



INTERNATIONAL

FINAL REPORT

Prepared For:

LVMH Group

and their legal advisors – Cleary Gottlieb Steen & Hamilton

An Economic Analysis of the Use of Selective Distribution by Luxury Goods Suppliers

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Date: 22 September 2008

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A. INTRODUCTION

1. This report discusses the economic foundations of competition policy towards vertical restraints on distribution, as applied to the selective distribution of luxury goods.¹ The aim is to contribute to the working group assembled by Commissioner Kroes to discuss “Opportunities in Online Goods and Services” and to contribute more generally to the discussion surrounding future revisions of the European Commission’s Vertical Restraints Guidelines (“Guidelines”).² The authors of this report are industrial economists who have spent a considerable portion of their careers working on the economics of vertical restraints and/or antitrust issues more generally. Their short biographies are included in Annex A.
2. As well as offering an overview of the economic foundations of competition policy towards vertical restraints and applying this analysis to the distribution of luxury goods, the report addresses some policy questions raised by the European Commission: whether the distinction between active and passive sales makes sense in an internet context, and whether luxury goods suppliers should be subject to regulatory restrictions when setting the criteria for retailers to join their selective distribution networks³.
3. The survey of the economic literature in the report draws largely on two sources, Rey and Vergé’s recent survey of the economics of vertical restraints in the *Handbook of Antitrust Economics*⁴, and Mathewson and Winter’s review of the law and economics of resale price maintenance (“RPM”), which was recently cited by the U.S. Supreme Court in the *Leegin* judgment (“*Leegin*”).^{5,6}
4. The report begins in the next section by discussing the economics of selective distribution. In Section 3 the analysis is applied to the selective distribution of luxury goods and Section 4 concludes.

1 The report has been commissioned by the LVMH Group and its legal advisers Cleary Gottlieb Steen & Hamilton.

2 Commission Notice – Guidelines on Vertical Restraints (2000/C 291/01) published in the OJEC of 13/10/2000.

3 Throughout the report we use the term “supplier” to indicate a company operating at the upstream level from the retailers. In many cases the supplier will also be the manufacturer of the product but in the luxury goods industry in a number of instances the supplier and trademark owner is not the manufacturer of the product.

4 Rey, Patrick and Thibaud Vergé, “Economics of Vertical Restraints” in *Handbook of Antitrust Economics* edited by P. Buccirossi, MIT Press, April 2008.

5 Mathewson, Frank and Ralph Winter, “The Law and Economics of Resale Price Maintenance”, *Review of Industrial Organization* 13 (nos. 1-2), April 1998: 57-84.

6 US Supreme Court, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, June 2007 (Docket No. 06-480).

5. Five key conclusions emerge from the economic analysis in this report and its application to the luxury goods industry:
 - (a) vertical restraints such as selective distribution are costly for upstream suppliers, which means that when the restraints are observed there must be offsetting benefits to implementing them (i.e., they must provide some benefits to the upstream suppliers). The clearest benefit to suppliers of selective distribution is the enhancement of product brand image via distribution through only upscale retailers. These retailers are associated by consumers with luxury products.
 - (b) Investment in brand image cannot be regarded as “bad” or “wasteful” and compared to “good” investment in R&D activities or new product development. Consumers evidently value a strong brand image and the benefits that flow from the protection of this value must be recognized in optimal competition policy towards restrictive distribution.
 - (c) Introducing more restrictive legal criteria for the use of selective distribution by suppliers can reduce consumer welfare by constraining a legitimate business practice that contributes to consumer welfare.
 - (d) It would be incorrect for regulators to try to second-guess the optimal level of investment in brand image or a company’s choice of different inputs to achieve a desired brand image. Intervention by competition policy enforcers in this decision cannot systematically improve total welfare or consumers’ welfare in the market for luxury goods.
 - (e) A supplier’s restrictions on “pure-play” retailers and more generally on internet sales by luxury goods suppliers can be a necessary and legitimate business practice.
6. In policy terms a rule of reason approach should be applied to selective distribution cases. Moreover, within the context of a rule of reason, the only potential concerns about restricted distribution relate to (1) instances where the vertical restraints imposed by the suppliers are found to facilitate collusion (among suppliers or among retailers) or (2) to instances where vertical restraints play a strategic, competition-dampening effect such as those described by Rey and Stiglitz and explained in this report. The burden of proof in a restricted distribution case, as in any vertical restraints case, should rest on the side of the regulator. That is, the appropriate burden rests not on the respondent to justify the use of restricted distribution, but rather on the side of government intervention to demonstrate that the use of restricted distribution is damaging to consumers or total welfare.

B. THE ECONOMICS OF SELECTIVE DISTRIBUTION

B.1. INTRODUCTION

7. Suppliers of products, in designing distribution systems for their products, rarely just set a wholesale price and let any retailers or distributors carry their products without contractual restrictions. Instead, suppliers often place restrictions on which retailers may carry their

products, the prices at which the products may be resold, the territories within which or customers to whom the products may be resold, and so on. Vertical restraints on distributors are constrained and in some cases prohibited by competition law in the EU. This is in contrast to the United States, where the law has evolved to a relatively liberal policy towards vertical restraints.

8. This section offers an economic analysis of competition policy towards *selective distribution*, the practice by which a supplier restricts the channels through which its products are distributed (e.g. in prohibiting the distribution of its products through low quality retail outlets).⁷

B.2. COMPETITION POLICY TOWARDS RESTRAINTS ON DISTRIBUTION: THE ECONOMIC FOUNDATIONS

The Case of a Monopolist

9. Substantial confusion can arise in the analysis of competition policy towards vertical restraints as to whether strong inter-brand competition should be *sufficient*, or *necessary* as well, for a restraint to be appropriately permitted by competition authorities. European competition policy is particularly suspicious of the practices of dominant firms. Substantial clarity about the role of inter-brand competition is therefore added by first analyzing the use of restraints by a firm that is completely dominant – with not even the *threat* of competition in its market. In this case of complete dominance, can one justify a restrictive policy towards restraints on distribution or is a *laissez-faire* policy appropriate? The case of a pure monopolist is obviously extreme but it is an essential analytical benchmark if one is to understand whether strong inter-brand competition is necessary to justify a *laissez-faire* approach to the use of vertical restraints.
10. In the simplest of markets, with the simplest of products, demand would be determined only by price. The demand function, $d(p)$, which describes the quantity demanded, would have a single argument, the price. In this kind of market, a monopolist would have no incentive whatsoever to restrict the retailers. Prohibiting or restricting “pure-play” internet retailers, for example, can only raise price at the retail level and in this simple world the increased price would harm the monopolist. Suppose, for example, that a monopolist has a cost of €5 per unit, and sets a wholesale price of €8 per unit. The monopolist would like as low a retail price as possible, because demand is downward-sloping, and the monopolist would like to collect its wholesale mark-up of €3 on as many units as possible. If the retail price in the absence of restricted distribution is, say, €12 then a monopolist that imposes restraints causing the retail price to rise to, say, €20 would be harming itself

⁷ Note that the economics of *RPM* in the form of vertically imposed price floors is very similar. In fact while *RPM* has often been used in the past to prevent distribution through discount outlets, selective distribution imposes this restriction directly. In terms of economic motivation as well as effects the two practices are quite similar in that both involve trade-offs between low prices and greater non-price dimensions of product distribution such as service, convenience, a pleasant shopping experience and so on. But there is an important difference: selective distribution does not eliminate intra-brand price competition since outlets within the distribution channels allowed by the supplier continue to compete on prices. Resale price maintenance on the other hand eliminates intra-brand price competition completely.

because at the higher price fewer units are demanded and the supplier therefore earns its mark-up of €3 on fewer units. A monopolist, in short, cannot benefit from restrictive distribution (e.g. prohibiting online distribution) in a world in which demand depended only on price. The “cost” of facing a higher retail price (and therefore lower quantity demanded) is not offset by any benefits as the wholesale price charged by the monopolist would not increase.

11. It cannot be emphasized enough that high prices at the retail level, or limitations on the number or types of retailers, are a *cost* to a supplier – and would be incurred in reality only if there is some offsetting benefit.⁸⁻⁹ This is stated explicitly in the brief submitted to the US Supreme Court in *Leegin* by twenty-three well-known antitrust economists including eight former chief economists of the DOJ and the FTC.¹⁰ While *Leegin* is a resale price maintenance case, the identical logic applies to selective distribution and

8 Non-economists have sometimes argued that RPM is a means by which a monopolist keeps its price high – and may have the (wrong) intuition that selective distribution is also explained as a profitable means of preventing low prices. This is incorrect as a supplier has absolutely no incentive to sell less and leave a higher mark-up to independent retailers.

9 Note that in the standard double marginalization problem, RPM is indeed a solution for the supplier, but it takes the form of a *price ceiling* not of a *price floor*. A price floor would be totally ineffective, since the retailer could continue to add its retail margin and harm the supplier’s profit through lower quantities.

