- If it is easier for me to compare prices and qualities of thousands of hotels in NYC, is it really important that I cannot book one particular hotel at different prices in several platforms?
  - When we have many brands, there is a lot of *inter-brand* competition, what is the additional role of *intra-brand* competition? Should we really focus enforcement there?
  - With many firms, there if often little transparency on prices and quality so practices that increase transparency may drastically increase *inter-brand* competition.
- OTAs increase transparency and foster Interbrand competitoin.
  - The platform needs to derive revenues from the service it provides.
  - If they do so per-reservation, they need to make sure it is not cheaper to book directly.
  - Is this really the role of antitrust agency to tell them they should have a different business model or how they should be remunerated? (indispensability strikes back)
- This is particularly the case when harm is doubtful in the first place
  - Consumers can be harmed when these practices also reduce *inter-brand* competition, but that can happen only if firms have market power.

Selective distribution

Selective Distribution

- Coty confirms previous case law on Selective Distribution
- Third-party platform bans can be used in SD systems in order to maintain the supplier's brand or product image.
- Coty re-affirms the *pro-competitive rationale* of Selective Distribution systems for any high-quality product that necessities a specific selling environment with expert advice and with underlying investments to maintain a specific product image.
- The discussion in Coty focused on luxury goods, considering the subject matter and the questions asked by the German Court. It however remains clear that any selective distribution system strictly applying the *Metro criteria* is compliant with Article 101(1) TFEU.
- Therefore, there is no real difference to be made between luxury/high quality/prestige
- This is an illustration of what we discussed earlier: if there is a plausible *pro-competitive rationale*, this is not a restriction by object.

Please do not hesitate to contact me if you have any questions on this presentation: **aboutin@positivecompetition.com**

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