10 “Generally, a manufacturer wants retail margins to be low; having sold the product to the retailer, it wants the retailing function to be performed as efficiently as possible, with competing retailers, in turn, passing on to consumers the lowest price consistent with retailers’ providing desired services and continuing in business. In real-world markets, however, the incentives facing retailers may be out of alignment with those of manufacturers, to the detriment of the manufacturers’ ability to compete effectively with the products of competing manufacturers (page 5).” Brief of Amici Curiae Economists in support of Petitioner *Leegin* in the Supreme Court of the US (*Leegin*) (“Economic Brief”)

other vertical restraints.¹¹

12. The critical piece of evidence in a vertical restraints case, which cannot be overlooked, is the simple fact that the supplier *is adopting* the restraint. As a matter of logic, assuming that firm managers are rational, retail demand in the case of a monopolist must therefore depend on more than price since only then can a monopolist benefit from the restraints. Demand must depend on factors other than price – factors such as (1) sales effort by the retailer; (2) sales staff enthusiasm or influence; (3) a well-organized inventory and short cashier lines allowing for less time input by a shopper; (4) a comfortable shopping environment allowing for less time and less stress on the part of the consumer; (5) information provided at the point of sale; (6) retail service provided after the sale of the good, and so on. *Anything* that a retailer provides affects demand, and we know that the actions provided by a retailer contribute to demand simply from the evidence that suppliers are willing to use them rather than simply sell everything on-line or in boxes at discount stores.
13. It is important to recognize that whatever service is being enhanced by vertical restraints cannot be specified in a contract and enforced perfectly. “Enthusiasm” and “conveying a high-class image” are examples. This is the reasonable underlying assumption used in the economic models of vertical restraints. This implies that it is simply not possible for suppliers to directly reward retailers for demand-enhancing activities to prevent free-riding by retailers who do not incur such costs that increase the demand for the product. This is also discussed in the Economic Brief.¹²

11 In principle the Commission could bring a case against RPM, based on the following theory even in the case of a pure monopolist in a world in which demand depended only on price: if contracts between a monopolist and all retailers are not publically observed, then the monopolist and any particular retailer have the incentive to strike a contract with a low variable price so as to extract a larger market share for that retailer at the expense of other retailers. (The other retailers cannot observe the contract and therefore cannot make their own contracts conditional upon the contract struck with the particular retailer.) The monopolist cannot commit against this type of behaviour, with the result that low variable prices are struck and prices below the profit-maximizing monopoly level follow (Hart, O. and J. Tirole (1990), “Vertical Integration and market foreclosure,” *Brookings Papers on Economic: Microeconomics*: 205-86 and O’Brien, D. and G. Shaffer (1992), “Vertical Control with Bilateral Contracts,” *RAND Journal of Economics* 23: 299-308.) O’Brien and Shaffer point out that the monopolist can ensure monopoly profits by adopting RPM, setting both retail and wholesale prices equal to the monopoly price. The monopolist becomes the residual claimant on all retail sales and can no longer extract transfers from other retailers when making an offer to one of the downstream firms. In any such application, however, the burden of proof should rest on the Commission and we are unaware of *any* persuasive application to this point of the theory to a specific case or any persuasive application of the theory in general. In any case, this theory cannot explain restrictive distribution, e.g. restricting or prohibiting online distribution, which is our focus in this report. We therefore set aside this “commitment theory” of the monopolist’s use of vertical restraints.

12 “[...] manufacturers can contract with retailers for specific services. However, the nature of marketing and selling is such that it may be difficult to specify completely all of the services that the retailer must perform and the level at which it must perform them. It is also possible that the retailer, rather than the manufacturer, knows which retailer-level services will be most effective in maximising the competitiveness of the product, or that the most effective services will be discovered only through experience with the market and will be more apparent to the retailer than to the manufacturer. (page 9)” (Economic Brief)

14. Suppose then that demand depends on non-price variables – for simplicity, a single variable other than price. We can write the demand function as $d(p,a)$ where a is the amount of the other variable, which we shall call service for short but which can represent any of the dimensions of retailer effort (or others) referred to above. Recognizing the impact of retailer actions on demand, we now have at least the potential for a profitable use of a vertical restraint such as selective distribution: if the use of the restraint enhances the additional dimension a , then this positive, indirect effect of the restraint may more than offset the direct negative effect that a restraint has on demand through the increase in price. For a pure monopolist, adding to retailer service as suggested by this framework is not only a *possible* rationale for vertical restraints, it is at the general level the *only* rationale.
15. This framework raises three key questions:
- (a) (the first positive economic question): why does an unrestrained market (in which the supplier simply sets a wholesale price and lets all retailers buy without restrictions) not automatically provide the right mix of price and “service” (p and a)?
 - (b) (the second positive economic question) How specifically can a restraint such as selective distribution (or resale price maintenance) change the mix of p and a provided at the retail level in a direction advantageous to the upstream monopolist?
 - (c) (the normative question) Is there a basis for assuming with confidence that the monopolist’s adoption of the vertical restraint to change the mix of p and a is against consumers’ interests or the collective interest of all participants in the market? Or is there evidence on which one can confidently rely to determine when the supplier’s change in the mix of p and a is against consumers’ interests?
16. We address these questions in turn. With respect to the first positive question, two general classes of theories have been prominent in the economic literature: (1) theories based on *free-riding arguments* and (2) theories based on *heterogeneity among consumers*. The uses of selective distribution and RPM have been much more widespread than can be accounted for simply by free-riding theories alone. In practice both rationales are likely to play a role for suppliers of luxury goods.
17. The free-riding argument for vertical restraints was originally developed by Telser (1960).¹³ His argument, extended to the context of image-sensitive luxury goods, is the following. Consider the case of an internet retailer of a luxury good, for which image is a critical and expensive component of the product. All of the non-internet, upscale retailers have undertaken investment in expensive image and product-image-conveying aspects of their business. An important part of the investment in product image is at the retail level and the costs of investment at this distribution level are paid for by suppliers voluntarily through high mark-ups, i.e. through high shares of revenue accruing to the retailers. An individual internet retailer can benefit from the investment by all the other retailers in the

13 Telser, Lester (1960), “Why should suppliers want fair trade”, *Journal of Law and Economics* 3: 86-195.

strong, upmarket images (which are conveyed to the product) without any investment itself. Its own contribution is small and it has an incentive to skip the investment in image formation, price low, and thus *free-ride* on the image investment by other retailers (i.e. on the investment by the supplier in having the product carried by the other, upscale retailers). This low-price internet retailer will therefore capture a large part of the sales that would have otherwise been realized by the upscale retailers. This in turn reduces the profitability of these upscale retailers, which might no longer be willing to make the important image-enhancing investments given that they cannot reap the full benefit of those investments. In the extreme case where all consumers buy at the lowest possible price, investment in consumer services will be stopped by all types of retailers.¹⁴ Whether we are considering investment by a particular retailer, or the choice “by the market” of which retail outlets will thrive, the logic is the same: the unrestricted market will choose points on the spectrum of low-price to high-image-investment that are lower than the supplier would prefer. In order to prevent such free-riding, and damage to the sales of its product, the supplier may impose RPM (thus preventing an outlet from attracting customers through low price instead of high image). Or, in today’s world where low-price channels such as the internet are so easily identified and RPM is in practice treated as a *per se* violation of Art.81, the supplier will simply impose restrictions that may prevent the on-line channels from carrying its product (or limit the volume they can sell). The Telser free-riding theory of vertical restraints extends well beyond the provision of retailer “special services” to which he originally applied the theory. Firms plausibly use a mix of distribution channels to match their need for creation of image, of provision to the customer of a place to sample the product, and so on. Importantly, perfume sampling at a store, then buying on the internet, is a perfect application or set-up for Telser’s special-services free-rider story.¹⁵

18. A second class of theories is based simply on heterogeneity of consumers, allowing in

14 A very similar example is used by the DOJ and the FTC to describe this problem in their Amicus Curiae Brief supporting the Petitioner: “A retailer offering no services but a lower price can sell to consumers who have been educated by retailers that do provide the services desired by the manufacturer and the consumer. The problem is exacerbated by catalog retailing and the advent of the Internet, as consumers may visit traditional, brick-and-mortar retailers to examine a product and select its features but then purchase the product at a discounted price from a catalog or on-line retailer, whose very lack of “bricks and mortar” affords point-of-sale services impossible and whose lack of expenses for bricks and mortar gives them a competitive advantage over traditional retailers who provide the services that some manufacturers desire (page 13).” Brief for the United States (DOJ and FTC) to the Supreme Court in *Leegin*.

15 Marvel and McCafferty (1984) discuss the role played by quality certification of products by reputable retailers. The idea is very similar to that of the free-riding problem: since quality certification involves some incremental cost, this cost will only be incurred by the retailers if they know that they can be protected from intra-brand competition (same argument as in the service provision free-riding problem). Such protection can be guaranteed through RPM (in the form of minimum imposed prices, but that would then be illegal in many jurisdictions) or selective distribution. Their paper applies directly to cases where the supplier is looking for certification from the retailers, which is not the case for suppliers already perceived as producing luxury goods that want to maintain their brand image through their retail network, but it might apply to new suppliers of luxury goods who want to be distributed by high quality retailers only. Marvel, Howard and Stephen McCafferty (1984), “Resale Price Maintenance and Quality Certification”, *Rand Journal of Economics*, 15, 346-359.

particular for a difference in the types of consumers who are willing to search or shop among retailers and those whose choice is more focused on which product to buy, rather than from which retailer to buy (see Winter (1993)¹⁶ and Klein and Murphy (1988)¹⁷). The key intuition behind this theory is that a retailer chooses its mix of competitive instruments to attract customers away from other retailers as well as attract customers to the product. The supplier would like the retailer to focus its sale strategy (mix of demand instruments) *exclusively* on attracting customers to its products since a customer attracted away from another retailer is not a net addition to the supplier's demand; instead the retailer chooses the strategy to attract customers in *both* dimensions. This would not be a problem, in terms of designing an efficient distribution system if the same mix of instruments (p and a) were optimal in attracting customers away from other retailers as in attracting customers into the market. But these two sets of customers are often of different types. A consumer who searches among retailers is often more concerned with low prices than with high service or other attributes. Consumers who search are often (1) less wealthy, with a lower cost of time, who are therefore less concerned with retailer actions that save time or provide a comfortable shopping environment (assuming comfort is a normal good, i.e. a good for which demand is increasing in income); (2) better informed about the product because they have taken the time to become informed at lower cost, or simply because becoming well-informed at home allows them the chance for a purposeful shopping strategy to find the lower price. These consumers with low search costs (who are attracted by low prices) are to be contrasted with impulse shoppers who are more likely to shop at the first store in which they stop. The impulse consumers are therefore more likely to be attracted by the image, shopping environment and services offered by upscale retailers. The retailer in attempting to attract customers away from other retailers, being focussed excessively on low search cost consumers is therefore biased towards price competition. In sum, there are plausible reasons that an unrestrained retail sector may, from the supplier's point of view, be biased towards price competition and away from providing various types of service. This bias may be manifest in individual retailers setting low prices and low service – or in a segment of the retail market (online retailers) offering low prices and limited service.

19. Other recent papers have presented variants of these arguments. For instance Spiegel and Yehezkel (2003) have considered an asymmetric situation assuming that a monopolist has the option to distribute its product through (exogeneously) differentiated retailers, i.e. through an upscale retailer (e.g., brick-and-mortar with fancy show-rooms) and/or through a no-frills discount retailer (e.g., "pure-play" internet player).¹⁸ Note here

16 Winter, Ralph A. (1993), "Vertical Restraints and Price versus Non-price Competition," *Quarterly Journal of Economics*, Vol. 108, Issue 1, pp. 61-76.

17 Klein, Benjamin and Kevin M. Murphy (1988), "Vertical Restraints as Contract Enforcement Mechanisms." *Journal of Law and Economics*, pp. 265-98.

18 Spiegel, Yossi and Yaron Yezekhel (2003), "Price and non-price restraints when retailers are vertically differentiated", *International Journal of Industrial Organization*, Vol. 21, pp. 923-947.

that the level of services offered by each retailer is fixed and cannot be adapted.¹⁹ These authors show that a monopolist would profitably use both channels *only if* it can somehow set customer restrictions ensuring that buyers with high willingness to pay are not diverted away from the upscale retailer. Otherwise, selective distribution – no distribution on-line – is optimal.

20. Let us turn to the second positive question of paragraph 15. How can selective distribution in particular change the mix of price and services to the monopolist's advantage? Selective distribution changes the mix of prices and service, towards higher prices and higher service, through three mechanisms. First, by protecting the retail price margin from erosion through greater competition at the retail level, the distribution system increases the marginal benefit that each retailer obtains from attracting customers through service. If the retail margin is €10 per unit instead of €5, then the retailer has twice the incentive to attract more customers at the margin, and service in all of its dimensions will increase. Second, in cases where there is any free-riding on services – by which we mean that a customer obtains pre-sales service (such as expert information, consultation or, for example, sampling perfumes) at a high-priced outlet and then purchases the product at a low-priced outlet that provides no service – prohibiting low-priced, no-service outlets increases the incentive for other stores to provide the informational service since they retain all of the customers that they inform. Third, restraining intra-brand competition enhances the profits that outlets earn. If an upstream supplier contracts with outlets for high service and must monitor (at some cost) the provision of this service with the strategy of terminating dealers who under-provide the service, the additional profits represent a “carrot” for the retailer that is lost with termination by the upstream supplier and therefore enhance the retailer's incentive to provide the service. This is a familiar argument in the economic theory of incentives and is developed in the vertical restraints context by Klein and Murphy (1988).²⁰
21. Finally, we turn to the normative question of paragraph 15. Note that this question is not, “does the monopolist act in consumers' interest?” Monopolists make some decisions that are in consumers' interest and others that are not. It is not enough, to support regulatory intervention, to find that a monopolist *may* act against consumers' interest in changing the mix of p and a by retailers. That is, the question is not whether the supplier and consumers always, or sometimes, agree on trading off higher prices for greater service. To justify regulatory intervention, it is essential that evidence be available in which the intervention can, with very high probability, improve the market outcome. If consumers' willingness to trade off higher prices for greater provision of a were *consistently* much less than the supplier's willingness to make the same trade-off, for example, then a restrictive policy towards restraints would be called for.
22. Is a monopolist *systematically* biased towards too much service and too high prices, compared to the socially optimal mix? If this were the case, then a regulatory prohibition

¹⁹ Although this assumption is always open to criticism, it is relatively realistic to imagine that upscale retailers are not likely to become no-frills discounters extremely quickly (especially when they do not sell only one type of goods but many different categories of products, which would be the case of up-market department stores).

²⁰ Supra note 17.

of the vertical restraints would be justified. But it is not the case. Indeed, under the free-rider theory of restricted distribution,²¹ if the free-riding problem is severe, then the adoption of restricted distribution or other vertical restraints is unambiguously welfare improving because the market would decrease in volume, perhaps even disappear, if vertical restraints were not available to remedy the free-riding problem.

23. The heterogeneous consumer theory of vertical restraints, the main alternative to the free-riding explanation of vertical restraints in the case of a monopolist, does not yield as easy an answer. As a matter of economic theory, the level of service (or quality) that a monopolist considers ideal depends on the preferences of marginal consumers, defined as those consumers just willing to buy at the monopoly price. If marginal consumers were willing to pay €1.05 more for an increase in service (or any other dimension such as image enhancement) that cost the monopolist only €1 per unit, for example, the monopolist would surely increase service by this amount. The *socially* optimal service, however, depends not on the *marginal* consumers but on the *average* consumer purchasing the product. If consumers currently purchasing a product are on average willing to pay €1.05 for an increase in service expenditure of €1 per unit, then it is socially optimal to increase the service. Whether a monopolist's provision of service (or quality) is too low or too high thus depends on a comparison of marginal versus average consumer preferences for greater service versus lower prices (Spence (1975)).²² In general, the willingness of marginal consumers to pay for higher quality may be less than or greater than the willingness-to-pay of average consumers. Thus, the supplier's shift in the mix of prices and service or other dimensions may or may not be in the right direction. Just as we cannot predict whether a supplier in general engages in too little or too much advertising, we cannot in general predict whether the supplier is biased towards too little or too much service. And just as we do not restrict in general a supplier's decision to advertise, nor should the decision of a supplier to adjust the mix of price competition and services through vertical restraints be prohibited in general. Unless there is persuasive evidence of the relative demand for service (or other non-price dimensions) by infra-marginal versus marginal consumers – and this evidence we believe is rare – there can be no presumption that a legal restriction against restricted distribution will improve the market performance in the case of a monopolist supplier.
24. One particular non-price dimension of retailer decisions that is enhanced by vertical restraints deserves special mention, because it is analytically distinct from others. Inventories, or product storage, are fundamentally undersupplied when a monopolist relies on downstream competing retailers to make decisions on inventory. This is demonstrated by Krishnan and Winter in a recent article in the *American Economic*

21 We use the term "restricted distribution" to refer both to selective distribution and forms of exclusive distribution.

22 Spence, A.M. (1975) "Monopoly, quality and regulation", *Bell Journal of Economics*, pp. 417-429.

Review (2007) and by Marvel, Deneckere and Peck in two recent articles.²³ The explanation of the incentive distortions giving rise to the failure of unrestrained retailers to choose adequate inventories is somewhat complex, but can be summarized roughly as follows: price competition among unrestrained retailers will drive down retail margins enough that retailers' incentives to carry inventory (on which they can earn the retail margins should demand be strong) are severely compromised. The upstream supplier can protect incentives to carry adequate inventory by protecting retail margins through resale price maintenance, as these articles demonstrate. The theory would extend directly to the use of restricted distribution to protect retail margins, especially in environments where RPM is illegal. Krishnan and Winter provide evidence to support the theory that vertical restraints can be necessary to elicit adequate retail inventory levels – evidence that when vertical restraints were prohibited for some firms by U.S. antitrust decisions in the early 1970's, inventories collapsed and product distribution was severely compromised.

Competing Suppliers Upstream

25. While the previous section has presented the key findings of the economic literature on the choice of vertical restraints (and selective distribution in particular) by a monopolist, in practice competition policy often deals with situations where there are a number of competing suppliers selling the products. The key question is to what extent the findings from the previous sections carry through to this setting and to what extent other concerns might emerge.
26. In the mid to late 1980s, a new strand of the economic literature was developed analyzing the role of vertical restraints when competition exists between suppliers selling through separate retail channels. This literature focused on the strategic use of vertical restraints by suppliers to affect the market outcome. The basic idea is that vertical restraints imposed by a supplier upon its retailers will affect the nature of (intra-brand) competition between these retailers on the downstream market. Since these retailers also compete with the other suppliers' retailers, this will ultimately affect the nature of the competition between suppliers.
27. In that setting, several authors (see for instance Bonanno and Vickers (1988) or Rey and Stiglitz (1988, 1995))²⁴ have shown that vertical restraints that eliminate intra-brand competition such as territorial exclusivity clauses can be used (through strategic interactions) to soften competition between suppliers. This ultimately leads to higher retail prices. The logic is that vertical restraints provide an upstream supplier with the

23 Harish Krishnan & Ralph A. Winter, "Vertical Control of Price and Inventory", *American Economic Review* 2007 (Vol. 96, No. 5): 1840-1857. See also Howard Marvel, Raymond Deneckere and James Peck, "Demand Uncertainty, Inventories, and Resale Price Maintenance," *Quarterly Journal of Economics*, Vol. 111, No. 3 (August 1996): 885-913; and "Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition," *American Economic Review*, Vol. 87, No. 4 (September 1997): 619-641.

24 Bonanno, G. and J. Vickers (1988), "Vertical separation", *Journal of Industrial Economics*, 36, 257-265; Rey, P. and J. Stiglitz (1988), "Vertical restraints and producers competition", *European Economic Review*, 32, 561-568; Rey, P. and J. Stiglitz (1995), "The role of exclusive territories in producer's competition", *Rand Journal of Economics*, 26, 431-451.

commitment to act less aggressively in price competition and when rivals observe the commitment to a more passive behaviour they are induced to set higher prices. In short, the commitment to passivity via vertical restraints induces higher prices on the part of rivals, to the benefit of the manufacturer.

28. There are however two important caveats that apply to the policy implications of this "strategic theory of vertical restraints". First, the impact of such restraints clearly depends on the extent of inter-brand competition. The competition-dampening effect has no force in the case of very little inter-brand competition (i.e. close to a monopoly) and is highly unlikely to be a serious consideration when competition between suppliers is fierce. It is in theory applicable only in the case of an intermediate degree of inter-brand rivalry.
29. Second, it is important to observe that different types of vertical restraints that affect intra-brand competition between retailers may well have different effects in this setting. The intuition of the Rey and Stiglitz's papers, to elaborate on our summary above, is the following. Suppose that competition between retailers (for a given product) is extremely fierce. Because of this fierce competition, in the absence of any restraint, a supplier's retailers will thus all set a retail price equal to the supplier's wholesale price plus their retail cost. Therefore, everything happens as if the two suppliers were directly competing in prices (i.e. the final prices are the same as in a model where the two suppliers can directly distribute their product and face the same retail cost as their retailers). Suppose now, that a supplier imposes territorial exclusivity clauses to its retailers. Formally, the situation is now the same as one where that supplier would use a single retailer (thus totally eliminating intra-brand competition). When setting its retail price, that retailer now takes into account the wholesale price at which it obtains the good from the supplier, but also the price set by the retailers carrying the competing brand. Because intra-brand competition has now been eliminated, it will set a higher retail price (it now takes a positive retail margin rather than simply setting a price equal to its wholesale price plus retail cost), which in turns affects the profits of the supplier producing the competing brand. As shown by Rey and Stiglitz, under reasonable assumptions on the demand functions, eliminating intra-brand through the use of territorial exclusivity clauses softens competition between suppliers and ultimately leads to higher retail prices in their model. Obviously, the effect on inter-brand competition will be limited if there are many suppliers (and many retailers).²⁵
30. Importantly, this strand of literature has focused on situations where suppliers distribute their products through distinct retail channels. This is clearly not the case for many consumer goods (such as for instance perfumes and cosmetics), for which retailers carry competing brands.
31. Beyond the Rey-Stiglitz theory of vertical restraints, a second, more concrete and empirically more relevant concern with vertical restraints has been discussed by

25 An example might be the approach used by car manufacturers in the past in the EU where exclusive dealers had different forms of territorial protection. This means the dealers could charge a mark-up over the wholesale price to reflect their market power thereby softening inter-brand competition among the car manufacturers.

Mathewson and Winter (1998),²⁶ Jullien and Rey (2007)²⁷ and originally in Telser (1960).²⁸ This is the concern that RPM can facilitate collusion. RPM leads to more uniform retail prices thereby making price cuts easier to detect for the colluding suppliers. The intuition is that suppliers colluding on wholesale prices in the absence of RPM would find it difficult to distinguish between changes in retail prices caused by cheating on the collusive agreements and changes caused by changes in demand conditions or retail costs. This concern is explicitly stated in the Guidelines at paragraph 110 “*when most or all of the competing suppliers limit the number of retailers, this may facilitate collusion, either at the distributor's level or at the supplier's level*”. This concern would be unlikely to apply to industries with multiple suppliers such as the cosmetics and perfumes sector.²⁹ More importantly, these concerns have been expressed in the economic literature in relation to the use of RPM and not in relation to the use of other vertical restraints such as selective distribution. Selective distribution does not facilitate collusion. Indeed since internet prices are easily observable and observability of prices by rivals is a necessary condition for collusion, prohibiting distribution over the internet may even have the *opposite* effect of making collusion more difficult. Finally, it is also important to bear in mind that suppliers have no incentive to facilitate a retailers’ cartel as this would lead to

26 Supra footnote 5.

27 Jullien, B. and P. Rey, (2007), “Resale Price Maintenance and Collusion”, Rand Journal of Economics, vol. 38, n°4, Winter 2007, p. 983-1001.

28 Supra, footnote 13.

29 There have been several recent vertical Chapter I prohibition cases (vertical price fixing cases) in the UK, in particular on toys, football kits, and cigarettes. (See OFT Decision CA98/08/2003 on “Agreements between Hasbro U.K. Ltd, Argos Ltd and Littlewoods Ltd fixing the price of Hasbro toys and games” and OFT Decision CA98/06/2003 on “Price-fixing of Replica football Kit”.) The recent cigarettes case, which was partially settled, appears most relevant for the question of facilitation of upstream collusion via vertical agreements, as it involved the two major cigarette suppliers in the UK, Gallaher and Imperial Tobacco, as well as a range of major retailers (including Tesco, Asda, Sainsbury’s etc). The settling parties admitted to (a) linking of the retail price of a supplier’s brand to the retail price of competing brands of another supplier; and (b) indirect exchanges of proposed future retail prices between (i) suppliers via retailers, and (ii) retailers via suppliers. The activities in this case went far beyond bilateral vertical restraints between suppliers and retailers. But the case illustrates one potential channel through which vertical agreements might facilitate upstream collusion. Nevertheless, this case arose in the context of an effective upstream duopoly and had nothing to do with the use of selective distribution by the suppliers. (See OFT press release 82/08 (11 July 2008), “OFT reaches early resolution agreements in tobacco case”, <http://www.of.gov.uk/news/press/2008/82-08>) There have also been a number of vertical cartel cases in France. A recent case involved vertical price fixing in the cosmetics and luxury perfumes market. The French Conseil fined 13 suppliers and three large retail chains a total of €45m for a series of independent vertical agreements to *de facto* enforce a form of RPM (recommended retail prices and maximum discounts allowed). (Décision n° 06-D-04 bis* du 13 mars 2006 relative à des pratiques relevées dans le secteur de la parfumerie de luxe, available at <http://www.conseil-concurrence.fr/pdf/avis/06d04.pdf>.) In Germany the Federal Cartel Office recently fined a number of perfume and cosmetics companies for collusion and price-fixing arising from information exchanges. The case also had nothing to do with the use of restricted distribution by these suppliers. (See media coverage at <http://www.ihf.com/articles/ap/2008/07/10/business/EU-Germany-Fragrance-Fines.php>.)

higher retail prices and lower sales for the suppliers.³⁰

B.3. POLICY IMPLICATIONS

32. As discussed above, in economics, taking the extreme case of a firm so dominant that its monopoly is not threatened, there is no general basis for regulatory intervention at all in the firm's use of vertical restraints including the use of selective distribution. Economic theory implies that in the most extreme case of a dominant firm – a monopolist without even the threat of competition – the restraints of selective distribution serve only to elicit some non-price dimension of a product or service that is demanded by consumers. (Otherwise the monopolist would not tolerate the higher retail prices associated with a selective distribution restraint that eliminates the lowest-price distribution channel.) This dimension may be better retail service, a more pleasant or convenient shopping environment, retail information, and so on. While there is no general theory that the supplier's willingness to trade off a higher price for better service (or other dimension) is always in consumers' interest, the more important point is that *there is also no basis for presuming that this trade-off is inefficient*. Absent any evidence that the trade-off reduces market efficiency – and we must acknowledge that such evidence is in general difficult to uncover – economic theory supports a laissez-faire approach to restricted distribution in the case of a monopolist. Competition policy does not restrict a supplier's choice between low prices and higher non-price dimensions such as service in its strategy of attracting demand; competition policy does not regulate the expenditure on advertising as a fraction of revenue, for example. Where the choice of price and non-price instruments is simply *implemented* through vertical restraints, economic analysis shows that the policy should be similar. This policy conclusion contrasts sharply with the general suspicion in the Commission's Guidelines on Vertical Restraints towards dominant firms.
33. The case where there *is* some competition is where one must be more vigilant for negative horizontal effects of these restraints. At various places in the Guidelines, however, the presence of "enough" competitors (in the absence of collusive effects) is taken as a *sufficient* condition for a more relaxed approach to vertical restraints (and this is the logic behind the block exemption). This is confirmed in recent papers written by economists working within DG Comp. For instance Verouden (2007) concludes his recent review by stating that "vertical restraints are unlikely to have detrimental effects when there is no market power on either level of the industry".³¹ We agree with this position. But we would emphasize that the presence of significant competition should not be regarded as *necessary* for a liberal policy towards these practices: as we have shown the complete absence of inter-brand competition does not warrant a restrictive policy towards these business practices.
34. The Guidelines in many places point to the importance of intra-brand competition. Suppression of intra-brand competition is clearly seen simply in terms of a lessening of

30 "[...] the manufacturer – a key element in these agreements – receives no benefit from a dealer cartel, but on the contrary, suffers diminished sales. Therefore, manufacturers generally lack incentives to cooperate in furthering a dealer cartel" (page 15) (Economic Brief).

31 V. Verouden (2007), "Vertical Agreements: Motivation and Impact" published in *Issues in Competition Law and Policy* (W.D. Collins eds.), American Bar Association, Antitrust Section 2008.

competition. There is little or no recognition of the economic point that (outside of inter-brand effects) if a supplier imposes a restraint on competition it *must* be that some other dimension of value to consumers is enhanced – otherwise the supplier (who also values competitive retail markets) would never restrict competition.³² For example, the Guidelines state:

For most vertical restraints, competition concerns can only arise if there is insufficient inter-brand competition, i.e. if there is some degree of market power at the level of the supplier or the buyer or at both levels. If there is insufficient inter-brand competition, the protection of inter- and intra-brand competition becomes important (paragraph 6).

35. As discussed above, economic analysis proves that protection of intra-brand competition is not universally efficient. If necessary to enhance non-price product dimensions that the consumers value, restrictions on this competition may well be both privately and socially efficient as they might enhance the demand for the product *and* inter-brand competition.³³
36. Second, we believe that as a matter of economic policy the burden of proof in a competition law case should rest on the side of the regulator. Markets do not always provide the ideal trade-off between price and non-price dimensions; there is no guarantee that firms in adopting vertical restraints make the right trade-off in accepting higher prices for greater provision of other dimensions at the retail level. But placing the burden of proof on the side of a respondent who has adopted a selected distribution system is tantamount to a policy of intervention when there is the mere *possibility* that regulatory prohibition of the restraints will improve market efficiency. In some areas of antitrust it is appropriate to place the burden of proof on the respondent or defendant. We do not believe that this area is one of them. A recent FTC working paper by Cooper, Froeb, O’ Brien and Vita concludes, in agreement with us, that “absent a good natural experiment to evaluate a particular restraint’s effect, an optimal policy places a heavy burden on plaintiffs to show that a restraint is anticompetitive”.³⁴ The U.S. law on vertical restraints

32 Footnote 11 above discusses the only potential exception (in terms of economic theory) of which we are aware of and it explains why this is likely to be of little practical relevance in general, and irrelevant when the vertical constraint in question is selective distribution.

33 This is at least in part recognised in the paragraph 115 in the Guidelines even if there is an explicit reference to companies without market power while the consideration applies more generally. *“It is important to recognise that vertical restraints often have positive effects by, in particular, promoting non-price competition and improved quality of services. When a company has no market power, it can only try to increase its profits by optimising its manufacturing or distribution processes. In a number of situations vertical restraints may be helpful in this respect since the usual arm’s length dealings between supplier and buyer, determining only price and quantity of a certain transaction, can lead to a sub-optimal level of investments and sales.”*

34 See the abstract in Cooper, J., L. Froeb, D. O’Brien and M. Vita (2005), “Vertical Antitrust Policy as a Problem of Inference”, FTC Working Paper, 18 February 2005 available at <http://www.ftc.gov/speeches/froeb/050218verticalecon.pdf> published in *International Journal of Industrial Organization*, 23 (2005) 639– 664.

has evolved to the point where it is consistent with this approach.³⁵ The Guidelines have not and we would suggest that this problem be remedied in the forthcoming revision of the Guidelines. With respect to the allocation of the burden of proof, the difference between the Guidelines and the accepted view of industrial economists as well as U.S. law on vertical restraints is striking.³⁶ Cooper, Froeb, O'Brien and Vita (2005) state in their comparison of the US and EU approaches to vertical policy that even after the Guidelines were issued "Art.81 is still likely to subject a greater number of agreements to condemnation than would US antitrust law".³⁷

37. Third, within the Guidelines there is excessive focus on free-riding as not just a *sufficient* explanation for an efficient use of vertical restraints but also a *necessary* condition.³⁸ When combined with the allocation of the burden of proof to the respondent, this means essentially that a respondent must come up with a convincing free-riding argument (not just "speculative claims", as in paragraph 136 of the Guidelines) to justify its use of the restraints. This position has no basis in economics, as there is a much wider range of circumstances under which RPM or selective distribution will be used. A dominant firm faced with the burden of a clear proof of efficiencies based on free-riding arguments may be put in an impossible position. This would for instance be the case in the absence of

35 For instance in the recent Supreme Court judgment in *Leegin*, Justice Antonin Scalia acknowledged the "free rider problem," when "customers shop at the place that has the big showroom" to learn about a product, but then buy it at a lower price from somebody else who has not incurred that expense." The free-rider explanation of RPM (and selective distribution) has clearly affected U.S. law. Earlier in *Monsanto Co. v. Spray-Rite Service Co.*, the Court endorsed vertical restrictions that encourage retail service, supporting a supplier's right to terminate a discounting dealer to prevent free riding: "*independent action is not proscribed. [A supplier] has a right to deal, or refuse to deal, with whomever it likes as long as it does so independently*" (465 U.S. 752, 760-61 (1984)).

36 See for instance in paragraph 136 of the Guidelines "[...] [t]hese efficiencies have to be substantiated and must produce a net positive effect. Speculative claims on avoidance of free-riding or general statements on cost savings will not be accepted." See also paragraph 163 "The market position of the supplier and his competitors is of major importance, as the loss of intra-brand competition can only be problematic if inter-brand competition is limited. The stronger the "position of the supplier", the more serious is the loss of intra-brand competition. Above the 30% market share threshold there may be a risk of a significant reduction of intra-brand competition. In order to be exemptable, the loss of intra-brand competition needs to be balanced with real efficiencies."

37 Page 9, Cooper, J., L. Froeb, Daniel O'Brien and Michael Vita (2005), "A Comparative Study of United States and European Union Approaches to Vertical Policy", *George Mason Law Review*, 13:2 (Winter, 2005) 289-308.

38 The Guidelines also take a fairly narrow view of the free riding problem. Paragraph 116 states "For there to be a problem, there needs to be a real free-rider issue. Free-riding between buyers can only occur on pre-sales services and not on after-sales services. The product will usually need to be relatively new or technically complex as the customer may otherwise very well know what he or she wants, based on past purchases. And the product must be of a reasonably high value as it is otherwise not attractive for a customer to go to one shop for information and to another to buy. Lastly, it must not be practical for the supplier to impose on all buyers, by contract, effective service requirements concerning pre-sales services." Economic analysis shows that the concept of free-riding should be broadened to include externalities. Free-riding is far too narrow a term. It is enough, to generate incentive for vertical restraints in the case of luxury goods, that investment in "image" by one outlet at the retail level add to the demand for the product at other outlets – or at least not attract demand away from the other outlets.

“pure” free-riding issues but where consumers are heterogeneous. In this type of situations, although selective distribution might lead to high prices (and high services) that may harm consumers with low search costs, it may still be socially optimal.

38. Economic analysis, in short, supports a rule of reason policy under which the search for evidence of negative impacts of selective distribution focuses on horizontal inter-brand effects such as facilitation of collusion in those cases where this might be a plausible theory of harm. The burden in any legal case involving these restraints should be on the regulator not on the firm that is simply using the restraints to adjust the mix of price versus non-price product dimensions supplied by independent retailers.³⁹
39. The development of discount stores in Europe and the North America with the fall in consumer transportation costs in the post-war period presented a challenge to traditional outlets. In this period, RPM periodically played a role of foreclosing discount stores, under pressure from traditional outlets, across a variety of suppliers. (This was most evident in drug store markets in the United States and grocery stores in Europe (Mathewson and Winter (1984)⁴⁰). The hypothesis that a group of suppliers is being collectively pressured to avoid distributing through the internet is one that could appear in a case involving selective distribution. In fact, this would seem to us to be the main plausible hypothesis under which a prohibition of selective distribution could be justified alongside potential concerns related to competition-dampening effects of vertical restraints à la Rey and Stiglitz.
40. On the other hand, we have explained in this section why a supplier might foreclose internet resellers entirely; the same arguments apply, *mutatis mutandis*, to partial limitations on internet resellers. The fact that observed contracts in the distribution of many luxury goods set minimal level of services clearly supports our claim that the role of the restraints is to enhance services. Economic theory is clear on why services may be undersupplied (from a supplier’s perspective) in the absence of vertical restraints – individual retailers are biased towards low prices and away from higher service in their choice of instruments to attract consumers because this blend of instruments is most effective at attracting consumers away from other retailers, whereas the supplier would like retailers to focus on attracting consumers away from other products. And economic theory offers no basis for the position that a supplier’s choice of price versus service, whether implemented directly or through vertical restraints, is so systematically distorted that it can be improved upon via legal restrictions.

B.4. CONCLUSIONS

41. The key conclusions from the economic literature discussed in this section are as follows:

39 Other vertical restraints can play the role of excluding competition in a market. In calling for a more laissez-faire policy towards selective distribution, we are not suggesting that other vertical restraints cannot have anticompetitive effects even in the absence of exclusion. Design of the right economic policy towards vertical restraints in general would be the topic of a much broader paper.

40 G.F. Mathewson and R.A. Winter *Competition Policy and Vertical Exchange*, Royal Commission on Canada’s Economic Prospects, 1984.

- (a) restricted distribution leads to high prices at the retail level or to limitations on the number or types of retailers, both of which represent a cost to a supplier – and a supplier would voluntarily incur this cost *only if* there is some offsetting benefit. That is, the simple fact that the supplier *is adopting* the restraint shows that retail demand must depend on more than price.
- (b) Economists believe there are two main reasons why an upstream supplier – setting aside inter-brand competition entirely – would use vertical restraints: to remedy free riding distortions among retailers and to offset biases in retailer dimensions of competition induced by consumer heterogeneity. Protecting retailer incentives for investing in adequate inventories is a third reason.
- (c) Introducing more restrictive legal criteria for the use of selective distribution by suppliers can reduce consumer welfare by constraining legitimate business practices that contribute to consumer welfare.
- (d) For vertical restraints in general, but especially for non-price restraints such as selective distribution, an appropriate policy places a heavy burden on plaintiffs to show that a restraint is anticompetitive. Economic analysis supports a rule of reason policy under which the search for evidence of negative impacts of selective distribution focuses on negative effects on horizontal inter-brand competition. Chief among these potential negative effects in the case of resale price maintenance would be the facilitating-practice hypothesis, that RPM is facilitating collusion. But as we have shown, for the vertical restraint at focus in this report – selective distribution – the facilitating practice theory simply does not hold. This leaves policymakers with a single theory of negative effects of selective distribution on welfare, on which intervention could be based: the Rey-Stiglitz theory that the device is adopted as a strategic commitment to dampening competition in the market. We believe that evidence supporting this theory would be rare in practice (although we do not rule out the theoretical possibility). Such evidence might for instance take the form of a geographical cross-section of markets for the same product (across countries, for example) in which the restraint is adopted for intermediate levels of concentration but not for near-monopoly levels or low levels of concentration: this is the key testable implication of the theory.

C. APPLICATION TO THE SUPPLY OF LUXURY GOODS USING SELECTIVE DISTRIBUTION NETWORKS

42. Why might some luxury good suppliers restrict the distribution of their products so as to exclude or restrict internet (“pure-play”) retailers? Are such restrictions anti-competitive or socially detrimental in a way that justifies regulatory intervention? This section applies the economic principles developed in the previous section to address these questions. We begin the section by discussing the economic rationale behind the Commission’s acceptance of the use of selective distribution networks for the distribution of luxury goods and then we ask what (if anything) is specific about the use of the internet as a distribution channel.

C.1. IMAGE AS A COMPONENT OF THE PRODUCTS

43. We start with the observation that luxury goods in general tend to be distributed by their suppliers through up-market retailers. Whether the distribution systems are vertically integrated or not, greater expenditure is undertaken at the retail level on aspects such as sales assistance, an exclusive show-room, comfort for the shopper, a strong retail brand name and so on. Some of this expenditure is designed to make the shopping experience more pleasant for the consumer. But the main effect is to enhance the image of the product and to improve the shopping experience by making experienced sales assistants readily available to the consumer.
44. The image of a luxury product is an essential component of the product. Consider the example of expensive perfume. If Chanel No. 5 were sold in bulk over the internet, without any image investment, it would be an entirely different product than the one sold in small bottles at up-market perfumeries, advertised in expensive magazines, and so on. The product is defined not simply by its chemical composition but by its image.
45. Suppliers choose to invest in image and sales assistance because this is what consumers demand. Chanel or Dior for instance have the option of selling their perfumes in bulk over the internet with zero investment in image advertising, but they choose not to because the demand for their products at any price would be much lower.
46. In designing regulatory policy, one must accept the demand for image as a component of a product reflecting consumer preferences and therefore welfare. The perfume with a strong (and expensive) image that is purchased by a consumer is enjoyed by her – and perceived differently by her friends as an input into her own image – more than if it were sold as a chemical compound without any image whatsoever. It is being experienced as a different product. Any assumption on the part of a regulator that the consumer's demand for image is wasteful would be a violation of the principle of consumer sovereignty. It is not for policymakers to second guess consumers' choices of products, as long as the products do not confer negative externalities.
47. We use perfume as an example because it is such a clear example of a consumer product that is defined by more than its physical composition. But the same principles apply to other luxury goods.

C.2. RETAIL DISTRIBUTION CHANNELS AS INVESTMENT IN PRODUCT IMAGE

48. Investment in the image of a product takes many forms: advertising, expensive packaging, and distribution through select retail channels that have themselves invested heavily in image and reputation as very selective purveyors of fine products. Once upscale distribution channels have invested in image and reputation, the selection of these channels by a supplier constitutes an investment in image. An upscale retailer is expensive to use to distribute the product but adds a component to the final product, as perceived by both the purchaser and those who interact with the purchaser, which would not be provided by a discount store or internet retailer.
49. The investment by the retailer in image consists of advertising through expensive channels, providing a pleasant shopping experience, sales assistance and even investment in the form of turning down products that would be profitable but would detract

from the image of the retailer as very selective in its choice of products.

C.3. THE NEED FOR VERTICAL RESTRAINTS ON DISTRIBUTION

50. Accepting that image is a valuable and expensive component of a product, and that one important investment into the overall product image takes place at the retail point-of-sale, the question is, why will the retail market not provide the supplier's desired investment in image? Why might an unfettered market, simply purchasing the supplier's product at a wholesale price and reselling to consumers, fail to provide the mix of low price and strong image? This is always the starting point to understanding retail distribution contracts and restraints.
51. In the case of luxury goods there are two prominent reasons for the failure of the unrestrained market – for the price system itself – to provide the right incentives. Both have been developed in the economic literature. These are based on free-riding arguments and arguments related to consumer heterogeneity as discussed above in paragraphs 17 and 18.

C.4. NORMATIVE ANALYSIS

52. With regard to selective distribution of luxury goods, we suggest that the image of a product as a luxury item is (1) a key input into the demand for these goods, (2) an input that is provided to some degree at the retail level when a supplier distributes through high-class luxury retail stores; and (3) an input that economic theory shows will be fundamentally under-supplied by retailers. Economic theory predicts that for luxury goods, if the style of the retail distribution outlets is an input into the image of a product, then suppliers will respond with selective distribution restriction. From an efficiency point of view, consumers are evidently willing to pay high prices for goods with a strong luxury image. The economist's perspective is that if consumers are willing to pay for image, then this dimension of luxury products should be regarded as valuable to consumers; the axiom of "consumer sovereignty" takes consumer welfare as the values that are revealed by their choices. To the extent that a supplier uses a selective distribution restraint to enhance the retail sector's input into the image of a product, then the supplier is adding to a valuable dimension. Prohibiting a supplier of luxury goods from engaging in restricted distribution is a restriction of the supplier's choice of inputs – image versus lower prices – into its final offer of a product-price package.⁴¹ It is no less of a restriction on product image than a prohibition of image advertising. And nothing in the development of this perspective relies on competition among suppliers. Even in the case of a pure monopolist of luxury goods, a restriction on downstream competition or distribution channels is a means of investing in product image. If image were not important to consumers, the supplier would be the first to enlist low-cost internet retailers. Regulation does not restrict the expenditure of suppliers on advertising, nor should it restrict the expenditure of suppliers on high-cost, image-protecting retail channels.

41 Note that this assumes that the supplier can fully prevent internet distribution. Analytically the results also extend to limitations imposed to the retailers in the network with regard to their internet sales (e.g., monitoring of the quality of the internet sites and a requirement that significant investment is also made on brick-and-mortar outlets).

53. The policy argument could simply end on this point. But for a deeper understanding of the issues, it is well worth pursuing the following questions: has a monopolist supplier the incentive to choose the “right” point along the spectrum of high-image (or high quality) versus lower price? Is it *possible* for a legal prohibition of restricted distribution to improve economic efficiency (defined as the sum of welfare of all market participants) because of a failure of the supplier to choose the right mix? And, moving away from the case of a monopolist, how are the answers to these questions affected by the presence of competition from other suppliers?
54. Once we accept consumer sovereignty, the principle that the preferences revealed by demand choices are the right measure of consumer welfare, then the analytics of the optimality in investment in product image are identical to those of investment in product quality. Here the key insight is provided by Spence (1975).⁴² A “social planner” would base the decision on whether to spend €1 more (per unit) on product image on the *average* value of current customers of this product. On the other hand, only if this extra expenditure is worth more than one euro to marginal consumers will the supplier spend the euro. As a matter of theory, this means that the supplier may spend too much or too little on image.
55. The point is that while it is *possible* to construct examples where a prohibition of restricted distribution improves efficiency – just as it is *possible* to construct examples where a legal constraint on supplier advertising or other image expenditure improves efficiency – there is no presumptive case for efficiency of this regulation. For luxury products, restricting distribution is a means of enhancing product image that is a response to incentive incompatibilities in the retail distribution sector. Economic theory therefore suggests that legal prohibitions against restricted distribution are no more justified than attempts by a regulator to micro-manage supplier’s advertising expenditures.

C.5. WHAT IS SPECIFIC ABOUT INTERNET DISTRIBUTION AS AN ADDITIONAL SALES CHANNEL?

56. The Commission’s Guidelines indicate that the Commission accepts the use of selective distribution networks for supplies of luxury goods. The key question is then to what extent can the suppliers restrict internet sales through quantitative restrictions on retailers who are part of the selective network or through sheer exclusion from the network of “pure-play” internet retailers. We begin by discussing the key results that have recently emerged in the economic literature on the use of internet as an additional sales channel and the approach suppliers have taken to dealing with channel conflict between online and offline retailers.
57. A recent paper by Gertner and Stillman (2001) explores the relationships between the development of online stores and vertical integration.⁴³ Their evidence suggests that vertically integrated chains developed online sales more quickly than non-integrated

42 Michael Spence, (1975) *supra* note 22.

43 Gertner, R. and R. Stillman (2001), “Vertical integration and internet strategies in the apparel industry”, *Journal of Industrial Economics*, 49, 417-440.

chains. One explanation they propose is that non-integrated chains find it difficult to provide the right incentives for retailers to develop online stores that match the standard that the chain would like to maintain. Suppliers selling through non-exclusive retailers and department stores also find it more difficult to address channel conflict issues. Gertner and Stillman conclude that “it is not surprising that executives in the apparel industry regard channel conflict between vendors and department stores as a major issue (page 430).” This is consistent with our theme that free-riding issues (and more generally channel conflict issues) play a critical role in suppliers’ choices among distribution models.

58. A recent paper by very prominent scholars in the area, Carlton and Chevalier (2001), suggests that suppliers prevent or limit internet distribution by discount sites and that suppliers’ website tend to have higher prices.⁴⁴ Carlton and Chevalier (2001), show that suppliers do try to prevent internet distribution. The authors explain that “suppliers of branded goods have placed a variety of restrictions on their brick and mortar retailers in an effort to control free-riding on the sales and promotional efforts of retailers. The emergence of the Internet as a new distribution channel requires suppliers to develop restrictions on Internet retailers to control free riding (page 441).” Economic theory, as we have discussed, offers only two hypotheses to explain the incentives for restricting internet distribution: (1) the desire by the suppliers to enhance some other dimension of the product that is valued by consumers; and (2) the attempt by the suppliers in a highly concentrated industry to use restricted distribution strategically to dampen competition by committing to a less aggressive organizational form (see the Rey and Stiglitz papers discussed above). If suppliers restrict distribution across industries for all levels of concentration, then the second hypothesis, that the practice reflects rampant suppression of inter-brand competition, is implausible. Chevalier (2002) reiterates her conclusions in a submission to the FTC in a workshop discussing “Possible Anticompetitive Efforts to Restrict Competition on the Internet”.⁴⁵⁴⁶ Borenstein and Saloner (2001) also report anecdotal evidence of some “clothing suppliers [...] [who] refused to sell their products over the internet or to allow retailers to do so, so as to prevent the free rider problem between “showroom” retailers, who allow consumers to check out the product in person, and purely Internet retailers, who can operate with much lower overhead (page 8).”⁴⁷

59. These papers document that in the U.S. legal environment, where firms are relatively free

44 Carlton, D. and J. Chevalier (2001), “Free riding and sales strategies for the internet”, *Journal of Industrial Economics*, 49, 441-461.

45 Judith Chevalier (2002), “Free Rider Issues and Internet Retailing”, available at <http://www.ftc.gov/opp/e-commerce/anticompetitive/panel/chevalier.pdf> [accessed on 20 August 2008.]

46 More recent academic papers in the marketing literature have discussed similar concerns. See for instance Van Baal, S. and C. Bach (2005), “Free Riding and Customer Retention across Retailers’ Channels”, *Journal of Interactive Marketing*, Volume 19, Number 2, Spring 2005, pages 75-85 and J. Shin (2007), “How Does Free Riding on Customer Service Affect Competition?”, *Marketing Science*, Vol. 26, No. 4, July-August 2007, pp. 488-503.

47 S. Borenstein and Saloner, G. (2001), “Economics and Electronic Commerce”, *Journal of Economic Perspectives*, Vol. 15, No. 1, Winter 2001, pp. 3-12.

to design their distribution systems, many suppliers will choose to restrict the distribution of their products through the internet to avoid free-riding and other types of incentive distortions. This is evidence of precisely the phenomena that justify a laissez-faire approach to the design of distribution systems.

60. The papers address an important economic question: given the evidence of serious channel conflicts between brick-and-mortar retailers and internet retailers, what is the most profitable strategy for suppliers who are free to distribute their products as they please in different industries? The answer is that the optimal trade-off varies across industries according to specific industry characteristics – and this variation is consistent with the hypothesis that manufacturers design distribution systems with an eye to free-riding problems and other incentive distortions. If upstream suppliers are allowed to choose their desired non-price restraints (and are allowed to amend them over time), they will do so to implement the best mix of price and non-price dimensions of retail activity (service, shopping environment, product image enhancement) that they can. They will choose the optimal point in this trade-off and modify it over time. The optimal competition policy towards suppliers distribution strategies then follows directly from the normative analysis in the first section of this report: there is no basis at all for the position that manufacturers' choices of the mix of price and non-price dimensions at the retail level (whether implemented via vertical restraints or not) systematically reduce consumers' welfare in a way that can be remedied with legal constraints. Indeed, where potential retailer free-riding distortions explain the design of distribution systems then legal constraints on the choice of such systems will reduce welfare. Because the burden of proof must lie on the regulator, and there is no basis for assuming that intervention will improve welfare, a laissez-faire policy towards the design of distribution systems is called for.

C.6. CONSISTENCY WITH MANAGEMENT LITERATURE

61. Management consultants describing luxury good suppliers' reluctance for widespread adoption of the internet channel make similar remarks to what economists predict in the papers discussed above. For instance:
- (a) Internetmarketingsolution.com, a consulting group states that “[m]ost luxury brands have spurned the Internet, certainly for any kind of selling, seeing its ‘find a bargain’ reputation as damaging to their image.” Michael Peters, founder of brand agency Identica, offers his thoughts on why luxury brands spurn the Web. “Luxury designers have been investing heavily in retail outlets. For example, Prada invested \$83m in its Epicenter in Tokyo last year and \$40m in a New York store. The physical surrounding and personal attention of luxury stores continue to remain important to the customer. The Web eliminates the fun of shopping.” Peters argues that the Internet offers a shopping experience diametrically opposed to that offered by high-end retailers. “The Web is all about being a smart shopper, saving time and money, and finding eclectic goods. Luxury brand shopping should be about an experience that feels exclusive. Luxury brands don’t want people to associate their products with getting a bargain online. It could be extremely

damaging to the brand."⁴⁸

- (b) Quite apart from the serious channel conflict issues, another strategy and branding consultant, Uche Okonkwo explains how difficult it is to sell luxury goods online and in particular how difficult it is to transfer the atmosphere and experience of luxury retail outlets onto the internet in a series of articles and books.⁴⁹⁻⁵⁰
- (c) A recent client report by Europa Star explains why "[w]ith regards to the Internet, watchmakers are confronted with a double problem: the size of distribution (fear of cannibalisation) and the percentage, still quite small but growing, of exclusive boutiques. If watch companies hesitate to move into e-commerce, it is because they have a dilemma: how can they sell online without endangering their brick-and-mortar retailers?"⁵¹

C.7. CONCLUSIONS

62. The key conclusions that emerge from the discussion in this section are as follows.

- (a) It is a basic result in economics that investment in brand image cannot be regarded as "bad" or "wasteful" and compared to "good" investment in R&D activities or new product development.
- (b) Investment in the image of a product takes many forms: advertising, expensive packaging, and distribution through select retail channels that have themselves invested heavily in image and reputation.
- (c) For luxury products, restricting distribution is a means of enhancing product image that is a response to incentive incompatibilities in the retail distribution sector. Economic theory therefore suggests that legal prohibitions against restricted distribution are no more justified than attempts by a regulator to micro-manage supplier's advertising expenditures.
- (d) It would be incorrect for regulators to try to second-guess the optimal level of investment in brand image and/or a company's choice of different inputs to

48 *"Internet Marketing and Luxury Brands"* by Internetmarketingsolution.com available at http://www.internetmarketingsolution.com.au/Internet_marketing__luxury_brands.html [accessed on 9 August 2008]

49 See for instance the discussion in "Can the Luxury fashion brand store atmosphere be transferred to the Internet?" available at http://www.brandchannel.com/images/papers/269_Lux_Goods_Online.pdf or her book "Luxury Fashion Branding: Trends, Tactics, Techniques", May 2007, McMillan Publishers.

50 These concerns explain why luxury good suppliers have been very slow at developing an e-commerce strategy. See for instance the article "Fashionably Late? Designer Brands Are Starting to Embrace E-Commerce" published in the Wall Street Journal on 19 May 2006.

51 Flavio Quaranta, David Sadigh, Europa Star, "The e-commerce boom: an opportunity for the luxury brands?" available at http://www.europastar.com/europastar/magazine/article_display.jsp?vnu_content_id=1002157482.

achieve a desired brand image.

- (e) A bias against “pure-play” retailers and more generally against internet sales by luxury goods suppliers relying on selective distribution might be a necessary and legitimate policy.

D. CONCLUSIONS

63. This section concludes the report by applying the economic framework presented in the previous section to address directly some of the relevant policy questions. Our key conclusions are as follows.

The distinction between active and passive sales loses merit in an internet context

64. As discussed above (paragraph 17), there is a clear efficiency rationale for suppliers to restrict active sales by retailers operating in different territories wishing to free-ride on the effort of retailers operating in the territory. The rationale applies with equal force to passive sales. In short, economic analysis suggests that suppliers should be free to restrict passive sales as well.
65. An additional important difference between the traditional “brick-and-mortar” case and internet sales is related to the magnitude of search costs. Prior to the development of the internet, when an exclusive distribution system had been put in place, with active sales prohibited but passive sales not prevented, search costs were very high for consumers. Consumers are in fact unlikely to drive long distances to compare the prices in different geographical markets. In this setting passive sales were unlikely to be a very important issue for retailers, and territorial clauses solved the free-riding issues even if passive sales cannot be prevented. The internet has totally changed the situation. The internet almost completely eliminates any search costs for consumers: consumers can check prices on many websites within minutes (through price comparison sites for instance), and they do not need to restrict attention to their own geographical area. Since shopping costs are often not much higher for international sales, internet reduces effective distances between outlets. Setting up a website to provide some products can be viewed as essentially a means of generating active sales.
66. Once it is correctly accepted that there are good reasons for a supplier to set up an exclusive distribution system, and that such a choice does not harm consumers, then we believe that this supplier should also be allowed to prevent sales from “pure-play” internet sellers, wherever these internet sellers may be based and independently of whether these sales would be classified as “active” or “passive”.

Suppliers should be free to select (and review over time) the criteria for the admission into their selective distribution networks (e.g., restrictions on “pure play” internet retailers)

67. The rationale for this is discussed above in paragraphs 17 and 18. Internet-only shops would free ride on the investment made by brick and mortar retailers to increase demand for the products. This would lead to underinvestment in activities that consumers value and are happy to pay for and lead to a reduction in consumer welfare. It is important that suppliers are able to decide whether retailers are making a sufficient investment in brick

and mortar shops and in sales assistance more generally before accepting them into their network. A simple formal requirement for the existence of a brick and mortar shop might attract retailers aiming to minimise investments in their brick and mortar network and focusing almost exclusively on internet sales. This would generate similar negative externalities to those generated by “pure-play” internet sellers.⁵² Suppliers need to be able to decide whether retailers make a *sufficient* contribution to the investment in the product image to belong to the sales network. The supplier has every incentive to welcome in its network as many retail outlets as possible as long as they contribute to product demand by making the required investments and as long as they do not undermine incentives to invest by retail outlets already in the network. The supplier must therefore be able to exclude any retailers who generate negative externalities. This includes being able to exclude retailers who invest “too much” in internet sales and “too little” in their brick and mortar network as they focus too much on winning sales away from other retailers as opposed to increasing the demand for the product. This means that the suppliers should be able to freely set (and review over time) the criteria used to select dealers without having to fear regulatory intervention.

68. This is consistent with the rationale (and the empirical findings) of Carlton and Chevalier (2001). In fact, they conclude their paper where they analyzed distribution of fragrances, DVD players and refrigerators as follows “[o]ur research indicates that channel conflict is and should be a serious concern for suppliers. Where exclusivity is used in offline brick-and-mortar retailing to control free riding, some comparable restraint is needed to control Internet websites. The two most common restraints are pricing (with no discounts allowed) and, less frequently, the restriction of available supply to only certain Internet websites (such as only a supplier’s or a selected retailer’s website) (page 460).” Importantly these authors find that suppliers of fragrances in the US market imposed restrictions on internet websites as an efficient way to control channel conflict. They go on to note that “[it] appears to us, from examining both the trade press and trends in litigation, that there is growing recognition that uncontrolled Internet sales through unauthorized websites are not always in a supplier’s best interest where free riding can occur and sales service is important. Accordingly, in the future, we expect to see suppliers paying more attention to channel conflict and further restricting Internet pricing and availability for products where sales service is important (page 461).” As discussed earlier their interpretation is that it is welfare-enhancing to allow suppliers to introduce these restrictions. Comanor and Scherer in their economic brief to the US Supreme Court in the *Leegin* case suggest that “the efficiency defenses of RPM and other similar restraints arise preponderantly from circumstances where the manufacturer is the moving

52 Strictly speaking one could also argue that free riding could occur in the opposite direction as well as internet sites could provide product reviews and product information more generally that could then be used by consumers purchasing the products in brick-and-mortar shops. In fact this is likely to be materially less relevant and easier for the suppliers to monitor and reward (e.g., a supplier could pay a fixed fee to internet sites hosting valuable product reviews and product information). Moreover, sales services costs at a brick-and-mortar shop (essentially costs of sales personnel) increase with the average number of consumers visiting the shops while sales services costs for Internet sites (product presentation, reviews etc) tend to be fixed. This is discussed in Carlton and Chevalier (2001), page 443.

party (page 7)".⁵³

Antitrust authorities need not worry that selective distribution systems and consequent limitations on internet sales are used for products the nature of which does not require selective distribution

69. For luxury goods suppliers choosing a selective distribution system instead of adopting a "mass market" distribution model generate significant costs. The number of retail outlets is more limited thereby reducing sales all else equal and asking retailers to invest in their stores (or investing directly through the employment of additional sales assistants) has a significant cost for these suppliers as the mark-up offered to retailers has to increase to ensure the retailers' commercial viability. These suppliers believe that employing this expensive distribution method increases the demand for their products and is ultimately more profitable than adopting a less selective (and cheaper) distribution method. If the characteristics of the products were different, these suppliers would move to a cheaper distribution system. The suppliers' incentives to choose a particular distribution system is therefore closely aligned with whether the nature of – and demand for – the product is such that it requires selective distribution.
70. For instance, airlines have traditionally used travel agents to provide sales assistance to consumers. Over the last few years, market circumstances have changed such that it is now in the airlines' best interest to choose a distribution system that is much more focused on internet distribution. Realizing this, airlines have moved to this distribution system, selling directly to consumers using their websites or via online agents. Should market circumstances and consumer demand evolve such that luxury products no longer require selective distribution, suppliers of these products can be expected to change their distribution systems accordingly.

Antitrust authorities need not worry that selective distribution systems hinder the development of new methods of distribution

71. Suppliers have no interest in hindering new methods of distribution that are suitable to distribute their product. A selective distribution system is a very expensive way for the suppliers to sell to consumers as it is based on expensive point of sale investment by the retailer and/or the supplier. The suppliers choose this system because demand for the product is significantly enhanced by this investment in sales activities (product image is enhanced, more consumers for instance buy make-up or skincare products if they can test the product and discuss their needs with beauty consultants etc). If demand could be similarly enhanced though a cheaper method of distribution the suppliers would have strong incentives to adopt it.
72. The fact that some luxury goods producers have decided against using internet "pure-players" to distribute their goods does not seem to have hindered the development of internet distribution. For instance almost all the best selling perfumes and cosmetic products can currently be purchased on the internet via the suppliers' own websites or the authorized distributors' sites.

53 Brief for W. Comanor and F. Scherer as Amici Curiae supporting neither party in the US Supreme Court in *Leegin*.

73. Going back to the airline example, although most airlines now sell tickets through their own websites but also through online agents (such as Lastminute, Expedia, and Orbitz), some have decided against it. Ryanair for instance is continuously fighting against websites trying to sell their tickets. It does not seem that this has been to the detriment of consumers or allowed Ryanair to maintain abusively high prices.

ANNEX A

Dr Andrea Coscelli, *Vice President, CRA International* – Since 1998 Dr Coscelli has worked on many antitrust cases and has presented expert evidence to a number of antitrust and regulatory agencies, including the European Commission, the Office of Fair Trading, the Competition Commission in the UK, the Italian Telecom and Media Regulator, and the Dutch Telecom and Media Regulator. He has recently been included in the list of top economists under 45 years of age compiled by the Global Competition Review (July 2006) and is a regular speaker at European antitrust conferences. He holds a PhD in Economics from Stanford University and a Laurea (with honours) in Economics from Bocconi University. He has published articles in a number of journals including the *Journal of Industrial Economics* and the *Journal of Econometrics*.

Dr Thomas Buettner, *Principal, CRA International* – Dr Buettner specializes in competition economics, industrial organization, and applied econometrics. Since 2001, he has advised clients on a wide range of different antitrust issues, including mergers, abuse of dominance cases, and cartel matters before the European Commission and national competition authorities. He holds a PhD in Economics from the London School of Economics.

Dr Thibaud Vergé, *Centre de Recherche en Économie et Statistique (CREST), Paris* – Dr Vergé is a Research Fellow at CREST in Paris. His academic research has focused on the economics of vertical restraints. He has recently co-authored with Patrick Rey the chapter on the economics of vertical restraints in the Handbook of Antitrust Economics and has also published articles on the same issues in academic journals including the *Rand Journal of Economics*. He holds a PhD in Economics from the University of Toulouse.

Professor Ralph A. Winter, Senior Consultant, CRA International; Canada Research Chair in Business Economic and Public Policy, Sauder School of Business, University of British Columbia; President of the Canadian Economic Association – Professor Winter is an authority on the economics of vertical restraints having published some of the seminal papers in the 1980s and having gone on to publish other key papers on these issues over the last 25 years in journals including the *American Economic Review*, the *Review of Industrial Organization*, the *Quarterly Journal of Economics*, and the *Rand Journal of Economics*. Professor Winter's papers on the economics of vertical restraints were cited in the two most important U.S. Supreme Court cases on vertical restraints in the past two decades: *State Oil Co. v. Khan*, 522 U.S. 3 (1997) and *Leegin Creative Leather Products Inc. v. PSKS Inc.*, No. 06-480,(2007).